



1 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Author(s)

Author(s)

FEDERAL SECURITIES
ACT OF 1933 Volume 1

A. A. SOMMER, JR.
General Editor [1982-2002]
Originally Authored by Hugh L. Sowards
2010



2 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Questions?

Questions?

Technical Questions?

Phone: (800) 223-5297
Fax: (800) 533-1645 or (518) 487-3191
E-Mail: technical.support@lexisnexis.com
Visit Our Web Site: <http://www.lexis.com>

Editorial Questions?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call:
Securities-Legal

Julie Chee, LL.B., M.A. Practice Area Editor Julie.Chee@lexisnexis.com at 1-800-252-9257 Ext. 673.3345

For assistance with replacement pages, shipments, billing or other customer service matters, please call:

Customer Services Department at (800)833-9844

Outside the United States and Canada, please call (518)487-3000

Fax Number (518)487-3584

For information on other Matthew Bender publications, please call

Your account manager or (800)223-1940

Outside the United States and Canada, please call (518)487-3000



3 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Cite As

Cite As

Cite this publication as:

Cite as: [Vol. no.] A.A. Sommer, Jr., Federal Securities Act of 1933 § [sec. no.] (Matthew Bender, Rev. Ed.) Example:
1 A.A. Sommer, Jr., Federal Securities Act of 1933 § 1.01 (Matthew Bender, Rev. Ed.)

Because the section you are citing may be revised in a later release, you may wish to photocopy or print out the section for convenient future reference.



4 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Copyright

Copyright

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

LexisNexis and the Knowledge Burst logo are registered trademarks and Michie is a trademark of Reed Elsevier Properties Inc., used under license. Matthew Bender and the Matthew Bender Flame Design are registered trademarks of Matthew Bender Properties Inc.

Copyright © 2010 Matthew Bender & Company, Inc., a member of the LexisNexis Group.
All Rights Reserved.

No copyright is claimed in the text of statutes, regulations, and excerpts from court opinions quoted within this work. Permission to copy material exceeding fair use, 17 U.S.C. § 107, may be licensed for a fee of 25cent(s) per page per copy from the Copyright Clearance Center, 222 Rosewood Drive, Danvers, Mass. 01923, telephone (978) 750-8400.

ISBN **978-0-8205-1627-1**

Library of Congress Card Number: 73-010837



5 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Publisher's Editorial Staff

Publisher's Editorial Staff

Edward Berger
Director Content Development

Julie Chee
Legal Editor

Jay Huber
Index Manager

Jeanne L. Leleszi
Index Editor

Courtney Barker
Manager, Publishing Operations

Carly Fornabio
Publishing Operations Analyst



6 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Foreword

Foreword

Foreword

A. A. SOMMER, JR.

Commissioner, Securities and Exchange Commission, 1973-1976

Counsel, Morgan, Lewis & Bockius, Washington, D.C., 1994-2002

Former Vice Chairman, National Association of Securities Dealers, Inc.

Former Chairman, Public Oversight Committee, American Institute of Certified Public Accountants

Former Chairman, Section on Corporation, Banking and Business Law and of the Federal Regulation of Securities Committee, American Bar Association



7 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Preface

Preface

For over thirty years "Sowards" has been the ultimate authority on the Securities Act of 1933 and "Gadsby" on the Securities Exchange Act of 1934. The treatises were originally the product of their talented hands and enormous experience - Sowards as a preeminent teacher and scholar, Gadsby as a former SEC chairman and outstanding practitioner. As the laws of which they wrote so well changed, and particularly after their deaths, their treatises increasingly reflected the work of the talented authors and editors at Matthew Bender & Co. and other outstanding lawyers and scholars who undertook to rewrite or update parts of the original treatises. While the original excellence of the books continued to reflect the pioneering work of Hugh Sowards and Ned Gadsby, the work of other capable hands became increasingly visible.

As the Securities and Exchange Commission rounded out its efforts to integrate the 1933 and 1934 Acts, a work commenced just about the time the original treatises were published, the distinction between the acts diminished, thus compelling the conclusion that there was little reason to distinguish the two treatises as sharply as had been done in the past. The volumes increasingly constituted an all-embracing "encyclopedia" of the two acts, an encyclopedia rounded out by *Securities Law Techniques* and the more recently published *Regulation of Investment Companies*. This integration of the core federal statutes, and recognition of the increased role of other authors, made it only fit and proper to integrate Sowards and Gadsby and their primary source volumes into the *Securities Regulation Series*.

So identified, they continue to be the unique resource for the practitioner they have always been: the one source in which he or she can find authoritative, up-to-date information about every aspect of the two acts. By combining the primary source volumes that have been discrete parts of each treatise, the recognition of the now integrated statutes and the treatise volumes is complete. Some tidying will continue, but the "heavy lifting" is done.

It is the continuing desire and determination of the editors and authors who are now and will in the future be responsible for these works to preserve the tradition of excellence, reliability and authoritativeness established by the two distinguished original authors. The debt which now more than one generation of securities law practitioners has to the original authors is monumental; it can only be repaid by their successors on behalf of those who use these volumes through continued adherence to the standards to which they so faithfully hewed when they write the original works.

Many of us who practiced through most of our careers with "Gadsby" and "Sowards" at our elbows may feel a sense of

loss when those familiar names no longer identify the volumes so long associated with them. But we can be confident their dedication to quality scholarship will continue unabated.

A. A. Sommer, Jr.
General Editor
July 1997



8 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

Publication Information

1 Federal Securities Act of 1933 Contributing Authors

Contributing Authors

Jonathan G. Katz

Former Secretary of the U.S. Securities and Exchange Commission

Theodore Altman

Joshua Sohn

Piper Rudnick

New York, New York

W. Reece Bader

Orrick, Herrington & Sutcliffe

Menlo Park, California

Frederick Robinson

Thomas A. Ferrigno

Matthew H. Kirtland

Fulbright & Jaworski

Washington, D.C.

Mark Borrelli

Sidley Austin

Chicago, Illinois

Elliot Cohen

Robert M. Carmen

Troutman Sanders LLP

New York, NY

Cristopher Greer

1 Federal Securities Act of 1933 Contributing Authors

Willkie, Farr & Gallagher
New York, New York

Marc E. Elovitz
William H. Gussman
Shulte, Roth & Zabel
New York, New York

Professor Howard M. Friedman
University of Toledo
Toledo, Ohio

Sara Hanks
Clifford Chance
New York, New York

Paul Hughes
Richard McGrath
Murtha Cullina
Stamford, Connecticut

Daniel J. Kramer
Paul, Weiss, Rifkind, Wharton & Garrison
New York, New York

Yoon-Young Lee
Wilmer Culter Pickering Hale & Dorr LLP
Washington D.C.

Thomas P. Lemke
Legg Mason, Inc.

Gerald T. Lins
ING Investment Management Americas

Brandon C. Parris
Andrew D. Thorpe
Morrison & Foerster
San Francisco, California

Marvin G. Pickholz
Duane Morris LLP
Alan H. Aronson
Akerman Senterfitt
New York, New York

Morton A. Pierce
Chang Do-Gong
Dewey & LeBoeuf

1 Federal Securities Act of 1933 Contributing Authors

New York, New York

Robert N. Rapp

Calfee, Halter & Griswold
Cleveland, Ohio

Peter J. Romeo

Hogan & Hartson
Washington, D.C.

Thomas I. Selling

Thunderbird, The Garvin School
of International Management
Glendale, AZ

Kenneth B. Winer

Samuel J. Winer

Marc B. Dorfman

Foley & Lardner LLP
Washington, D.C.

Yvette VanRiper

Patrick Daugherty

Foley & Lardner LLP
Detroit, MI.

Peter Underwood

Regal-Beloitt Corporation

Antonio Yanez, Jr.

James C. Dugan

Willkie, Farr & Gallagher
New York, New York



9 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

What's New

1 Federal Securities Act of 1933 Scope

Scope

and related publications

Federal Securities Exchange Act of 1934
Securities Primary Law Sourcebook

HIGHLIGHTS

Release 108 November 2010

Federal Securities Act of 1933

Chapter 1, *Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission*.
Chapter 10, *SEC Enforcement Practice*

Federal Securities Exchange Act of 1934

Chapter 9, *SEC Enforcement Legal Considerations*

Securities Primary Law Sourcebook

Volumes A, B, D and E have been revised and updated.

Federal Securities Act of 1933. Chapter 1, *Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission*. . Chapter One has been significantly revised to expand topics of discussion and reflect important legislative and regulatory developments since 2004. In particular, the discussion of the function and organization of the SEC has been broadened, including a new section on the structure of the SEC and an enhanced discussion of the roles of the Division of Corporation Finance and the Division of Enforcement. A new and in-depth discussion of the securities offering reform rules promulgated in 2005 has been added, including information on the categories of issuers, various reforms to the process of communicating with shareholders before, during and after registered securities transactions, the use of research reports and shelf registration reforms. Finally, an updated discussion of the enactment of the Sarbanes-Oxley Act of 2002 and developments under that Act since the prior update has been included.

1 Federal Securities Act of 1933 Scope

Chapter 10, SEC Enforcement Practice. The chapter has been updated to reflected initiatives that the SEC took in 2009-2010 under the leadership of Chairman Schapiro and Enforcement Director Khuzami. These initiatives include delegating to the Staff authority to issue a Formal Order empowering the Staff to issue subpoenas, an extensive restructuring of the Enforcement Staff, and initiatives to encourage cooperation.

Federal Securities Exchange Act of 1934. Chapter 9 , SEC Enforcement--Legal Considerations. Regulation of Market Manipulation Chapter 9 provides an overview of the SEC's power to investigate and initiate legal proceedings against the entities and individuals it regulates. This chapter reviews the investigative process and related legal issues. This chapter has been revised to reflect the legislative responses to the 2008 Financial Crisis, as well as to the revelation of Bernard Madoff's massive fraudulent Ponzi scheme. In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama in July 2010, represents perhaps the largest overhaul of the enforcement powers of the SEC since its creation in the 1930s. Dodd-Frank has broadened not only the jurisdictional reach of the SEC and the federal securities laws, but also granted the SEC new enforcement powers. Furthermore, Dodd-Frank enhances whistleblower protection and rewards whistleblowers who supply new information to the SEC with ten-to-thirty percent of any fines recovered in excess of \$1 million. In addition to Congressional action, the SEC itself has demonstrated its intention to be a more forceful watchdog of the securities industry through the reorganization of its subdivisions in order to be more expeditious in the prosecution of securities violations. The SEC has already created specialized enforcement units staffed by professionals with extensive experience in specialized areas and has begun seeking and obtaining increased monetary penalties against wrong-doers. Accordingly, as a result of these recent legislative and administrative developments, it can be expected that individuals and entities subject to the federal securities laws will face a more vigorous and rigorous regulatory and investigatory regime for the foreseeable future.

Securities Primary Law Sourcebook. Some of the highlights in The Securities Primary Law Sourcebook update includes new Sections to the Securities Exchange Act 1934 such as § 4D-Additional Duties of Inspector General, § 4E-Deadline for completing enforcement investigations and compliance examinations and inspections, § 4F-Report and certification of internal supervisory controls, § 4G-Triennial report on personnel management, 4H-Annual financial controls audit and § 4I-Report on oversight of national securities associations. There are also new sections 15F and 15G, pertaining to Registration and regulation of security-based swap dealers and major security-based swap participants and Credit Risk Retention. There is also a new rule to facilitate interim Commission review of Public Company Accounting Oversight Board inspection reports under Section 104(h) of the Sarbanes-Oxley Act of 2002, and its Rules of Organization and Program Management and Rule of Practice to delegate authority to the Chief Accountant related to these reviews. Regulation P is established to include procedural rules relating to the Public Company Accounting and Oversight Board.



10 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 1

1-SA Federal Securities Act of 1933 SA.syn

§ SA.syn Synopsis to Chapter SA: Special Alert to Chapter 1

Special Alert to Chapter 1

§ I. Introduction to the National Securities Markets Improvement Act of 1996

§ II. Provisions of the Act Affecting the Securities Act of 1933 and the Securities Exchange Act of 1934

[A] Preemption of State Authority Over Securities Offerings

[B] Commission Exemptive Authority

[C] Broker Dealer Margin Requirements

[D] Promotion of Efficiency, Competition, and Capital Formation

[E] Coordination of Supervision

[F] Commission Reports

[G] Foreign Press Conferences

[H] Fees

§ III. Provisions of the Act Affecting the Investment Advisers Act of 1940

§ IV. Provisions of the Act Affecting the Investment Company Act of 1940

[A] Partial Preemption of State Registration Requirements -- Amendments to Section 18 of the Securities Act of 1933

[B] Fund-of-Funds -- Amendments to Section 12(d)(1) of the 1940 act

[C] Registration of Indefinite Amount of Securities -- Amendments to Section 24(f) of the 1940 Act

[D] Advertising Flexibility -- New Section 24(g) of the 1940 Act

[E] Modification of Attribution Rule for Private Investment Companies -- Amendments to Section 3(c)(1) of the 1940 Act

[F] Exclusions for "Qualified Purchaser" Private Investment Companies -- Amended Section 3(c)(7) of the 1940 Act

[G] Expansion of Exclusion for Brokers and Financial Intermediaries -- Amendment to Section 3(c)(2) of the 1940 Act

[H] Exemption from Unit Investment Trust Requirements for Variable Insurance Contracts -- Amendments to Section 26 of the 1940 Act

§ V. Analysis and Conclusions by A. A. Sommer, Jr.



11 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 1

1-SA Federal Securities Act of 1933

Special Alert to Chapter 1

THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996 n1

FOOTNOTES:

(n1)Footnote 1. This Special Alert was written by A.A. Sommer, Jr., the General Editor of the ***Securities Regulation Series***. Part IV, discussing the amendments to the Investment Company Act of 1940, was written by the co-authors of *Regulation of Investment Companies*, Thomas P. Lemke, Gerald T. Lins, and A. Thomas Smith III.

This Special Alert is not intended to be a complete summary or statement of all of the provisions of the National Securities Markets Improvement Act of 1996. Reference should be made to the text of the Act and the Conference Committee Report.



12 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 1

1-SA Federal Securities Act of 1933 § I

§ I. Introduction to the National Securities Markets Improvement Act of 1996

On October 11, President Clinton signed into law the National Securities Markets Improvement Act of 1996 (H.R. 3005 -- "The Act") proclaiming it the "most significant overhaul of the securities regulatory structure in decades." The Act effected significant changes in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, and removed many anomalies and inefficiencies from securities regulation that had been discussed and sought for a long time.

The Act originated with two bills introduced in 1995 by Representative Jack Fields, chairman of the House Commerce Committee's Subcommittee on Telecommunications and Finance. The first would have amended the Investment Company Act of 1940; the second would have amended the 1933 and 1934 Acts. The latter, while containing in different form many of the provisions eventually enacted, also contained a number of highly controversial provisions that were omitted from the Act as enacted.



13 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 1

1-SA Federal Securities Act of 1933 § II

§ II. Provisions of the Act Affecting the Securities Act of 1933 and the Securities Exchange Act of 1934

The following is a summary of the principal provisions of the Act affecting the Securities Act of 1933 ("the 1933 Act") and the Securities Exchange Act of 1934 ("the 1934 Act").

[A] Preemption of State Authority Over Securities Offerings

Perhaps the most significant change effected by the Act is the near total preemption of state authority over offerings of securities. Under amended Section 18 of the 1933 Act, no state may prohibit an offering or sale in the state, oppose additional disclosure requirements, impose "merit" standards, require the registration or qualification of a security or transaction, or prohibit or limit the use of any offering document prepared by or on behalf of an issuer in connection with an offering (including proxy statements and reports to shareholders required to be filed under Section 15A of the 1934 Act unless the issuer is incorporated in the state) if the security offered is a "covered" security. A "covered security is defined as:

- a security listed, or authorized for listing, on the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market System, or listed or authorized for listing on a national securities exchange which the Securities and Exchange Commission ("Commission") determines has listing standards substantially similar to those of the named markets;
- a security that is equal in seniority or senior to a securities described in the preceding paragraph;
- a security issued by an investment company registered under the Investment Company Act;
- a security offered or sold to a "qualified purchaser" as defined by the Commission -- presumably the Commission will define such purchasers in a manner similar to the definition of "accredited investor" in Rule 501 under the 1933 Act;
- securities offered or sold pursuant to most of the exemptions contained in 1933 Act Sections 3(a) and 4 (in the case of Sections 4(1) and 4(3) the issuer must be a reporting company under the 1934 Act), the principal exceptions being the intrastate exemption in Section 3(a)(11) and the exemption in Section 3(a)(4) for securities issued by non-profit religious and eleemosynary institutions; and

- a security that will become a covered security under any of the foregoing definitions of covered security upon completion of the transaction.

The states may continue to impose filing requirements for documents filed with the Commission and for certain annual and periodic reports. The states may also require filing of consents to service of process and may impose filing fees (except for listed or to be listed securities and securities senior to them) in the amounts provided by state law on the day before the Act became effective. Moreover, the states under the Act continue to have the authority to investigate and bring enforcement actions for fraud and deceit or unlawful conduct by a broker or dealer.

With regard to brokers and dealers, while the states retain the power to require the registration of brokers and dealers subject to their jurisdiction, states may not impose requirements with respect to capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operating requirements that differ from or are in addition to those provided by federal law. In addition, the Act provides an exemption from registration in a state by an associated person of a broker or dealer if he or she makes an occasional sale in the state to a previous customer who is visiting for a short period in the state.

[B] Commission Exemptive Authority

The Act gives the Commission the authority to exempt by rule or regulation any person, security or transaction, or class of such, from any provision of the 1933 Act or rule or regulation thereunder "to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors." It is believed that this latter clause, which qualifies all of the Commission's rulemaking power, would preclude the Commission from exempting a security, person or transaction from the anti-fraud provisions of the federal statutes.

The Act gives the Commission a similar exemptive authority, expanded to include the authority to exempt by order, with respect to the 1934 Act.

[C] Broker Dealer Margin Requirements

The Act permits broker-dealers to borrow from sources other than banks. It also exempts from the margin requirements credit extended, maintained, or arranged to or for a member of a national securities exchange or other broker or dealer: (1) a substantial portion of whose business consists of transactions with persons other than brokers or dealers (e.g., a retail broker), or (2) to finance its activities as a market maker or an underwriter.

[D] Promotion of Efficiency, Competition, and Capital Formation

The Act requires the Commission in its rulemaking and other actions to take into account whether its action promotes efficiency, competition, and capital formation.

[E] Coordination of Supervision

The Act requires that the Commission and the self-regulatory organizations, through cooperation and coordination of their activities and sharing of information, eliminate unnecessary and burdensome duplication of examinations. Somewhat in anticipation of the adopted of this provision, in late 1995 the Commission, state regulators, and the SROs entered into a memorandum of understanding with respect to the coordination of activities.

[F] Commission Reports

Congress mandated that the Commission undertake to make studies and submit to it reports with respect to a number of matters.

1-SA Federal Securities Act of 1933 § II

- Congress directed the Commission to examine proposals for the privatization of the EDGAR system and to report on such examination within 180 days after adoption of the Act, and to include in such report recommendations for legislative action to implement any Commission proposals for privatization.
- Congress directed the Commission to make a study of the impact of technological advances, the use of on-line information systems on securities markets, and related matters and to make a report within one year after the adoption of the Act of the steps the Commission has taken to address such matters.
- Congress directed the Commission to study whether shareholder access to proxy statements by the submission of shareholder proposals had been impaired by recent statutory, judicial or regulatory changes, and the ability of shareholders to have proposals relating to corporate practices and social issues included as a part of proxy statements, and to report within a year, including recommendations for regulatory or legislative changes to improve shareholder access to proxy statements. This proposal stemmed from the 1992 Commission staff decision allowing corporations to exclude shareholder proposals regarding corporate employment practices.
- Congress directed the Commission to study "preferencing," i.e., the practice of a broker as a dealer on a national securities exchange directing a customer order to itself for execution as principal under rules that permit the broker to take priority in execution over same-priced orders or quotations entered prior in time, and to report within 6 months after adoption of the Act.
- The Commission was directed to report to Congress within one year on progress in the development of international accounting standards and the outlook for the successful completion of a set of international standards that would be acceptable to the Commission for offerings and listings of foreign corporations in U.S. markets. Earlier, the Commission had indicated its support for the effort of the International Accounting Standards Committee to develop suitable standards and indicated the characteristics they would be required to have to be acceptable to the Commission.

[G] Foreign Press Conferences

Responding to the complaints of financial writers that they were often excluded from the press conferences of foreign companies proposing to offer securities in the United States because of concerns with the registration and prospectus requirements of the 1933 Act, Congress directed the Commission to develop, within a year, rules concerning the status of foreign press conferences and foreign press releases under the registration provisions of the 1933 Act.

[H] Fees

The Act contains provisions with respect to the fees that the Commission may charge. It directs the Commission to collect registration fees under the 1933 Act that are designed to recover the costs to the government of the securities registration process and the costs related to that process. It also sets forth a new schedule of such fees under which the registration fees are reduced each year until 2007. For the first time, pursuant to the Act, security transactions off an exchange are subjected to the same fees to which transactions on exchanges have been subject.

FOOTNOTES:

(n1)Footnote 2. The text of the Act does not appear to include as a "covered security" a security offered for listing on the Nasdaq National Market System; this appears to have been a drafting error. 142 Cong. Rec. E1928 (October 4, 1996) (statement of Rep. Bliley).



14 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 1

1-SA Federal Securities Act of 1933 § III

§ III. Provisions of the Act Affecting the Investment Advisers Act of 1940

Title III of the Act contains the Investment Advisers Supervision Coordination Act, which amends the Investment Advisers Act of 1940.

The principal effect of the Act on the Investment Advisers Act of 1940 is the partial federal preemption of the regulation of investment advisers. The Act accomplishes this by providing that no investment adviser regulated or required to be regulated in the state in which it maintains its principal office and place of business may register with the Commission unless it manages assets of not less than \$25 million (or such higher figure set by the Commission) or is an adviser to an investment company registered with the Commission under the Investment Company act of 1940, and that no state may require an investment adviser registered with the Commission to register, secure a license, or qualify under any state law. This formulation was apparently adopted to assure that no small investment advisers located in states that do not regulate investment advisers would be required to register with the Commission.

States may continue to require the registration of investment adviser representatives (broadly defined in the Act) if they have an office in the state.

States may not impose books and records, minimum capital, or bond requirements on advisers licensed in other states in addition to those required by the licensing state if the adviser is in compliance with those requirements. In addition, states may not require the licensing, registration, or qualification of anyone exempted from registration under the Investment Advisers Act of 1940 or of any investment adviser that does not have a place of business in the state and during the preceding twelve months has had fewer than six clients resident in the state.

Consistently with other provisions of the Act, the states' authority to investigate and bring enforcement actions with respect to fraud and deceit is preserved, and states may require the filing of anything filed with the Commission for notice purposes and continue to impose the fees in effect on the day before adoption of the Act.

In recognition of the Commission's frequent complaint about its ability to regularly examine investment advisers, the Act authorizes \$20 million in each of 1997 and 1998 for enforcement of the Investment Advisers Act of 1940.



15 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 1

1-SA Federal Securities Act of 1933 § IV

§ IV. Provisions of the Act Affecting the Investment Company Act of 1940

Title II of the Act contains the Investment Company Act Amendments of 1996. The most important of the amendments affecting investment companies are set forth below.

[A] Partial Preemption of State Registration Requirements -- Amendments to Section 18 of the Securities Act of 1933

One of the most important aspects of the National Securities Markets Improvement Act of 1996 is the partial preemption of state "blue sky" registration and disclosure requirements for mutual funds. Under amended Section 18 of the Securities Act of 1933, states may no longer impose registration or qualification requirements on certain sales of securities, including shares of registered investment companies. States are also precluded from reviewing mutual fund prospectuses and advertising.

However, states retain the authority to require investment companies to file, for notice purposes, any documents filed with the SEC and to continue to collect filing fees. States also retain jurisdiction to investigate and bring enforcement actions for fraud and deceit.

[B] Fund-of-Funds -- Amendments to Section 12(d)(1) of the 1940 act

The Investment Company Act amendments permit fund-of-fund structures within an investment company without an exemption from the SEC. Under amended Section 12(d)(1)(G) of the 1940 Act, a registered open-end investment company or unit investment trust (an "upper-tier fund") may acquire shares or units of other open-end funds or unit investment trusts ("lower-tier funds") within the same group of investment companies without percentage limitations, as long as:

- the shares or units are the only investments held by the upper-tier fund (other than government securities and short-term paper):
- distribution-related fees or charges are not charged by both the upper-tier and lower-tier funds, or, alternatively, the aggregate distribution-related charges at both levels are not excessive under SEC rules; and

- the lower-tier fund may not itself invest in shares or units of registered investment companies or unit investment trusts.

[C] Registration of Indefinite Amount of Securities -- Amendments to Section 24(f) of the 1940 Act

Under amended Section 24(f), commencing in October 1997 (or earlier if the SEC adopts rules), registered open-end investment companies and unit investment trusts will be deemed automatically to have registered an indefinite amount of securities and will pay registration fees based on the net amount of new shares or units sold (i.e., purchases less redemptions).

[D] Advertising Flexibility -- New Section 24(g) of the 1940 Act

Under new Section 24(g) of the 1940 Act, mutual fund advertising restrictions will be eased. Section 24(g) directs the SEC to adopt rules and regulations to permit advertising that includes information "the substance of which is not included in a [Section 10(a)] prospectus"

[E] Modification of Attribution Rule for Private Investment Companies -- Amendments to Section 3(c)(1) of the 1940 Act

The amendments significantly reduce the need for a private investment company to look through and count the underlying owners of an entity investing in it as its beneficial owners. Under amended Section 3(c)(1)(A) of the 1940 Act, the ownership of the private investment company is attributed to the underlying owners of the investing entity only if the investing entity itself is an investment company or an entity relying on the exclusion from the definition of an investment company in Sections 3(c)(1) or 3(c)(7).

[F] Exclusions for "Qualified Purchaser" Private Investment Companies -- Amended Section 3(c)(7) of the 1940 Act

The amendments provide an exclusion for a new type of private investment company. Under amended Section 3(c)(7) of the 1940 Act, effective October 1997, a company is excluded from the definition of an investment company if its outstanding securities are owned only by "qualified purchasers" and it is not making or proposing to make a public offering of its securities.

A "qualified purchaser" is defined in new Section 2(a)(51)(A) of the 1940 Act to include the following categories of persons:

- a natural person with at least \$5,000,000 in investments;
- certain family-owned companies owning at least \$5,000,000 in investments; and
- any person who, for its own account or for other qualified purchasers, owns and invests on a discretionary basis at least \$25,000,000 in investments.

[G] Expansion of Exclusion for Brokers and Financial Intermediaries -- Amendment to Section 3(c)(2) of the 1940 Act

In recognition of the growing number and complexity of financial instruments, Congress expanded the class of intermediaries entitled to rely on the exclusion from the definition of an investment company in Section 3(c)(2) of the 1940 Act. Under amended Section 3(c)(2), in addition to certain underwriters, distributors, and brokers, a "market intermediary" is excluded from the definition. A "market intermediary" is a person who holds itself out as being willing to engage in transactions on both sides of individually negotiated financial contracts, such as swaps, repurchase

agreements, and options.

[H] Exemption from Unit Investment Trust Requirements for Variable Insurance Contracts -- Amendments to Section 26 of the 1940 Act

Under new Section 26(e) of the 1940 Act, the trustee and custodian requirements governing unit investment trusts do not apply to any registered separate account funding variable annuity contracts, or the sponsoring insurance company and principal underwriter of the account, provided:

- the various fees and charges for the contract are reasonable; and
- the insurance company files annual financial information with the appropriate state insurance authority evidencing a combined capital and surplus of \$1,000,000.



16 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 1

1-SA Federal Securities Act of 1933 § V

§ V. Analysis and Conclusions by A. A. Sommer, Jr.

The National Securities Markets Reform Act of 1996 accomplished numerous reforms which virtually all practitioners and people in the securities industry regarded as long overdue without endangering investor protections. As capital markets have become increasingly global, the necessity of multiple state registration in addition to federal registration has become increasingly anomalous. The original scheme which carefully preserved state jurisdiction was the fruit of an age in which "states rights" were accorded deep respect and during which the national nature of the capital markets was less clear. The dual system of registration endured as long as it did because of the adoption of a number of devices designed to ease the burdens of the system (e.g., registration by coordination and notification, exemptions for offerings of securities to be listed, etc.).

In the final analysis, the states preserved perhaps their most important power which was imperiled in the first draft of the eventually enacted Act, namely, the undiminished power to pursue fraud committed within their jurisdictions. In addition, they continue to share concurrent jurisdiction over offerings of securities registered with the Commission which are not going to be listed. Thus, limited partnerships public offerings, initial public offerings of securities that will be traded in the NASDAQ Small Cap Market or in the "pink sheets," and offerings of numerous other types of "exotic" securities will continue to be subject to the full authority of the states where the offering is made.

Perhaps the main beneficiaries of the preemption are the investment companies that have historically been restrained because of the sometime vagaries of state regulation, many of which were recounted during the course of Congressional testimony on the Act.

The states retain considerable, if somewhat attenuated, authority with respect to brokers and dealers. However, the signals are clear in the Act and the dialogue leading to its enactment that failure by the states to use their authority in a less burdensome manner may result in the forfeiture of virtually all authority with respect to brokers and dealers.

The Commission received enhanced power to adopt rules and regulations providing exemptions under the 1933 and 1934 Acts. This eliminates the awkward necessity of using questionable "definitions" and other circuitous means to achieve needed exemptions, such as those included in Regulation D and Rule 144. The enhanced power opens the door to a more comprehensive and conceptually consistent overhaul of the disclosure system such as that reflected in the proposals of the Commission's Advisory Committee on the Capital Formation and Regulatory Processes.

The division of jurisdiction over investment advisers between the states and the Commission is a sensible way of assuring better policing of an activity that has never received the attention it should receive and which poses increasing peril to investors. Hopefully, the overall quality, quantity, and effectiveness of investment adviser will be considerably enhanced with the Act's direction that the SEC focus attention on the larger advisers and that the states retain unfettered opportunity to regulate small advisers.

The requirement in the Act that the Commission, in rulemaking, take into account efficiency, competition, and capital formation is unlikely to affect the Commission's rulemaking since the Commission would undoubtedly deny that any of its rulemaking ever mandated inefficiencies or hampered competition or capital formation.

Absent from the final version of the Act were some of the more controversial provisions of the original Fields bill, such as a provision that would have sharply reduced the ability of institutional investors to assert lack of suitability claims against broker-dealers. Apparently, the initiative of the National Association of Securities Dealers in adopting a rule governing suitability for institutional investors prompted Congress to drop this proposal. However, if Congress believes that the NASD rule, in practice, has not struck a fair balance, it may revisit the issue down the line.

The reports the Commission is directed to make after the numerous mandated studies may constitute the agenda for future legislation. However, it is doubtful that Congress will revisit the fundamentals of securities regulation in the near term. In the Act, Congress has addressed the most troublesome problems in the current securities regulation scheme and has given the Commission significantly increased power to deal with future problems. Perhaps the most pertinent question until the end of this century and somewhat beyond is how the Commission will use its enhanced powers.



17 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933 1.syn

§ 1.syn Synopsis to Chapter 1: Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

Scope

§ 1.01 Background

§ 1.02 The Securities Act of 1933--Objectives and Scope

§ 1.03 Overview of the Securities and Exchange Commission

[1] Structure of the Commission

[2] The Work of the Commission in Relation to the 1933 Act

[a] The Division of Corporation Finance: Disclosure Review, Interpretations and Rulemaking

[b] The Division of Enforcement

[i] Investigation and Enforcement

[ii] Statutory Sanctions

[3] Administrative Proceedings

[4] Disciplinary Proceedings

§ 1.04 Registration of Securities

[1] Non-Shelf Registration Statements

[2] Shelf Registration Statements

1-1 Federal Securities Act of 1933 1.syn

[3] Exemptions Under the 1933 Act

[4] Causes of Action Under the 1933 Act

[5] Securities Offering Reform of 2005

[a] Background: National Securities Markets Improvement Act of 1996

[b] General Framework

[c] Categories of Issuers

[d] Communications Reforms

[i] The New Communications Scheme

[ii] Regularly Released Information

[iii] Communications More Than 30 Days Prior to Filing a Registration Statement

[iv] Communications by WKSIs

[v] "Tombstone" Advertisements Under Rule 134

[vi] The Free Writing Prospectus

[vii] Road Shows

[viii] Communications on Web Sites

[ix] Media Publications and Broadcasts

[x] Expanded Use of Research Reports

[6] Registration Reforms

[a] Shelf Registration Reforms

[b] Automatic Shelf Registration for WKSIs

§ 1.05 The Sarbanes-Oxley Act of 2002

[1] The Need for Reform

[2] Internal Control and Disclosure Controls

[3] CEO/CFO Certifications and Corporate Responsibility

[4] Enhanced Disclosure

[5] Audit Committees and Auditor Independence

[6] Listing Standards

[7] Public Company Accounting Oversight Board

[8] Enforcement and Criminal Sanctions

§ 1.06 Recent Developments and The Future

[1] SEC Developments in Recent Years

[2] The Future



18 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933

Summary of This Chapter

The first U.S. federal regulation of securities transactions, the Securities Act of 1933 (the "1933 Act" or the "Securities Act"), and the establishment of the Securities and Exchange Commission (the "Commission" or the "SEC") pursuant to the Securities Exchange Act of 1934, were direct legislative responses to the loss of public confidence in the U.S. securities markets that followed the stock market crash of 1929, the ineffectiveness of then-existing state laws regulating securities transactions and the widespread employment of unethical and manipulative practices by sellers of securities that had contributed to the severe losses suffered by the investing public. See § 1.01 *infra*.

In public offerings of securities, the 1933 Act requires full and fair disclosure of pertinent information regarding the issuer, the offered securities and the offering. Disclosure is made by means of a registration statement, which the issuer files with the Commission, and a prospectus, which is part of the registration statement and is distributed to potential purchasers of the securities. Although the 1933 Act exempts offerings of certain types of securities and certain types of offerings from registration and prospectus delivery requirements, there are no exemptions from the 1933 Act's antifraud provisions. In 2005, the Commission adopted fundamental reforms of the rules governing the communications and offering processes for securities offerings registered under the 1933 Act. See § 1.02 *infra*.

Administration and enforcement of the 1933 Act are the responsibility of the Commission, which is empowered under the 1933 Act, consistent with investor protection, to adopt rules and regulations, issue interpretations of the federal securities laws and the rules and regulations thereunder and investigate possible violations of the 1933 Act. Where violations are found, the Commission may seek a civil injunction in a United States District Court, refer fraudulent or willful violations to the Department of Justice with a recommendation for criminal prosecution, or apply administrative sanctions.

The Commission does not intercede on behalf of investors who may have sustained damages as a result of violations of the 1933 Act. It is the responsibility of the investor to evaluate the merits and risks of a securities investment and to pursue any private remedy available.

Administrative proceedings conducted by the Commission must comply with the Commission's Rules of Practice and with the Administrative Procedure Act. These provide for notice of hearing, a hearing before a Hearing Officer and an

opportunity for interested parties to participate in the hearing. After conclusion of the hearing, the Hearing Officer issues an initial decision that may be appealed to the Commission. The Commission's rulings may be appealed to a United States Court of Appeals. The Commission, with sufficient cause, may suspend, temporarily or permanently, any person from practicing before it.

The Commission consists of five presidentially-appointed commissioners, one of whom is designated by the President as Chairman of the Commission. The work of the Commission is carried out by five Divisions and 16 Offices in Washington, D.C. and 11 regional offices throughout the United States.

In recent years, the Commission has been faced with major challenges in keeping up with the rapid expansion and globalization of the financial markets and changes, technological and otherwise, in the ways that securities are traded and information distributed. The Commission has implemented significant rulemaking to respond to pressures created by demands for more efficient global markets. The Commission engaged in significant rulemaking following the passage of the Sarbanes-Oxley Act of 2002 in an effort to address accounting scandals and other corporate fraud in the wake of the Enron and Worldcom bankruptcies. See § 1.04 *infra*.

This publication is not concerned with a detailed description of the historical background and development of securities legislation. Rather, its primary purpose is to deal with the 1933 Act in its current form. Nevertheless, as in the case of most legislation, at least a brief and general statement of that background and development is helpful in gaining a clear understanding of the basic philosophy of the 1933 Act and what it seeks to accomplish.

* Patrick Daugherty, Yvette M. VanRiper and Peter C. Underwood. This chapter was revised and updated by Patrick Daugherty and Yvette M. VanRiper, partners at Foley & Lardner LLP, and Peter C. Underwood, Vice President, General Counsel and Secretary of Regal-Beloitt Corporation. The authors would like to thank Stephen J. Byrnes, Jr. and Megan A. Odronic, associates at Foley & Lardner LLP, and Morgan J. Tilleman, Nicholas J. Fox, Christina T. Jones and Morgan J. West, summer associates at Foley & Lardner LLP, for their assistance.



19 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933 § 1.01

§ 1.01 Background

In the prosperous era following World War I, there was little support for federal regulation of securities markets. n1 This ended abruptly with the 1929 stock market crash and the onset of the Great Depression. n2 The time was ripe for reform and to restore the public's confidence in the market system. n3

Before the passage of the 1933 Act, various forms of securities legislation had been enacted, both by other countries n4 and by individual states in the United States. n5 Some of these state "blue sky laws," as they came to be called, n6 required only registration of securities; others required only registration of persons engaged in selling securities; still others required registration of neither securities nor sellers, but instead contained antifraud provisions. Some blue sky laws combined two or more of the foregoing types of provisions. It was against this varied background of existing foreign and state regulation and the paucity of existing federal regulation n7 that the authors of the 1933 Act and the Congress that enacted it had to determine what the basic philosophy of the new Act was to be.

Certain facts were clear. First, strong and workable federal legislation was a requirement if public confidence in securities and the securities markets, badly shaken as a result of the 1929 debacle, was to be restored. Second, the existing securities laws of the several states were inadequate to deal with the situation. n8

From pre-1933 securities legislation two fundamental approaches to the problem of securities regulation had emerged. Legislation could either regulate the intrinsic merit of securities as potentially profitable investments, or it could simply require the kind of disclosure sufficient to enable an investor to make his or her own informed decision regarding intrinsic merit. In 1933 there were many proponents of strong securities legislation who insisted that the only way to provide adequate investor protection was to give the federal government the power to pass upon the merits of securities before they could be offered and sold to the public. Bills to that effect were introduced in the Senate and the House of Representatives. n9 But perhaps an even greater number of informed persons were wary of giving the federal government, as a "capital issues bureaucracy," the power to control the domestic issuance and sale of securities. n10 These were the proponents of "full and fair disclosure." Significantly, the latter camp included President Roosevelt, whose message to Congress on March 29, 1933, contained the following observations:

[T]he Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine "Let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence. n11

FOOTNOTES:

(n1)Footnote 1. U.S. Securities & Exchange Comm'n, *How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.Securitiesgov/about/whatwedo.shtml>.

(n2)Footnote 2. *Id.*

(n3)Footnote 3. *Id.*

(n4)Footnote 4. Prominent among these statutes was the English Companies Act, 1929, 19 & 20 Geo. 5, c. 23, although England had legislation dealing with securities for over 200 years prior to that time. See 1 William Robert Scott, *The Constitution and Finance of English, Scottish and Irish Joint-Stock Companies to 1720* (1912); Seigvald Nielson, *The Issuance of Securities Under the English Companies Act, 20 Va. L. Rev. 88* (1933).

(n5)Footnote 5. Section 16(a) of the 1933 Act provides: "The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb (2006). Thus federal securities laws were not intended to preempt state securities laws. However, state statutes may be void under the Supremacy Clause, U.S. Const. art. VI, to the extent that they conflict with valid federal legislation. See, e.g., *Rousseff v. Dean Witter & Co.*, 453 F. Supp. 774, 780, Fed. Securities L. Rep. (CCH) P 96,578 (N.D. Ind. 1978); *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 158, 98 S. Ct. 988, 55 L. Ed. 2d 179 (1978). The blue sky situation has been simplified by the National Securities Markets Improvements Act of 1996, which amended the 1933 Act to preempt state registration requirements for securities listed, or authorized to be listed, on the New York Stock Exchange or the American Stock Exchange or listed on the Nasdaq National Market. National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416. See also Robert N. Rapp, *Blue Sky Regulation*, (Matthew Bender)

(n6)Footnote 6. These laws are frequently referred to as "blue sky" laws because of colorful language in a United States Supreme Court case decided in 1917, in which the Court upheld the power of a state to pass legislation aimed at "speculative schemes which have no more basis than so many feet of 'blue sky.'" *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550, 37 S. Ct. 217, 61 L. Ed 480 (1917).

(n7)Footnote 7. For a discussion of federal regulation of securities issuance prior to 1933, see Edward N. Gadsby, *Historical Development of the S.E.C.--The Government View*, 28 Geo. Wash. L. Rev. 6, 7 (1959); Forrest B. Ashby, *Federal Regulation of Securities Sales*, 22 Ill. L. Rev. 635 (1928).

(n8)Footnote 8. A Department of Commerce survey indicated the following principal reasons for inadequacy of state blue sky laws and the corresponding need for federal participation: (1) evasion of state regulation by operating strictly on an interstate basis; (2) lack of uniformity in state legislation; (3) lack of adequate investor protection under the laws of several states; and (4) loopholes through exemptions afforded by the laws of several states. *A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act: Hearing on H.R. 4314 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong., 99-101 (1933).

(n9)Footnote 9. S. Rep. No. 73-875 & H.R. 73-4314 (1933). See also James M. Landis et al., *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 30 (1959).

(n10)Footnote 10. See Landis et al., *supra* note 9 at 30-31. As early as 1914, Brandeis, in *Other People's Money*,

had advocated disclosure: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."

(n11)Footnote 11. S. Rep. No. 73-47, at 6-7, & H.R. Rep. No. 73- 85, at 1-2 (1933).

* Patrick Daugherty, Yvette M. VanRiper and Peter C. Underwood. This chapter was revised and updated by Patrick Daugherty and Yvette M. VanRiper, partners at Foley & Lardner LLP, and Peter C. Underwood, Vice President, General Counsel and Secretary of Regal-Beloitt Corporation. The authors would like to thank Stephen J. Byrnes, Jr. and Megan A. Odronic, associates at Foley & Lardner LLP, and Morgan J. Tilleman, Nicholas J. Fox, Christina T. Jones and Morgan J. West, summer associates at Foley & Lardner LLP, for their assistance.



20 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933 § 1.02

§ 1.02 The Securities Act of 1933--Objectives and Scope

The advocates of full and fair disclosure prevailed, and that is the basic philosophy of the 1933 Act. Seventy-five years later, the Commission still has no inherent power to regulate the investment quality of the securities issues that it processes. It is in this respect that the 1933 Act differs markedly from many of the state blue sky laws that grant to state securities commissions the power to evaluate the merits of securities proposed to be offered. Although the 1933 Act adopted the full disclosure philosophy of the English Companies Act, the authors, with subsequent approval by Congress, borrowed antifraud provisions from existing state blue sky legislation. Accordingly, the antifraud provisions of the 1933 Act prohibit material misrepresentation, falsity and other fraudulent or manipulative acts and practices in connection with the sale of securities. n1

The 1933 Act, also known as the "Truth in Securities" law, n2 has two primary objectives: to require that investors receive pertinent financial information regarding securities offered for public sale and to eliminate fraud, deceit and misrepresentation in the sale of securities. n3 The 1933 Act accomplishes this by requiring companies to file a registration statement with the Commission. n4 A registration statement must include a prospectus containing material financial and other information about the company and the offering. n5 The registration statement is available to the public upon filing. n6 The Commission is not responsible for the content of the registration statement or for the quality of the underlying security. n7

FOOTNOTES:

(n1)Footnote 1. Securities Act of 1933 § 17, ch. 38, 48 Stat. 74.

(n2)Footnote 2. Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*. 24 *Ann. Rev. Banking & Fin. L.* 375, 382 (2005) .

(n3)Footnote 3. U.S. Securities & Exch. Comm'n, *How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.Securitiesgov/about/whatwedo.shtml>.

(n4)Footnote 4. Bloomenthal & Wolff, *Securities and Federal Corporate Law* § 1:54.

(n5)Footnote 5. *Id.* For tips on Drafting and Filing the Registration Statement see K&L Gates, *Securities Practice Guide* § 4.05 (2010 Edition)

(n6)Footnote 6. *Id.*

(n7)Footnote 7. *Id.*

* Patrick Daugherty, Yvette M. VanRiper and Peter C. Underwood. This chapter was revised and updated by Patrick Daugherty and Yvette M. VanRiper, partners at Foley & Lardner LLP, and Peter C. Underwood, Vice President, General Counsel and Secretary of Regal-Beloitt Corporation. The authors would like to thank Stephen J. Byrnes, Jr. and Megan A. Odronic, associates at Foley & Lardner LLP, and Morgan J. Tilleman, Nicholas J. Fox, Christina T. Jones and Morgan J. West, summer associates at Foley & Lardner LLP, for their assistance.



21 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933 § 1.03

§ 1.03 Overview of the Securities and Exchange Commission

[1] Structure of the Commission

The Commission was created in 1934 pursuant to the Securities Exchange Act of 1934 (the "Exchange Act" or the "1934 Act") to protect investors, promote stability in the market, and facilitate capital formation. n1 The Commission achieves this by overseeing key participants in the securities industry, requiring public disclosure of important financial information and enforcing securities laws, with the goal of achieving a more active, efficient, and transparent capital market. n2 The Commission administers seven statutes: the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970 and the Sarbanes-Oxley Act of 2002. n3

The Commission has broad authority over the securities industry n4 and has a variety of powers to ensure securities transactions are performed in fair and honest markets. n5 The Commission may register, regulate and oversee various members of the securities industry, including brokerage firms, transfer agents, clearing agencies and self regulatory organizations (SROs). n6 The Commission is also vested with the power to discipline regulated entities for a variety of prohibited behaviors. n7 Additionally, the Commission has the power to require periodic reporting of information by companies with publicly traded securities. n8

The Commission consists of five Commissioners, with an administrative structure organized into five Divisions and sixteen Offices. Additionally, there are eleven regional offices that operate primarily as extensions of the Commission's Division of Enforcement and the Commission's Office of Compliance Inspections and Examinations. n9

The five Commissioners are presidential appointees, each for a five-year term. n10 The terms are staggered, so that one expires each year on June 5. n11 No more than three of the Commissioners may belong to the same political party. n12 One Commissioner is designated as Chairman of the Commission by the President and serves as the Commission's chief executive. As the Commission's staff and responsibilities have grown in recent decades, authority and responsibility for the Commission's program has become increasingly concentrated in the Chairman and his or her staff. The Commission's primary responsibilities include interpreting federal security laws, issuing new rules and amending existing rules, overseeing the inspection of security firms, brokers, investment advisers and ratings agencies and coordinating U.S. securities regulation with federal, state and foreign authorities. n13

The Commission has five Divisions: the Division of Trading and Markets; the Division of Investment Management; the Division of Risk, Strategy and Financial Innovation; the Division of Corporation Finance and the Division of Enforcement.

The Division of Trading and Markets has the responsibility to help maintain fair, orderly and efficient securities markets by overseeing the nation's stock exchanges and other major security market participants. The Division oversees the Securities Investor Protection Corporation, carries out the Commission's financial integrity program for broker-dealers, assists the Commission in establishing rules and issuing interpretations on matters affecting the operation of the securities market, and monitors the markets. n14

The Division of Investment Management (commonly referred to as "IM") is primarily responsible for the oversight of mutual funds, professional fund managers, analysts and investment advisers. The Division also assists the Commission in interpreting laws and regulations for the public, responding to no-action requests, reviewing investment company and investment adviser filings, assisting the Commission in enforcement matters involving investment companies and advisers, and advising the Commission on adapting its rules to new circumstances. n15

The Division of Risk, Strategy, and Financial Innovation (commonly referred to as "Risk Fin") was established in September 2009 to help the Commission identify developing risks and trends in the financial markets. The Division is primarily responsible for risk and economic analysis, strategic research and financial innovation. n16 It provides cross-disciplinary support and specialized expertise to the Commission's other Divisions and acts as a "think tank" in the Commission's policy making, rule making, enforcement and examination activities.

The Division of Corporation Finance and the Division of Enforcement are the two largest Divisions within the Commission. Their responsibilities are discussed below.

The Commission has sixteen offices, including the Office of the General Counsel, the Office of the Chief Accountant, the Office of Compliance Inspections and Examinations and the Office of Investor Education and Advocacy. The General Counsel serves as the chief legal adviser to the Chair of the Commission and is responsible for establishing the Commission's policy on legal matters. When appropriate, the General Counsel also represents the Commission in civil, private, or appellate proceedings. n17

The Office of the Chief Accountant serves as the Commission's primary adviser on accounting and auditing matters. Additionally, the Office establishes accounting principles and oversees the private sector standards-setting process. n18

[2] The Work of the Commission in Relation to the 1933 Act n19

[a] The Division of Corporation Finance: Disclosure Review, Interpretations and Rulemaking

The Division of Corporation Finance (commonly referred to as "Corp Fin") oversees corporate disclosure of financial information. n20 It reviews documents such as registration statements, annual and quarterly filings, proxy materials and annual reports to determine whether and to what extent public companies are meeting their disclosure requirements. n21 Additionally, as part of its activities under the 1933 Act, the Division provides guidance to registrants, prospective registrants and the public to help them comply with the 1933 Act and relevant rules and regulations. This guidance is formally provided through no-action letters, which the Division issues to requesting companies, indicating whether it would recommend the Commission take action against the company's course of action proposed in its request for the letter. n22 This guidance might also take the form of an informal expression of opinion as to whether the offering of a particular security is subject to the registration requirements of the 1933 Act and, if so, providing advice relating to compliance with the disclosure requirements of the applicable registration form. Interpretive letters also are issued on other topics. The Division also drafts proposals for new rules, solicits comments on these drafts and recommends final rules to the Commission for adoption.

The Commission's overall objective of effective disclosure with minimum burden and expense requires the periodic review of the practical operation of the rules, registration forms and procedures that it promulgates. If a particular requirement fails to achieve its objective or if a rule appears unduly burdensome in relation to the benefits resulting from the disclosures it requires, the Division presents the issue to the Commission for possible modification of the rule or requirement. Many suggestions for rule modification follow consultation with industry representatives and others affected by the regulation. Moreover, the Commission also gives public notice of proposed rules or rule amendments and invites comments and criticism. The comments submitted are considered by the Commission in determining the nature and scope of the rules or rule changes ultimately adopted.

[b] The Division of Enforcement

[i] Investigation and Enforcement

It is the Commission's duty under the laws it administers to investigate complaints or other indications of possible violations of law in securities transactions, most of which arise under the 1933 Act and the 1934 Act. Investigation and enforcement work is primarily the responsibility of the Commission's regional offices and its Division of Enforcement. The Division reviews cases and recommends when the Commission should bring a civil action in federal court or before an administrative law judge. The Division then prosecutes these cases on behalf of the Commission. n23

Most of the Commission's investigations are conducted privately, and facts are developed through informal inquiry, interviewing of witnesses and examination of books, records, trading data and other documents. The Commission is empowered to issue subpoenas requiring sworn testimony and the production of information pertinent to the investigation. If a party refuses to respond to a subpoena, the Commission may apply to a federal court for an order compelling obedience.

Inquiries and complaints of investors and the general public provide a primary source for the detection of securities law violations. Another is the surprise inspection of books and records of regulated persons and organizations that are conducted by the regional offices of the Commission and the Division of Trading and Markets to evaluate whether their business practices conform to the prescribed rules. Still another source is the Commission's inquiries into market fluctuations in particular stocks that do not appear to result from general market trends or from known developments affecting an issuer.

The more general types of investigations concern (1) the sale of unregistered securities that are subject to the registration requirements of the 1933 Act and (2) the misrepresentation or omission of material facts concerning securities offered for sale (whether or not registration is required). With the exception of Section 17(a) under the 1933 Act, which only applies to the *sale* of securities, the antifraud provisions of the law apply equally to the *purchase* of securities, whether such a purchase involves outright misrepresentations or simply the withholding or omission of material facts that the seller of the securities has a right to know. For example, it is unlawful in certain situations to purchase securities from another person while withholding material information that would reveal that the securities have a value substantially greater than the price at which they are being acquired. These legal principles apply not only to transactions between broker-dealers and their customers but also to the reacquisition of securities by an issuer or its "insiders."

[ii] Statutory Sanctions

The Commission's investigations are essentially fact-finding inquiries. Following its investigations, the staff of the Commission (the "Staff") considers the information gathered to determine whether there is *prima facie* evidence of a violation of law and, if so, whether an action should be commenced to determine whether a sanction should be imposed. Assuming that the developed facts show possible fraud or other violation, the laws provide several courses of action or

remedies that the Commission, upon recommendation by the Staff, may elect to pursue:

- *Civil Injunction.* The Commission may apply to an appropriate United States District Court for an order enjoining those acts or practices alleged to violate the law or the Commission's rules and other equitable remedies.
- *Criminal Prosecution.* If fraud or other willful violation is detected, the Commission may refer the facts to the Department of Justice with a recommendation for criminal prosecution of the offending persons. That Department, through its United States Attorneys (who are sometimes assisted by Commission counsel), may then present the evidence to a grand jury and seek an indictment.
- *Administrative Remedy.* The Commission may, after an administrative proceeding, issue orders suspending or expelling members from the national securities exchanges, or denying, suspending, or revoking the registrations of broker-dealers, censuring individuals for misconduct or barring them from employment with registered firms.

[3] Administrative Proceedings

All formal administrative proceedings before the Commission are conducted in accordance with its Rules of Practice, n24 which must conform to the Administrative Procedure Act and are therefore designed to establish procedural "due process" safeguards protecting the rights and interests of the parties to the proceedings. Among these is a requirement for reasonable advance notice of the proceeding as well as sufficient specification of the charges or issues involved so that the parties are able to adequately prepare for the proceeding. All parties, including counsel for the interested Division or Office of the Commission, may appear and present evidence and cross-examine witnesses at the hearing in much the same manner as in the trial of court actions. In addition, interested persons who are not parties may be given limited rights of participation.

Hearings are conducted before a Hearing Officer, who is normally an Administrative Law Judge appointed by the Commission. The Hearing Officer is charged with serving independently of the interested Division or Office and rules on the admissibility of evidence and on other issues arising during the course of the hearing. At the conclusion of the hearing, the parties and participants may urge, in writing, specific findings of fact and conclusions of law for adoption by the Hearing Officer. Thereupon, the Hearing Officer prepares and files an initial decision (unless waived), setting forth his or her conclusions as to the facts established by the evidence and including an order disposing of the issues involved in the proceeding. The parties may seek Commission review of the Hearing Officer's initial decision. If review is not sought and the Commission does not order review on its own motion, then the initial decision becomes final and the Hearing Officer's order becomes effective.

In the event of Commission review of the initial decision, the parties and participants may file briefs and be heard in oral argument before the Commission. On the basis of an independent review of the record, the Commission prepares and issues its own decision; the Office of Opinions and Review aids the Commission in this decisional process. The laws provide that any person or firm aggrieved by a decision or order of the Commission may seek a review by the appropriate United States Court of Appeals.

[4] Disciplinary Proceedings

Rule 102(e) of the Commission's Rules of Practice n25 is the disciplinary rule governing the conduct of persons who appear before the Commission in a representative capacity. For the most part, such persons are attorneys and accountants. Broadly speaking, paragraph (1) of the rule authorizes the Commission to temporarily or permanently suspend any person from appearing before it in a representative capacity if that person is found by the Commission "not to possess the requisite qualifications to represent others, or to be lacking in character or integrity or to have engaged in

unethical or improper professional conduct." n26 Additionally, the Commission may suspend from practicing before itself any person who is found to have willfully violated, or willfully aided and abetted the violation of, any provision of the federal securities laws. n27

Rule 102(e)(2) and 102(e)(3) have automatic sanctions. Rule 102(e)(2) provides for suspension from securities practice in the event of suspension or disbarment by a federal or state court or conviction of a felony or misdemeanor involving moral turpitude. Rule 102(e)(3) provides for suspension if a court enters a permanent injunction of misconduct in an action brought by the Commission stemming from the violation of, or the aiding and abetting of the violation of, any provision of the federal securities laws. Moreover, partners of a suspended attorney may not permit the attorney to participate in the firm's profits from Commission business. n28

FOOTNOTES:

(n1)Footnote 1. U.S. Securities & Exch. Comm'n, *How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.Securitiesgov/about/whatwedo.shtml>.

(n2)Footnote 2. *Id.*

(n3)Footnote 3. 1 Louis Loss et al., *Securities Regulation* 326 (4th ed. 2006). For 70 years, the Commission also administered the Public Utility Holding Company Act of 1935. The Energy Policy Act of 2005 repealed this statute, effective February 8, 2006.

(n4)Footnote 4. U.S. Securities & Exch. Comm'n, *supra* note 1 .

(n5)Footnote 5. Loss et al., *supra* note 3, at 328 .

(n6)Footnote 6. U.S. Securities & Exch. Comm'n, *supra* note 1 .

(n7)Footnote 7. *Id.*

(n8)Footnote 8. Companies with over \$10 million in assets whose securities are held by over 500 owners must file periodic reports. *Id.*

(n9)Footnote 9. Loss et al., *supra* note 3, at 473 .

(n10)Footnote 10. U.S. Securities & Exch. Comm'n, *supra* note 1 .

(n11)Footnote 11. Bloomenthal & Wolff, *Securities and Federal Corporate Law* § 1:111.

(n12)Footnote 12. U.S. Securities & Exch. Comm'n, *supra* note 1 .

(n13)Footnote 13. *Id.*

(n14)Footnote 14. *Id.*

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *Id.*

(n17)Footnote 17. *Id.*

(n18)Footnote 18. *Id.*

(n19)Footnote 19. Part of the material in the remainder of this chapter has been adapted from the text of *The*

Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity, published by the Commission. Only those portions pertaining to the Commission's activities in connection with the 1933 Act have been included. This publication, as well as much other useful information about the Commission and its activities, is available on the Commission's website, www.Securities.gov.

(n20)Footnote 20. Loss et al., *supra* note 3, at 467 .

(n21)Footnote 21. U.S. Securities & Exch. Comm'n, *supra* note 1 .

(n22)Footnote 22. *Id.*

(n23)Footnote 23. *Id.*

(n24)Footnote 24. Rules of Practice, 17 C.F.R. Part 201 (2008). In 1995, the Commission adopted comprehensive revisions to its Rules of Practice. Rules of Practice, Exchange Act Release No. 34-35833, 60 Fed. Reg. 32738, 1995 SEC LEXIS 1505 (June 9, 1995) (the "Rules Release"). The revisions were the culmination of three years of effort by the Commission's Task Force on Administrative Proceedings appointed in 1990. The Rules Release presents the text of the revised Rules of Practice, together with comments that describe the basis and rationale for each rule, reference related rules, provide pertinent information regarding Commission practice and explain changes in the adopted Rules from those that were proposed in 1993. The comments are intended to assist a practitioner in obtaining a more thorough understanding of the Commission's Rules of Practice.

(n25)Footnote 25. 17 C.F.R. § 201.102(e). No federal statute expressly grants authority to the Commission to regulate the conduct of professionals who appear before it. Rule 102(e) was adopted pursuant to Section 23(a)(1) of the 1934 Act, 15 U.S.C. § 78w(a), granting the Commission "power to make such rules and regulations as may be necessary... for the execution of the functions vested in [it]..." In *Schwebel v. Orrick*, 153 F. Supp. 701 (D.D.C. 1957) , *aff'd on other grounds*, 251 F.2d 919 (D.C. Cir. 1958) , it was held that the Commission has the power under Rule 102(e) to discipline attorneys. This issue was a contentious one for decades but is now considered settled.

(n26)Footnote 26. See *Paul M. Kaufman*, Securities Act Release 8925, 1970 SEC LEXIS 414 (July 2, 1970) ; *Emmanuel Fields*, Securities Act Release 5404, 1973 SEC LEXIS 2816 (June 18, 1973) ; *George Mariscal*, Securities Act Release 5442, 1973 SEC LEXIS 156 (Nov. 30, 1973) . The Commission has amended Rule 102(e) to clarify the Commission's standard for determining when accountants engage in "improper professional conduct." *Securities Act Release 7593*, 1998 SEC LEXIS 2256 (Oct. 19, 1998) . This amendment was in response to a finding by a U.S. Court of Appeals that the Commission had not articulated clearly the improper professional conduct element of Rule 102(e). *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998) .

(n27)Footnote 27. 17 C.F.R. § 201.102(e)(1)(iii). In 1974, the Commission announced a proposal to amend Rule 102(e)(7) to provide that proceedings brought under Rule 102(e) be public. *Securities Act Release 5477*, 1974 SEC LEXIS 3344 (April 5, 1974) . The proposal was withdrawn, but in so doing the Commission stated that "it nevertheless wishes to apprise members of the profession who practice before it that the Commission is not suggesting that all disciplinary proceedings will be conducted on a private basis in the future...it believes that the provisions of existing Rule 102(e)(7) provide it with ample discretion to institute public disciplinary proceedings under Rule 102(e) when the Commission deems it to be in the public interest to do so." *Securities Act Release 5572*, 1975 SEC LEXIS 2117 (Mar. 5, 1975) . In what was reportedly the first Rule 102(e) proceeding ever opened to the public, the Second Circuit upheld the Commission's authority to discipline accountants under Rule 102(e) as a means of "merely attempting to preserve the integrity of its own procedures, by assuring the fitness of those professionals who represent others before the Commission." *Touche Ross & Co. v. SEC*, 609 F.2d 570, 579 (2d Cir. 1979) . The court also found that the rule is not inconsistent with the Commission's statutory authority since the regulation is in furtherance of a legitimate statutory purpose and was promulgated pursuant to its statutory rulemaking authority. *Id.* at 579-582 .

(n28)Footnote 28. See *Securities Act Release 5147*, 1971 SEC LEXIS 1390 (Aug. 23, 1971) .

* Patrick Daugherty, Yvette M. VanRiper and Peter C. Underwood. This chapter was revised and updated by Patrick Daugherty and Yvette M. VanRiper, partners at Foley & Lardner LLP, and Peter C. Underwood, Vice President, General Counsel and Secretary of Regal-Beloitt Corporation. The authors would like to thank Stephen J. Byrnes, Jr. and Megan A. Odronic, associates at Foley & Lardner LLP, and Morgan J. Tilleman, Nicholas J. Fox, Christina T. Jones and Morgan J. West, summer associates at Foley & Lardner LLP, for their assistance.



22 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933 § 1.04

§ 1.04 Registration of Securities

In a public offerings of securities, the 1933 Act requires full and fair disclosure of pertinent information regarding the issuer, the offered securities and the offering. Disclosure is made by means of a registration statement, which the issuer files with the Commission, and a prospectus, which is part of the registration statement and is distributed to potential purchasers of the securities.

There are two principal methods of utilizing registration statements: traditional, non-shelf registration statements; and shelf registration statements permitted by Rule 415 under the 1933 Act. n1 The latter method is, as a practical matter, generally available only to fairly large, well-established issuers that are already public companies.

[1] Non-Shelf Registration Statements

In a public offering of securities utilizing a non-shelf registration statement, including the initial public offering ("IPO") of securities by a company, the registration statement and the prospectus relate only to a specific issuance of securities and describe the terms of the particular securities being offered and the particular manner in which they will be offered to the public. The registration statement must be filed before the public offering of the securities and includes a preliminary prospectus containing that portion of the information in the registration statement considered necessary to enable an investor to evaluate the securities and to make an informed judgment whether or not to purchase them. n2 No sale of the securities may be made until the registration statement has been declared "effective" by the Commission. n3 In short, there is a "waiting period" between the time of filing and the effective date. In this connection, the 1933 Act provides for the effectiveness of registration statements on the 20th day after filing (or on the 20th day after the filing of an amendment to the registration statement) or such earlier date as the Commission may determine. n4

In practice, the length of the waiting period varies depending upon whether the registration statement is reviewed by the Commission, the issuer's ability to meet the applicable registration requirements, how quickly the issuer responds to any deficiencies noted by the Staff in comment letters, and various other factors. In many instances, particularly those involving IPOs, the waiting period will be much longer than 20 days and may be several months. But for certain short-form registration statements filed under the integrated disclosure system and not fully reviewed by the Staff, the waiting period may be only a couple of days (or less).

The Commission may examine the registration statement to determine whether it complies with the full and fair

disclosure requirements of the 1933 Act. If the examination reveals material misstatements or omissions, the Commission may, after notice and opportunity for hearing, issue a "stop order" denying effectiveness to, or suspending or revoking the effectiveness of, the registration statement, thus prohibiting the sale of the issuer's securities until the registration statement is amended to correct the deficiencies. In practice, however, the Commission usually resorts to this procedure only in cases of willful concealment or misrepresentation. The usual practice is to send a comment letter to the issuer suggesting that the registration statement be amended to cure the apparent deficiencies. Upon the filing of appropriate amendments, or shortly thereafter, the registration statement will usually be made effective and the public sale of the securities can be commenced.

The Commission's examination of a prospectus, thorough as it may be, is no guarantee of the adequacy or accuracy of the information presented in the prospectus. Indeed, the 1933 Act expressly makes it unlawful to represent to investors that the Commission has approved or otherwise passed on the merit of the securities or found that disclosure was accurate or complete. n5

[2] Shelf Registration Statements

In a public offering of securities utilizing a shelf registration statement pursuant to Rule 415 under the 1933 Act, the registration statement and the "base" prospectus in the registration statement can relate to a specified amount of generic "securities" (which may include debt and equity securities and warrants for the purchase of those securities) and may describe a variety of ways in which the securities might be distributed to the public (such as through underwriters or agents or directly by the issuer).

The process for the filing, Commission review and declaration of effectiveness of a shelf registration statement are the same as for a non-shelf registration statement, as described above. Typically, however, the securities covered by a shelf registration statement are not offered for sale prior to the effectiveness of the registration statement and preliminary prospectuses are not circulated.

Once a shelf registration statement has been made effective by the Commission, the issuer may offer and sell all or any portion of the securities covered by the registration statement at any time, without further review or other action by the Commission. The issuer simply prepares and files with the Commission a supplement to the base prospectus that describes the particular terms of the specific securities being offered and the method by which the securities are being offered. The prospectus supplement (together with the base prospectus) is sent to investors with a confirmation evidencing purchase of the offered securities and must ordinarily be filed with the Commission no later than two business days after the earlier of the date the securities are first offered for sale or the date the prospectus supplement is first used. n6 By using a shelf registration statement, an issuer is essentially able to offer and sell its securities on a moment's notice and thereby take advantage of opportune market conditions.

[3] Exemptions Under the 1933 Act

The 1933 Act contains specific exemptions from registration for certain securities and transactions. Some are "true" exemptions in that they are automatic if the security or transaction complies with statutory conditions. But others, such as Regulation A, which permits certain issuers and controlling persons to make "exempt" offerings under certain conditions, require the filing of documents with, and processing by, the Commission before the securities may be sold. Furthermore, exempt securities and transactions are exempt only from the registration and prospectus requirements of the 1933 Act. The antifraud provisions of the 1933 Act are applicable to all sales of securities in interstate commerce or by use of the mails, whether or not the securities are registered with the Commission. n7

For a thorough discussion of the various exempt securities and offerings, see Chapters 3, 4, 5 and 6 *infra*.

[4] Causes of Action Under the 1933 Act

In addition to its antifraud provisions, n8 the 1933 Act contains penal sanctions for false and misleading statements in the registration statement and prospectus. n9 Furthermore, investors who suffer losses in the purchase of securities have recovery rights under the 1933 Act if the disclosures contained in the registration statement or prospectus are incomplete, false, or misleading. n10 Equally important, recovery rights exist in the event of nondisclosure or misrepresentation in the sale of even "unregistered" securities when the mails or facilities of interstate commerce are used to effect the transaction. n11 Finally, liability exists if securities that must be registered are sold without registration and the provisions with regard to the delivery of prospectuses are not followed. n12

[5] Securities Offering Reform of 2005

[a] Background: National Securities Markets Improvement Act of 1996

Previously under the 1933 Act and 1934 Act, the Commission generally had limited authority to adopt rules exempting transactions and issuers from specific requirements of the Acts. n13 This changed dramatically with Congress' adoption of the National Securities Markets Improvement Act of 1996 ("NSMIA"). n14 With the passage of the NSMIA, the Commission became empowered to exempt issuers, securities and transactions from provisions of the 1933 Act and the 1934 Act by rulemaking for purposes of not only protecting investors, but also for promoting efficiency, competition, and capital formation. n15 Thus, the Commission now had the authority to undertake fundamental reforms of the securities offering process.

In 2005, the Commission used its expanded rulemaking power by adopting fundamental reforms of the rules governing the communications and offering processes for securities offerings registered under the 1933 Act. The new rules adopted by the Commission are commonly known as the Securities Offering Reform rules. The Securities Offering Reform rules impact registration and other procedures in offering and capital formation processes, communications related to registered securities offerings and delivery of information to investors and timeliness of that delivery. n16

[b] General Framework

The Securities Offering Reform rules were meant to bring the regulatory regime governing registered securities offerings into line with modern market needs and capabilities by adapting to recent advances in technology, facilitating timely disclosure to investors of issuer information and developments and reducing needless regulatory hurdles to issuers' access to the public market.

[c] Categories of Issuers

The Commission used a tiered approach to classify issuers and the commensurate benefits they receive under the Securities Offering Reform rules. The categories of issuers are:

- (1) Well-Known Seasoned Issuer ("WKSI")--A WKSI has the greatest freedom to take advantage of the Securities Offering Reform rules benefits. Generally, an issuer is a well-known seasoned issuer if it qualifies to use a Form S-3 registration statement n17 and it has a worldwide public float of at least \$700 million in common equity. n18
- (2) Seasoned Issuer--Generally, an issuer qualifies as a seasoned issuer if it qualifies to register securities on Form S-3. n19
- (3) Unseasoned Issuer--Generally, an issuer is an unseasoned issuer if it is required to file reports under the 1934 Act but it is not eligible to use Form S-3. n20
- (4) Non-Reporting Issuer--An issuer is a non-reporting issuer if it is not required to file reports under the

1934 Act. n21

(5) Ineligible Issuer--Generally, an issuer is an ineligible issuer if: (a) it was not current in filing reports under the 1934 Act during the prior 12 months, excluding certain current reports on Form 8-K; (b) it was a blank check company, shell company, or issuer for an offering of "penny stock" during the prior three years; (c) it has filed for bankruptcy or insolvency during the past three years; or (d) it has been convicted of certain felonies or misdemeanors or has been found to have violated the antifraud provisions of the 1933 Act. n22

[d] Communications Reforms

Under the Securities Offering Reform rules, the Commission relaxed restrictions on the types of offering communications that can be used in connection with a registered securities offering. Previously, permissible communications made to investors in connection with a registered securities offering were severely limited. Under Section 5 of the 1933 Act, an issuer was prohibited from making any communications that constituted "offers" prior to the filing of a registration statement. During the period between the filing of a registration statement and the time it became effective, known as the "waiting period," the issuer could make written offers only through a "statutory prospectus" meeting the requirements of Section 10 of the 1933 Act (although issuers were able to freely communicate with investors through oral communications, such as by telephone or an in-person meeting). n23 Moreover, even when a registration statement became effective, the issuer could still make offers to investors only through the final statutory prospectus, or through additional written materials, so long as a final statutory prospectus had previously been sent to the investors. n24 These restrictions on offering communications are commonly known as "gun-jumping provisions."

The practical effect of the gun-jumping provisions was that issuers could not actively and periodically communicate with potential investors while a registered securities offering was in process. As a result, investors often did not receive timely information regarding the securities offering or developments relating to the issuer undertaking a securities offering. A regulatory regime founded on the principle of full disclosure was actually impeding disclosure. The Commission recognized the burdens on the effective use of communications between issuers and investors caused by the gun-jumping provisions. n25 In response, the Commission implemented a series of reforms under the Securities Offering Reform rules.

[i] The New Communications Scheme

The Securities Offering Reform rules include communications rules designed to meet the market's need for ongoing information from issuers while easing the restrictions on the ability of issuers and offering participants to make written offers outside of the statutory prospectus.

The communication framework permits the following communications:

- (1) regularly released factual business information and forward-looking information; n26
- (2) communications made more than 30 days before filing a registration statement; n27
- (3) communications by WKSIs at any time prior to filing a registration statement; n28
- (4) written communications made in accordance with an expanded safe harbor (Rule 134) under the 1933 Act; and n29
- (5) written communications (other than a statutory prospectus) by an eligible issuer after filing a registration statement. n30

[iii] Regularly Released Information

The Securities Offering Reform rules provided two safe harbors from the gun-jumping provisions of the 1933 Act to exempt and permit continuing ongoing business communications by issuers. First, issuers filing reports under the 1934 Act ("reporting issuers") are permitted to continue publishing and disseminating communications containing regularly released factual business and forward-looking information at any time, including during the time of a registered securities offering. n31 "Factual business information" includes factual information about an issuer, its business or financial or other aspects of its business, advertisements or information about its products or services, and dividend notices. n32 "Forward-looking information" includes projections of an issuer's financial performance, statements about the issuer's management's plans and objectives for future operations, statements about the issuer's future economic performance and those assumptions underlying the assessments of the issuer's future performance. n33 Second, non-reporting issuers may continue publishing and disseminating regularly released business information intended for use by persons that are not acting as potential investors. n34

[iii] Communications More Than 30 Days Prior to Filing a Registration Statement

The Commission also provided a broad safe harbor for communications by all issuers that are made more than 30 days prior to the filing of a registration statement. n35 Issuers may communicate freely without risk of violating the gun-jumping provisions so long as: (1) the communications do not refer to the issuer's securities offering that "is or will be the subject of a registration statement"; (2) the communication is made by the issuer or by representatives or agents other than underwriters or other offering participants; and (3) the issuer takes reasonable steps to prevent further publication of the communication during the 30 days preceding the actual filing of its registration statement. The 30-day bright-line exemption allows freer communication by issuers with investors, but still limits pre-filing communications by prohibiting any references to a registered securities offering that the issuer will undertake.

[iv] Communications by WKSIs

The Commission also provided a safe harbor for all pre-filing communications by WKSIs. Under this exemption, a WKSI or its agents or employees, other than underwriters or offering participants, may make unrestricted written or oral offers at any time before the filing of a registration statement without violating the gun-jumping provisions. n36 If the communications made under this exemption are offers, they must contain a legend as prescribed by the Commission. In certain circumstances, the communication must also be filed with the Commission.

[v] "Tombstone" Advertisements Under Rule 134

Previously under Rule 134 of the 1933 Act, issuers and offering participants such as underwriters were permitted to provide very limited public notices about a registered offering (commonly referred to as "tombstone" advertisements) after the issuer had filed a registration statement including a preliminary statutory prospectus. The Securities Offering Reform rules expanded the type of information that may be included in a Rule 134 notice. These notices may now include: additional information about the issuer and its business; more detailed information about the terms of the securities being offered; more information about the offering; more information on the participation of the issuer's officers, directors, and employees in the offering; and disclosure of any security rating expected to be assigned to the offering. n37

A Rule 134 notice still may not be used to provide detailed descriptions of the terms of the offered securities. This information may instead be disclosed in a new type of authorized communication, the free writing prospectus.

[vi] The Free Writing Prospectus

As previously explained, the gun-jumping provisions of Section 5 of the 1933 Act generally permitted issuers to make written offers only through a statutory prospectus following the filing of a registration statement. Further, once the

registration statement became effective, written offers other than a statutory prospectus could only be made to investors if a statutory prospectus had been delivered to investors. Under the Securities Offering Reform rules, the Commission authorized a much wider array of written offers outside the statutory prospectus, which are referred to as "free writing prospectuses." n38 A free writing prospectus may include information about a registered securities offering that is in addition to, supplements, or is different from the information contained in the statutory prospectus filed with the registration statement, as long as the information does not conflict with the information in the prospectus. n39

Any eligible issuer may use a free writing prospectus to make offers to potential investors following the filing of a registration statement without violating the gun-jumping provisions of the 1933 Act. In addition, other offering participants such as underwriters and broker-dealers may use free writing prospectuses to make offers to investors.

Unseasoned issuers and non-reporting issuers can use free writing prospectuses only if a registration statement including a statutory prospectus has been filed and the most recently filed statutory prospectus is delivered prior to or concurrently with the free writing prospectus. n40 For WKSIs and seasoned issuers, a free writing prospectus may be delivered after the issuer files a registration statement containing a statutory prospectus; the issuer is not required to make actual delivery of the statutory prospectus. The free writing prospectus must include a specified legend and is generally filed with the Commission, subject to certain exceptions. n41

[vii] Road Shows

Historically, electronic road shows were regarded by the Commission as impermissible written offers that were not lawful statutory prospectuses. The Commission began permitting electronic road shows under limited circumstances in 1997 pursuant to a series of no-action letters. The Commission's embrace of information technology continued in its Securities Offering Reform rulemaking.

Due to advances in electronic media, the Commission concluded in the Securities Offering Reform rules that electronic road shows that are not presented live, in real time, to a live audience, and are transmitted graphically, are "written communications" that are free writing prospectuses. n42 Accordingly, they must generally satisfy the conditions applicable to free writing prospectuses under Rule 433. The new rules ease the Commission's previous restrictions on use of electronic road shows as there are now no limitations on the road show audience, the road show need not be a re-transmission of a live presentation, reviewers can obtain a copy of, and may download, the road show, and multiple versions of a road show may be presented.

[viii] Communications on Web Sites

Under the Securities Offering Reform rules, offers of securities featured on the issuer's website, or featured on a third party's website that may be linked through the issuer's website, are considered written offers and, as a result, are deemed to be free writing prospectuses that must satisfy the conditions of Rule 433 of the 1933 Act. n43 Thus, issuers must be careful in assuring that any offers of securities featured on their websites, or on linked third-party websites, satisfy the requirements of a free writing prospectus so that no violation of the gun-jumping provisions occurs.

[ix] Media Publications and Broadcasts

Along with the use of Internet and electronic media, issuers use traditional broadcast and other media to provide information about their registered securities offerings. In adopting the Securities Offering Reform rules, the Commission recognized the role that the financial news media plays in reporting on issuers and their securities offerings and gave special consideration to independent media publications or broadcasts about issuers. n44 Generally, in determining whether media broadcasts about an issuer or its offering are considered offers of securities by the issuer, the Commission focuses on whether the issuer or another offering participant prepares or pays for the media broadcast or publication, or whether an unaffiliated media outlet prepares and distributes the media broadcast or publication. n45

When a media publication is prepared or paid for by an issuer or an offering participant, it is considered an offer under the 1933 Act and a free writing prospectus. As a result, the issuer must comply with all the delivery, informational content and other conditions that apply to free writing prospectuses. n46 The rules are different when a media publication is prepared and published or broadcast by unaffiliated media outlets. First, while a registration statement must be on file for issuers (other than WKSIs), an independent media publication about an offering need not be preceded or accompanied by a statutory prospectus. Second, an issuer has flexibility in satisfying the filing condition for independent media publications. n47 Finally, independent media outlets are not required to file any media publications or broadcasts that they prepare about an issuer and its registered securities offering. n48

[x] Expanded Use of Research Reports

The use of research reports in connection with registered securities offerings was also liberalized under the Securities Offering Reform rules. Generally, research reports are subject to separate safe harbors that exempt them from treatment as offers of securities that may violate the gun-jumping provisions, depending on the time of publication. n49 Under the Securities Offering Reform rules, the Commission adopted a uniform definition of what constitutes a "research report"; namely, a written communication "that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision." n50

In the Securities Offering Reform rules, the Commission expanded the research report safe harbors to permit brokers or dealers that are not offering participants to publish research reports on a non-reporting issuer's securities (previously, the only reports that could be published were those regarding reporting issuers) n51 and to allow publication of research reports on a broader class of issuers by brokers and dealers that participate in a distribution of securities. n52

The increased scope of permissible research reports provides potential investors with more diverse resources for gathering information relevant to weighing the merits of an investment in an issuer's securities offering. Further, the adoption of a uniform definition of "research report" brings certainty to brokers and dealers about the information they can publish about issuers and their securities when involved in a distribution of a particular issuer's securities.

[6] Registration Reforms

Under the Securities Offering Reform rules, the Commission adopted important changes that modernize the shelf registration process. Most significantly, the rules eliminated restrictions affecting "at-the-market offerings," immediate takedowns from shelf registration statements and the volume of securities that can be registered for the shelf. n53

[a] Shelf Registration Reforms

As previously discussed, n54 issuers may register securities for offering and sale on an extended or delayed basis through use of a shelf registration statement pursuant to Rule 415 of the 1933 Act. n55 Previously, the volume of securities that could be registered for the shelf was limited to the volume reasonably expected to be offered and sold within two years from the effective date of the registration statement. n56 The Securities Offering Reform rules removed this limitation. n57 Nevertheless, the shelf registration statements used for these offerings may now be used for only three years from the initial effective date. n58 Thus, issuers must file new shelf registration statements every three years if they wish to continuously sell registered securities.

The Securities Offering Reform rules also removed restrictions on "at-the-market" offerings that required an underwriter's involvement and limited the volume of securities that could be registered. An "at-the-market" offering is an offering of securities into an existing trading market other than at a fixed price. Issuers registering certain primary equity shelf offerings can now register at-the-market offerings without identifying any underwriters or limiting the size

of the offering. n59

[b] Automatic Shelf Registration for WKSIs

One of the more significant changes brought about by the Securities Offering Reform rules was the establishment of "automatic shelf registrations" for WKSIs. WKSIs were singled out for this favorable treatment because they are established companies with reporting histories under the 1934 Act and significant market followings. n60

Under the automatic shelf registration process, all automatic shelf registration statements and post-effective amendments are not subject to staff review and become effective immediately upon filing with the Commission. n61 Using an automatic shelf registration statement, WKSIs may register unspecified amounts of different classes of securities and can add new classes of securities by post-effective amendments that are immediately effective upon filing. n62 Automatic shelf registration statements may be used for up to three years. n63

With these reforms, the automatic shelf registration process permits WKSIs to gain immediate market access, raising more money on better terms than would otherwise be the case. n64

FOOTNOTES:

(n1)Footnote 1. Rule 415 of the 1933 Act, 17 C.F.R. § 230.415. The Rules under the 1933 Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section C. *See infra* Ch. 7 for discussion of registration forms.

(n2)Footnote 2. Section 5(c) of the 1933 Act, 15 U.S.C. § 77e(c).

(n3)Footnote 3. Section 5(a) of the 1933 Act, 15 U.S.C. § 77e(a).

(n4)Footnote 4. In the language of Section 8(a) of the 1933 Act, "such earlier date as the Commission may determine, having due regard to the adequacy of information respecting the issuer theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of the holders thereof can be understood, and to the public interest and the protection of investors." 15 U.S.C. § 77h(a). *See* Rule 461 of the 1933 Act, 17 C.F.R. § 230.461.

(n5)Footnote 5. Section 23 of the 1933 Act, 15 U.S.C. § 77w.

(n6)Footnote 6. Rule 424(b) of the 1933 Act, 17 C.F.R. § 230.424(b). Note that there are limitations on the types of offerings that can be shelf-registered. *See* 7A.05 *infra* for a discussion of shelf registration.

(n7)Footnote 7. Section 17 of the 1933 Act, 15 U.S.C. § 77a.

(n8)Footnote 8. *Id.*

(n9)Footnote 9. Sections 20 and 24 of the 1933 Act, 15 U.S.C. §§ 77t, x.

(n10)Footnote 10. Section 12 of the 1933 Act, 15 U.S.C. § 77l.

(n11)Footnote 11. Sections 12 and 17 of the 1933 Act, 15 U.S.C. §§ 77l, q.

(n12)Footnote 12. Section 12 of the 1933 Act, 15 U.S.C. § 77l.

(n13)Footnote 13. *See* Linda C. Quinn, *The SEC's "Aircraft Carrier" Release--A New Registration System: An Assessment Retrenchment and Reform*, in *Securities Offerings 1999: What Issuers' & Underwriters' Counsel Need to Know*, 1110 P.L.I. Corp. 93, 96 (1999) ("Prior to its being given broad exemptive authority under the Securities Act of 1933 by the National Securities Markets Improvement Act of 1996 (NSMIA), the Commission had to resort to its

definitional powers to provide safe harbors for various communications that might otherwise run afoul of Section 5 [of the Securities Act].")

(n14)Footnote 14. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C.).

(n15)Footnote 15. Alan R. Parmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 Col. Bus. L.R. 1, 89-90 (citing H.R. Rep. No. 104-622, at 101-02 (1996)).

(n16)Footnote 16. Securities Offering Reform, Securities Act Release No. 33-8591; *Exchange Act Release No. 34-52056*, 70 Fed. Reg. 44,722 (July 19, 2005) , available at <http://www.Securitiesgov/rules/final/33-8591.pdf> [hereinafter Securities Offering Reform Release].

(n17)Footnote 17. An issuer qualifies to use Form S-3 if it has registered securities under the 1934 Act or is required to file reports under the 1934 Acts and has timely filed such reports in the previous 12 months. See General Instructions I.A.2 and 3(a) and (b) to Form S-3.

(n18)Footnote 18. Rule 405 of the 1933 Act, 17 C.F.R. § 230.405.

(n19)Footnote 19. Securities Offering Reform Release, 70 Fed. Reg. at 44,730 ; Rule 433(b)(1) of the 1933 Act, 17 C.F.R. § 230.433(b)(1).

(n20)Footnote 20. Securities Offering Reform Release at 44,731

(n21)Footnote 21. *Id.*

(n22)Footnote 22. Rule 405 of the 1933 Act, 17 C.F.R. § 230.405.

(n23)Footnote 23. See 15 U.S.C. § 77e(b).

(n24)Footnote 24. Securities Offering Reform Release, 70 Fed. Reg. at 44,731 .

(n25)Footnote 25. See *id.*

(n26)Footnote 26. Rule 168 of the 1933 Act, 17 C.F.R. § 230.168.

(n27)Footnote 27. Rule 163A of the 1933 Act, 17 C.F.R. § 230.163A.

(n28)Footnote 28. Rule 163 of the 1933 Act, 17 C.F.R. § 230.163.

(n29)Footnote 29. Rule 134 of the 1933 Act, 17 C.F.R. § 230.134.

(n30)Footnote 30. Rule 433 of the 1933 Act, 17 C.F.R. § 230.433.

(n31)Footnote 31. Rule 168(a) of the 1933 Act, 17 C.F.R. § 230.168(a).

(n32)Footnote 32. Rule 168(b)(1) of the 1933 Act, 17 C.F.R. § 230.168(b)(1).

(n33)Footnote 33. Rule 168(b)(2) of the 1933 Act, 17 C.F.R. § 230.168(b)(2).

(n34)Footnote 34. Rule 169 of the 1933 Act, 17 C.F.R. § 230.169.

(n35)Footnote 35. Rule 163A of the 1933 Act, 17 C.F.R. § 230.163A.

(n36)Footnote 36. Rule 163 of the 1933 Act, 17 C.F.R. § 230.163.

(n37)Footnote 37. *Id.*

(n38)Footnote 38. Securities Offering Reform Release, 70 Fed. Reg. at 44,746 .

(n39)Footnote 39. Rule 433(c) of the 1933 Act, 17 C.F.R. § 230.433(c).

(n40)Footnote 40. Rule 433(b)(2) of the 1933 Act, 17 C.F.R. § 230.433(b)(2).

(n41)Footnote 41. Rules 164 and 433(b)(1) of the 1933 Act, 17 C.F.R. §§ 230.164, 230.433(b)(1).

(n42)Footnote 42. Securities Offering Reform Release, 70 Fed. Reg. at 44,753-4 .

(n43)Footnote 43. Rule 433(e) of the 1933 Act, 17 C.F.R. § 230.433(e).

(n44)Footnote 44. Securities Offering Reform Release, 70 Fed. Reg. at 44,757 .

(n45)Footnote 45. *Id.*

(n46)Footnote 46. Rule 433 of the 1933 Act, 17 C.F.R. § 230.433.

(n47)Footnote 47. Rule 433(f) of the 1933 Act, 17 C.F.R. § 230.433(f).

(n48)Footnote 48. *Id.*

(n49)Footnote 49. Rules 137-39 of the 1933 Act, 17 C.F.R. §§ 230.137-139

(n50)Footnote 50. *Id.*

(n51)Footnote 51. *Id.*

(n52)Footnote 52. Rule 138 of the 1933 Act, 17 C.F.R. § 230.138.

(n53)Footnote 53. Securities Offering Reform Release, 70 Fed. Reg. at 44,770 .Additionally, the Securities Offering Reform rules clarified information that may be included in or omitted from shelf registration statements and spelled out the manner for including information in the final statutory prospectus.

(n54)Footnote 54. *See supra* § 1.04[2].

(n55)Footnote 55. Rule 415 of the 1933 Act, 17 C.F.R. § 230.415.

(n56)Footnote 56. Securities Offering Reform Release, 70 Fed. Reg. at 44,774 .

(n57)Footnote 57. Rule 415 of the 1933 Act, 17 C.F.R. § 230.415.

(n58)Footnote 58. *Id.*

(n59)Footnote 59. Securities Offering Reform Release, 70 Fed. Reg. at 44,770 .

(n60)Footnote 60. *Id.* at 44,774 .

(n61)Footnote 61. Rule 462(e) of the 1933 Act, 17 C.F.R. § 230.462(e).

(n62)Footnote 62. *Id.*

(n63)Footnote 63. Rule 415(a)(5) of the 1933 Act, *17 C.F.R. § 230.415(a)(5)*.

(n64)Footnote 64. Securities Offering Reform Release, 709 Fed. Reg. at 44,777 .

* Patrick Daugherty, Yvette M. VanRiper and Peter C. Underwood. This chapter was revised and updated by Patrick Daugherty and Yvette M. VanRiper, partners at Foley & Lardner LLP, and Peter C. Underwood, Vice President, General Counsel and Secretary of Regal-Beloitt Corporation. The authors would like to thank Stephen J. Byrnes, Jr. and Megan A. Odronic, associates at Foley & Lardner LLP, and Morgan J. Tilleman, Nicholas J. Fox, Christina T. Jones and Morgan J. West, summer associates at Foley & Lardner LLP, for their assistance.



23 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933 § 1.05

§ 1.05 The Sarbanes-Oxley Act of 2002

[1] The Need for Reform

In late 2001, Enron Corporation, which was one of the largest U.S. companies, collapsed into bankruptcy amid allegations of fraud and improper accounting. n1 Following the collapse of Enron, accounting scandals and other types of corporate misbehavior at several other large companies came to light. In response to the public outcry over these improprieties and in an effort to restore investor confidence in the public equity market, Congress enacted the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"). n2 The Sarbanes-Oxley Act was the most comprehensive legislation in the field of corporate governance in U.S. history. Its sweeping package of reforms was intended to remedy many of the accounting, disclosure, mismanagement and self-dealing issues that commanded headlines following the Enron debacle. Because of Congress' desire to respond quickly to these problems, the Sarbanes-Oxley Act was approved with little debate. n3 As a result, many of its provisions required SEC rulemaking (or clarification) for effective implementation.

The enactment of the Sarbanes-Oxley Act significantly changed U.S. securities laws and regulations. These changes were intended to improve the quality of corporate disclosure and accelerate the flow of public information to investors. As summarized below, the Sarbanes-Oxley Act contained provisions designed to create a "culture of oversight and compliance" by instilling greater corporate responsibility among senior management of public companies, enhancing disclosure made by issuers in the reports they file under the 1934 Act, improving auditor independence, introducing regulatory oversight of the auditing profession and remedying perceived conflicts of interest of equity analysts. The Sarbanes-Oxley Act also substantially increased the penalties and other sanctions associated with corporate and criminal fraud and white-collar crimes. Changes in the rules and regulations affecting these areas are discussed below.

[2] Internal Control and Disclosure Controls

Since 1977, U.S. securities laws have required public companies to maintain a system of internal control relative to accounting and financial reporting. The Sarbanes-Oxley Act elaborated on what controls are specifically required and mandated that independent auditors issue an audit report on internal control in conjunction with the annual audit of an issuer's financial statements.

Responding to the Sarbanes-Oxley Act, the Commission adopted the term "internal control over financial reporting," stating that its purpose is to provide "reasonable assurance regarding the reliability of financial reporting and the

preparation of financial statements for external purposes in accordance with generally accepted accounting principles." n4 The process of internal control over financial reporting must address three elements: (1) the maintenance of records that accurately, fairly and in reasonable detail reflect transactions; (2) reasonable assurance that transactions are properly recorded; and (3) reasonable assurance regarding prevention or detection of unauthorized acquisition, use or disposition of the company's assets.

Each issuer must include an internal control report of management in its annual report as well as an audit report on internal control by its independent auditor. n5 Further, the CEO and CFO must each acknowledge management's responsibility to establish and maintain adequate internal control over financial reporting. n6 Management's report must describe its conclusions about the effectiveness of the company's internal control over financial reporting based on its evaluation of those controls as of the end of the company's most recent fiscal year. n7 The report must also disclose any "material weakness" in internal control and cannot conclude that internal control is "effective" if there is any material weakness. n8

The Sarbanes-Oxley Act also requires periodic disclosure of conclusions of the issuer's principal executive officer and principal financial officer about the effectiveness of the issuer's disclosure controls and procedures based on their evaluation of these controls and procedures, as well as the occurrence of significant changes in the issuer's internal controls or in other factors that could significantly affect its controls. n9

[3] CEO/CFO Certifications and Corporate Responsibility

In addition to the certifications described above, CEOs and CFOs of public companies are required to certify that each periodic report containing financial statements filed with the Commission fully complies with the reporting requirements of the 1934 Act and that the report fairly presents the financial condition and results of operations of the company. n10

Loans by public companies to directors and executive officers are prohibited, subject to limited exceptions. n11

If a public company makes an accounting restatement due to misconduct, its CEO and CFO are required to reimburse the company for their bonuses and other incentive-based or equity-based compensation received from the company in the one-year period after the error, as well as any profits from sales of the company's securities during that period. n12

The Commission can prohibit any person who has violated the antifraud provisions contained in Section 10(b) of the 1934 Act or Section 17(a)(1) of the 1933 Act from acting as an officer or director of a public company, if the conduct of that person demonstrates "unfitness" to serve in those roles. n13

Directors and executive officers of an issuer are prohibited from trading equity securities of the issuer during pension plan blackout periods. n14

[4] Enhanced Disclosure

The SEC is required to review, at least once every three years, the annual reports and other periodic reports of public companies. n15

Directors, officers and persons owning 10% or more of any class of registered equity securities of a public company must report changes in their ownership of the company's equity securities, in each case before the end of the second business day after the occurrence of the change. n16

Issuers are prohibited from making public any financial measure that is not calculated in accordance with U.S. generally accepted accounting principles ("GAAP") and that contains an untrue statement of material fact or omits to state a

material fact necessary to make the information not misleading. If an issuer publicly discloses any material information that includes a non-GAAP financial measure, the issuer must also reconcile the differences between the non-GAAP financial measure and the comparable GAAP measure. n17

Issuers must disclose material correcting adjustments and off-balance sheet transactions. n18

The Sarbanes-Oxley Act effectively requires public companies to adopt codes of ethics for senior financial officers by mandating disclosure of whether or not the issuer has adopted a code of ethics covering these persons and, if not, explaining why not. n19

Issuers must make "real time" disclosure of material changes in financial condition or operations. n20

Each issuer must disclose whether its audit committee has at least one member who is a "financial expert" and, if not, an explanation of why it has no financial expert on its audit committee. n21

[5] Audit Committees and Auditor Independence

An issuer's independent auditor must communicate certain information to the issuer's Audit Committee before filing its audit report with the Commission, including a description of critical accounting policies and practices being used and alternative accounting treatments within GAAP relating to material items that have been discussed with management.

The Sarbanes-Oxley Act limited the scope of non-audit and consulting services that accounting firms can perform for their public company audit clients. n22 The audit committee of a public company must pre-approve all non-audit services performed by the company's auditors. n23

All audit committee members of companies with shares listed on a national securities exchange are required to be independent, and all authority regarding audit-related matters must be vested in the audit committee. n24 Further, companies must disclose in their annual reports whether or not the board has determined if the company has at least one "audit committee financial expert" serving on its audit committee and, if there is no such expert, why not. n25

The Sarbanes-Oxley Act prohibits any improper influence over the audit process, including bribery, providing the auditor a misleading legal analysis, threatening to cancel existing non-audit engagements, blackmail and physical threats and seeking removal of an audit partner who objects to the issuer's accounting. n26

[6] Listing Standards

The New York Stock Exchange and the Nasdaq Stock Market adopted numerous changes to the corporate governance listing standards that must be continuously satisfied by their respective listed companies, as required by the Sarbanes-Oxley Act. These included changes regarding director independence, the composition of and procedures followed by audit committees, compensation committees and nominating or governance committees, codes of conduct, meetings of independent directors and shareholder approval of equity compensation plans, among other topics. In general, the New York Stock Exchange listing standards are somewhat more demanding relative to corporate governance than the Nasdaq Stock Market standards.

[7] Public Company Accounting Oversight Board

The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board ("PCAOB") and subjects public accounting firms and accounting professionals to significant supervision by the PCAOB. n27 The PCAOB itself is subject to SEC supervision and functions as a self-regulating body. n28 The PCAOB has adopted auditing, quality control, ethics and independence standards for registered public accounting firms to use in performing audits of public

companies. n29 Additionally, the PCAOB conducts periodic inspections of registered public accounting firms and has the authority to conduct investigations and disciplinary proceedings. n30

The constitutionality of the PCAOB was considered by the Supreme Court in 2010. n31 The Court held that the Sarbanes-Oxley Act's "dual for-cause" limitation n32 violated the separation of powers because it prevented the President from removing PCAOB members and restricted the President's ability to oversee the decision to remove members. n33 Nevertheless, the Supreme Court also held that these limitations were severable from the remainder of the Sarbanes-Oxley Act. n34 After giving effect to the Court's severance of the unconstitutional provisions, the Commission has the right to remove members of the PCAOB at will. Accordingly, the Commission is accountable for the PCAOB's actions, and, in turn, the PCAOB is subject to Presidential control through the President's oversight of the Commission's actions. n35

[8] Enforcement and Criminal Sanctions

The Commission's enforcement authority was expanded through the adoption as law of Rule 102(e) of the Commission's Rules of Practice. n36

The Sarbanes-Oxley Act established new criminal offenses, including for securities fraud, tampering with and destruction of records and conspiracy, and increased criminal penalties under certain existing statutes. n37

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Smith, Enron Files for Chapter 11 Bankruptcy, Sues Dynergy*, Wall Street Journal, Dec. 3, 2001, at A3; *Emshwiller and Smith, Corporate Veil: Behind Enron's Fall, A Culture of Operating Outside Public's View*, Wall Street Journal, Dec. 5, 2001, at A1.

(n2)Footnote 2. Pub. L. No. 107-204, 116 Stat. 745.

(n3)Footnote 3. *See, e.g., Investor Self-Protection*, The Economist, November 30, 2002; Bourge, "Analysts Say New Accounting Act Inadequate", United Press International, October 31, 2002.

(n4)Footnote 4. Securities Act Release No. 33-8238, Exchange Act Release No. 34-47936, 2003 SEC LEXIS 1380 (June 5, 2003) ; Rules 13a-14(d) and 15d-14(d) of the 1934 Act, 17 C.F.R. §§ 240.13a14(d), .15d14(d).

(n5)Footnote 5. Item 9A of Form 10-K; Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

(n6)Footnote 6. *Id.*

(n7)Footnote 7. *Id.*

(n8)Footnote 8. *Id.*

(n9)Footnote 9. The concept of "disclosure controls and procedures" is broader than the concept of "internal control over financial reporting." Disclosure controls and procedures refers to controls and procedures designed to assure that information required to be disclosed by an issuer in the reports that it files under the 1934 Act is accumulated and communicated to the issuer's managers so as to facilitate timely decisions regarding disclosure of the information. See Section 302 of the Sarbanes-Oxley Act; Item 9A of Form 10-K; Item 4 of Form 10-Q; Item 307 of Regulation S-K, 17 C.F.R. § 229.307.

(n10)Footnote 10. *See* Section 906 of the Sarbanes-Oxley Act; 18 U.S.C. § 1350.

(n11)Footnote 11. Section 402 of the Sarbanes-Oxley Act provides, in part, that "It shall be unlawful for any issuer ... , directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of

credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer." *See* 15 U.S.C. § 78m(k).

(n12)Footnote 12. *See* Section 304 of the Sarbanes-Oxley Act.

(n13)Footnote 13. *See* Section 305 of the Sarbanes-Oxley Act; Section 21(d)(2) of the 1934 Act, 15 U.S.C. § 78n(d)(2); Section 20(e) of the 1933 Act, 15 U.S.C. § 771(e). Previously, the Commission had to seek an order from a court to ban an individual from service as a director or officer. Section 1105 of the Sarbanes-Oxley Act authorizes the Commission to issue such an order through an administrative proceeding without judicial involvement. *See* Section 21C of the 1934 Act, 15 U.S.C. § 78u-3(f).

(n14)Footnote 14. Section 306(a) of the Sarbanes-Oxley Act is a restriction of insider trading by any director or executive officer during a pension plan blackout period that prevents plan participants and beneficiaries from engaging in transactions involving issuer equity securities held in their plan accounts, if the director or executive officer acquires the equity security in connection with his or her service or employment as a director or executive officer. *See Exchange Act Release No. 34-47225, 68 Fed. Reg. 4337 (Jan. 22, 2003)* (adopting Regulation BTR, which clarifies the application and prevents the evasion of Section 306(a) of the Sarbanes-Oxley Act). *See* Regulation BTR, 17 C.F.R. §§ 245.100-104.

(n15)Footnote 15. *See* Section 408 of the Sarbanes-Oxley Act. In scheduling the order and timing of reviews, the Sarbanes-Oxley Act directs the Commission to consider specific criteria, including issuers with material financial statement restatements, significant stock price volatility and the largest market capitalizations and emerging companies with disparities in price to earnings ratios.

(n16)Footnote 16. Section 403 of the Sarbanes-Oxley Act amended Section 16(a) of the 1934 Act to provide that officers and directors of a company with equity securities registered pursuant to Section 12 of the 1934 Act and "beneficial owners" of 10% or more of any class of those equity securities (other than exempt securities) must file with the Commission (and any applicable exchange) a statement before the end of the second business day following the day on which the reportable transaction is executed, except for cases in which the Commission determines that this reporting deadline is not feasible. *Exchange Act Release No. 34-46421, 67 Fed. Reg. 56462 (August 21, 2002)* implemented the accelerated two-business-day filing deadline for Form 4 effected by Section 403 of the Sarbanes-Oxley Act and established a slightly later filing deadline for certain transactions for which the Commission determined that the statutory period is not feasible. *See also* Securities Act Release No. 33-8230, Exchange Act Release No. 34-47809, 2003 SEC LEXIS 1095 (May 7, 2003) (requiring the electronic filing, and website posting by issuers with corporate websites, of beneficial ownership reports filed by officers, directors and principal security holders under Section 16(a) of the 1934 Act).

(n17)Footnote 17. *See* Section 401(b) of the Sarbanes-Oxley Act (directing the Commission to issue rules requiring that any public disclosure or release of "pro forma financial information" by a public company be presented in a manner that (i) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the "pro forma financial information," in light of the circumstances under which it is presented, not misleading; and (ii) reconciles the "pro forma financial information" presented with the financial condition and results of operations of the company under GAAP). *See* Securities Act Release No. 33-8176, Exchange Act Release No. 34-47226, 2003 SEC LEXIS 193 (January 22, 2003) (adopting rules to address the disclosure of certain financial information that is calculated and presented on the basis of methodologies other than in accordance with GAAP, including the adoption of a new disclosure regulation, Regulation G, which will require public companies to disclose or release such non-GAAP financial measures to include a presentation of and a reconciliation to the most directly comparable GAAP financial measure); 17 C.F.R. § 244.100-102.

(n18)Footnote 18. Section 401(a) of the Sarbanes-Oxley Act requires each annual and quarterly report filed with the Commission to disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material

current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. *See* Securities Act Release No. 33-8182, *Exchange Act Release No. 34-47264*, 68 *Fed. Reg.* 5982 (January 28, 2003) (requiring a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" section in its disclosure documents). *See* Item 303 of Regulation S-K, 17 *C.F.R.* § 229.303(a)(4).

(n19)Footnote 19. Section 406 of the Sarbanes-Oxley Act required the Commission to issue rules requiring each issuer to disclose whether or not it has adopted a code of ethics for senior financial officers and, if not, the reason for not doing so. *See* Securities Act Release No. 33-8177, *Exchange Act Release No. 34-47235*, 68 *Fed. Reg.* 5100 (January 23, 2003) (adopting rules requiring disclosure in annual reports of whether the company has a code of ethics for its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and requiring speedy disclosure of any changes to, or waivers from, the code for the specified senior officers). *See* Item 406 of Regulation S-K, 17 *C.F.R.* § 229.406.

(n20)Footnote 20. *See* Section 409 of the Sarbanes-Oxley Act. *See also* Securities Act Release No. 33-8400, *Exchange Act Release No. 34-49424*, 69 *Fed. Reg.* 15594 (March 16, 2004) (adopting rules expanding the number of reportable items under Form 8-K in response to the "real time issuer mandate" in Section 409).

(n21)Footnote 21. *See* Securities Act Release No. 33-8177, *Exchange Act Release No. 34-47235*, 68 *Fed. Reg.* 5100 (January 23, 2003) (adopting rules requiring disclosure in annual reports with respect to financial experts); Item 407 of Regulation S-K, 17 *C.F.R.* § 229.407(d)(5).

(n22)Footnote 22. Section 201 of the Sarbanes-Oxley Act limits the scope of non-audit and consulting services that accounting firms can perform for their public audit clients. Prohibited services include, among others, bookkeeping, financial information systems design, appraisal, investment adviser services and legal services and expert services unrelated to the audit. *See generally* Securities Act Release No. 33-8183, *Exchange Act Release No. 34-47265*, 68 *Fed. Reg.* 6005 (January 28, 2003) (adopting rules pursuant to Title II of the Sarbanes-Oxley Act strengthening auditor independence and requiring additional disclosures to investors about the services provided to issuers by the independent accountant) and Section 10A(g)-(l) of the 1934 Act.

(n23)Footnote 23. Section 202 of the Sarbanes-Oxley Act also requires (apart from specified *de minimus* exceptions) the audit committee of a public company to pre-approve all audit and non-audit services performed by the company's auditors. *See* Sections 10A(h) and (i) of the 1934 Act.

(n24)Footnote 24. Section 301 of the Sarbanes-Oxley Act required the Commission to adopt rules having the effect of prohibiting any issuer from having its securities listed on any national securities exchange if that issuer is not in compliance with requirements set forth in the Sarbanes-Oxley Act relating to independent audit committees. One of these requirements is that audit committees must be comprised solely of independent board members. The Sarbanes-Oxley Act defines an "independent" director for this purpose as one who, except in his or her capacity as a member of the audit committee, another board committee or the board, (i) does not accept *any* consulting, advisory or other compensation from the issuer and (ii) is not an affiliated person of the issuer or its subsidiaries. *See* Securities Act Release No. 33-8220, *Exchange Act Release No. 34-47654*, 68 *Fed. Reg.* 18788 (April 9, 2003) (adopting Rule 10A-3 under the 1934 Act implementing requirements for standards relating to listed company audit committees).

(n25)Footnote 25. Securities Act Release No. 33-8177, *Exchange Act Release No. 34-47235*, 68 *Fed. Reg.* 5110 (January 23, 2003) (adopting rules requiring disclosure in annual reports with respect to financial experts). *See* Item 401 of Regulation S-K, 17 *C.F.R.* § 229.401.

(n26)Footnote 26. Section 303 of the Sarbanes-Oxley Act provides that it shall be unlawful for any director or officer of an issuer, or any other person acting under the direction thereof, in contravention of rules to be adopted by the

Commission, to take any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading. *See* Exchange Act Release No. 34-47890 (May 20, 2003) (adopting new Rules 13b2- 2 (b) and (c) under the 1934 Act relating to the improper influence on audits).

(n27)Footnote 27. Section 101 of the Sarbanes-Oxley Act established the PCAOB to oversee the audits of public companies that are subject to the federal securities laws. The PCAOB has five members, each selected by the Commission, only two of whom may be or have been certified public accountants. Members may not be employed in any other professional or business activity, nor receive a share of any profits from any public accounting firm (other than customary and fixed retirement payments). *See generally* Title I of the Sarbanes-Oxley Act. A company's auditor cannot prepare or issue or participate in the preparation of any audit report for the company unless it is registered as a "registered public accounting firm" by the PCAOB. *See* Section 102 of the Sarbanes-Oxley Act. The company's registered public accounting firm must provide the audit committee of the company with timely reports regarding critical policies, alternative treatments of financial information and any other material communications between the accounting firm and the company's management. *See* Section 204 of the Sarbanes-Oxley Act; 15 U.S.C. § 78j-l(k).

(n28)Footnote 28. *See* Section 107 of the Sarbanes-Oxley Act.

(n29)Footnote 29. *See* Section 103 of the Sarbanes-Oxley Act. In establishing rules for auditing and quality control, the PCAOB may adopt its own standards or use any portion of auditing standards or professionalism standards proposed by professional groups of accountants designated for such purpose by rule (such as the American Institute of Certified Public Accountants) or other advisory groups. The rules are subject to approval by the Commission (with a notice-and-comment process based on the rulemaking process for self-regulatory organizations), except for initial or transition rules that will be subject only to Commission approval.

(n30)Footnote 30. *See* Sections 104 (inspections of registered public accounting firms) and 105 (investigations and disciplinary proceedings) of the Sarbanes-Oxley Act.

(n31)Footnote 31. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, --- U.S. ---, 78 U.S.L.W. 4766, No. 08-861, slip op. at 5-7 (2010).

(n32)Footnote 32. Under the Sarbanes-Oxley Act, the members of the PCAOB could be removed by the Commission only for good cause. The Commissioners of the SEC be removed by the President only for good cause. *Id.* at 14-16.

(n33)Footnote 33. *Id.* at 11-27.

(n34)Footnote 34. *Id.* at 28-29.

(n35)Footnote 35. *Id.*

(n36)Footnote 36. *See* Section 602 of the Sarbanes-Oxley Act.

(n37)Footnote 37. *See, e.g.*, Sections 802 (alteration or destruction of records) (18 U.S.C. §§ 1519-20), 807 (securities fraud) (18 U.S.C. § 1348), 1102 (impeding an official proceeding) (18 U.S.C. § 1512), 1106 (increased criminal penalties) (15 U.S.C. § 78ff(a)) and 1107 (retaliation against whistleblowers) (18 U.S.C. § 1513) of the Sarbanes-Oxley Act.

* Patrick Daugherty, Yvette M. VanRiper and Peter C. Underwood. This chapter was revised and updated by Patrick Daugherty and Yvette M. VanRiper, partners at Foley & Lardner LLP, and Peter C. Underwood, Vice President, General Counsel and Secretary of Regal-Beloitt Corporation. The authors would like to thank Stephen J. Byrnes, Jr. and Megan A. Odronec, associates at Foley & Lardner LLP, and Morgan J. Tilleman, Nicholas J. Fox, Christina T. Jones

and Morgan J. West, summer associates at Foley & Lardner LLP, for their assistance.



24 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 1 Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission *

1-1 Federal Securities Act of 1933 § 1.06

§ 1.06 Recent Developments and The Future

[1] SEC Developments in Recent Years

Although the Commission is one of the world's most experienced regulatory agencies in matters relating to both the issuance and trading of securities in the world's primary financial markets, the Commission has faced major challenges in recent years in keeping up with the rapid expansion and globalization of the financial markets and changes, technological and otherwise, in the ways that securities are traded and information distributed.

The following is a brief description of some the changes the Commission has implemented under the 1933 Act in recent years in response to these challenges:

- In an effort to address the problem of selective disclosure of material nonpublic information, the Commission adopted Regulation FD, which requires the broad dissemination of information by public companies and thereby enhances the efficiency and fairness of the securities markets.
- The Commission has actively sought to reduce the accounting burden on foreign issuers that wish to offer and sell their securities in this country.
- The Commission, through its small business initiatives, has made it easier and less expensive for smaller, less well-known companies to raise capital in the public markets.
- The Commission, as part of its efforts to shorten the time period for the settlement of securities transaction (so as to minimize the systemic risks of severe market breaks), modified its rules regarding the form and content of prospectuses so that prospectuses can more easily be prepared and delivered to investors in the reduced time period.
- The Commission has also sought to keep up with technical innovations by first permitting, and then requiring, issuers to file registration statements and prospectuses with the Commission electronically (by means of the Commission's "EDGAR" system) and by making these same documents electronically available to the public. In addition, the Commission has issued guidelines with respect to the use of electronic media for information delivery under the federal securities laws and has proposed amending

its rules to permit issuers and underwriters to deliver prospectuses electronically.

[2] The Future

The Commission has come under substantial criticism in recent years for the perceived failure to detect massive Ponzi schemes perpetrated by Bernard L. Madoff and others. Additionally, detractors have criticized the Commission for taking a hands-off approach with respect to the financial services industry in recent years, asserting that reliance on industry self-regulation contributed to conditions that led to the 2008-2009 financial crisis. In response to this, the Commission implemented a number of initiatives and reforms, most of which impact the Commission's Division of Investment Management, Division of Trading and Markets, Division of Enforcement and Division of Risk, Strategy, and Financial Innovation. n1 In its draft "Strategic Plan for Fiscal Years 2010 through 2015" n2 the Commission does, however, identify several initiatives impacting the work of the Division of Corporation Finance in relation to the 1933 Act. Specifically, before 2015, the Commission plans to implement the following initiatives:

- Improve the quality and usefulness of disclosure by public companies, particularly disclosure regarding risk management, executive compensation decisions and practices, nomination of directors, board governance and discussion and analysis of results of operations and financial condition; n3
- Promote high-quality accounting standards by supporting efforts to improve financial reporting and support of a single set of global accounting standards; n4
- Continue to assess the effect of the Commission's rulemaking to gauge the effectiveness of the Commission's rules and determine whether better alternatives are available; n5
- Improve the processing of no action, interpretive and exemptive regulatory requests so that responses are completed in a timely manner; n6 and
- Evaluate the Commission's filing review programs to determine whether the Commission is identifying appropriate filings for review and to seek disclosure enhancements. n7

The challenge for the Commission in the future will be to endeavor to retain its reputation for high standards of agency excellence in the regulation of the domestic securities market while continuing to respond to pressures created by demands for ever-more-efficient global markets. Increasing internationalization, institutionalization and computerization of the markets must be addressed by the Commission, both timely and effectively, if it is to fulfill its historic mission as the investor's advocate. n8

FOOTNOTES:

(n1)Footnote 1. Additionally, in July 2010 the Commission announced the creation of three specialized offices within the Division of Corporation Finance to enhance its disclosure review and policy operations. The new offices are: a disclosure review office, expanding the Division's reviews of large financial services companies; an office focused on disclosure review and policy-making for asset-backed securities and similar structured finance products; and an office, to review new securities products and capital market trends and recommend changes to enhance investor protection in securities offerings.

(n2)Footnote 2. U.S. Sec. and Exch. Comm'n, *Strategic Plan for Fiscal Years 2010-2015 Draft for Comment*, www.Securitiesgov/about/secstratplan1015.htm.

(n3)Footnote 3. *Id.* at 23.

(n4)Footnote 4. *Id.* at 24-25.

(n5)Footnote 5. *Id. at 30-31.*

(n6)Footnote 6. *Id. at 32.*

(n7)Footnote 7. *Id. at 35.*

(n8)Footnote 8. The substantive work on this chapter was completed before enactment, on July 21, 2010, of the Dodd-Frank Wall Street Reform and Consumer Protection Act. That legislation was enacted in response to the stock market crash and severe recession that occurred in 2008 and 2009. It did not alter the composition or mission of the Commission and did not amend core provisions of the 1933 Act, but it did require the Commission to conduct numerous studies and adopt rules unrelated to the agency's traditional disclosure program. The ramifications of the Dodd-Frank statute have not yet been felt. Subsequent developments will be covered in the next edition of this book.

* Patrick Daugherty, Yvette M. VanRiper and Peter C. Underwood. This chapter was revised and updated by Patrick Daugherty and Yvette M. VanRiper, partners at Foley & Lardner LLP, and Peter C. Underwood, Vice President, General Counsel and Secretary of Regal-Beloitt Corporation. The authors would like to thank Stephen J. Byrnes, Jr. and Megan A. Odronic, associates at Foley & Lardner LLP, and Morgan J. Tilleman, Nicholas J. Fox, Christina T. Jones and Morgan J. West, summer associates at Foley & Lardner LLP, for their assistance.



25 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 2 Applicability of the Act: "Security" and "Sale"

1-2 Federal Securities Act of 1933 2.syn

AUTHOR: Robert N. Rapp This chapter was prepared by Robert N. Rapp (A.B., 1969, J.D., 1972, Case Western Reserve University; M.B.A., 1989, Cleveland State University), partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation*, Second Edition (LexisNexis Matthew Bender, 2003).

§ 2.syn Synopsis to Chapter 2: Applicability of the Act: "Security" and "Sale"

§ 2.01 The Meaning of "Security" -- Section 2(1)

[1] Notes and Other Evidences of Indebtedness

[a] Generally.

[b] *Reves v. Ernst & Young*: Family Resemblances.

[c] Factors for Evaluating Notes as Securities.

[i] Motivations Associated with the Transaction.

[ii] The Plan of Distribution.

[iii] Reasonable Expectations of the Investing Public.

[iv] Presence of Some Other Risk-reducing Factor.

[d] The Commercial Paper Exclusion and Demand Notes.

[e] Other Evidences of Indebtedness.

[i] Loan Participations.

[ii] Mortgage Pools.

[iii] Bank Checks and Deposit Relationships.

[iv] Guarantees.

[2] Stock

[a] Generally.

[b] Traditional Attributes, Economic Reality, and the Meaning of "Stock."

[3] Bonds

[4] Voting Trust and Collateral Trust Certificates; Other Commercial Trust Instruments

[5] Certificates of Deposit for Securities; Receipts for Securities

[6] Guarantees

[7] Warrants and Subscription Rights

[8] Preorganization Subscriptions

[9] Options, Derivatives and Synthetic Securities

[10] Fractional Undivided Interests in Oil, Gas, or Other Mineral Rights; Related Financing Schemes

[11] The Unconventional Forms: "Certificate of Interest In Any Profit-Sharing Agreement [or any] Investment Contract"

[a] Generally.

[b] The Elements of an Investment Contract.

[i] Investment of Money.

[ii] Common Enterprise.

[iii] Expectation of Profits From the Efforts of Others.

[c] Particular Applications

[i] Partnership and Joint Venture Interests.

[ii] Limited Liability Partnerships.

[iii] Limited Liability Company Membership Interests.

[iv] Club Memberships and Membership Organizations.

[v] Real Estate and Related Financing.

- [vi] Pooled Funds and Collective Investment Vehicles.
- [vii] Employee Benefit Plans.
 - [A] Corporate Plans.
 - [B] Keogh Plans.
 - [C] IRAs and Simplified Employee Pension Plans.
 - [D] 401(k) Plans.
 - [E] Miscellaneous Plans.
 - [F] Interests of Plans in Collective Investment Media.
 - [G] Workout and Reorganization Participations.
- [viii] Pyramid Sales Schemes, Multilevel Distributorships, and Franchises.
- [ix] Insurance and Annuities.
- [x] Insurance Premium Funding Plans.
- [xi] Viatical Settlements.
- [xii] Bank and Thrift Deposit Relationships.
- [xiii] Investment Programs in Personal Property.
- [xiv] Management "Services" Generally.
- [xv] Securities and Commodity Trading Accounts: "Horizontal" vs. "Vertical" Commonality.
- [12] The "Risk Capital" Alternative in Determining the Existence of a Security.
 - § 2.02 The Meaning of "Sale" -- Section 2(3)
 - [1] Gifts, Bonuses and Free Stock Distributions
 - [2] Stock Dividends and Related Distributions
 - [3] Reorganization Distributions
 - [4] Pledges
 - [5] Changes in Securities Provisions; Exchanges of Securities
 - [6] Warrants and Rights; Conversion Privileges

[7] Employee Benefit Plans and Related Distributions

[8] Spin-offs and the "Shell" Game: The Instant Public Market

[9] When a "Sale" Occurs

Robert N. Rapp n*

FOOTNOTES:

(n1)Footnote *.

This chapter was prepared by Robert N. Rapp (A.B., 1969, J.D., 1972, Case Western Reserve University; M.B.A., 1989, Cleveland State University), partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation, Second Edition* (LexisNexis Matthew Bender, 2003).



26 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 2 Applicability of the Act: "Security" and "Sale"

1-2 Federal Securities Act of 1933 § 2.01

AUTHOR: Robert N. Rapp This chapter was prepared by Robert N. Rapp (A.B., 1969, J.D., 1972, Case Western Reserve University; M.B.A., 1989, Cleveland State University), partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation*, Second Edition (LexisNexis Matthew Bender, 2003).

§ 2.01 The Meaning of "Security" -- Section 2(1)

The federal securities laws establish a scheme of special protections, the object of which is a security transaction. "Security" is a defined term in Section 2(1) of the Securities Act of 1933 ("Securities Act" or "1933 Act").ⁿ¹ The statutory definition was drafted in "sufficiently broad and general terms so as to include within it the many types of instruments that in our commercial world fall within the ordinary concept of a security,"ⁿ² but decades of practice and application in the courts have since taught that the concept is something more complex.

A "security" may be thought of as an easily recognizable thing. A share of stock, a bond, or a limited partnership interest is generally known to be a security. As seen above, Section 2(1) of the Securities Act prescribes a collection of instruments that is both specific and non-specific, in which all included items are presumed to possess characteristics that create a need for special protection in the circumstances of an "offer" or "sale," as defined by Section 2(3) of the Securities Act. It is in that set of circumstances that the object of securities law protection -- an investment decision -- arises.

Section 2(1) enumerates instruments that are by definition deemed to be securities "unless the context otherwise requires." The specific instruments included in the definition are presumed to have certain characteristics, which set securities apart from other species of property or interests in property, and create a need for special protection. Non-specific categories, such as "investment contracts," are included in order to extend the reach of the Securities Act to circumstances evidencing the characteristics of a security and the consequent need for protection, regardless of form. The elements of a security transaction defy precise definition. Whether the focal point is a conventional, recognizable form, or whether the inquiry concerns the undefined forms, such as an "investment contract," whether a security is present is a function of the characteristics of the instrument and the relationship between the parties to a transaction that it entails. A security is a bundle of characteristics that evidence *investment risk*.

The expansion of Securities Act coverage to novel and uncommon situations has come with recognition of circumstances evidencing the need for special securities law protections, without regard to the form of an instrument or, indeed, whether there is any "form" at all. Conversely, the presence of a form of instrument "literally" included within

1-2 Federal Securities Act of 1933 § 2.01

Section 2(1) does not automatically lead to "security" classification where the *context* in which it appears manifests other characteristics. Reviewing the evolution of the definition of a security in terms of the fundamental objectives of the regulatory scheme, the U.S. Supreme Court offered this cogent instruction on the meaning of the term "security:"

The fundamental purpose undergirding the Securities Acts is "to eliminate serious abuses in a largely unregulated securities market." In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits" and determined that the best way to achieve its goal of protecting investors was "to define" the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.' " Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of "security" sufficiently broad to encompass virtually any instrument that might be sold as an investment. n3

Although the term "security" generally evokes the notion of property, a security, in all its forms, is thus a species of property or an interest in an enterprise marked by characteristics that demonstrate the need for the special protections accorded by federal and state securities laws. n4 Congress' purpose in enacting the federal securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called. n5 The list of specific instruments and interests contained in Section 2(1) notwithstanding, the existence of a security is thus not a matter of particular form. Rather, it is a function of a set of characteristics and a relationship between parties, one of whom makes an investment decision. An "investment decision" implies a rational assessment of the risk associated with a choice of action, namely, the commitment of financial resources, relative to an expected return. Any "security," whatever its form or type, has the essential characteristic of risk that is a function of the loss of control over the value "invested." One who makes an investment decision, therefore, must be able to evaluate that risk. The federal securities laws are intended to provide, to the greatest extent possible, the informational means to do so. Indeed, the single most significant consequence of identifying the existence of a "security" is to trigger the information generation and dissemination mechanisms of the Securities Act through the registration and prospectus delivery requirements of § 5 of the Securities Act. The particular instruments and interests identified in Section 2(1) are there because, they are presumed to embody these characteristics -- relating to ownership, control, and, perhaps most importantly, relative access to information that is necessary to assess risk.

The latter characteristic -- the disadvantaged position of a purchaser in regard to necessary information -- has long been identified as a principal focus of Securities Act protection. As the U.S. Supreme Court observed in *Wilko v. Swan*:

While a buyer and seller of securities, under some circumstances, may deal at arm's length on equal terms, it is clear that the Securities Act was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by the Securities Act on a different basis from other purchasers. n6

Literally, every transaction involving one of the instruments or interests identified in Section 2(1) involves a security. Yet, as will be seen, the analysis does not end there. Indeed, in many instances Section 2(1) is but the starting point.

The inadvertent creation of a security and the failure to recognize one already existing in a set of circumstances are perhaps two of the most prominent occupational hazards of the business lawyer. From the simple organization and capitalization of a small business enterprise to a sophisticated financing transaction, the presence of a security and the complex regulatory and liability scheme it triggers dramatically affect all aspects of the undertaking. n7 Thus, the

practitioner must be alert to recognize the essential characteristics of not just those specifically enumerated instruments that are presumed to be securities, but, more importantly, the characteristics of a transaction or relationship that create one under one of the broader general headings.

To better understand the characteristics common to all securities, and as a prelude to consideration of each type of security within the ambit of Section 2(1) of the Securities Act, consider the following situation: A, B, and C pool their funds to purchase an apartment building. By mutual agreement, the three individuals delegate day-to-day management responsibilities to C, who will receive a somewhat larger share of net profits for her efforts. Otherwise they intend to share equally in profits and losses from operation of what each individual hopes will be a successful enterprise.

In this scenario, each of the participants has acquired an ownership interest in tangible property. It is not direct ownership, but rather an undivided, indirect interest to which the right to possess is curtailed and control is apportioned. Though something less than absolute, it is ownership nonetheless, and the dominant attribute of the relationship among the three participants is the ultimate control that each of them is presumed to possess. Despite the delegation of day-to-day management duties to one among them, the ultimate ability of each participant to exercise control over the enterprise is presumed. It is that empowerment or opportunity to exercise control that creates a relationship immediately recognizable as one of general partnership or joint venture.ⁿ⁸ Each of the participants in this situation is positioned so as to be able to directly affect the value of the property. Whether exercised or not, the opportunity for control: (a) defines the relationship between the participants in the enterprise; and (b) determines the relationship between the "owner" of the property and its value as an enterprise, or, more precisely, the nature of the risk faced by the participant.

Implicit in this relationship is the notion that each of the participants in the enterprise has the ability to protect herself through the power to control, even though two of them may be considered "passive" in operations. The essential point is this:

So long as the investor retains ultimate control, he has the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager. It is not enough, therefore, that partners in fact rely on others for the management of their investment; a partnership can be a [security] only when the partners are so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control.ⁿ⁹

A true general partnership or joint venture relationship can never involve a security because it is premised upon the ability of the participants to control the enterprise. Agreements negotiated one-on-one, creating enterprises in which "investors" are actively involved, have access to or are empowered to obtain information, and are able to protect their own interests, are not within the protective reach of the federal securities laws.ⁿ¹⁰ In the above example A, B, and C came together under this presumption. They may, of course, choose fundamentally to alter their relationship. A and B, for example, might agree to be specifically excluded from any right to or opportunity for the exercise of control whatsoever. To do so would not change their ownership but would obviously alter the nature and extent of risk to them in making their contribution. The introduction of constraints on control, and the concomitant change in the risk characteristics of the relationship between the parties and the ability of a participant to deal with them, can transform the relationship into one involving a security, even though the relationship is labeled as a "partnership" or "joint venture."ⁿ¹¹

The fundamental characteristic of a security is the presence of investment risk, created by the separation of ownership from value determinants. That is to say, a security is involved where the value of a thing purchased is, either presently or in the future, a function of something other than the thing itself and the realization of that value is beyond the meaningful control of the purchaser. In the earlier example, A, B, and C, as partners or joint venturers in the acquisition and operation of an apartment building, cannot demonstrate the presence of investment risk because the value of what they own, as an enterprise, is presumed to be within their shared control. The business risk of their enterprise is ever

present, but it is a risk each of them is presumed to know and, more importantly, presumed to have the power to manage. n12

If A, B, and C had instead elected to form a corporation to acquire and own the apartment building, and if each of them contributed equally to capital of the new entity by purchasing a third of its common stock, would the characteristics of their relationship and the nature of their control be different? Introducing "stock" to the scenario invokes a different presumption. Traditional corporate "stock" is presumed to be a security because the common perception of the relationship between stockholders and corporations involves separation of ownership and control. The presence of "stock" alters expectations about a relationship and, as a matter of law, creates no right of control beyond whatever appurtenant rights in corporate governance may be associated with owning the shares. And, of course, stock is "literally" a security under Section 2(1) of the Securities Act.

Among A, B, and C, it may well be that nothing has changed in their relationship regarding shared control of what is now a "corporate" enterprise rather than the partnership or joint venture relation described earlier. That their ownership interests are now evidenced by "stock" certificates may not alone make any one or all of them purchasers of securities simply by reason of the instrument now involved. Yet, the presence of actual corporate "stock" may in fact alter expectations of a participant in the venture concerning risk and the availability of securities law protections, and thus, as will be seen, the presumption of coverage applies solely by reason of the traditional attributes of the instrument involved. n13

Whether the focal point of a transaction is a conventional, recognizable instrument such as a share of stock, or a bond, or whether the focus is on the more esoteric, undefined, categories of securities in Section 2(1) of the Securities Act, the real issue is not the form of the instrument but its characteristics and the relationship between the parties that results. The Securities Act itself, by qualifying the entire list of things defined to be securities with the caveat that they are securities "[u]nless the context otherwise requires," n14 presumes that particular circumstances may shape the contours of the definition and its application. Context can operate to exclude certain types of instruments literally within the definition from coverage. Certain kinds of "notes" or "evidences of indebtedness," for example, have been recognized to fall outside the intended scope of the securities laws. n15 But in all cases the inclusion or exclusion of an instrument within the definition, or the creation of any other form of security in any set of circumstances, depends on the presence of three elements:

- (1) Present or future value being determined by something other than the thing itself;
- (2) A separation of ownership from value determinants; and
- (3) Disparate positions of a purchaser and seller with respect to information with which to evaluate risk.

Understanding the meaning of *value* is critical to isolating the characteristics of a security. There may be intrinsic value in a thing purchased. The price paid for an asset is first and foremost a reflection of the essential value of the thing. Even a share of common stock represents, at the very least, an identifiable interest in the liquidation value of the corporation, net of creditors, and other superior claims to the assets. However, few would suggest that such "value" defines the *investment* characteristics of stock. The real value of stock as an investment is the expected return to the purchaser that derives from a future income stream and capital gain from market value appreciation of the stock. These aspects of value are entirely a matter of enterprise risk when management of the company is separated from the control of the shareholder.

It may also be that an asset purchased has *no* value apart from an enterprise attached to it. In an early examination of the meaning of security, *SEC v. C.M. Joiner Leasing Corp.*, n16 the Supreme Court held that assignments in oil leases were securities where the assignments -- interests in real property -- only had value in the opportunity to share in

discovery values that might follow the drilling of a nearby test well. According to the Court, "the undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung." n17 But for the test well and the prospect of its success, the assignments were worthless. *Joiner* well illustrates that whatever the circumstances, the key to finding a security is whether there is a separate and unmanageable risk affecting the actual or *reasonably expected* value of the asset purchased. n18

It is also the nature of every security transaction that the purchaser must rely on the seller for information concerning the value of the security. In *Rubin v. United States* n19 the Supreme Court held that a pledge of securities to secure a loan is a sale of those securities for purposes of the antifraud provisions of the securities laws. The Court considered the "economic considerations and realities" of such a transaction as similar to those facing an investor when purchasing shares: "Both are relying on the value of the securities themselves, and both must be able to depend on the representations made by the transferor of the securities" n20 This is true investment risk. The transaction is such that some portion of the *present value* of the property received by the buyer is explained in terms of the *future successful operations* of an enterprise. Not only does the buyer have no meaningful control over that enterprise but the seller also possesses the information with which to evaluate the extent of the risk.

The enumerated instruments in Section 2(1) of the Securities Act, in "context," are presumed to entail these essential characteristics. In its assessments of particular categories of instruments included within the Section 2(1) definition considered in detail below, the Supreme Court has underscored the point that the enumerated instruments in Section 2(1) are there because they match, or tend to match, a standard view of value characteristics that are dependent upon separate value determinants. Not all "stock" may be a security, nor are all "notes," but the exclusion of such instruments from the definition will come only when the presumption arising from their express inclusion is rebutted by showing actual characteristics that are contrary to a standard view. Beyond them, the catchall categories -- "certificates of interest or participation in any profit sharing agreement [or] investment contract" -- expand the reach of the statute to situations in which the characteristics are present regardless of the form of instrument, if any, involved.

Evolution of the concept of "investment contract" from *SEC v. W.J. Howey Co.*, n21 in which the sale of tracts of land in orange groves coupled with essential management and exploitation services was held to be the sale of securities, has cemented the circumstantial focus of any inquiry concerning the presence of a security, in which it is today universally recognized that "form [is] disregarded for substance and emphasis [is] placed upon economic reality." n22 In 2004, the Supreme Court made clear in *SEC v. Edwards* n23 that the focus is on *investments* in whatever form they are made and by whatever name they are called. In *Edwards*, which involved a passive sale and leaseback program for pay telephones promising a low risk fixed rate of return, the Court dispelled any notion that an investment within the ambit of securities law protections can only involve "profit" of an uncertain or variable nature. The fact that investors have bargained for a fixed return, said the Court, does not make any difference when the investor is attracted by representations of investment income, whether fixed or variable. Nor does it change the fact that whatever return is promised is dependent on the efforts of others. n24

This element of investment contract analysis continues to be developed in "viatical settlement" cases. A viatical settlement is a transaction in which a terminally ill insured sells the benefits of his or her life insurance policy to a third party in return for a lump sum cash payment equal to a percentage of the policy's face value. The purchaser of the viatical settlement realizes a profit if, when the insured dies, the policy benefits paid are greater than the purchase price, adjusted for the time value. In these circumstances, the extent to which a return is dependent on the efforts of others, in order to find an investment contract, is an ongoing challenge for courts in the assessment of programs and activities undertaken by opportunistic entrepreneurs. Viatical settlements as investment contracts are specifically discussed elsewhere. n25 Their economic realities are such, however, that courts have shown a marked willingness to apply an expansive approach to the notion of investor dependence that is critical to finding an investment contract. n26

There are differing approaches to requisite commonality of interests in investment contract analysis. The *Howey* analysis of "common enterprise" is characterized as "horizontal" commonality. There is no uniformly accepted method

of determining whether a transaction satisfies the common enterprise requirement of *Howey*. Instead, the courts employ various interpretations, with most circuits embracing the "horizontal commonality" approach. Under that interpretation, courts find the common enterprise requirement satisfied where a movant shows the "pooling" of investor funds, through which the individual investors share all the risks and benefits of the business enterprise. The Eleventh Circuit, however, has articulated the "broad vertical commonality" approach. n27 Broad vertical commonality only requires a movant to show that 'the investors are dependent upon the expertise or efforts of the investment promoter for their returns. Arguably the focus on the efforts of a promoter in the broad vertical commonality approach deprives the term "common enterprise" of any significance. n28

A large part of "economic reality" is perception, which in turn generates legitimate expectations. Common "stock" is generally perceived to be a security, although state "close corporation" and "limited liability company" statutes, n29 and the agreements defining managerial powers and rights among stockholders or members that result from them, may severely undermine the validity of that perception and of "economic reality," if all that has occurred is the reconfiguration of a true general partnership or joint venture relationship into a corporate form of organization. The purchase of acreage in an orange grove, or perhaps the purchase of a resort condominium, is not generally perceived to involve a security, but, as *Howey* and its progeny have taught, "economic reality" changes perceptions and expectations.

In *United Housing Foundation, Inc. v. Forman*, n30 the Supreme Court squarely confronted purchaser "expectations" -- and at the same time the broader point of the intended scope of federal securities law protections -- in a decision holding that shares of "stock" in a state-subsidized housing cooperative were not securities. The "stock" in question represented the right to an apartment. It was not transferable and could not appreciate in value. There were no dividend rights associated with it and, as a general proposition, the shares had none of the traditional attributes of corporate stock. Thus, the Court declared: "Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock." n31

On the other hand, the Supreme Court has mandated the availability of securities law protections where the subject of a transaction is stock possessing the significant characteristics typically associated with corporate stock. In the companion cases of *Landreth Timber Co. v. Landreth* n32 and *Gould v. Rufenacht*, n33 the Court rejected the "Sale of Business" doctrine under which some lower courts had refused to recognize securities law antifraud claims by purchasers of all or substantially all of a corporation's outstanding stock. Courts applying that doctrine reasoned that notwithstanding the presence of traditional corporate stock, the instruments were merely indicia of ownership and should not be considered securities by reason of the control over the future course of the enterprise acquired by the purchaser. The idea was that someone who bought all of the stock in a closely-held corporation was as an economic matter buying the corporation's assets, so the transaction should not be governed by the securities laws. *Landreth* held, however, that one who wants the legal treatment of an asset acquisition must buy the assets rather than the stock; people may choose between transacting in securities and transacting in assets, and the law follows the form--not only because that is what the statute says, but also because trying to determine, one case at a time, when a transaction "really" has the economic attributes of a different form would lead to a great deal of uncertainty for little purpose. n34

In *Landreth* and *Gould*, the Supreme Court held that stock is a security *when its characteristics bear out the label*. n35 As discussed in greater detail later in this Chapter n36 such characteristics commonly include the right to receive dividends, transferability, and the potential for appreciation in value. n37

Purchaser expectations, and the role of the characteristics of an instrument in shaping those expectations, are thus plainly important factors in identifying a security. In *Forman*, purchasers of "stock" could not have reasonably believed that they purchased an investment security, and no promotional efforts fostered such a belief. n38 In *Landreth* and *Gould*, the characteristics of the corporate stock were not in doubt, and it was likely, said the Court, that an investor would believe that the securities laws would apply. Thus: "[t]he public perception of common stock as the paradigm of a security suggests that stock, *in whatever context it is sold*, should be treated as within the ambit of the Acts." n39

The Court subsequently amplified this view in *Reves v. Ernst & Young*,ⁿ⁴⁰ in which the question expressly left open in *Landreth* and *Gould* whether a similar *per se* rule could be applied to notes as securities. In *Reves*, the Court opined that such a rule would not be justified in the case of notes. The Court opted instead for the so-called "family resemblance" test, by which particular notes are compared to a recognized collection of instruments that are plainly *not* securities. The resemblance of the particular note in question to one within that collection, or the determination that the note in question should be added to the collection, controls whether it shall be deemed a security within the ambit of the federal securities laws.ⁿ⁴¹ For other situations, where investment expectations are induced through marketing or promotional efforts, the caveat in *Joiner* applies: "In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be."ⁿ⁴²

In sum, it can safely be said that the identification of a security is first the function of the attributes of the thing itself. Secondly, but only to the extent necessary, external considerations that produce investment characteristics will be considered. *Landreth* and *Gould* teach that courts will, indeed should, look beyond the characteristics of an instrument *when there is a need to do so* in order to determine whether securities law protections should apply. The enumeration of many types of instruments in Section 2(1) means that such instruments are securities unless the characteristics traditionally associated with them are inconclusive or where the label attached to an instrument, e.g., "stock," does not hold true. This message of *Landreth* and *Gould* is clear enough,ⁿ⁴³ but the reality of Section 2(1) is that among the enumerated instruments only "stock" can be described as having "traditional characteristics" against which any such assessment can be made. For the others, courts must look further.

In *Reves v. Ernst & Young*ⁿ⁴⁴ the Supreme Court provided further guidance in the process. *Reves* focused specifically on the question of "notes" as securities under Section 2(1) of the Securities Act -- a question perennially described as one of the most "vexatious" raised under the federal securities lawsⁿ⁴⁵-- but in doing so articulated criteria of general application in inquiries beyond the particular label of an instrument. The standards the Court established in the "notes" context further illuminate the fundamental characteristics of any security transaction. They are:

- (1) The motivations that prompt reasonable parties to enter into the transaction;
- (2) The "plan of distribution" involved;
- (3) The reasonable expectations of the investing public concerning the instrument involved; and
- (4) The presence of any other factor which significantly impacts the risk associated with the particular instrument.ⁿ⁴⁶

Each of these factors is helpful in identifying and understanding investment risk regardless of the form of instrument or relationship involved. They are benchmarks of a security transaction and were offered by the Supreme Court as a backdrop of what Congress intended to accomplish in the enactment of the securities laws. Taken together with all that has been said about purpose, context, and "characteristics," it can be said in summary that identifying *any* security requires a series of inquiries:

First, what is actually being acquired in the transaction? If the value of the thing purchased is significantly measured by the thing itself, i.e., its own worth, the likelihood of a security being found is lessened.

Second, what is the *post*-acquisition value of the thing, and what determines that value? If the motivation for the transaction is an expected return that is dependent upon factors not within the control of the purchaser, an investment is indicated.

Similarly, if one purchases a thing based upon an assessment of *post*-acquisition value, whether or not there will be control by the purchaser, investment risk is indicated where the information bearing upon the validity of the purchaser's expectations is within the control of the seller. This is to say that post-acquisition control is irrelevant to obtaining the knowledge *before the purchase* by which to evaluate the risk/return characteristics for the future.

Expectations concerning post-acquisition value in turn lead to the *third* essential inquiry: what are the relative positions of the purchaser and seller vis-a-vis the information necessary to assess risk/return? The securities laws operate on the premise that purchasers of securities are necessarily disadvantaged in knowledge of or access to information needed to make an investment decision. An "investor" must rely on the representations made by the seller. n47 Where the circumstances of a transaction are such that the disparity is not present, as in ordinary "commercial" or "mercantile" settings, for example, application of the securities laws is unwarranted. n48

Relative positions of a buyer and a seller vis-a-vis information are also a part of the *fourth* essential inquiry to be undertaken in the search for a security: what is the setting for the transaction? Do the surrounding circumstances paint a picture of meaningful disparity in the possession of or ability to access material information? It is this disparity that best distinguishes settings involving actual investment risk from the "commercial" or "mercantile" settings mentioned above.

The transactional setting is the canvas on which this picture is painted. Some transactional settings simply do not produce concerns for investment protections. Those notes, for example, which after *Reves* are recognized as being excluded from the definition of security, arise out of settings that are decidedly commercial or consumer oriented and in which no "investor" expectations are reasonable. n49 To be sure, some aspect of a transaction may ultimately alter its non-investment character as, for example, where a pledge of stock is made to secure a commercial loan. n50 In all cases, however, unless there are factors that evidence genuine investment risk and that legitimate securities law protections, no security will be found.

Collectively, these preliminary inquiries into the nature of the thing purchased, its value determinants, and the transactional setting are the predicates for a conclusion that an instrument or transaction embodies the characteristics of a security. It is an essential series of inquiries because the federal securities laws were intended to operate only when special protection over and above that otherwise available at law or in equity is needed. When Congress formulated Section 2(1) of the Securities Act, the traditional views of instruments such as stocks or bonds prevailed. The included instruments were generally perceived as possessing these characteristics. Today, however, the task is more difficult not only because the securities laws to reach are "[n]ovel, uncommon or irregular devices, whatever they appear to be," n51 but also because it has been shown that there are limits on the scope of intended protection.

Addressing the definition of security under both the Securities Act and the Securities Exchange Act of 1934 ("Exchange Act" or "1934 Act"), the Supreme Court has consistently focused attention on the intended role of the securities laws. In *United Housing Foundation, Inc. v. Forman*, n52 the Court isolated capital formation and the operation of capital markets as the prime congressional concerns and observed that the primary purpose of the securities laws was to eliminate abuses in a "largely unregulated securities market." In *International Brotherhood of Teamsters v. Daniel*, n53 the Court raised the important, and practical, point that other regulation aimed specifically at the need for protection in particular areas is the proper vehicle for that protection rather than unwarranted extensions of the securities laws. That point was underscored again in *Marine Bank v. Weaver*, n54 in which not only was other regulation a determining factor but other *protection* plainly eliminated investment risk and dispatched any perceived need for securities law coverage. And in *Reves v. Ernst & Young*, the message that congressional intent for the operation of the federal securities laws is a paramount consideration, and that interpretation of the definition of security must be consistent with the objective of the acts, could not be any clearer. n55

While Section 2(1) purports to identify what is deemed to be a security, the larger and more important question is why an instrument or transaction may, or should, be so characterized. What follows below is an examination of the enumerated instruments in Section 2(1) -- the "statutory" securities. Thereafter, thorough consideration of the catchall

categories is undertaken. In all of it, the common elements that make a security in whatever form or transaction are identified, thus facilitating practical assessments based on the true scope and intended protection of the securities laws.

[1] Notes and Other Evidences of Indebtedness

[a] Generally. The array of instruments defined to be securities in Section 2(1) is headed by "any note," with any "evidence of indebtedness" following shortly thereafter. It is clear on the face of the Securities Act, however, that all "notes" were not intended to be viewed alike for purposes of Securities Act coverage. Indeed, in creating exemptions from coverage of the Securities Act, Congress itself made distinctions between some kinds of notes, by exempting instruments generally referred to as prime commercial paper. Section 3(a)(3) exempts: "any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months" n56 Moreover, *Reves v. Ernst & Young* n57 clearly instructs that there are categories of notes which are to be excluded from the definition. Doing so recognizes that in certain circumstances concerns for "investor" protection are simply not present. Nevertheless, literal inclusion of the terms "note" or "evidence of indebtedness" in the statutory definition of security establishes a rebuttable presumption of coverage. That presumption is not rebutted in most instances except by looking beyond the instrument itself to the circumstances in which it is used.

Varying historical approaches to the question of notes as securities produced considerable uncertainty. Courts employing a "commercial/investment dichotomy" test looked for investment characteristics. Notes offered and sold to large numbers of people for investment or speculation were easily distinguished from those instruments involved in commercial financing of a business enterprise. Other courts grounded their conclusions in "risk capital" assessments, in which factors evidencing the nature and determinants of returns were prominent considerations. This approach was often used in conjunction with investment contract analysis. Still other courts adopted an approach based on the assumption that all notes are securities, but which assumption was rebutted upon a showing that the particular instrument bears a "strong family resemblance" to instruments used in commercial or consumer finance settings, which are presumed not to be securities.

In *Landreth Timber Co. v. Landreth*, n58 the Supreme Court addressed "traditional characteristics" of "stock" in assessing whether an instrument within the literal coverage of Section 2(1) should be deemed to be a security, but expressly left open the question whether notes or any other category of instrument listed in the definition of security might be shown "by proving [only] the document itself." n59 For all of the uncertainty and varying approaches to the question that had prevailed to that point, however, certain fundamental points flowing from the purpose of the federal securities laws had emerged. The Supreme Court itself identified the gist of intended securities law protection in *Marine Bank v. Weaver* n60 with the observation that "Congress was concerned with regulating the *investment market*, not with creating a general federal cause of action for fraud." And the lower courts, despite their varying approaches, had plainly identified a set of common factors that were critical elements in all assessments, regardless of terminology, and which remain at the heart of the issue. They are:

The purpose of a transaction. The process of capital formation and conduct relating to capital markets are of prime importance to the Securities Act. Where capital is being raised to establish and operate an enterprise in which the provider of that capital has no meaningful managerial control, an "investment" is plainly indicated regardless of the form of instrument that may be involved. n61 Where the purpose of a transaction, or the use of proceeds of a loan evidenced by a note, is to raise money for a business enterprise, and the lender ("purchaser") of the note is interested primarily in a return expected to be generated from the enterprise, the purpose or motivation for the transaction is decidedly investment-oriented.

The nature and determinants of risk. When the nature of an expected return in a negotiated loan transaction is a fixed or formula rate of interest, the payment of which is not dependent upon the entrepreneurial efforts of the borrower to generate profits, and the loan is secured, no "investment" risk is indicated. Credit risk is one thing; investment risk is

another. Moreover, in some credit relationships such as deposit relationships, risk reducing factors such as other regulation may be present. n62 Collateral may also be involved, playing an important risk reducing role by reducing dependence upon the borrower's success to secure the expected return. n63

Term. The notion of an "investment" implies a long term commitment and corresponding exposure to risk of an enterprise. A loan for working capital needs, a short term construction loan, or other similarly short term obligations indicates a commercial credit relationship, both in substance of the transaction and the expectations of the lender. n64 Thus, term may itself be a risk reducing factor that runs counter to an investment orientation.

The relationship to the borrower and the borrower's enterprise. Restrictions or covenants concerning a borrower's business operations and the ability to extract them as a condition of providing capital evidence diminished risk and a position of the lender vis-a-vis the borrower's enterprise that runs counter to the essence of a security transaction. Relative bargaining position and the ability to secure protection are important considerations in determining the need for securities law protections. n65

The transaction setting. Where notes are issued in circumstances involving a "public" solicitation to persons who are not engaged in the business of making loans, the setting is no different from that involving a traditional distribution of any security. The form of instrument involved is unrelated to the fundamental objectives of the Securities Act to assure the dissemination of adequate, accurate information in the distribution process. n66 There may be no better indicator of a security transaction than the offering of any form of instrument characterized as an investment to a broad segment of the public in circumstances that trigger all the concerns of inadequate information, a "selling" process, and the need for antifraud protection. Any "plan of distribution" now figures prominently in determining whether notes will be deemed securities. Public solicitation or "common trading" has invariably resulted in the creation of a security, and, where notes are involved, the Supreme Court has made no distinction. Indeed, in *Reves v. Ernst & Young*, the Court made "plan of distribution" a critical consideration:

As to the plan of distribution, the Co-Op offered the notes over an extended period to its 23,000 members, as well as to non-members, and more than 1,600 people held notes when the Co-Op filed for bankruptcy. To be sure, the notes were not traded on an exchange. They were, however, offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite "common trading" in an instrument. n67

The evolution of a practical, rather than literal, definition of "notes" as securities proceeded within a patchwork analysis of characteristics of particular instruments and a set of objectives that the federal securities laws were intended to accomplish. Yet, in the varying approaches and "tests," there emerged a unitary sense of intended protection. The task was to unify its application, and in *Reves v. Ernst & Young* the U.S. Supreme Court responded.

[b] *Reves v. Ernst & Young:* Family Resemblances. In *Reves*, the Supreme Court acted to resolve uncertainties surrounding the status of notes as securities. The Court eschewed the "commercial/investment," investment contract and various "economic reality" approaches that had been employed by lower courts, and, instead, adopted the "family resemblance" test articulated in *Exchange National Bank v. Touche Ross & Co.* n68 as setting the parameters by which all notes are to be evaluated. After *Reves*, it every note is presumed to be a security, but the presumption may be rebutted by showing that a particular note bears a strong resemblance to identified categories of notes recognized as not constituting securities, or is one that should be added to the list of such exceptions.

In *Reves* the holders of variable rate demand notes issued by an agricultural cooperative asserted claims under the antifraud provisions of the Exchange Act. The notes had been offered to large numbers of people, who were both members and nonmembers of the co-op, as an "investment program" to raise capital for general business operations. Purchasers took the notes expecting to profit from interest at a rate that was constantly revised to keep it slightly above that available at local bank and thrift institutions. Observing that from both sides a transaction involving these notes "is

most naturally conceived as an investment in a business enterprise rather than as a purely commercial or consumer transaction," n69 the Supreme Court found no resemblance between the notes and any category of notes previously identified as not constituting securities. Thus, claims under the Exchange Act antifraud provisions were allowed to stand.

Although under *Reves* any note is first presumed to be a security, there is nothing about the analysis that is based upon "literal" inclusion in the Section 2(1) definition. To the contrary, the Court made clear that "the phrase 'any note' should not be interpreted to mean literally 'any note', but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts." n70 This purpose, said the Court, was to regulate *investments*. Thus, *Reves* actually establishes a two-tiered approach in determining whether a particular note or debt instrument is a security. The first step involves assessment of "family resemblance;" comparison of the instrument to those specific categories comprising the list of non- securities. Assuming no direct family resemblance, however, does not end the inquiry. The second stage inquiry is whether the presumption that a note is a security is rebutted through an application of specific standards articulated by the Court. That is to say, any particular note or debt instrument may bear sufficient family resemblance in terms of factors applied. The Supreme Court framed the inquiry as follows:

[I]n determining whether an instrument denominated a "note" is a "security," courts are to apply the version of the "family resemblance" test that we have articulated here: a note is presumed to be a "security," and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of the enumerated categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors. n71

As to "family resemblance," the categories of notes identified in *Exchange National Bank*, as being excluded from the definition of a security include those involved in consumer financing, residential mortgages, open account relationships, and commercial loans. n72 However, the critical aspect of *Reves* is not what particular kind of note is or is not on the established "list" of non-securities. What matters instead is *why* a certain type of note either is or should be on it. Making the critical point that there is no list "graven in stone," the Supreme Court undertook in *Reves* to supply guidance for a meaningful inquiry concerning any particular instrument. According to the Court, it is impossible to evaluate family resemblance without specifying what it is about those instruments comprising the list that make them non-securities.

The object of the ensuing analysis in *Reves* was thus simple enough: "[S]ome standards must be developed for determining when an item should be added to the list." n73 In articulating those standards, however, the Court provided a capsule restatement of fundamental characteristics that, to one degree or another, have always been involved in determining the existence of a security. As presented in *Reves*, they are:

- (1) the motivations that prompt reasonable parties to enter into the transaction;
- (2) the "plan of distribution" involved;
- (3) the reasonable expectations of the investing public concerning the instrument; and
- (4) the presence of any other factor which significantly impacts the risk associated with the particular instrument. n74

These standards had in fact been a part of all of the Court's previous analyses of the definition of a security. The motivations, or purpose, for a transaction are the heart of *United Housing Foundation, Inc. v. Forman*. n75 The "plan of distribution" was critical in *SEC v. C.M. Joiner Leasing Corp.* n76 The reasonable expectations of the investing public were a major focus in *Landreth Timber Co. v. Landreth*. n77 A factor that significantly reduced the risk associated with

a particular instrument, namely, another regulatory scheme, rendered application of the securities laws unnecessary in *Marine Bank v. Weaver*. n78

Clearly, the "standards" articulated in *Reves* are not new or different from those that apply universally in determining the existence of a security. n79 Yet, the manner of their presentation in explaining why the specific notes that comprise the *Exchange National Bank* "list" are conclusively deemed not to be securities and to provide the means of assessing "family resemblance" of other notes is particularly instructive. Post-*Reves* decisions evidence a much sharper focus on, and more careful analysis of, the intended scope of securities law protections. Courts approach the question of notes as securities with a degree of confidence that is a function of common "standards." n80 Still, these standards are in most cases only the starting point.

It is essential to bear in mind that *Reves* did not resolve the question of whether any particular note or evidence of indebtedness is not a security except in those cases where the "family resemblance" to an excluded category is plainly apparent. These will not be difficult cases. The list of non-security notes adopted in *Reves* is fairly straightforward. In addition to notes evidencing loans by commercial banks for current operations, the list is comprised of the following:

[T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of a customer of a broker, it is collateralized). n81

The real challenge in the "family resemblance" test lies in its application to the myriad transactions and settings involving notes or other evidences of indebtedness that do not look at all like these basic commercial or consumer credit instruments. *Reves* and the "family resemblance" test only establish a specific collection of notes that are not securities. Every other instrument must be measured against the *Reves* standards either to confirm the presumption that it is a security or to justify its inclusion with those notes that are not. "Resemblance" to a particular type of note enumerated in the *Reves* and *Exchange National Bank* list will not be the crucial inquiry in most cases. Rather, courts will necessarily continue to examine what it is about any note in any setting that either compels or negates concern for securities law protections. Notes arising out of common commercial and consumer credit relationships may be easily dispatched, but, in the majority of note cases, the analysis must proceed as it always has, only now with the *Reves* four factors as the common frame of reference.

To declare that all notes are presumed securities unless shown by particular characteristics or a transactional setting defined by "standards" to be something else is only another way of saying that *context* controls. Where notes or "other evidences of indebtedness" are involved, there is really no other way. The same form of instrument can evoke diametrically opposed concerns for securities law protection depending upon the context of the transaction. The point is perhaps best illustrated by *Marine Bank v. Weaver*, n82 the Supreme Court's first consideration of the application of the federal securities laws to a form of debt instrument. In *Marine Bank*, the Court held that a certificate of deposit issued by a federally insured bank was not a security, and in doing so counseled: "Each transaction must be analyzed and evaluated on the basis of the content of the instrument in question, the purposes intended to be served, and the factual setting as a whole." n83 In *Marine Bank*, the narrow issue was whether a federally insured certificate of deposit was a security -- the functional equivalent of "withdrawable capital shares" of a savings and loan association held to be securities in *Tcherepnin v. Knight*. n84 The Court held that such a certificate was not a security by reason of the "abundant" protection accorded to holders under the federal *banking* laws. The larger sense of the case is the Court's emphasis on weighing the facts of a particular set of circumstances to identify characteristics which bring a particular instrument within "the ordinary concept of a security." Clearly setting the stage for the ultimate identification of factors in *Reves*, the Court declared in *Marine Bank*: "We have repeatedly held that the test is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." n85 This approach has been aptly characterized as a "functional" one. n86

The four factors articulated by the Court in *Reves* for ultimately evaluating "family resemblance" to notes which are deemed not to be securities, and for determining whether a particular note should be added to that category, represent the same transactional criteria. Thus, in *Holloway v. Peat, Marwick, Mitchell & Co.*,ⁿ⁸⁷ state regulated, uninsured savings certificates issued by the finance and trust subsidiaries of a bank holding company were held to be securities on an application of the *Reves* criteria and, in particular, the absence of a cognizable risk-reducing "other regulation" factor that was so important in *Marine Bank*.ⁿ⁸⁸

Holloway illustrates that there will be relatively few debt instruments conclusively excluded from the definition of security by reason of "family resemblance." Rather, the *Reves* standards supply guidance for what must continue to be a largely case-by-case analysis of the attributes of a particular instrument in a given set of circumstances. Thus, closer attention to each of the *Reves* factors is essential to resolving the critical question posed by the Court concerning what it is about any instrument that removes it from the definition of a security.

[c] Factors for Evaluating Notes as Securities.

The four factors articulated in *Reves*, which set the standard for determining when a note should be added to the list of those notes deemed not to be securities and rebut the presumption embodied in Section 2(1) of the Securities Act, merit close consideration.

[i] Motivations Associated with the Transaction. In *Reves*, the Supreme Court identified the motivation for a transaction -- what would prompt a reasonable buyer and seller to enter into it -- as the first factor in deciding whether the transaction involves a security. If the purpose is to raise money for the general use of a business enterprise, or to finance an investment, and the buyer is interested primarily in a profitⁿ⁸⁹ the note is expected to generate, the instrument is more likely to be a security. On the other hand, if a note is used in connection with a minor asset transaction to address cash-flow difficulties or some other commercial or consumer purpose, a security is much less likely to be involved.ⁿ⁹⁰ The line between commercial and investment uses or purposes may not always be sharp. One court approached the distinction in terms of funding an enterprise generally versus funding a discrete component or department of the enterprise.ⁿ⁹¹

Historically, courts labored to make the same distinction that is now identified as the first factor in *Reves*. Commercial financing transactions are negotiated face-to-face, with the lender presumed to be able to obtain all desired information and to be able to fend for itself in obtaining satisfactory security and other protections against the credit risk involved. The motivation of a "lender" has always been seen differently from that of an "investor." In *Reves*, the Court spoke of motivation in terms of what is most naturally conceived by both sides of the transaction, and it is plain that the perceptions of a senior lender in a corporate acquisition are different from those of the purchasers of agricultural co-op notes. The Court described the perceptions of the parties this way:

The Co-Op sold the notes in an effort to raise capital for its general business operations, and purchasers bought them in order to earn a profit in the form of interest. Indeed, one of the primary inducements offered purchasers was an interest rate constantly revised to keep it slightly above the rate paid by local banks and savings and loans. From both sides, then, the transaction is most naturally conceived as an investment in a business enterprise rather than as purely a commercial or consumer transaction.ⁿ⁹²

"Motivation" under *Reves* practically translates into the putative seller's *purpose*. With any anchor in purpose, however, there is little objective guidance. Indeed, the *Reves* distinction between raising money "for the general use of a business enterprise or to finance substantial capital investment" versus raising money "to correct for the seller's cash flow difficulties or to advance some other commercial or consumer purpose" has been described as somewhat tautological.ⁿ⁹³ From the buyer's perspective, a transaction clearly intended to address the seller's cash flow difficulties may

manifest the same economic characteristics as one aimed at providing funds for general business use. There may be situations in which a "purpose" distinction is easily made, n94 but plainly this *Reves* factor reincarnates a version of the commercial/investment dichotomy as the first consideration in identifying the presence of a security once it is determined that a particular note or evidence of indebtedness fails a family resemblance match.

[ii] The Plan of Distribution. Since the decision in *SEC v. C.M. Joiner Leasing Corp.* n95 the manner in which an instrument finds its way to the holder has been a most significant consideration in identifying the presence of a security. As the second factor established in *Reves*, it is in fact the one among all four that could be independently dispositive. There is no more recognizable basis for concern in providing securities law protections than the circumstances attendant to a "public offering" or systematic solicitation of potential investors.

In *Reves*, the Supreme Court spoke of "plan of distribution" in terms of examining whether the instrument in question is one in which there is "common trading for speculation or investment" n96 However, as shown by the Court's own analysis, "trading" is not the critical point. Rather, as noted earlier, n97 it is the manner and scope of the offer and sale of an instrument.

With this second factor, the Court necessarily sought to differentiate transactional settings. A large number of notes or payees involved in solicited transactions evidence an economic context vastly different from the process involved in the negotiation of a conventional mortgage loan. n98 Confronting hundreds, or in the case of *Reves* thousands, of individuals with the decision to purchase a note or other evidence of indebtedness is as much the quintessential security transaction as the public offering of stock by a corporate issuer. The attributes of the transaction -- its economic context -- are indistinguishable. n99

Family resemblance to notes that are excluded from the definition of security after *Reves* will likely be determined under this factor by characteristics that indicate a "unique agreement, negotiated one-on-one" or a "private transaction" rather than "offers to a number of potential investors." n100 While it is clear that a truly private transaction may still be accorded securities law protection, n101 a plan of *distribution* of notes or other evidences of indebtedness that, perforce, involves significant numbers of offerees or purchasers or circumstances that evidence no genuine ability of the purchaser to interact with the borrower in the manner of a true debtor/creditor relationship will not likely be seen as akin to any *Reves* excluded note. In the main, the focus will be on whether the subject transactions involve broad-based, unrestricted sales to the general investing public. n102

[iii] Reasonable Expectations of the Investing Public. In *Reves*, the Supreme Court declared that it would consider instruments to be securities on the basis of public expectations "even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction." n103 The rejection of "economic reality" as the test for defining a note as a security is a major aspect of *Reves*. While such analysis may be necessary to set parameters for identifying the presence of an "investment contract" form of security, it is inapplicable where a specific instrument is enumerated in Section 2(1). Notes may not be investment contracts, said the Court, but that does not mean they are not securities.

Public expectations concerning the particular instrument, however, can operate either to exclude or confirm its status as a security. In *Reves*, the Court emphasized that the fundamental essence of a security is its character as an "investment." The notes involved there had been *advertised* as such, and the Court found no countervailing factors that would have led a reasonable person to question the characterization. n104 Advertising or holding out an instrument to the public as an investment implies an intent that the instrument be perceived as such. It is well to remember that long ago the Court declared: "In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be." n105

Much as with the "plan of distribution" factor of *Reves*, public expectations will easily be discerned in circumstances involving a large-scale solicitation focused on investment character of an instrument. n106 Beyond those situations,

however, the inquiry depends upon the largely subjective perspectives of buyers and sellers. In *Singer v. Livoti*, n107 for example, the court could only observe that "[s]urely there was no public expectation that a short term note of this sort would be traded or speculated in as a security" But in *Pollack v. Laidlaw Holdings, Inc.*, n108 the court had no trouble concluding that notes representing participations in home mortgages purchased by unsophisticated, passive investors, who had instructed that conservative investments be made on their behalf, produced reasonable expectations that securities laws would apply despite such factors as fixed interest rates and personal guarantees. n109 In the same manner *conversion* features, by which the unpaid balance on a promissory note may be converted into common stock has been viewed as a strong factor for holding the note to be a security. n110

In the end, apart from what will be asserted as purchaser expectations, *reasonable* expectations of the public will be a function of an identifiable need for special securities law protections. The presence or absence of a security in any transaction involving a note or other evidence of indebtedness is not a matter of subjective perception but, rather, a set of circumstances that demonstrates those concerns addressed by the securities laws. n111 This *Reves* factor necessarily translates into an examination of the aspects of any note transaction that make it deserving of securities law protections. "Reasonable expectations" can be objectively evaluated in terms of the specific concerns of the securities laws applied to any given fact setting.

[iv] Presence of Some Other Risk-reducing Factor. The fourth and final factor established in *Reves* is whether there is a risk-reducing factor suggesting that the instrument in question is not a security. In *Reves*, the notes were uncollateralized and uninsured. The Court drew a distinction between them and FDIC insured certificates of deposit, which were involved in *Marine Bank v. Weaver*, or the ERISA regulated pension plans that were the subject of *International Brotherhood of Teamsters v. Daniel*. n112 In both of those cases, the presence of a comprehensive regulatory scheme was seen as eliminating the need for securities law protections. On the other hand, in *Reves*, without application of the federal securities laws the Court observed that the notes involved would escape federal regulation entirely.

Another regulatory scheme is surely not determinative on the question of notes or other evidences of indebtedness as securities. FDIC insured certificates of deposit do not appear among the excluded categories of instruments adopted in *Reves* against which family resemblance is measured, and the Supreme Court did not suggest that such instruments should be added to the list. Thus, for example, in *Holloway v. Peat, Marwick, Mitchell & Co.*, n113 the court post-*Reves* reaffirmed its holding that thrift certificates and passbook savings certificates issued by the finance and trust subsidiaries of a bank holding company were securities. The court found no resemblance between such instruments and anything on the excluded list in *Reves*. In its second stage analysis, i.e., whether the instruments should be added to the list via application of the four factors, the court found nothing to alter its earlier conclusion on any applicable factor, including the existence of "other" regulation. In *Holloway*, the instruments were subject only to state regulation. The court limited application of the *Reves* risk-reducing factor to other *federal* regulation. n114

The proper inquiry is whether there is *any* risk-reducing factor that alters to some significant degree the characteristics of an instrument, whether a note or any other evidence of indebtedness, such that securities law protections are not needed. n115 As in the past, collateral will continue to play a role in the post-*Reves* environment. n116 Adequate collateralization not only operates to diminish a lender's dependence upon the success of the borrower to secure its return but is also evidence of such broader points as the lender's bargaining position, access to information concerning the transaction, and, in general, its ability to secure protection. n117 Other protections against a lender's risk, such as forms of guarantees, are also possible. The array of available risk-reducing mechanisms or factors in debtor/creditor relationships is considerable.

It is well to remember that in applying this *Reves* factor, other regulation is but one avenue to displacement of the federal securities laws where notes and other evidences of indebtedness are involved. None of the instruments comprising the list of non-securities embraced in *Reves* is subject to any comprehensive scheme of other regulation. Yet, the Court instructs that they are on the list because of fundamental characteristics that include risk-reducing factors.

[d] The Commercial Paper Exclusion and Demand Notes. In *Reves*, the Supreme Court was unanimous in holding that the definition of notes as securities should be controlled by the "family resemblance" test. However, the Court was sharply divided over the operation of the statutory exclusion from the definition of security for any "note ... which has a maturity at the time of issuance of not exceeding nine months." This aspect of *Reves* involves Section 3(a)(10) of the Exchange Act, which incorporates the exclusion directly into the definition of a security for purposes of that act. Securities Act § 2(1) does not incorporate an exclusion within its definition but, rather, creates a category of "Exempted Securities" under § 3(a)(3) of the Securities Act as follows:

Any note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

This exclusion is thought primarily to cover short term commercial paper -- notes, drafts, bills of exchange, and bankers' acceptances that are eligible for discount at a Federal Reserve Bank. n118 In *Reves*, however, the particular notes at issue were *demand* notes, and that feature triggered the prospect of statutory exclusion by reason of the fact that demand for payment could be made within nine months.

A bare majority of the *Reves* Court interpreted the statutory exclusion as not covering the Co-Op notes because demand notes do not *necessarily* have short terms and exclusion of these notes would be inconsistent with the broadly protective purpose of the federal securities laws. However, the majority opinion on this issue clearly left open the possibility of a different conclusion where the design of a transaction is such that both parties contemplate demand being made within the statutory period. n119

While the further contours of the statutory exclusion for "demand" notes will be developed case-by-case, it is clear that the exclusions from the definition of security in both the Securities Act and the Exchange Act will operate where "commercial paper" is involved. Indeed, concurring in the majority opinion in *Reves*, Justice Stevens characterized this conclusion as so well established that "[a] departure from this reliable consensus would upset the justified expectations of both the legal and investment communities." n120

In *Tanner v. State Corporation Commission*, n121 the Virginia Supreme Court most recently underscored that the nine month commercial paper exclusion found in that state's securities law, which mirrors the federal exclusions, is not controlled simply by a less than nine month maturity. Rather, the essential inquiry is whether true "commercial paper" is involved in the transaction. The nine month notes in *Tanner* were not prime quality negotiable paper, and were sold to the general public. The instruments thus did not qualify for the exclusion despite their less than nine month maturities.

Beyond the consensus associated with commercial paper, the status of demand notes generally as securities after *Reves* is entirely a matter of context. The note may qualify for exclusion if it can clearly be shown that the parties' expectations and intentions for the instrument are that demand will be made within the statutory period *and that excluding it is consistent with the protective purposes of the federal securities laws*. It is highly unlikely (indeed after *Reves* it would be ill-advised) that a court would exclude a short-term note used in what is plainly an "investment" setting simply because the parties have designed the transaction to require payment, or demand for it, to occur within nine months. The "commercial paper" exclusion involves implicit assumptions concerning the nature of the instruments, the parties involved, and the context. The door to its extension for some demand notes may have been opened in *Reves*, but passage remains closely guarded.

[e] Other Evidences of Indebtedness.

The presumption after *Reves* that all "notes" are securities may logically be extended to any evidence of indebtedness that arises out of a debtor/creditor relationship. n122 The "family resemblance" test, and second-stage analysis under the

Reves four factors, are triggered by the circumstances of a transaction rather than the label affixed to the particular form of debt instrument involved. n123

[i] Loan Participations. In some cases, it will be necessary to determine whether a particular instrument or set of circumstances involves a note or other evidence of indebtedness in order to be evaluated under the *Reves* factors at all. Such a determination is often required with respect to "participations" of various forms related to or involved in debt financing. Loan participations in which a lead lender, in order to spread credit risk, arranges for a group of financial institutions to fund portions of a loan or line of credit to a borrower (often by means of a "master participation agreement" or like instrument) have generally been held not to constitute securities. To be sure, a "note" of the borrower underlies the financing, but institutions participating in the credit occupy a position no different from that of any commercial lender for purposes of ascertaining "family resemblances" under *Reves*. Their interest is tied directly to the direct relationship with the borrower, and the "participation" agreement or relationship establishes no separate identity from the underlying instrument. n124

Other kinds of "participation" interests may, however, be deemed to be securities. For example, although an underlying financing or credit relationship may not involve a security, a participation in it may. n125 This is in keeping with the caveat expressed by the Supreme Court in *Marine Bank v. Weaver*, that "[e]ach transaction must be analyzed and evaluated on the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole." n126 The key, post-*Reves*, is to demonstrate circumstances and expectations that set the transaction apart from an ordinary commercial credit relationship, and present a risk that is different from usual business or credit risk. n127 Purchasing an undivided interest in a pool of loans, rather than participating in a specific, identifiable loan, may have all the essential characteristics of a security transaction. n128 Application of *Reves* factors resulted in a "certificate of participation," which represented the right to receive payments of principal and interest under an instrument involved in financing the construction and operation of a county government facility being deemed a security in which the instrument had "all the earmarks of a note as that term is commonly understood." n129 In *Putnam Diversified Premium Income Trust*, n130 the SEC examined the question of loan participations as securities for purposes of portfolio investment limitations imposed on closed-end management investment companies under the Investment Company Act of 1940. Expressing the view that loan participations should be considered securities in that context, the Staff supplied insight into the true sense of the inquiry:

[W]hile it would be difficult to generalize as to their characteristics, the loan participations in which the Fund proposes to invest will possess risk attributes which strongly suggest securities treatment. These include the risk of insolvency of the underlying debtor and/or issuing bank, and the risk that the debtor will prepay principal if interest rates fall, which would require the Fund to reinvest these prepayments at potentially lower yields. Additionally, the Fund will purchase loan participations solely for investment purposes. Except for its investigation of the creditworthiness of the corporate borrower, the Fund will have no involvement in the commercial transactions underlying the original loans. The Fund's transactions in loan participations, viewed as a whole, will be handled no differently from transactions involving other U.S. Government, domestic high yield and international debt instruments. n131

As a matter of "earmarks" or any other description or characterization of a note or evidence of indebtedness and "participations" involving them after *Reves*, the ultimate determination of family resemblance to a non-security classification necessarily entails such an inquiry as this. What the instrument or interest represents in the hands of the particular buyer, in the context of the transaction and the buyer's business, and the logical view of the circumstances as a whole, will bear heavily on the outcome.

[ii] Mortgage Pools. As with loan "participations" generally, an interest or participation in a pool of real estate mortgages may involve a security, despite the fact that an individual underlying mortgage loan falls squarely within a non-security classification of notes under *Reves*. The main considerations have been articulated thusly:

[A] note secured by a mortgage on a single home is typically not a security because the return on

investment therefrom is not derived from the entrepreneurial or managerial efforts of others ... However, participation interests in a managed pool of mortgage notes are securities Such interest in amalgamated mortgage notes are securities because any profits realized are derived from the managerial efforts of those who run the pool and make such decisions as determining which mortgages shall be in the pool, and how the individual notes will be serviced and managed, and other fund decisions. Thus, a commercial mortgage-maker ... may sell two different kinds of investment products to the public: 1) individual notes, which are not securities; and 2) interests in a managed pool, which are securities. n132

In making this determination, courts apply "investment contract" analysis, which emphasizes economic reality and the expectations of people regarding success of the investment being dependent on the efforts of others. "Securitization" programs involving the packaging and distribution of interests in a managed pool of mortgages may easily present investment contract elements. n133 On the other hand, the purchase of specific mortgages, on specific properties, involves different expectations and, presumably, an entirely different set of characteristics that determine family resemblance under *Reves*. n134

[iii] Bank Checks and Deposit Relationships. Bank checks, which would normally be regarded as cash substitutes, may become evidences of indebtedness. n135 However, checks were held not to be securities where post-dated instruments were used in the context of a loan obtained to correct cash flow problems. The post-dated checks represented payment of principal and interest on the loan, and the substance of the transaction was seen as falling within the *Reves* family of excluded instruments. n136 In a similar vein, a bona fide personal loan has been held not to involve a security. n137

Deposit relationships present specialized evidences of indebtedness. On the one hand, bank or savings and loan institution certificates of deposit, passbook savings accounts and the like do not evoke notions of "investments" and associated risk in an "other" regulation environment. n138 The instruments associated with such relationships would, in the main, qualify for exemption from the Securities Act in any event. n139 Moreover, under *Reves*, despite the fact that an evidence of indebtedness is plainly involved, the four factors required to establish a category of family resemblance -- particularly motivation and "other regulation" -- would normally operate to prevent these instruments from being securities. Other regulation protecting holders of bank-issued instruments was the key to the holding in *Marine Bank v. Weaver* that a certificate of deposit issued by a federally regulated, FDIC insured bank was not a security. The reasoning has been extended to certificates of deposit issued by a federal and state regulated credit union, with the observation that to apply federal securities laws would unnecessarily "double-coat" the transactions. n140 A certificate of deposit that does not involve a shifting of risk to the holder will not be deemed to be a security. n141

Nevertheless, in *Holloway v. Peat, Marwick, Mitchell & Co.*, n142 the court applied *Reves* to hold that "thrift certificates" and passbook savings certificates issued by the finance and trust subsidiaries of a bank holding company were securities. The court saw no family resemblance to a classification excluded under *Reves* and found no basis for creating another excluded category where there was no other federal regulation involved and the instruments were issued to a broad class of persons as a vehicle for raising capital. n143

There is also little doubt that investment schemes involving bank accounts will not avoid being considered securities simply because bank instruments are present. In *SEC v. Deyon*, n144 a program touting 85% monthly returns from deposits made into a Mexican bank account was held to be a security applying "investment contract" analysis. The bank account was represented to potential investors as being safe because, among other things, the bank was supported by the Mexican government. The court, however, found the factual scenario to be "bizarre and incredulous." Although there was no question in the case that individuals did make deposits into the Mexican bank account, the court found that the depositors faced the risk that interest the bank offered could fall significantly, and imperil any return. The depositors were characterized as participants with the promoters of the bank account for the expected return, and that there was a pro rata sharing of profits, thus establishing either vertical or horizontal commonality for purposes of finding an investment contract. Moreover any claim of legitimacy of the bank account was vitiated by fraud in the promotion of

the scheme. The case simply illustrates that circumstances evidencing the need for protection of the federal securities laws may outweigh more parochial notions whether bank instruments and deposit relationships fall within the definition of security.

Outside the bank account setting, an instrument relating to the "deposit" of an asset acquired for investment has been held not to be a security where the bank acts only as a depository and the investment is with the offering corporation. n145

[iv] Guarantees. A *guarantee* of a debt represented by a note may be a separate security in its own right, n146 but may also be merged with the associated obligation for consideration under *Reves* as a promissory note. n147 The scope of the terms "note" and "evidence of indebtedness" in Section 2(1) plainly is not to be bounded by any precise criteria. The second-stage analysis under *Reves* is capable of broad application to the full range of instruments and transactions where the fundamental issue is the need for securities law protection in any debtor/creditor relationship.

[2] Stock

[a] Generally. Surely there is no more common perception of a security than "stock." Indeed, it has been characterized as the "paradigm of a security." n148 Yet, in *United Housing Foundation, Inc. v. Forman*, n149 the U.S. Supreme Court instructed that there is more to a security than the label affixed. Section 2(1) may reference "any stock," but unlike notes in the post-*Reves* environment, there is no clearly stated presumption that "stock" is a security. Indeed where stock is involved, the Supreme Court, in *Forman* and *Landreth Timber Co. v. Landreth*, n150 has instructed that the "stock" label assigned to an instrument is determinative only when it is matched by characteristics generally associated with actual corporate stock. Though outwardly akin to a "family resemblance" test, the approach to stock is much more direct. There is little room for application of context or transactional factors that now dominate post-*Reves* analyses of notes as securities. n151

In *Forman*, the Supreme Court held that shares of "stock" in a state-sponsored cooperative housing project were not securities. The Court emphasized the characteristics of the instrument as the controlling consideration under Section 2(1). Under *Forman*, "stock" possessing traditional characteristics--a "standardized" instrument in commerce -- is a security under Section 2(1). The Court identified the characteristics generally associated with such an instrument as these:

- (1) the right to receive dividends when profits are apportioned, the "most common feature;"
- (2) negotiability;
- (3) the capacity for pledge or hypothecation;
- (4) voting rights proportionate to the number of shares owned; and
- (5) the potential to appreciate in value. n152

These characteristics indicate attributes of an instrument that is recognizable as "stock" and that would "lead a purchaser justifiably to assume that the federal securities laws apply." n153

The "stock" involved in *Forman* possessed none of these characteristics and represented only the right to a residential apartment. No purchaser could rationally look upon the "stock" as presenting an investment decision, and the economic realities were such that no other conclusion could obtain. As the Supreme Court characterized the situation:

There is no doubt that purchasers in this housing cooperative sought to obtain a decent home at an attractive price. But that type of economic interest characterizes every form of commercial dealing. What

distinguishes a security transaction -- and what is absent here -- is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use. n154

Economic reality -- disregarding form for substance -- has long been the "touchstone" of inquiries into the existence of a security. n155 It is something that may be embodied in the instrument itself. A share of "stock" possessing traditional characteristics by its very nature evidences the economic reality that underlies *any* security, that is, separation from control over the value determinants of the interest represented and a reliant position with respect to information needed to evaluate risk. The determination that stock possessing traditional characteristics is a security is now virtually automatic, n156 and courts are not required to look beyond the character of the instrument to the economic substance of the transaction. n157

The protections of the federal securities laws have rarely been denied to purchasers of corporate stock. The Supreme Court opinions in *Landreth* n158 and the companion case, *Gould v. Ruefenacht*, n159 underscore the fact that the characteristics traditionally associated with corporate stock not only identify the instrument in commerce as an investment security but also evidence the "typical kind of context" in which the securities laws normally operate. n160 It is, said the Court, a matter of the plain meaning of the statutory definition.

In *Landreth* and *Gould*, the Supreme Court rejected the "Sale of Business" doctrine formulated in several lower court decisions that had denied securities law protections to purchasers of all or a substantial amount of a corporation's stock to acquire control. Despite the presence of corporate stock, courts embracing the doctrine found no security by reason of the control vested in the purchaser. The Supreme Court held that where the focus is upon corporate stock possessing traditional attributes, there is to be no definitional distinction made on the basis of transactional circumstances. The Court declared in *Landreth*:

Reading the securities laws to apply to the sale of stock at issue here comports with Congress' remedial purpose in enacting the legislation to protect investors by "compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.' " Although we recognize that Congress did not intend to provide a comprehensive remedy for all fraud, we think it would improperly narrow Congress' broad definition of "security" to hold that the traditional stock at issue here falls outside the Act's coverage. n161

Where protection has been denied for "stock" transactions it is because the object of protection -- an investment decision -- is not in evidence. n162 Or, as *Forman* so clearly demonstrates, protection will be denied where there is no legitimate expectation of protection shown. Where "stock" is the focal point, the expectations of purchasers take on much importance. The conclusion in *Forman* that purchasers of the "stock" involved there could not be misled by use of the label into thinking that the securities laws applied to their transactions was central to the decision. However, in *Landreth* the Court contrasted the situations, noting that by the nature of the instrument itself -- actual corporate stock -- it was likely that an investor would believe that securities law protections would apply. n163

Use of the term "stock" may produce an expectation of securities law protection, and where the instrument involved is corporate stock possessing traditional attributes, no further inquiry is necessary after *Landreth* and *Gould*. But use of the term will not reasonably lead to such an expectation in all cases, and it remains true that not all "stock" is a security, even where the context is a business enterprise.

Business co-op cases illustrate distinctions in attributes of "stock" and the effect on expectations of those who purchase it. Participation in a business cooperative may be evidenced by "stock," but the typical characteristics of the enterprise are these:

- (1) all members participate directly in management;

- (2) all members act together to set policy;
- (3) the "stock" involved is non-negotiable and may not be pledged or hypothecated;
- (4) the "stock" cannot appreciate in value, since termination of membership requires the sale of the stock back to the co-op at a predetermined price, or in accordance with a predetermined formula; and
- (5) no dividends are paid, as members are paid in accordance with contributions to the productivity of the enterprise. n164

In contrast to *Forman* and the housing cooperative cases, a business cooperative may pursue profits and be viewed as an enterprise in which the members are motivated by the prospect of economic success. Yet the purchasers of its "stock" do not take securities because they do not make an *investment* decision. In *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*, n165 the court held that "capital credits" which, among other things, included the right to purchase stock issued by the coop, were not securities because they lacked essential characteristics. Although they were financial interests that were transferable under limited circumstances, and convertible into common stock by qualified holders, the capital credits were non-voting and conferred no dividend rights. Chief among the factors applied by the court to conclude that no security was involved was the expectation of members:

"[T]he class members enter into the cooperative relationship not in the expectation of the profits that will be generated from such a relationship but instead to reap the benefits of that relationship. The capital credits are non-interest bearing and thus do not provide the valuable return on an investment normally expected from the purchase of a security." n166

The credits involved here reflected a membership or former membership in the cooperative, and their sole value, the court observed, laid in future redemption at face value. In business coop relationships, members base their decisions to join on the effectiveness of the services provided rather than on the risk inherent in an investment. Regulation as a security, said the court, "would do little to protect or advance the interests of the cooperatives' members or patrons." n167

Even where actual stock is involved, the relationship between parties may still be characterized as something other than "corporate," such that the protections of the securities laws could be denied. Where, for example, a relationship among entrepreneurs is actually a joint venture in which the parties actively participate in the management of the business, a "joint venture gloss" may be applied to defeat securities law claims where the factual setting contradicts essential aspects of a securities transaction. A true partnership or joint venture relationship is the antithesis of a security. The presence of corporate "stock" possessing all traditional characteristics means little where stockholders are in fact active entrepreneurs and managers in the enterprise. n168

Post-*Landreth* state courts have shown a willingness to examine circumstances to determine whether in coming together to pursue a business enterprise active participants create what is actually a partnership in corporate form. n169 In these analyses the corporate stock, regardless of its characteristics, may be deemed insignificant in relation to the apparent direct contributions to the success of the enterprise that are the true focus of a transaction in which the combination of resources trumps any "investment" characteristics. This analysis is at the heart of considerations of "close corporation agreements" discussed further below.

In many of these situations one may fairly conclude that there is no security expectation tied to the "stock" involved. However, after *Landreth*, a true "corporate" relationship based upon stock ownership can change expectations and perceptions, if not the reality. Consider, for example, *Sulkow v. Crosstown Apparel, Inc.*, n170 in which "corporate stock" of a closely-held corporation involving three equal shareholders was held to be a security because the stock

carried proportional voting rights, rights to dividends, and the capacity to appreciate in value. The fact that Crosstown was a close corporation and that a shareholders' agreement placed limitations on transferability of the stock was insufficient, said the court, to negate the character of the stock as a security.

The advent of "close corporation agreements" as a matter of state corporation law adds a new wrinkle to the issue of stock as a security in an otherwise standard corporate setting. In order to allow for negotiated shareholder rights, responsibilities, minority protections, and, in effect, to permit closely held corporations and their shareholders to be governed as if the corporation were a partnership, the typical "close corporation agreement" now authorized under state law n171 empowers shareholders to agree among themselves on such matters as:

- (1) Regulation of management the business and affairs of the corporation;
- (2) The right of one or more shareholders to dissolve the corporation at will, or on the occurrence of a specified event;
- (3) Voting obligations among shareholders;
- (4) The designation of directors and officers;
- (5) Terms and conditions of employment of officers and other employees;
- (6) Dividend policy;
- (7) The scope of directors' authority;
- (8) Access to books and records;
- (9) Limitations on the issuance of new shares; and
- (10) Deadlock resolution procedures.

To empower corporate shareholders in the manner that is functionally equivalent to partnership or joint venture relationships, in which no security is involved, is to test the meaning of *Landreth's* "traditional attributes" premise. The association among agreeing shareholders may be "corporate," but an essential aspect of a security -- separation from control over value determinants -- is missing. In *Sulkow*, the court viewed the limitations imposed by an agreement among the shareholders as insufficient to negate the character of the stock as a security. The much broader powers and internal affairs constraints possible under a close corporation agreement, however, may be quite sufficient to change the character of "stock," particularly where the express purpose of allowing such agreements is to empower shareholders as if they were partners. The contours of the definition of "stock" as a security in this special context remain to be shaped. Plainly, however, the *Landreth* admonition that "stock" is a security when it matches characteristics generally associated with corporate stock mandates careful analysis of the impact of a close corporation agreement in light of the protections intended by the Securities Act. n172

In any event, the contemporary Supreme Court cases focusing on "stock" as a security teach the wisdom of the observation, many years earlier in *SEC v. C.M. Joiner Leasing Corp.*, that whatever the subject matter of a transaction may be, whether or not it involves a security, will not be determined solely by the label of what is being sold but equally by "what character the instrument is given ... by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." n173 Corporate stock is a security because its traditional attributes make it so and because, in the main, its character in commerce is established.

This is not to impose an absolutely "literal" application of the definition of security in Section 2(1). In both *Landreth* and *Gould*, as it had done in *Forman*, the Supreme Court eschewed an approach to defining a security that would invoke coverage simply because an instrument carried the label "stock." Application of a joint venture gloss in a particular setting to defeat or avoid security status despite the presence of stock remains possible. However, where traditional stock is involved, and the instrument thus falls plainly within the statutory definition, "[t]here is no need ... to look beyond the characteristics of the instrument to determine whether the Acts apply." n174

[b] Traditional Attributes, Economic Reality, and the Meaning of "Stock." In *Landreth* and *Gould* the Supreme Court revitalized the meaning of the much earlier observation of the Court concerning "stock" as an instrument that is "pretty much standardized [with] the name alone carr[ying] well settled meaning." n175 Such a standardized notion is a function of the traditional attributes of the instrument, i.e., dividend rights, negotiability, the ability to be pledged or hypothecated, voting rights and the ability to appreciate in value. Thus, in *Gould* the Court added:

In *Landreth*, we held that where an instrument bears the label "stock" and possesses all of the characteristics typically associated with stock, a court will not be required to look beyond the character of the instrument to the economic substance of the transaction to determine whether the stock is a "security" within the meaning of the Acts. n176

Landreth and *Gould* direct attention to the traditional attributes of corporate stock as the guide on which instruments labeled stock are to be examined. The attributes of corporate stock are identifiable and capable of consistent, predictable application. As the Court observed in *Landreth*:

Instruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage by the plain language of the definition. First, traditional stock "represents to many people, both trained and untrained in business matters, the paradigm of a security." Thus persons trading in traditional stock likely have a high expectation that their activities are governed by the Acts. Second, ... "stock" is relatively easy to identify because it lends itself to consistent definition. n177

Implicit in the Court's holdings that traditional attributes of corporate stock supply the parameters of the statutory definition is emphasis upon the real object of securities law protection -- an investment decision. Lower court decisions previously embracing the "Sale of Business" doctrine focused entirely upon post-purchase considerations in defining the nature of the stock being purchased. However, it must be remembered that the purchase of corporate stock entails a decision to purchase what the stock and all of its "attributes" then represent, that is, an interest in the net assets and future earnings stream of the corporation. The value of real stock is determined by the ability of the corporation to succeed in the future and to produce an expected return. The investment risk in the purchase is that the stock is presently misvalued.

The bundle of "characteristics" that evidences real corporate stock more fundamentally evidences the investment decision being made when it is purchased. "Economic reality" after *Landreth* and *Gould* necessarily means that the presence of "stock" with attributes that match the conventional perception of the term not only prompts a legitimate expectation of securities law protection but the characteristics themselves are such as to warrant the special protection of the Acts.

Some state courts looking to *Landreth* and *Gould* for guidance in the application of blue sky law definitions patterned after the federal acts have fashioned a decidedly literal stock "characteristics" test. Under this test, the controlling question is whether the stock bears such characteristics usually associated with corporate common stock so that a purchaser justifiably may assume that securities laws apply. n178 Some caution is in order. A "literal" test is not the message of the Supreme Court cases. The cases do not stand for the proposition that any stock displaying traditional characteristics is a security. The presumption may be large, but the analysis in *Forman* is in no way lessened, and indeed in *Landreth* the Court made it explicit. n179 Innovations such as "close corporation agreements" and operating

agreements that define relationships among members of a "limited liability company," all of which impact fundamental aspects of a securities transaction in a particular "corporate" relationship, will yet have to be confronted case-by case. However, the Supreme Court decisions surely do redirect the focus of attention to the reality of stock in a commercial universe rather than a transaction-specific analysis of the meaning of the instrument for a particular purchaser. n180

[3] Bonds

Like stock, "bonds" are generally perceived to be securities. Case authority pertaining to the status of bonds under the securities laws is scarce. In *Marine Bank v. Weaver*, n181 the Supreme Court simply noted without analysis that "ordinary bonds" are clearly securities. n182 The characteristics of an "ordinary" bond would appear to raise no question of security status under Section 2(1). However, as *Marine Bank* and the cases focusing on notes, certificates of deposit, and other forms of evidences of indebtedness well illustrate, the character of a thing in commerce and its attributes affecting risk can alter the assessment. n183 Thus, in *Wingsco Energy One v. Vanguard Groups Resources, Inc. 1984, Inc.*, n184 zero coupon bonds were held not to be securities. Plaintiffs were investors in a series of leveraged oil and gas limited partnerships in which the partnerships purchased zero coupon bonds that were pledged as collateral for loans to the partnerships. Plaintiffs claimed that they were purchasers, through the partnerships, of the zero coupon bonds and asserted securities law claims. The court rejected their claims, finding that the "bonds" were simply "commercial notes" used to secure a loan rather than any "speculation or investment." n185

There are no attributes or "traditional" characteristics of bonds that prompt a swift conclusion on security status. *Marine Bank* itself best illustrates the extent to which attributes of the instrument bear upon risk assessment. The certificate of deposit issued by the bank had the basic characteristics of a bond, i.e., a long term debt instrument with a fixed rate of return. Yet, because of other regulation and the virtual full guarantee of repayment assured by FDIC insurance, the instrument was held not to be a security. Bonds, on the other hand, involve at least a credit risk, that can easily be translated into an "investment" risk where the expected future income stream associated with the bond is dependent upon the issuer's ability to generate sufficient revenues to pay it.

Corporate bonds are typically offered in public distributions, the instruments typically have long maturities, and manifest characteristics of an investment in the issuer's enterprise. Government or municipal bonds, though publicly offered, are most often distinguished by government guarantees. As such, their characteristics differ to the extent that most are specifically exempted from registration requirements under the Securities Act, n186 some even from the express antifraud remedy prescribed in Section 12(a)(2) of the Securities Act. n187 However, investment programs or schemes built around otherwise exempt securities will not escape application of all aspects of the Securities Act to the plan or program itself via an application of "investment contract" analysis, or another catchall term in the Section 2(1) definition.

The general perception of a bond as a security prompts thoughtful consideration of the caveat, in *United Housing Foundation, Inc. v. Forman*, that use of the term "bond" itself may lead to a finding that an instrument not intended to be a bond may be one and that the purchaser may legitimately expect the availability of securities law protections. n188 Conversely, use of "bonds" to capitalize a business enterprise in which the purchaser expects to play a significant managerial role would lead to a conclusion that the bonds are not securities. As with stock, the economic reality of the circumstances will dictate the availability of securities law protections where the generally recognized characteristics of the instrument do not fit the circumstances in which it appears. Labeling an instrument as a "bond" in an entrepreneurial setting in which the purchaser is directly involved in the operation of the enterprise may have no significance in circumstances where it is clear that protections of the securities laws are not needed, and not reasonably expected. n189

[4] Voting Trust and Collateral Trust Certificates; Other Commercial Trust Instruments

The Securities and Exchange Commission ("Commission" or "SEC") observed in an early Release that the express inclusion of voting trust certificates in Section 2(1) left no question that these certificates are securities under the

Securities Act. n190 Consideration of voting trust certificates under the Securities Act would most likely arise in an antifraud setting. However, in some circumstances, a public offering of the certificates may be deemed to exist. In some states, for example, all stockholders of a corporation are entitled to deposit their shares under the terms of a voting trust agreement. Since the certificates are securities, and the voting trust is open to all shareholders, a public offering may exist, thus triggering the full range of compliance responsibilities. n191 Collateral trust certificates, on the other hand, are specifically identified as securities, but their issuance is not likely ever to involve a public offering with attendant registration requirements. Collateral trust certificates (or bonds) represent an interest by collateral deposited by a borrower with a trustee. The collateral may consist of stocks or bonds of a company controlled by the issuer, or other securities. Such a transaction involves an agreement on the part of the borrower to pledge these other securities with a trustee, who acts as the lenders' representative and whose duty it is, in the case of default to realize on the collateral. The "certificate" is evidence of the holder's interest in the collateral securing the obligation, which collateral is comprised of securities other than those of the borrower. Although a somewhat archaic form of financing arrangement, the attributes of a collateral trust certificate can be assessed in modern terms of value determinants and other factors evidencing a security. n192

Voting trust certificates and collateral trust certificates are the only trust instruments specifically identified in Section 2(1). However, the Securities Act specifically contemplates that any trust may be an "issuer" of securities, n193 and the expanding financial services environment has led to the development of new trust programs that are scrutinized under the Securities Act.

While a typical commercial trust account with a financial institution evidences no investment character and is not deemed to be a security, the creation of trust accounts for commingled funds having investment objectives may well create a security. As the court observed in one such case, *SEC v. Professional Associates*: n194 "[T]he classification of an investment as a trust does not *ipso facto* prevent it from being a security if it in actuality ... fits the description of an investment contract under the securities law." n195 Contemporary analyses look to the purpose of the program. If trust assets are received for a true *fiduciary* purpose rather than as an investment vehicle, no security will be found. n196 But, where funds are received for collective investment and management services, often as a result of promotional and marketing campaigns, interests in the collective investment fund may be deemed to be securities. The question is whether there is a departure from true fiduciary service that leads instead to reliance upon investment skill. n197

Though not a trust vehicle per se, private, mortgage-backed "pass-through certificates" have been found to be securities on the basis of a collective investment trust analogy. These instruments represent an undivided percentage ownership in a trust that, in turn, consists of a pool of conventional mortgage receivables of a financial institution. In *Securities Industry Association v. Clarke*, n198 a plan proposed to be undertaken by a national bank to offer publicly such certificates was challenged as a violation of Glass-Steagall Act prohibitions against bank underwriting of securities. The bank claimed that the certificates were not securities but, rather, only represented an interest in its own assets. The court disagreed, finding that the certificates represented the right to receive apportioned interest profits, were negotiable, and had the potential for appreciation. Relying on *United Housing Foundation Inc. v. Forman*, and the attributes addressed there, the court thus held the certificates to be securities.

[5] Certificates of Deposit for Securities; Receipts for Securities

A "certificate of deposit for a security" and a "receipt for [a security]" are expressly included as securities in Section 2(1). The term "certificate of deposit for a security" has its roots in instruments issued by a protective committee, and reflect a security interest in a company undergoing reorganization. n199 These certificates should be distinguished from a certificate of deposit representing a deposit of cash or cash equivalents in a bank. n200

The notion of "certificate of deposit for a security" is not well developed outside the reorganization setting. However, its potential application in other areas is illustrated by *Morgan Stanley & Co., Inc.*, n201 in which the SEC staff declined to issue no-action advice that certificates for undivided participations in a security would not themselves be securities.

The "certificates" in issue were proposed to be publicly offered and represented undivided interests in a "guaranteed investment contract," or funding agreement. Relying on the analysis of the Second Circuit Court of Appeals in *Gary Plastics Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,ⁿ²⁰² the staff opined that issuing such certificates was no different than publicly offering interests in bank certificates of deposits, and that the plan would thus create a security. It is not clear whether these programs represent certificates of deposit for securities or are simply investment contracts themselves. In either case, the consequences for the issuer are the same.

American Depository Receipts (ADRs), which evidence an interest in foreign securities held by a depository to facilitate trading, are securities.ⁿ²⁰³

ADR trading usually involves at least two banks: a foreign bank located where the foreign company selling its shares is organized or transacts business and a United States bank. A company deposits certificates for the underlying securities with the foreign bank and, when that bank confirms the deposit, the United States bank issues the ADRs. Receipts may then be traded without having to mail certificates between countries. While the ADR simply evidences the underlying security on deposit with the foreign bank, it is the functional equivalent of the security when offered to investors.

Other investment vehicles which represent an interest in underlying government securities also illustrate this form of security. However, a receipt for a security is not itself a security if it merely evidences obligations of an ordinary bailee as, for example, where a transfer agent issues a window ticket evidencing the deposit of securities for transfer.ⁿ²⁰⁴

[6] Guarantees

A "guarantee" of a security is included within Section 2(1) as being a security itself.ⁿ²⁰⁵ It is certain, however, that there is no commonly understood meaning or set of traditional characteristics that mark such an instrument as a security.ⁿ²⁰⁶ Thus, investment contract analysis is more likely to be applied in determining whether such an instrument qualifies as a security as a matter of economic reality rather than attempting to characterize an instrument or arrangement as a security merely because of the included label.ⁿ²⁰⁷

Separate security status for a "guarantee" could arise in circumstances in which a debt security, for example, is guaranteed as to principal, interest, or both, by a party other than the issuer. To illustrate, if Company X wishes to undertake a major project but is unable to finance the project itself, it may look to Company Y to become involved in a joint undertaking in which both will share in the project and its benefits. Company X may issue bonds separately guaranteed by Company Y. The bonds are securities, but the separate guarantee may also be a security. In the hands of purchasers, the guarantee, as a separate security, may have important ramifications under the antifraud provisions of the securities laws. Indeed, it may be the actual focus of the investment decision.ⁿ²⁰⁸

[7] Warrants and Subscription Rights

A right to purchase a security may take the form of a warrant (a separate freely traded instrument) or a form of contract (a "subscription right"). When a company wishes to raise additional funds by issuing additional securities, it may give its shareholders the opportunity, ahead of others, to purchase the new securities in proportion to the number of shares each owns. Through a "rights offering," the shareholders, for the exercise price of the "right," may purchase one or more of the new shares at a specified price, typically below the prevailing market price. In other situations, a "warrant" may be used specifying the rights of the shareholder.ⁿ²⁰⁹

Generally speaking, a warrant or right to subscribe is a contract that allows the holder to purchase a security at a future date on specified terms. Logically, a right to purchase a security, offered in circumstances no different from those that would involve the offer and sale of the subject security itself, should be treated no differently. However, in some circumstances conveying a contract right to acquire a security may evoke no concerns for making the protections of the securities laws available. In *Rispo v. Spring Lake Mews, Inc.*,ⁿ²¹⁰ for example, a promise to deliver stock as partial

consideration for a loan was held not to constitute a warrant or right. "Commercial context" was apparent, and the arrangement did not evidence the "very specific sort of written agreement" indicative of a warrant or right for purposes of the securities laws. n211

However structured and evidenced, the substance of the transaction is the conveyance of the right to acquire an underlying security. If presently exercisable, the sale or distribution of the right is the simultaneous offering of the underlying security. n212 Warrants and rights are thus specifically included as securities under Section 2(1). They need not be evidenced by a written instrument. n213 In the preorganization stage of an enterprise, where subscription rights are most common, whether security classification can be avoided through a "joint venture" gloss, or whether an exemption is available, is entirely dependent upon the circumstances.

[8] Preorganization Subscriptions

Section 2(1) further prescribes that a "preorganization certificate or subscription" for a security is itself a security. n214 In the pre-formation stage of an enterprise, the nature of the "investment" decision to be made by one committing capital to the enterprise is no different from a post-formation decision to do the same. The offer and sale of pre-formation units or subscriptions is common, and, absent an available exemption, these securities are subject to all aspects of the Securities Act. n215

Consideration of preorganization subscriptions as securities prompts a closer look at the relationship between those who "subscribe." Consider the following situation: "A" has plenty of experience in a specific business. "B" and "C" have no experience but have plenty of money. The three individuals agree to form a corporation in which each will contribute \$10,000 and receive one-third of the stock. The money is quickly used up, and the corporation is never formed. "B" and "C" believe that they were deceived by "A." Are they purchasers of "securities"?

Though apparently not evidenced by an instrument, "B" and "C" purchased preorganization subscriptions in the corporation to be formed. Does the context evidence an investment character of the transaction that the securities laws are intended to protect, or are the two really participants with "A" in the organization and operation of the enterprise, i.e., joint venturers?

As with all of the specific forms of securities included in Section 2(1), there is a presumption that preorganization subscriptions entail characteristics of separation of ownership from value determinants and disparate positions with respect to material information, for which special protection is needed. The preorganization setting perhaps best illustrates the need to distinguish between co-venturers, for whom no securities law protection is available, and *investors*, for whom it is. A preorganization subscription is a security "unless the context otherwise requires." The interest of a true joint venture participant cannot be deemed to be a security. Presumably, joint venture participants actively participate in the management of the enterprise. The *expectation* of participants to do so should be no less significant in the pre-formation stage of the enterprise. A joint venture gloss may be applied to exclude the preorganization stage from coverage under the Securities Act. However, logic would require that the same gloss be applied to any other security ultimately issued upon organization of the enterprise. n216

The typical preorganization subscription process involves solicitation and a selling process no different from that which marks the offering and sale of any conventional form of security. The joint participation of entrepreneurs in the organization of a business venture does not. To examine the preorganization setting and the relationship between those involved in it is to examine the fundamental purpose of the Securities Act and to identify the setting in which it was intended to operate.

[9] Options, Derivatives and Synthetic Securities

Options. Section 2(1) specifically includes within the definition of a security any put, call, or option. Exchange-traded

puts and calls, like warrants or rights, are contracts conferring the right to buy or sell a fixed number of shares of an underlying stock at a specified price during a particular period of time are themselves securities. Options are a simple form of *derivative* securities, meaning that their value and pricing derives from the underlying common stock, coupled with temporal factors that control pricing models. Options do not represent any equity interest in the issuer of the underlying common stock.

A call option is the right to *buy* shares of stock, and a put option represents the right to *sell* shares, at a set price during the life of the option. The seller of an option becomes obligated to deliver (in the case of a call) the stock to, or purchase (in the case of a put) the stock from, the option holder during the period of the option. If the holder of an option does not exercise it or sell it prior to expiration, the option becomes worthless. n217

In the early 1970's, with the introduction of exchange-traded options and their increasing popularity, special securities law concerns emerged. Regulatory initiatives were directed principally at market professionals and exchanges. n218 At the same time the registration and prospectus delivery procedures of the Securities Act operate to assure the dissemination of information and risk disclosure to prospective option traders.

An ever-increasing array of option instruments, particularly those relating to a group or "index" of securities, raised new questions, and jurisdictional tensions, between securities and commodities futures regulators. To address these issues and bring certainty to the regulatory process, Section 2(1) was amended in 1982 specifically to include within the definition of security "any put, call, straddle, option, or privilege on any securities (including any interest therein based upon the value thereof), or ... entered into on a national securities exchange relating to foreign currency"

The 1982 amendments to the Securities Act, along with correlative amendments to the Commodity Exchange Act, were undertaken to clarify the respective jurisdictions of the SEC and the Commodity Futures Trading Commission with respect to innovative investment and trading instruments emergent in the 1970s that confused previously drawn lines of regulatory responsibility. Today, as a result of this legislative action, the following are included within the definition of "security" in § 2(1):

- (1) options on securities;
- (2) options on certificates of deposit;
- (3) options on security indexes or groups; and
- (4) options on foreign currencies, when such options are traded on a national securities exchange.

Exclusive jurisdiction of the Commodity Futures Trading Commission, and regulation under the Commodity Exchange Act, is provided for options on commodity futures contracts and for futures contracts on a group or index of securities where, *inter alia*, settlement or delivery on the contract is effected in cash or by means *other than the transfer of or receipt of any security*, except an exempted security under § 3(a)(12) of the Securities Act (government securities). n219 Nevertheless, "index participations" -- contracts of indefinite duration based on the value of a basket, or index, of securities -- have been held not to be covered by the securities laws because they do not constitute options on a *security*. n220

The specific reference in Section 2(1) to puts and calls should not distract attention from the fact that security status attaches to *any* option that amounts to the right to purchase another security. Indeed, an option to purchase stock has been characterized in the post-*Landreth* era as such a traditional instrument that its existence as a security may be shown simply "by proving the document itself," and without any need to look beyond its own characteristics. n221

While there is no question concerning the applicability of the Securities Act to options themselves, n222 the nature of

trading in them and the propensity of market professionals to develop and market specific options investment strategies has raised other questions concerning the creation of separate securities in the form of managed, or discretionary, trading accounts. Applying investment contract analysis, some courts have held that discretionary trading *accounts* involving options and other securities or commodities futures are securities. n223 These results are not a function of the particular investment vehicle employed, but the nature of option trading and strategies has made discretionary accounts built around them particularly open to scrutiny. Thus, whether the focus is on a specific option instrument or a more specialized contract vehicle, securing the right to purchase a security is no less significant than the purchase of the security itself.

The treatment of options as securities is most often considered in the context of standardized option contracts to buy or sell listed securities that are themselves traded on national securities exchanges. However, any option contract may be deemed to be a security if the elements of an investment contract are present. In *RA Investments I, LLC v. Deutsche Bank AG*, n224 option contracts on foreign currency that were not traded on any recognized market, and that involved no right to physical delivery of any underlying currency, were held to be securities. The court applied investment contract analysis to determine that there was a common enterprise in which profits were to be derived solely from the efforts of others. The option contracts, identified as "foreign exchange digital contracts," represented the investment element of a complex tax planning strategy designed and marketed by the defendants to wealthy individuals. The investment element of the program was represented as a legitimate opportunity for investors to make substantial profits while enjoying very significant tax benefits of the program. Control over key elements of the investment in the option contracts was retained by the defendants, and the court found that the option contracts, when considered as part of the entire program, constituted a common enterprise under investment contract analysis. The option contracts were thus deemed to be securities. n225

Derivative and Synthetic Securities. Although not specifically addressed in Section 2(1), under the general heading of options there has emerged a genre of securities generally referred to as derivative or synthetic, which involves contracts under which counter-parties have certain rights based on the value of securities. "Synthetic" transactions, for example, typically involve cash-settled over-the-counter options and "equity swaps." Such options are not on securities themselves, but are rather based upon the value of a security. The arrangements involve cash settlements based on security values rather than any right to take possession of a security.

In *Caiola v. Citibank, N.A.*, n226 the Second Circuit Court of Appeals concluded that "synthetic" options represented simply cash-settled over-the-counter options on an underlying stock and are therefore securities within the scope of the antifraud provisions of the federal securities laws. An "option" within the definition of security is not limited, said the court to "conventional" exchange-traded options. It applies to both exchange-traded as well as over-the-counter options, and does not distinguish between physically-settled and cash-settled options. The right to take possession of a security does not define an option within the coverage of the securities laws. The court was satisfied that the broad definition of security to include an option on "any" security, as well as an option on any "group or index of securities" permits no distinction between cash-settled options and those that are settled by physical delivery. n227 *Caiola* illustrates that courts will find the necessary flexibility in the statutory definition of security to be certain that actual investments will not escape coverage by the creation of a new instrument that would not be covered by a more determinate definition. The transaction at issue was fairly straightforward in its link to the value of a specific underlying stock. In other situations courts will examine the structure of transactions and instruments to determine whether a security is present. *Caiola* demonstrates once again, however, that in all cases the key is determining economic reality of a transaction or arrangement. n228

[10] Fractional Undivided Interests in Oil, Gas, or Other Mineral Rights; Related Financing Schemes

In 1934, the SEC described the intended scope of the Securities Act regarding oil and gas interests as follows:

The amendment to the definition of the term security makes clear that the provisions of the

1-2 Federal Securities Act of 1933 § 2.01

Securities Act apply to the sale of certain oil or gas interests. The ordinary royalty interest which entitles the holder to share in the oil or gas produced from a particular tract of land clearly comes within this definition. Whether such interests are transferred by *deed* or *contract* and whether under the law of the particular state in which the tract is located *such interests are regarded as real estate or as personal property makes no difference in the application of the Act*. The word "rights" is broad enough to make the definition applicable to interests which are regarded as giving ownership to the oil or gas in place as well as to interests which merely afford the owner the right to produce oil or gas. The Act applies, however, only to "fractional" interests. The transfer of the *whole* royalty interest in any tract of land, though under the terms of the lease the holder may be entitled only to a portion of the production, is *not* considered a transfer of a security under the Act. n229

Fractional interests in oil, gas, or mineral rights constitute interests in real property -- often leasehold interests or assignments of leases. However, *SEC v. C.M. Joiner Leasing Corp.* n230 taught at an early date that the focus in many of these situations is not upon the conveyance of real estate but, rather, upon an enterprise and the induced expectation of profit to come from it. *Joiner* emphasized the dependency of value of the real property interest upon the enterprise, and the Court undertook to apply securities law protections to property rights that were clearly subject to speculation and fraud and that had no independent value. Although the Court was careful to point out that the sale of "naked leasehold rights" does not involve the sale of a security, the opinion makes it clear that when *something more* than a lease is involved, the concerns for securities law protection arise. The something more is investment risk, brought on by an associated value-determinative enterprise. The defendants in *Joiner* did not offer naked leasehold rights but, instead, held out the economic inducement of the proposed, and promised, exploration well. The defendants' proposition, said the Court:

[W]as to sell documents which offered the purchaser a chance, without undue delay or additional cost, of sharing in discovery values which might follow a current exploration enterprise. The drilling of this well was not an unconnected or uncontrolled phenomenon to which salesmen pointed merely to show the possibilities of the offered leases. The exploration enterprise was woven into these leaseholds, in both an economic and legal sense; the undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung. n231

Thus, if what a promoter offers is not a lease in the regular way, but actually a plan for an enterprise and profit-sharing, with the profits to come from the efforts of persons other than the "purchaser," the interest will be deemed to be a security. Congress did not intend for the Securities Act to burden the oil industry with controls designed only for traffic in securities, or impact upon ordinary financing arrangements among oil and gas developers. But it did intend to regulate the form of splitting up of mineral resources used for speculative purposes. Context thus becomes important, and investment characteristics must be identified. n232 The "common thread" in this setting need not be among a large group of purchasers. In the oil and gas setting, a one investor/one promoter relationship ("vertical commonality") may suffice so long as it is clear that the fortunes of the investor are interwoven with and dependent upon the efforts and success of the promoter. n233

Investment programs built around the sale or lease of mineral rights further illustrate contemporary applications of the *Joiner* principle. For example, in *SEC v. International Mining Exchange, Inc.*, n234 interests in mines were held to be securities where there was no practical prospect for development or exploitation of individual interests. In *Johnson v. Rogers*, n235 not only were working interests in oil and gas leases held to be securities by definition, "turnkey" contracts for drilling and completion of wells were held to be separate securities where they were offered to investors as an inducement to increase investments in the lease interests.

These cases exemplify the *Joiner* approach to identifying the investment character of a property interest. The approach is certainly not limited to interests in oil, gas, or mineral rights. It is in fact a fundamental element of all "investment contract" analysis, n236 but it is well illustrated in these cases in which the expected value of the interest is so clearly

dependent upon the enterprise.

Mineral interests, fractional or otherwise, have most often been evaluated as securities via investment contract analysis. That need not be the case, however, where the instrument involved plainly constitutes a "fractional undivided interest in ... mineral rights." In the post-*Landreth* environment, there may be no need to look beyond the characteristics of the instrument itself to determine its status as a security. n237 Still, the sale of such interests, even in prearranged programs, should not involve a security when the buyer enjoys rights and powers beyond those of a passive investor, and the presence of such powers would likely alter the characteristics of the instrument so as to preclude literal treatment. It is axiomatic that the federal securities laws are intended to protect passive investors. One who purchases a mineral interest, and with it has the means to protect his or her interest through controls on the process of development or operation, is not such a passive investor and, absent other considerations, has no legitimate expectation of securities law protection. n238

Oil and gas financing schemes have rarely escaped the securities laws. Fractional interests in producing properties are normally deemed to be securities by definition. n239 Moreover, courts have long shown a willingness to apply investment contract analysis to reach the same result. In *SEC v. Crude Oil Corp. of America*, n240 for example, a corporation with interests in oil royalties sold contracts for future delivery of specified quantities of oil to investors, none of whom contemplated taking actual delivery but who instead expected to profit from sales of the oil by the promoter. The purchase contract, a forward contract, provided that actual delivery was intended but further stated that if the purchaser did not demand delivery, the seller was empowered to sell the oil and remit the proceeds to the holder of the contract. The investors purchased oil; however, the court held the scheme to be an investment contract. n241

Finally, oil and gas investment *funds*, typically organized as limited partnerships, for the acquisition and development of producing properties involve the creation of interests deemed to be securities under several Section 2(1) classifications. Such interests may be deemed to be interests in a profit-sharing agreement, to constitute investment contracts, or, as limited partnership interests, to represent interests commonly known as securities. They often utilize preorganization subscriptions as well, another express Section 2(1) category. Whatever form the fund investment takes, the interests are securities, and they must be offered and sold in compliance with the Securities Act or pursuant to an available exemption. n242

[11] The Unconventional Forms: "Certificate of Interest In Any Profit-Sharing Agreement [or any Investment Contract]"

[a] Generally. Examination of the "conventional" instruments collected in Section 2(1), and their character in commerce, produces sensitivity to the three common elements of any form of security:

- (1) The absence of control over value determinants;
- (2) Disparate positions between seller and buyer vis-a-vis information needed to assess risk; and, as a function of both,
- (3) The presence of investment risk.

The approaches taken by the courts to conventional instruments such as notes and stock teach that the definition of a "security" is in actuality a definition of the scope of specialized securities law protections. As some courts have sought to limit protection through "context" analyses despite literal inclusion of an instrument within the definition, many more decisions have expanded the protective umbrella to reach the "[n]ovel, uncommon, or irregular devices, whatever they appear to be ..." n243 where investment characteristics are demonstrated and the need for protection evident. This expansion has come under the mantle of the "unconventional" forms of securities, most prominently the "investment contract."

"Investment contract" and "certificate of interest in any profit-sharing agreement" comprise the so-called "catchall" categories in the definition of security. n244 But for speaking of a "certificate" of interest in any profit-sharing agreement, and thus contemplating some writing, n245 Section 2(1) prescribes no attributes for either of these forms of securities. Only the ingenuity of promoters has limited the variety of schemes that have become securities by way of these categories, and it is here that practitioners face the greatest challenge. An "investment contract" is not identifiable because of its character in commerce or because of attributes that prompt its common recognition as a security. It arises out of circumstances and relationships.

The setting plays an extremely important role. It is unlikely that an investment contract will be found where the setting contradicts any asserted need for securities law protections. For example, in *Behar v. Professional Network Systems, Inc.*, n246 the court concluded that although an agreement for financing a business undertaking ostensibly met each element of the test for an investment contract, still no security was found. The setting, said the court, was a private face-to-face negotiation in which the putative investor demanded, and received, concessions and "was not merely a passive purchaser of a security offered to the general public." The investor, the court further stated, was "able through his bargaining power to determine the terms" on which he made his advance of funds. Securities law protections were not intended to be available in this context and the claims were dismissed. n247

The concept of investment contract, as applied in all areas, has evolved from *SEC v. W.J. Howey Co.*, n248 the landmark 1946 decision in which the Supreme Court held the sale of tracts in an orange grove, coupled with a contract for management and production, was the sale of an investment contract. The Court defined the term as follows:

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by normal interests in the physical assets n249

The essence of an investment contract is the extent to which the risk of an enterprise lies within the control of someone other than the purchaser. Countless applications in the decades since *Howey* have shown the universe of candidates for investment contract analysis to be nearly limitless. n250 Yet, there is both a constancy and consistency in the case law considering the many and varied schemes. Before undertaking to examine the many specific areas in which "unconventional" forms of securities lurk, it is necessary to focus on the elements of an investment contract involved in all of the applications. n251

[b] The Elements of an Investment Contract.

[i] Investment of Money. In looking for an investment contract, an "investment of money" does not mean the commercial purchase of property or an interest in a tangible thing. Rather, it is the induced commitment of money or value to the purchase of something having no significant economic viability apart from a coupled scheme or structural mechanism for shared fortunes with others. This is the concept of economic reality that is the foundation of *Howey*, in which the Supreme Court observed that the promoters offered persons who resided in distant localities and who lacked any experience or equipment necessary to undertake cultivation, harvesting and marketing of citrus products the opportunity to contribute money and share in the enterprise operated by others. Thus, said the Court:

Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. ... *A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.* n252

While virtually any purchase of property, or interest in property, may be perceived by the purchaser to be an

"investment," such a general perception is not the focal point of protection under the federal securities laws. In *Forman* the Supreme Court observed that "economic interest" characterizes every form of commercial dealing, but that it does not create a security transaction. n253 Plainly stated, the special protections of the securities laws do not extend to every perceived "investment." An investment of money within the contemplation of *Howey* and its progeny means that the investor must commit his assets to an enterprise or venture in such a manner as to subject himself to financial loss from a risk he or she cannot manage. n254

By contrast, there is no *Howey* investment of money where, as an incentive to attract and retain the services of competent persons, and to provide an incentive for such key persons to expand and improve the profitability of a company, "appreciation units" are awarded to employees at management's discretion. In *Orthotec, LLC v. Reo Spine, LLC*. n255 The court rejected the claim that such "appreciation units" amounted to a form of equity, and were thus securities. The units allowed beneficiaries to receive cash payments in the event of a sale of the company. The units created no other rights, and offered only the opportunity to appreciate in value. Applying the *Howey* investment contract analysis, the court found that there was no investment of money by beneficiaries. The units, offered as an incentive, were awarded solely by management's decision. Recipients did not contribute any cash or value in exchange. Because the units failed to satisfy the first prong of the *Howey* test, there was no basis to proceed further.

For investment contract analysis, an investment of money also must involve an expectation of "profit." In *SEC v. Edwards*, n256 the U.S. Supreme Court made clear that a fixed rate of return offered by a promoter can constitute an expectation of profits under *Howey*. In *Edwards*, the Supreme Court examined a program involving the sale and leaseback of pay telephones under agreements by which the promoter provided essential managerial efforts in the placement and servicing of the telephones. The agreements provided for investor-lessors to receive fixed monthly payments representing a fixed 14% annual return. Holding that the program constituted an investment contract, the Supreme Court found that there is no reason to distinguish between promises of fixed returns and promises of variable returns when assessing the "profit" element of *Howey*. n257

[iii] Common Enterprise. The root of an investment contract is common enterprise, a circumstantial and economic relationship among purchasers and someone else. The notion was perhaps most cogently described in *SEC v. C.M. Joiner Leasing Corp.* as "the thread on which everybody's beads were strung." n258 Common enterprise normally connotes some form of *pooling*. n259 A simple contract relationship with another will generally not constitute a common enterprise, which presumes the existence of other investors and an intertwining of their interests and expectations. A financial consulting agreement, for example, whereby an investment banking firm was engaged to assist in the search for suitable "reverse merger" candidates, was held to involve only a private service transaction and not a security. The engaging company had no expectation of receiving profits from the efforts of the investment banker or any other third party. It would benefit under the agreement only by reason of its own efforts, despite provision for payment of a fee of 10% of the value of any reverse merger transaction consummated. n260

Commonality among putative investors has historically been classified as either "vertical" or "horizontal" for investment contract analysis, with courts differing as to which approach should be required. "Vertical" commonality allows for a common enterprise between a single investor and a promoter/seller without regard to the presence of others or any pooling of interests. On the other hand, "horizontal" commonality is based upon the presence of a pool of investors whose fortunes are intertwined and collectively tied to the success of the overall venture. Horizontal commonality is "a pooling of interests not only between the developer or promoter and each individual 'investor' but also among the other investors... in short, a wheel and not just a hub and a spoke." n261 To require horizontal commonality for establishing a common enterprise is a more restrictive approach to investment contracts. n262 Nevertheless, the pooling required to satisfy horizontal commonality may in some circumstances be demonstrated simply by the design and marketing of the scheme regardless of whether it actually occurs. In *SEC v. Lauer*, n263 for example, the subject program for trading purported bank instruments was presented as involving the pooling of investor funds and required such pooling in order to operate as represented. n264

Vertical commonality focuses only upon the extent to which an investor's fortunes are interwoven with and dependent upon the efforts and success of the promoter/seller or a third party. As distinguished from horizontal commonality, the focus is upon the relationship between an investor and a promoter. While others may be similarly situated in relationships with the promoter, "[t]he critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts." n265 In those cases in which vertical commonality is accepted as sufficient "common enterprise," however, it must still be shown that there is actual interdependence between the parties. n266 Interdependence does not necessarily require that there be a sharing in profits or losses, but it must be clear that the relationship involves reliance on the promoter's expertise. Thus, where vertical commonality suffices:

It is not necessary that the funds of investors are pooled; what must be shown is that the fortunes of the investors are linked with those of the promoters, thereby establishing the requisite element of vertical commonality. Thus, a common enterprise exists if a direct correlation has been established between success or failure of [the promoter's] efforts and success or failure of the investment. n267

[iii] Expectation of Profits From the Efforts of Others. The separation of ownership and control over value determinants is an element of every "security" transaction. For investment contract analysis, it is the most significant point of emphasis. Where power or rights in a transaction give the purchasers the leverage or the ability to protect themselves, no investment contract will be found. A person who is positioned to manage enterprise risk may not claim securities law protections. The *Howey* test prescribes a *passive* investor n268 who invests in a common enterprise with profits to come *solely* from the efforts of others. However, the term "solely" as used in *Howey* has not been applied in its strictest sense. When the functions an investor performs are not *managerial* but rather ministerial ones, investment contract status will not be denied merely because the profits are not derived "solely" from the efforts of others. As the Supreme Court itself recast the *Howey* test: "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the *entrepreneurial or managerial* efforts of others." n269 The *degree* of managerial control may be an issue. n270 Moreover, the *expectation* itself may play an important role when promotional initiatives are aimed at enticing purchasers.

The inter-relationship of induced expectations and the specific *Howey* criteria is richly illustrated in this Fourth Circuit assessment of the offering of "Lifetime Partnerships" for accommodations at resort facilities operated by the defunct "PTL" ministry of the Rev. James Bakker:

[T]he promotional materials used to market the LTPs can be seen as emphasizing the profit potential of the LTPs. The materials not only speak generally of the LTPs as "investment[s]," but also offer specific calculations of the true value of the LTPs as compared to their purchase price. The materials also allow the reader to infer that the value of the LTPs was enhanced by virtue of the commercial activities of the PTL facilities in catering to patrons paying the full price. Moreover, it is clear and... undisputed, that this benefit arises from the managerial efforts of others. For *Howey*'s third prong to be satisfied, the benefit available to lifetime partners must arise either as capital appreciation or as participation in earnings. We believe that the record before us allows for the conclusion that the benefit in this case arises as capital appreciation. Under the LTP scheme, it seems that the value of the rights to use the various Heritage, USA, facilities would be enhanced, and therefore capital appreciation might accrue, by virtue of the regular commercial operations of half of all the facilities reserved by regular patrons paying full price for their accommodations. n271

In almost all instances that an investment contract has been found in what is, ostensibly, the sale of tangible property, promotional characteristics have played a role. Indeed, the Supreme Court set the stage in *Joiner* when it declared: "In the enforcement of an Act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be." n272 There is a logical link between promotional characteristics and the expectation of an "investor" that is an essential element of an investment contract. n273

A New York state court made the point best: "The manner in which an item is sold and presented to the buying public is very often a factor, if not the major one, in determining the nature of the relationship between the seller and purchaser. ... In the *Joiner* and *Howey* cases the United States Supreme Court considered investment-oriented advertising to be a factor in finding the existence of an investment contract." n274 Similarly, in an SEC enforcement action a federal appeals court concluded that representations made on a website ostensibly operating a "virtual stock market" game played upon greed and fueled expectations of profit, holding out a form of inducement that substantial profits could be earned in buying "virtual shares" in the game. The payments were not for entertainment, said the court, but were in fact made in anticipation of investment gains. n275

In *SEC v. Infinity Group Company*, n276 the district court held that "property transfer agreements" sold to over 10,000 people and promoted through offering materials that, in the words of the court, constructed a "wonderland of international finance," were securities. As a central theme in the analysis, the court offered:

[T]he duck theory applies: if it looks, reads and sounds like an investment contract, it is an investment contract. TIGC's get-rich-without-risk scheme certainly is such a duck.

In the end, the essential question is always where the risk of the enterprise lies. If it is within the control of the purchaser, or the purchaser plays a significant role in determining the success of the enterprise, this third element of an investment contract will not be found. n277

The treatment of franchises under the federal securities laws well illustrates the extent to which the role played by purchasers in the management and operation of an enterprise is a determinative factor in determining the presence of and investment contract. Where a franchisee must contribute meaningfully to the success of a franchise, no security will be found. n278 However, where a franchisee is clearly dependent upon the efforts of others in order to achieve sales through which to gain on their investment, a security will be found. Where, for example, the realization of profit through exploitation of a franchised territory in which deregulated electric utility services would be provided depended upon the ability of the franchisor to deliver the utility power, and upon the telemarketing operations of the franchisor to convert residential customers in the territory within a finite period, the role of the franchisee was purely ministerial and involved no real control over the success of the enterprise. The relationship involves all investment contract elements. n279

With the essential elements of an investment contract now in place, various applications of the concept are considered below.

[c] Particular Applications

[i] Partnership and Joint Venture Interests. The essential characteristic of a partnership or joint venture is the presumed equal role of participants in management and control of the enterprise. Such a role is the antithesis of the relationship that marks a security transaction. *General* partnership and joint venture interests, as such, are not securities. On the other hand, *limited* partnerships, which by law separate "partners" from control, are securities. n280

The structural distinction between general and limited partnerships well illustrates the notion of the "passive" investor often used to describe one who has purchased an investment contract. A general partnership by its very definition is an "association of two or more persons to carry on as co-owners a business for profit." n281 Unless otherwise agreed, all general partners have an equal voice in management regardless of their financial interest in the partnership, and all partners share in the profits and losses. n282 General partners act as principals for themselves and agents for the partners as a group. They are jointly and severally liable for damages caused by any tort or breach of trust committed by a partner within the scope of the partnership's business, and they are jointly liable for other partnership obligations. n283 In terms of *Howey*, a true general partner or joint venturer, n284 can only expect to derive profits through his or her individual contribution to the efforts of the partners or co-venturers. n285

Entirely different considerations apply to *limited* partnership interests. Indeed the use of the word "partner" is actually a misnomer. A limited partner is a passive investor, having no active voice or meaningful control in the conduct of the partnership's affairs. Nevertheless, use of the term will not control if in fact a limited partner retains such control in an enterprise as to directly affect the profits expected to be received. In *Steinhardt Group, Inc. v. Citicorp*, n286 a limited partnership agreement empowered the partner to take various "material actions" without the consent of other partners, including actions that the court considered crucial to the success of the enterprise. The kinds of powers reserved to the "limited" partner, said the court, actually gave him pervasive control over the management of the partnership, and were powers far afield of the typical limited partnership agreement. Indeed, the court concluded that without the limited partner's involvement, "the Partnership could only operate in a static, inflexible way that is unrealistic and impractical in today's business climate." n287

An assessment of actual control characteristics can surely lead to a conclusion such as that in *Steinhardt* that no "limited" partnership is present. In the main, however, because the Uniform Limited Partnership Act provides that a limited partner is not liable for the obligations of the partnership beyond the amount of his investment *unless* he takes part in the control of the business, n288 structuring a relationship so as to comport with the mandated absence of control means that the interest of a limited partner is unquestionably an investment contract and, at the same time, a "certificate of interest in [a] profit-sharing agreement." n289

Armed with the principle that, in determining the scope of federal securities law protection, the *form* of an instrument or transaction is to be disregarded for its *substance* and the emphasis placed on economic reality, n290 purported "general" partnerships have been held to involve investment contracts. This result flows from an examination of the actual relationship among the partners or venturers and an assessment of control characteristics. Partners or co-venturers may, among themselves, alter the presumption of shared control through delegation of management responsibilities. But delegation of authority does not deprive actual partners of ultimate responsibilities for management of the enterprise. Contrasting the position of a general partner to that of a corporate stockholder, it has been said:

General partners, no matter how many or few they may be, are still as a group, legally responsible for the management of the firm. Stockholders, however, no matter how many or few they may be, have a legally circumscribed role in the management of the corporation. State corporation statutes uniformly invest exclusive power to manage the ordinary business affairs with the Board of Directors, and indeed the very concept of a corporation is one in which the control of assets is divorced from ownership. n291

The power of general partners to alter their own relationships for purposes of managing the enterprise is evidence of their ultimate control.

Other factors, however, can lead to different conclusions concerning the reality of a general partnership interest as a security. In the leading case to consider the issue, the following factors were enunciated for making the determination:

- an agreement among the partners leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership;
- the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or
- the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. n292

The essential question is whether the partnership agreement or arrangement leaves purported "general" partners with

such little power as to place them in a position analogous to a limited partner. n293 The issue is one of fact. n294 It is not whether one has been *deprived* of partnership powers, which would be solely redressable as a matter of partnership law, but rather whether the structure and actual relationship among partners *ab initio* is such that the partner had no real opportunity to exercise any power normally accorded to a general partner. The controlling principle has been most cogently stated:

Even when general partners do not individually have decisive control over major decisions, they do have the sort of influence which generally provides them with access to important information and protection against a dependence on others The managerial powers and the right of inspection vested in general partners therefore takes them outside the intended scope of federal securities laws. n295

[ii] Limited Liability Partnerships. As an emergent hybrid between general and limited partnerships, the "limited liability partnership" (LLP) is one in which a partner is liable only for the amount of his or her capital contribution, plus the partner's personal acts, and is not exposed to vicarious liability for the acts of other partners or the acts of the partnership as a whole. In that respect the LLP bears some similarity to a limited partnership. However, while the limitation on liability in an LLP may mean that partners have less incentive to preserve control than general partners do because their personal assets are at not at risk, this does not mean that LLP partners lack the ability to control the profitability of their investments. The powers of partners can be prescribed by a partnership agreement in the same manner as any form of organization. An LLP partner may wish to remain wholly passive, and the applicable agreement may provide for that. However, it is just as likely that an LLP agreement will provide significant powers of partners, as in a general partnership. Not surprisingly, the same investment contract analysis applied in the determination whether general partnership interests are securities is applied in the LLP context.

In *SEC v. Merchant Capital, LLC*, n296 the court considered the application of registration and antifraud provisions of the federal securities laws to interests sold in twenty-eight registered limited liability partnerships to 485 persons, raising \$26 million. The LLP partners were all members of the general public with no demonstrated expertise in the debt purchasing business of the partnerships. The SEC asserted that the LLP interests were investment contracts within the meaning of the federal securities laws, and that the defendants had committed securities fraud in marketing the interests. The Eleventh Circuit agreed, and reversed a District Court determination that had found no investment contract to be involved.

In *Merchant Capital* the LLP partners entered into agreements under which a "Managing General Partner" was designated as the operational head of each partnership, with sole authority to bind the partnership. Partnership marketing materials informed the partners that they were expected to have an active role in managing the business of the partnership, and the partnership agreement reserved certain powers to the partners. Partners had the ability to select the managing general partner. They had the exclusive right to approve any act obligating the partnership in an amount exceeding \$5,000. They could remove the Managing General Partner for cause, and they could inspect books and records and participate in committee meetings. That being the case, the Court nevertheless concluded that in practice the LLP partners exercised little control over the operations of their partnerships. The Managing General Partner, who was the only candidate for the position on ballots submitted to partners, made the key business decisions, and the commitment approval process was inadequate and often ignored. The court concluded that partners had no significant ability to control the business after their initial investment, and that their other reserved powers were either insignificant or meaningless in practical terms.

The court applied each of the factors that had been articulated in *Williamson v. Tucker*, n297 discussed above in regard to whether interests in a general partnership could be deemed to be securities, to conclude that the LLP partners in *Marchant Capital* had only the powers of limited partners. They had no real ability to remove the Managing General Partner, and their purported authority to approve partnership commitments was illusory. The partners were completely inexperienced in the business of the partnership. All of these factors compelled the conclusion that the LLP interests were securities. n298

[iii] Limited Liability Company Membership Interests. "State Limited Liability Company" (LLC) laws provide for the creation of a business organization by "members" who enjoy the limited liability associated with a corporate form of organization while at the same time permitting taxation of the entity as a partnership. LLCs are based upon a contractual arrangement ("Operating Agreement") among members prescribing, among other things, the extent of participation in and control by members in management and operations. Unlike limited partnerships, the limited liability of LLC members is not lost with participation in control of the enterprise. LLCs are hybrid entities that combine desirable characteristics of corporations, limited partnerships, and general partnerships. LLCs have greater flexibility than corporations in terms of organizational structure. Most LLC statutes establish a default rule that management of the LLC shall be vested in its members, but permit that members may establish particular forms of governance in their operating agreements

In some instances, the ability or extent to which LLC members may participate in management of the enterprise is dictated by statute. Some statutes require management by managers--a board-managed or centralized form of organization in which management is reserved to a limited number of persons. n299 Others prescribe variants of both centralized and decentralized management, the latter leaving management in the hands of the members and allowing for the specification of member roles and rights through "operating" or "member control" agreements. In this manner, the LLC resembles a close corporation, controlled in accordance with a "close corporation agreement." n300 However, because LLCs are non-corporate, they are not bound by state corporation law requirements and restrictions in matters such as governance and finance. LLC members' governance rights may be prescribed by the LLC statute or by agreement among the members. The operating agreement, is the key to defining LLC membership interests as securities.

Although many state securities laws today expressly include limited liability membership interests in the statutory definition of security, as a matter of the federal securities laws whether LLC membership interests are securities depends upon the application of investment contract analysis. In this analysis the focus is largely upon the management characteristics of a particular LLC. Interests in a centralized management LLC, in which members are merely passive investors, will clearly be deemed to be investment contracts. An operating agreement among members that delegates control over ordinary business decisions to certain "managing members," who also are vested with the sole power to bind the LLC and do all other things necessary to carry on the business and affairs of the LLC, creates a relationship and set of investment risks little different from a limited partnership. n301 On the other hand, as meaningful involvement in operations and control increases, the likelihood that general partnership or joint venture control characteristics will be found also increases, thus precluding security status. For example, in *Keith v. Black Diamond Advisors, Inc.*, n302 membership interests in a New York limited liability company were held not to be investment contracts because there was no expectation of profits from the efforts of others, and the member was not a passive investor. In fact, the member became involved in the enterprise on representations that he would oversee marketing operations, and that his ownership interest would never be unfairly diluted. Coupled with rights accorded to him under the state's LLC Law, the court concluded that although the degree of control the member actually exercised was less than he expected, he clearly did not intend to be a passive investor. The level of control he possessed, said the court, was "antithetical to the notion of member passivity required under the fourth prong of *Howey*." n303

Because an ultimate question is whether securities law protection is needed in a particular set of circumstances, the plan or manner of distribution of LLC membership interests will also play an important role in determining their status as securities. Public offerings or systematic solicitation of unsophisticated prospective members by promoter/managers through mass marketing campaigns have triggered administrative actions by state securities regulators. n304 Moreover, investment contract analysis is easily applied in such settings, where the essential managerial efforts for the success of an LLC enterprise are those of the promoter or a related party.

In the absence of any clear line, and the ultimate necessity of applying investment contract criteria notwithstanding, as noted above, several states have expressly included LLC membership interests within their own Blue Sky Law definitions of security. n305 At the same time, respected commentators urge that there should be a rebuttable

presumption *against* characterizing LLC membership interests as securities. n306 Neither approach is sound unless there is uniformity among provisions for, or limitations on, member involvement in managerial control of an LLC. Partnership and joint venture cases teach that finding a security in any non-corporate business association requires a discrete assessment of the relationship between the parties and the risk characteristics inherent in it. Statutory flexibility in prescribing possibilities for structuring management and control of LLCs compels an examination of the particular form in operation and counsels against generalizations about whether the membership interests are securities.

[iv] Club Memberships and Membership Organizations. The sale of memberships in a club or similar organization has sometimes been held to constitute the sale of securities in the form of investment contracts. n307 Use of the term "membership" in these situations is often merely a cover for a financing scheme that evidences the characteristics of any investment contract as promoters raise capital and "members" assume risk. Indeed, it was in the "membership" context that the important "risk capital" approach to the definition of a security first emerged. n308

A bona fide membership organization with no investment characteristics will not involve the sale of a security. The SEC Staff has agreed, for example, that memberships, or seats, on the American Stock Exchange are not securities. Exchange members have interests in a not-for-profit organization, characterized as a commonly- owned platform which members use to earn their livelihood from their individual trading efforts or the efforts of a lessee. Their "economic interests" are not such as to support an expectation of profits from the efforts of anyone else. n309 On the other hand, a New York state court concluded that "a seat on the NYSE is the ultimate security." In *Wey v. New York Stock Exchange*, n310 the court concluded that an NYSE seat clearly meets the test for an investment contract. The creation of the NYSE itself, said the court, satisfies the common venture and reasonable expectation of profits elements of an investment contract. Moreover, the value of a seat on the Exchange is derived from the efforts of brokers and traders driving the stock market, by trading volume, by adding new companies to the Exchange, and making a profit from each trade. The particular Exchange seat involved in *Wey* was purchased as an investment opportunity. It is not at all clear in this "membership" context that investment contract analysis is faithfully applied to protect against true investment risk. However, *Wey* clearly illustrates a willingness to look beyond common perceptions of a membership organization to identify a need for investor protection.

Even the sale of memberships for financing the acquisition of property by a *non-profit* membership corporation has been deemed permissible without Securities Act compliance. n311 The true character of the particular "membership" will control. Thus, "memberships" that represent nothing more than pyramid or multi-level sales programs constituting investment contracts will not escape security status. n312

The question of whether memberships in investment clubs constitute securities is a difficult one. The many forms such clubs can take make it dangerous to generalize about them. However, a common characteristic, indeed an attraction, is the shared decision-making among members with respect to investments. The relationship suggests a joint venture and, despite the goal of "investment" profits, the members jointly participate in the selection process. As previously seen, however, the structure of a particular club may negate meaningful participation. Each case must be evaluated on its own facts. n313

[v] Real Estate and Related Financing. *Howey* illustrates the transformation of what is ostensibly a purchase of real property into a security through coupled arrangements or mechanisms that bear directly upon the value of the property. The promoters offered small tracts in an orange grove development coupled with a contract for cultivating, marketing, and remitting the net proceeds of production to owners of the tracts. The coupled arrangements were not mandatory, but the small size of the individual tracts rendered any independent development and management economically unrealistic. Although purchasers received warranty deeds to the property upon full payment of the price, the court held that the land sales contracts coupled with the service contracts were securities and, thus, set the stage for evaluating all investment-oriented programs built around "ownership" of real property.

In the opposite corner, *United Housing Foundation, Inc. v. Forman* n314 stands as a caveat. The federal securities laws

protect *investment* decisions. *Forman* and its progeny deny that protection to the acquisition of residential real estate, purchased with the expectation of residence. n315 Real estate transactions are typically deemed outside the definition of "security." A piece of real estate, such as a condominium, has an inherent worth that is not solely dependent on the efforts of a promoter. "Investments" in real estate solely for the purpose of gaining from appreciation on resale cannot be securities. n316

On the other hand, where properties are offered with emphasis on investment considerations and with coupled programs for management and income production, as have typified some offerings of condominiums, investment contracts are likely to be found. Certain real estate investments may be securities when the sale itself is tied to a collateral rental or service agreement, when the purchase is motivated by economic inducements and expected profits, when the purchaser expects to participate in a profit-sharing or rental pooling arrangement upon completing the transaction, or when the transaction includes restrictions limiting the owner's control over the property. n317 The presence of rental pools and the employment of marketing and promotional campaigns that stress investment potential have often triggered application of the securities laws and have been isolated as determinative factors in certain settings. In a 1973 Release on point, the SEC addressed offerings of resort condominiums in which such "investment" opportunities are a major thrust. The Commission offered these guidelines for determining whether a security is present:

- (1) The condominiums, with any rental arrangement or other similar [device], are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units;
- (2) The offering of participation in a rental pool arrangement; and
- (3) The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit. n318

By contrast, when real estate units "are not offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of others, and assuming that no plan to avoid the registration requirements of the Securities Act is involved," the unit owner "may enter into a non-pooled rental arrangement with an agent not designated or required to be used as a condition of purchase" and the transaction will not involve the sale of a security. n319

Induced expectations play an important role, as this observation in *Adams v. Hyannis Harborview, Inc.* n320 well attests:

Not surprisingly ... the plaintiffs bought their units with the expectation that they would operate as investments. The thrust of their testimony was that they wanted investments that would be run by a management company so they would not have to be involved in the day-to-day management of the property. Their testimony is supported by the fact that the plaintiffs generally are nonresidents who lack the skill, knowledge and equipment necessary to manage the kind of investment involved in this case The fact that some plaintiffs expressed an interest in using their units for vacations a few times each year does not negate their investment-oriented expectations. It simply acknowledges the fringe benefits to the investment. n321

However, sale and leaseback arrangements and other management or service programs that do not intertwine potential profit with the enterprise of the seller/lessor or other purchasers will generally preclude security status for want of requisite common enterprise. For example, where condominium purchasers entered only into management service contracts with a seller/promoter, there was nothing to indicate that the fortunes of the purchasers were interwoven with the promoter's fortunes. Although purchasers intended their units to be investments, *i.e.*, to rent out, the purchases were

in no way conditioned upon participation in any rental pooling arrangement and there were no limitations placed on use of the units. n322

Financing real estate development through *syndications* to investors is common, and, in their typical format, syndications are unquestionably subject to the securities laws. n323 In these situations, the "security" involved is not the ownership interest in real estate. Rather, the security is that issued by the entity, most often a limited partnership, which acquires the ownership interest in the real estate. n324 Real estate investment trusts are also financing vehicles for the development of commercial properties. As with limited partnerships, there is little question that the securities issued by these entities are subject to all aspects of the Securities Act in the absence of an exemption.

Limited partnership syndications and real estate investment trusts engage in capital formation for financing real estate development. Capital formation activities lay at the heart of the securities laws. Other financing schemes relating to real estate do not facially resemble these kinds of offerings but trigger the same concern for investor protection. For example, in *Woolridge Homes, Inc. v. Bronze Tree, Inc.*, n325 monies collected as pre-sale purchase commitments for units in a resort condominium complex were pooled and utilized to obtain construction financing for the project. The scheme was held to involve the sale of securities, and it rather clearly evidences the capital formation and investment risk setting at which protections of the Securities Act are targeted.

Investment contracts in the real estate setting are most often found in situations in which purchasers are led to expect future development and profitable results from the promoter's efforts. n326 Offerings of resort or recreational properties provide many excellent examples. Many of these are development projects in which the purchasers actually fund the completion and development. It is important, however, to understand the distinction between the conventional sale of real estate and one involving an investment contract. Even if bought for "investment," the acquisition of real estate is not considered to be a security. Commitments and promises incident to the purchase, linked enterprise of the seller/developer, and other arrangements may convert the interest acquired into one involving a common enterprise. However, as the First Circuit opined in *Rodriguez v. Banco Central Corp.*, n327 merely purchasing with an induced expectation that the surrounding area would develop into a thriving residential community does not indicate the requisite linkage to what amounts to a promised business venture harnessing the entrepreneurship of the promoter. Where there was only an expectation that a community was going to develop through "natural forces," said the court, there was no pretense of a common enterprise, and no investment contract could be found.

Other contemporary investment contract issues in real estate arise in the context of interval ownership or "time sharing;" n328 mortgage pooling, "pass-through," or servicing programs; n329 "leaseback" programs; n330 and, in general, in many creative programs relating to mortgage financing of residential and commercial properties. n331 The fundamental analysis under *Howey* remains constant. In *Wals v. Fox Hills Development Corporation*, for example, a time sharing purchase and rental and swapping agreement was held not to be a security where the purchasers did not receive an undivided share of some pool of rentals or profits. The court characterized the "investment" of the purchasers as:

[A] specific time slice of a specific apartment the physical and temporal characteristics of which (including price) differed from those of other apartments. Their return was tied to another space-time slice with its own unique characteristics. Every week of every apartment was a different product. n332

Owning a temporal slice of a condominium unit, said the court, was no different than owning the unit year round. The expected return was rental on a single unit and not a pooling of all units.

Whatever the subject matter of a transaction, a mere expectation of "profit," be it in the form of an income stream or simply the appreciation in value of a property, will not create a security without more. It is the third element of the *Howey* test -- an induced expectation of profits from the efforts of others -- that makes the purchaser of real estate an investor within the contemplation of the securities laws. It has been said that Congress did not intend to bring every real estate venture, limited partnership, or multi-party transaction within the regulatory sweep of the federal securities laws,

n333 and *Forman* itself best illustrates that an investment contract turns, first and foremost, on the presence of an *investment* and the creation of investment risk through an arrangement in which value determinants -- the "entrepreneurial or managerial efforts" -- are separated from ownership. n334

The extent of involvement, if any, of a purchaser in a real estate venture is a question of fact to be considered in every case. The purchase of an apartment building from a property management firm with the expectation that the seller will continue to manage the building is not the purchase of a security where the purchasers possess ultimate authority over the management function. n335 Condominiums sold with a rental pooling arrangement are not securities in which the management company and the promoter are unaffiliated and the rental pool is under the exclusive control of the homeowners' association. n336 On the other hand, investors in syndicates formed to develop and operate real estate could be purchasers of securities despite the fact that governing agreements conveyed substantial control over the properties to them but where, as a practical matter, the investors were incapable of exercising the powers. n337

These examples underscore the contemporary emphasis on the economic reality underlying *Howey*. To find an investment contract in the real estate setting is to find that "ownership" is secondary to the significant value determinants. If a fee simple interest in real property depends for its expected real value upon a common enterprise with others to share in the fruits of others' efforts and abilities, a security is present. One state Blue Sky administrator, for example, has cautioned that real estate "tenancies in common" may be considered investment contracts. Generally, a tenancy in common is a form of property ownership in which multiple persons own an undivided fractional interest in the entire property. But the form of ownership makes no difference if in the tenancy in common individual "owners" commit their assets to what is in fact a pooling of funds to acquire real estate with the expectation of making profits from the entrepreneurial or managerial efforts of others. n338

Modern *Howey* cases teach only that in assessing a given situation, one must pay close attention to *reasonable* expectations, promotional characteristics, essential managerial efforts, and, the sum of it all, the nature of the risk presented to the purchaser. n339

[vi] Pooled Funds and Collective Investment Vehicles. Traditional collective investment vehicles such as mutual funds, unit investment trusts, or other "managed" fund investment programs built around the pooling of funds, and which involve the issuance and distribution of their own securities, are subject not only to the Securities Act, but, quite likely, the Investment Company Act of 1940 as well. n340

The contemporary financial services market has prompted a different look at mechanisms for pooling of funds for investment or investment-related purposes. Investment management services have proliferated, as have new collective investment vehicles designed to provide opportunities for public participation in response to general economic developments. High interest rates, for example, spawned the creation of certificates of interest for fractional interests in portfolios of large denomination, short-term certificates of deposit issued by commercial banks. These instruments created opportunities for persons who could not otherwise do so to share in the available high rates of return. While the underlying instruments were bank-issued certificates of deposit, the sponsors of the program performed significant functions, and the program was deemed to involve the sale of securities. n341

Bank-sponsored services built around asset management and the desirability of providing collective investment mechanisms for accounts administered by banks raise questions of securities law coverage, as have plans for custodial accounts and collective trust funds for the assets of employee benefit plans. n342 Purely *service-oriented* bank programs for collective investment of trust funds are generally not deemed to involve the creation of securities. n343 Similarly, depository and other services related to investment programs of others will not be deemed to be the creation of a separate security where the actual "investment" is separate from the services provided. n344 However, commingled funds received for investment, particularly where promotional characteristics and solicitation are in evidence, are likely to be securities where a *common enterprise* among participants is clearly shown. n345

[vii] Employee Benefit Plans.

The specific reference in Section 2(1) to "participation in any profit-sharing agreement" calls to mind stock option, stock purchase, and other types of employee benefit plans built around the distribution of stock of an employer. These kinds of conventional plans generally do not create any security independent of the stock involved. n346

There is no question, of course, that the "stock" offered through such a plan is a security, n347 and where the distribution process involves the "sale" of that stock, it is subject to regulation under the Securities Act. n348 In these situations, the focal point of securities law concern is the stock being distributed and not the nature of the *plan* itself. n349

The distinction is critically important and is illustrated by the Second Circuit decision in *Yoder v. Orthomolecular Nutrition Institute, Inc.* n350 In *Yoder*, the court opined that a claim under the antifraud provisions of the federal securities laws was stated in a complaint alleging that a company had knowingly misrepresented its financial condition when it undertook to issue stock to a person who, in reliance thereon, became an employee and transferred certain assets to the company. The court observed that stock is "the paradigm of a security" and that: "We see no reason why 'the context requires' us to hold that an individual who commits herself to employment by a corporation in return for stock or promise of stock should not be considered an investor." n351 In the *Yoder* context, stock is not incidentally involved as part of a benefit plan but is rather the focal point of a decision. Because the value of the stock being offered as an inducement to become employed is the issue, a protected investment decision may be said to be involved. The same is true in circumstances in which an existing employee, through a voluntary wage reduction program, is allocated shares through an ESOP. Each employee who elects to participate gives up a portion of wages as specific consideration, and thus makes an investment decision. n352 This stands in contrast, however, to compulsory, non-contributory stock ownership plans, which do not involve a person giving up any specific consideration for a separable financial interest in the company. In these situations, participation in a plan is only an incident of employment and not an investment decision. n353

Where employee benefit plans n354 are involved, participations in the plans may evidence investment characteristics and may be deemed to be investment contracts, certificates of interest, or participation in a profit-sharing agreement. n355 Even where stock is involved, the *indirect* character of ownership, as with an ESOP, suggests a separate investment contract where the attributes of the plan are such that the employee-beneficiary is divested of control over his or her interest in the plan. n356 The SEC has identified the key factors for evaluating such a plan under investment contract principles as follows:

- (1) whether there are limitations on employee rights to withdraw from the plan, or to withdraw securities;
- (2) whether management discretion is granted to someone other than plan participants;
- (3) whether substantial sums of money are accumulated by the plan manager for material periods of time before investment;
- (4) whether participants pay any special fees or charges; and
- (5) whether plan participation involves diminution of an employee's rights or privileges as a shareholder.

n357

It is *International Brotherhood of Teamsters v. Daniel* n358 that has focused the greatest amount of attention on employee benefit plans, particularly retirement plans, under the securities laws. In *Daniel*, the Supreme Court held that interests in noncontributory, compulsory pension plans are not securities. The case has broad ramifications not only for

the definition of "security" and the scope of federal securities law protection in general but for the key notion of "sale" as well. n359

Daniel, a retired truck driver, had worked 22 years for employers covered by the Teamsters' pension plan. The plan required a 20-year vesting period with no break in service. However, because of an involuntary three month layoff during his years of service, Daniel was denied benefits under the plan. In a suit alleging violations of the antifraud provisions of the Exchange Act, Daniel asserted that interests in the pension plan were securities and that the union had misrepresented the requirements of the plan. The interests were said to be investment contracts, a "sale" of which had been made when Daniel voted on collective bargaining agreements and opted for employer contributions to the plan in lieu of other wages or benefits.

Daniel's securities law contentions were upheld against a motion to dismiss, and the Seventh Circuit affirmed. n360 However, the Supreme Court unanimously reversed. It did so on three fundamental grounds. In the first place, Daniel made no "investment of money." The Court opined that to equate *employer* contributions with an "investment" by the employee would be to ignore economic reality. n361 Secondly, Daniel had no expectation of profits from a common enterprise. The plan, said the Court, was part of a total compensation package. The earnings of the fund were not significant to the employee -- only the length of service mattered. Neither did the financial health or results of the fund matter. Finally, *other regulation* provided adequate, and intended, protection to persons in Daniel's position. As the Court declared: "The existence of comprehensive legislation governing the use and terms of employee pension plans [ERISA] severely undercuts all arguments for extending the Securities Act to noncontributory, compulsory pension plans." n362

The "economic realities" of *Daniel* centered on the absence of any genuine investment decision. "[I]t seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment." n363 The Court was not inclined to convert millions of workers into security holders on the contentions presented in the case. It did, however, leave certain questions unanswered concerning the possible application of the Securities Act to other types of employee benefit and retirement plans, particularly those that are voluntary and involve employee contributions. n364

Most such plans have been examined in terms of investment risk and the expectations of participants. *Coward v. Colgate-Palmolive Co.* n365 illustrates the clear weight of authority: "After examining the economic substance of plaintiff's interest in the pension fund, we conclude that there is no real risk to the capital representing the participants' contributions as to make plaintiffs, in any meaningful sense, 'sharer[s] in the investment experience' of the enterprise." n366 These decisions, like *Daniel*, emphasize that the participant's expectations, and the plan benefits, are determined by an applicable formula and not by the investment success of the plan managers. n367

Three common factors emerge in judicial assessments that benefit plan interests are not securities:

- (1) The existence of a comprehensive scheme of other regulation, i.e., ERISA, which filled a Congressionally acknowledged regulatory void;
- (2) The fact that any profits resulting from investment of plan assets become an indivisible part of the plan and are not attributed to the individual interests of participants in a way that could be said to yield an investment return to the participant; and
- (3) The benefits that plan participants expect to receive are not linked to the success of plan investments, i.e., benefits are a function of compensation, length of service and other factors unrelated to investment performance. n368

In two post-*Daniel* releases, the staff of the SEC expressed the view that interests in employee benefit plans that are not

both voluntary and contributory are not securities. n369 Those few situations that have been viewed by the Staff as creating securities illustrate the distinction. In *Diasonics, Inc.*, n370 for example, a profit-sharing plan built around elective salary reductions by employees was considered to involve a security. Also, in *Analog Devices, Inc.*, n371 a voluntary "salary conversion" plan in which employee's funds were invested according to their wishes was considered to involve creation of a security in light of the employee election to contribute a portion of compensation to the plan.

The post-*Daniel* releases emphasize that whether interests in an employee benefit plan are securities will not be determined solely by the form of the plan, that is, whether it is defined benefit or defined contribution. Rather, the particular aspects of the plan--for example, whether it is voluntary or involuntary, or whether it is contributory or non-contributory--must be examined. Voluntary, contributory plans are clearly most susceptible to investment contract analysis in the post-*Daniel* era, and as seen below, these types of plans continue to be scrutinized under the Securities Act.

[A] Corporate Plans. Of the four possible combinations of corporate plans--(a) involuntary, noncontributory; (b) involuntary, contributory; (c) voluntary, noncontributory; and (d) voluntary, contributory--the SEC has taken the position that only interests of employees in voluntary, contributory pension and profit-sharing plans may be securities within the contemplation of the Securities Act. n372 Following this lead, in *Dubin v. E.F. Hutton Group, Inc.*, n373 the court held that interests in a company "Equity Ownership Plan" were securities. Under the plan, certain executives of the company were "eligible to participate," but participation was neither required nor guaranteed. In effect, executives were invited to participate and were expected to make some contribution to the company in return for the stock or stock options made available to them under the plan. Plaintiff claimed that the plan had a direct bearing upon his willingness to accept employment and asserted that he was deceived concerning vesting rights in the plan. The court allowed his claim under the antifraud provisions to stand. In doing so, the court found that the interests in the plan were consistent with the SEC releases and that, while the distinctions between the particular plan and the plan in *Daniel* were not "crystalline," the interests were appropriately characterized as securities.

[B] Keogh Plans. In the view of the Staff, interests or participations in Keogh plans (also known as "H.R. 10 plans"), n374 which include (1) interests in collective funding vehicles arising from investments made by the plan and (2) interests of employee participants in the plans themselves, are securities. However, registration of interest in Keogh plans is not required even if no exemption is readily available. n375

[C] IRAs and Simplified Employee Pension Plans. Individual retirement accounts that involve the placement of an individual's funds in the hands of another person, with reliance on that person to produce profits have been treated by the SEC Staff as investment contracts. The use of pooled investment media and the role of an employer or other sponsor in the investment process triggers investment contract analysis. In determining whether plans that permit participants to direct the investment of their funds through the sponsor involve separate employee interests that constitute investment contracts, the Staff will take the following into consideration:

- (1) whether the sponsor of the plan acts as a mere custodian of the participant's account and the participants have complete discretion and control over the account; or
 - (2) whether the sponsor actively manages plan funds and the participants rely on him to produce profits.
- n376

The inference in this view is that funds are contributed by the individual for investment through a collective medium or managed vehicle as to which a requisite common enterprise can be found. On the other hand, IRAs that involve direct investment by an individual, or "self direction," are not themselves securities. n377 In these settings the Staff has focused attention on the role of the sponsor/promoter. The sponsor usually limits its own involvement to establishing the plan and setting up separate accounts for each participant. Commingling of account assets is not permitted, and it is the individual participant who exercises investment discretion.

An argument often made is that interests in these types of plans do not constitute securities within the meaning of Section 2(1). The theory underlying this view is that each individual relies on his own efforts to earn a profit in his account, rather than the efforts of others, and therefore one of the key elements of an investment contract is missing. Although in practice this theory does not apply where an IRA or Keogh plan is funded through the use of a pooled investment medium, it has more validity where the sponsor acts as a mere custodian for a participant's separate account (the assets of which are not commingled) and the participant retains complete investment power or control over his account. Recognizing that the existence of an investment contract in such circumstances may be open to question, the SEC Staff generally has taken a no-action position regarding the registration of such interests. n378 Key elements in investment contract analysis are obviously missing in these situations.

[D] 401(k) Plans. *Section 401(k) of the Internal Revenue Code* exempts certain nondiscriminatory profit-sharing or stock bonus plans from taxation. n379 These immensely popular plans allow employees to elect annually either to receive immediate payment of their employer's contribution to the plan or to defer receipt of, and not be subject to, income tax on the contribution but, instead, have it invested in a trust where it will accumulate for later payment. The SEC Staff has taken the position that any cash or deferred arrangements qualifying under Section 401(k) that do not involve out-of-pocket investments by employees of their own funds but are instead funded entirely by employer contributions are not *voluntary* contribution plans and, as such, do not constitute securities. n380

[E] Miscellaneous Plans. Employee interests in stock purchase plans that acquire the employer's stock in the open market may be deemed to be securities where there are substantial differences between the manner of acquiring stock under the plan and the manner of acquiring stock through ordinary brokerage transactions. Other variations as might result in open market stock purchase plan interests themselves being deemed to be securities. n381 The inquiry is whether there are factors that tend to place the employee in a position of reliance upon the plan managers to maintain or protect his or her investment. n382

Other benefit plans such as Employee Stock Ownership Plans (ESOPs), Stock Appreciation Rights (SARs), and similar plans *involve* securities -- the stock itself -- but interests themselves in the plans will not create separate, additional securities unless factors evidencing investment risk are shown. n383 The key consideration is whether the person claiming to be an "investor" through such a plan has chosen to give up a specific consideration in return for a separable financial interest with the characteristics of a security rather than simply participating in a plan as an incident of employment. Thus, in *Childers v. Northwest Airlines, Inc.*, n384 the court declared that despite the fact that an ESOP was a "common venture" and that it was comprised of stock of the former company involved, plaintiff's participation in the plan was an incident of employment and not the purchase of a separate security. The plan was compulsory and did not involve an affirmative decision to give up a particular consideration in return for a financial interest. The plaintiff employee's participation could not have been based on any reasonable expectation of profits from management of the ESOP.

[F] Interests of Plans in Collective Investment Media. The investment of contributions made to employee benefit plans in pools of assets (such as bank collective trust funds or insurance company separate accounts) managed by other entities has previously been considered. n385 These vehicles for collective investments of funds may involve the creation of securities where they are marketed as investment vehicles and where the focus is on investment rather than a fiduciary service. n386

Whether interests in plans themselves, or interests in the vehicles in which the plans invest, are securities are separate issues. However, where there is a basis for finding a security somewhere in either the plan or the investment medium, where the employee participant makes a decision concerning the investment, securities law protections are most likely to be available. n387

[G] Workout and Reorganization Participations. "Workout" scenarios, involving employee agreements or participation in programs intended to save distressed companies, could involve the creation of securities where the

elements of an investment contract or a form promissory future obligation is involved. However, in *In re Tucker Freight Lines, Inc.*,ⁿ³⁸⁸ wage deferral contracts entered into between employees and their company were held not to be securities. Under the agreement, employees deferred part of their current wages as a "contribution" in support of the company, which would be paid without interest in the future contingent on the company attaining certain levels of profitability. After the ultimate bankruptcy of the company, ex-employees claimed the contracts were securities that had been sold to them by means of false or deceptive representations concerning future profitability. Asserted investment contract status of the agreements was premised upon the anticipated future participation in earnings. Dismissing the claim, the court held that future wages are not a participation in earnings because they are received for work, rather than passively as investments. The opportunity to earn wages, said the court, "[i]s merely something to be used to earn profit rather than profit itself."ⁿ³⁸⁹ The court also dismissed the employees' contention that the agreements constituted securities in the form of notes or other evidences of indebtedness. The agreements were characterized as "promissory obligations," and although the court found no *Reves* specific family resemblance to a class of non-security notes, the four factors to be generally applied resulted in a conclusion that no security was involved. There was no "profit" motivation presented.ⁿ³⁹⁰

[viii] Pyramid Sales Schemes, Multilevel Distributorships, and Franchises. The three elements of an "investment contract" must combine for that form of security to exist. Common enterprise and an expectation of profits from the efforts of others transform an "investment of money" into a security. But where a purchaser must make some significant effort toward the success of an enterprise, and as a result possesses some significant control over the profit potential of that enterprise, no investment contract can exist. The existence of an investment contract is premised upon the fact that profits of an enterprise will be derived from the seller's, or some third party's, *entrepreneurial or managerial efforts*.ⁿ³⁹¹ Strict application of the tripartite *Howey* test, with its requirement that an investor be led to expect profits "solely from the efforts of the promoter or a third party," has historically precluded the existence of an investment contract where a purchaser is required to make some significant effort toward the success of an enterprise. To be involved in the operation of the enterprise in this fashion is to retain some control over profit potential. Thus, attempts to characterize franchises as investment contracts have generally succumbed to this element of the *Howey* test.

A true franchise represents a business opportunity, a right to a name, perhaps a right to advertising and support services, but most fundamentally a right to engage in an enterprise. A franchisee is not presumed to be a "passive" investor and typically must work to make the franchise succeed. A franchisee may not claim a legitimate expectation of profits to come from the efforts of others, and federal courts are virtually unanimous in rejecting application of the securities laws to conventional franchise arrangements.ⁿ³⁹² The cases focus on the relative roles of franchisee and franchisor in the economic success of the enterprise. Where the success of the franchise operation is primarily dependent on factors controlled by the franchisee, no investment contract will be found.

A traditional franchise is built around the involvement of the franchisee in the operation of the enterprise. Non-traditional, or differently structured, schemes labeled as franchises, but which actually involve investments by persons who do not participate in the enterprise and who do not expect to do so, may nevertheless be considered investment contracts. This is so despite the fact that an investor may participate to *some* extent in the enterprise. However, the controlling consideration is always the degree to which an *expected return* is dependent upon the managerial/entrepreneurial efforts of the "franchisee." In *SEC v. Galaxy Foods, Inc.*,ⁿ³⁹³ for example, franchises in a home delivery service for supermarket items were held to be securities. The "franchisees" were required to invest substantial funds in exchange for only the opportunity to profit from the efforts of the franchisor company's management. The franchisee had no practical control over the success or failure of the enterprise. On the other hand, where "master franchise agreements" clearly held out the promise of profits from success of other franchisees recruited to engage in the business, no investment contract was found because profits "at least in large part" depended upon the master franchise holders' own successful first step to recruit successful franchisees in a territory.ⁿ³⁹⁴

The evolution of the *Howey* test in the courts has led to a focus on "undeniably significant" efforts as the key to application of investment contract analysis in these situations.ⁿ³⁹⁵ The "undeniably significant" characterization, also

referred to in terms of "those essential managerial efforts which affect the failure or success of the enterprise," n396 has received most thorough consideration in the pyramid sales and multilevel distributorship cases. The typical form of multilevel distributorship is established through "pyramid" promotions in which a company represents its intention to manufacture or sell, under its own trade name, a line of products. The company purports to offer franchises or distributorships for those products that ostensibly appear to follow established forms of franchise-distributorships. Normally, several types of distributorship agreements are said to be available to the public. At the lowest level, for a relatively small fee, the participant is provided with a sample inventory and will be authorized only to make retail sales to the public. For a larger fee, the participant is entitled to receive a wholesale inventory that he or she in turn supplies to salespeople whom he or she supervises. This participant may also be authorized to make retail sales. For an even larger fee, a more substantial wholesale inventory is obtained and responsibility is assumed for supervision of lower level participants. At the highest level of distribution, for a very substantial fee, a purported right to be the link between the company and the distribution chain is acquired. n397

Most prominent among the multilevel distributorship and pyramid scheme cases are *SEC v. Glen W. Turner Enterprises, Inc.* n398 and *SEC v. Koscot Interplanetary, Inc.*, n399 which together paved a way for application of securities laws to these schemes by identifying the presence of both investment contracts and "instruments[s] commonly known as a security." Both cases involved the promise and expectation of profits for purchasers that would come with the entry of new purchasers into the programs.

The lower levels of these plans, involving the actual marketing of a line of products, have never been the focus of securities law concerns. As the court observed in *Koscot*: "The SEC does not contend that the distribution of cosmetics is amenable to regulation under the federal securities laws. Rather, it maintains that the marketing of cosmetics and the recruitment aspects of Koscot's enterprise are separable and that only the latter are within the definition of a security. ..." n400 In its pronouncements, the SEC has emphasized the real "sales pitch" involved in these programs, stressing the amount of money a participant can make on the recruitment of others as the common element of pyramid promotions and the underlying "inherently fraudulent" nature of the programs: n401

Under these programs, various cash fees and percentage incentives are offered to those willing to participate as an inducement for the recruitment of additional participants. This aspect of the promotion is often given great emphasis ... [by] concentrating on the allegedly unlimited potential to make money in a relatively short period of time by recruiting others into the program. Since there are a finite number of prospective participants in any area, however, those induced to participate at later stages have little or no opportunity for recruitment of further persons. The promoters make significant efforts in bringing this about by inducing others whom existing purchasers attract to meetings to invest in the programs. n402 Courts viewed the promoters' efforts in these circumstances to be *managerial*, versus the *ministerial* acts of the investor/distributors. n403

The fact that in these types of schemes *some* effort on the part of the purchasers was required for the enterprise to be successful, called for confrontation of the "solely" from the efforts of others language of the *Howey* definition. However, viewing a "literal" application of *Howey* as frustrating the remedial purposes of the Securities Act, both the *Turner* and *Koscot* courts endorsed a "functional" approach to the issue of an investor's involvement in the enterprise. Under this approach, the critical inquiry is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts that affect the failure or success of the enterprise. In *Koscot*, the court opined that the salutary purposes of the federal securities laws can only be furthered by a functional approach to the role of an investor under the *Howey* test rather than its literal application. Concerning *Howey*, the court observed: "Nowhere in the opinion does the Supreme Court characterize the nature of the 'efforts' that would render a promotional scheme beyond the pale of the definition of an investment contract. Clearly the facts presented no issue of how to assess a scheme in which an investor performed mere perfunctory tasks." n404

The role played by investors in *Koscot* was recruitment of others to attend meetings and to participate in the consummation of sales by following a carefully scripted program as a part of the sales format thrust upon prospects by

the promoter. The orchestrated sales format was deemed to be the key to success: "An investor's sole contribution in following the script is a nominal one. Without the scenario created by the Opportunity Meetings and Go-Tours, an investor would invariably be powerless to realize any return. ..." n405 This represents a significant refinement of the *Howey* test but one grounded in economic reality. On the other hand, where one must engage in significant efforts as a distributor or supervisor, in order to realize any profit from that position in the hierarchical structure of a multi-level distributorship program, a security is much less likely to be found.

Although the focus of investment contract analysis here is primarily on the managerial element of *Howey*, there must also be a resolution of the "common enterprise" requirement in pyramid and multi-level programs. In *U.S. v. Holtzclaw*, n406 for example, the court rejected the argument that a pyramid program was an investment contract where the structure of the program was such that the fortunes of the participant were not tied to the fortunes of others. That is to say, investment contract status was denied for want of *horizontal* commonality. In the program, the individual participant was enticed by the opportunity to earn commissions from the sale of gold coin contracts to others through the promoter. Each participant represented that it was responsible for its own sales efforts. The scheme was structured so that when a sale was made, the profits were split between the participant and the promoter. The promoter was central to the transaction, and the emphasis was on selling contracts to others in order to pay one's own purchase obligation.

Although the court easily concluded that the scheme was a pyramid, and that *vertical* commonality between the participant and the promoter was presented, there was no intertwining of fortunes with other participants. A contextual reading of *Howey*, said the court, compels a conclusion that "a common enterprise exists only when the transaction contemplates a multiplicity of investors contemporaneously holding equipotential interests in the enterprise." n407 The "vertical" versus "horizontal" commonality conundrum in investment contract analysis has been previously examined. n408 In the pyramid context, however, the *Holtzclaw* assessment shows that it can be meaningful. The court distinguished the *Glenn W. Turner* and *Koscot* scenarios on the basic point that the numerous participants shared dependence on the promoters, which was not the case in *Holtzclaw*. n409

Conventional distributorships, like conventional franchises, are not deemed to be securities where the distributor is in control of his own business. n410 However, a license agreement to distribute certain devices was deemed to be a security where a companion agreement provided for the promoter to undertake substantially all significant sales efforts, and the licenses were marketed primarily to persons who were unlikely to sell the product themselves. n411 The induced expectation of a purchaser is extremely important. If the economic attraction and viability of a distributorship, license, or other form of "franchise" is the service to be provided by the seller, the likelihood of an investment contract being present is high.

[ix] Insurance and Annuities. Is "insurance" a security? It is certain that the drafters of the Securities Act were sufficiently concerned with the point to provide for the specific exemption from coverage provided in Section 3(a)(8) for "[a]ny insurance or endowment policy or annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions. ..." Legislative history indicates that insurance policies should not be regarded as securities and that, even without the exemption, they would be excluded. That view was premised upon the notion that insurance policies are not considered in the commercial world as investment securities. The exemption was included to make misinterpretation of this impossible. n412 The exemption is founded upon the existence of other regulation of the industry, but the fact that there is such an exemption does not preclude examination of insurance-related products and the application of securities law protections where the product involved is not clearly only an "insurance" or an "annuity contract" but, instead, has the elements of an investment contract or other form of security. n413 The treatment of variable annuity contracts in the courts brings the distinction into sharp focus.

In simplest terms, a variable annuity contract provides for deferred income for a holder based upon investment "sub-account" options chosen by the purchaser in which premium payments are invested by the issuing company. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market

instruments or some combination of all three. Investment options may be defined in terms of asset allocation along with investment objective and risk tolerance, and normally the owner is permitted to transfer sub-accounts from one investment option to another. The key features of variable annuities are, first, that they are contracts providing for periodic payments for the rest of the purchaser's or a designated beneficiary's life. Second, variable annuities have a death benefit which guarantees that the beneficiary will receive a specified amount, most often at least the total amount of premiums paid, at the time of the purchaser's death if the account value is less than the guaranteed amount. Third, variable annuities are tax-deferred. No taxes are paid on the income and investment gains from the annuity until money is withdrawn.

With a variable annuity, during a pay-in, or "accumulation," period, the purchaser makes premium payments, which are allocated to or among the available investment options. The value of the variable annuity, as its name implies, is not stable. It fluctuates in accordance with the value of the investment subaccounts. At retirement, or whatever predetermined point, the holder becomes entitled to a stream of payments (or a lump-sum payment if elected) based upon the value of his or her interest at that time (the "payout phase"). There are often choices of how long periodic payments will last, and the particular variable annuity may also provide for election to receive a fixed period payment amount, or payments that vary based upon continuing performance of the investment sub-accounts.

The *investment* characteristics of this type of contract are obvious. The purchaser assumes all investment risk concerning the value of his or her interest and the success of the issuing company's investment management. The chief characteristic of a variable annuity is the direct correlation between investments and the payouts to annuitants. n414 In *SEC v. Variable Life Insurance Co.* n415 (VALIC), the Supreme Court held a variable annuity contract to be a security in the form of either an investment contract, a certificate of interest, or participation in a profit-sharing agreement.

VALIC underscores the nature and importance of investment risk. Justice Douglas observed: "[T]he variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity interest reflects -- which may be a lot, a little, or nothing." n416 He explained by contrast that insurance involves risk-taking on the part of the issuing company. It involves a contractual *guarantee* of the benefit to the insured or its representatives. n417 VALIC guaranteed nothing but an interest in an investment portfolio -- "an interest that has a ceiling but no floor." n418

The allocation of investment risk was further underscored in the subsequent attempt to avoid the VALIC result by creation of the so-called "flexible fund," considered by the Supreme Court in *SEC v. United Benefit Life Insurance Co.* n419 In an effort to shift some risk to the issuing company yet preserve the "variable" feature of the product, the "flexible fund" annuity included a guarantee of cash value based upon the net premiums paid by an annuitant. Like VALIC, however, the thrust of the program was not accumulation of funds to a fixed amount but, rather, the opportunity to share in the investment experience of the company's portfolio, a point that was "pitched" to prospective purchasers. n420

The Supreme Court held the "flexible fund" to be an investment contract:

"[W]hile the guarantee of cash value ... reduces substantially the investment risk of the contract holder, the assumption of an investment risk cannot by itself create an insurance provision under the federal definition. ... *The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.*" n421

The focal point is when, and to what degree, risk is transferred from the insurance company to the buyer. Framing the question in terms of how much risk is too much, the Seventh Circuit examined the evolution of the critical point in this manner:

No annuity transfers all of the risk to the seller. Any fixed annuity places on the buyer the risk that

the seller's portfolio will perform too poorly to finance the promised payments. Section 3(a)(8) therefore necessarily exempts annuities that leave purchasers with some investment risk. If on the other hand a seller just pins the label "annuity" on a mutual fund, in which the buyer bears all of the risk, § 3(a)(8) is inapplicable. [VALIC] holds that a contract providing for variable payments based on the investors' stakes in a special investment portfolio is not an "annuity contract." The Court reasoned that because there was no guarantee of any return, the entire investment risk was borne by the purchaser of the annuity. Where there is no transfer of risk, the exemption does not apply. [United Benefit] extended "no" to "slight," holding that § 3(a)(8) does not apply to an instrument permitting purchasers to share in the performance of an investment portfolio with a guaranteed but low minimum rate of return. These guaranteed rates were well below what would be provided in a conventional annuity, so that the purchaser relied on the investment skills of the issuer to maintain earnings in excess of the contractual minimum. The Court thought that the dominant aspect of the instrument was that the seller acted as an "investment agency." n422

It is the uncertainty of "excess" earnings, i.e., those over and above any guaranteed rate of return that makes the difference. n423 The decision to purchase a fixed annuity is not an investment decision.

Distinctions between insurance-related products in the contemporary legal environment are often made as between *investment* annuities and *conventional* annuities. The latter do not result in the creation of a security. n424 For "variable" annuities, which do create securities, dual regulation under both securities and insurance laws is the norm. n425 What is actually "insurance" will not be deemed to be a security within the meaning of the Securities Act, but the focus in all cases is upon the actual characteristics of the product, particularly including the manner of its marketing. n426

New products continue to pose challenges. In *Malone v. Addison Insurance Marketing, Inc.*, n427 for example, the plaintiff purchased an "indexed deferred annuity," which guaranteed a fixed payment at a later date subject to an increase based on the performance of a stock index. The differences between fixed and variable annuities were not clearly apparent for this type of product, but the court ultimately determined that because a minimum rate of return was guaranteed without regard to the future value of the stock index, the insurance company and not the purchaser assumed the risk. Moreover, the court concluded, as a structural matter, that the contract did not operate like a variable annuity because there was no "separate account" through which the plaintiff's payments were invested. Finally, because of the guaranteed payment requirement there was no element of uncertainty and risk. Plaintiff's risk, said the court, was not that she would lose the value of her initial investment, but rather the risk that had she chosen a different contract her money might have become worth more. This, said the court, is not the type of risk central to determining whether a security exists. n428

The type of annuity contract involved in *Malone* is today commonly referred to as an "equity indexed annuity" (EIA). Most life insurance companies issuing this product link the rate of return paid on the annuity to the S & P 500 equity index. Some insurance companies may, however, use a different stock market index as the performance link for the annuity. EIAs have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. EIAs place more risk on the purchaser (with more potential return) than a fixed annuity, but less risk (and less potential return) than a variable annuity. EIAs often offer a minimum guaranteed interest rate combined with an interest rate linked to a market index. Because of the guaranteed interest rate, EIAs have less market risk than variable annuities. EIAs also have the potential to earn returns better than traditional fixed annuities when the stock market is rising. Depending on the mix of features, an EIA may or may not be a security. *Malone* illustrates one approach that found no security. On the other hand, in *Holding v. Cook* n429 the court was unwilling to dismiss federal securities law claims relating to the offer and sale of an EIA on the face of a contract, and concluded that a developed factual record after discovery was necessary to determine whether the EIA qualified for exemption under the federal Securities Act.

The evolution of insurance products involving investment features, and uncertainty concerning the proper application of securities regulation to such products, led in 1986 to adoption of Rule 151 under the Securities Act. The rule is intended to provide a "safe harbor" for issuers of such products by defining more precisely what constitutes sufficient risk-taking by the insurance company to avoid the contract being deemed a security. It declares that any annuity contract or "optional" annuity contract shall be deemed to fall within Section 3(a)(8) of the Securities Act, and thus be exempt from Securities Act coverage if certain conditions are met.

As a general matter, the safe harbor is available where the insurer assumes sufficient investment risk, and the contract is *not marketed primarily as an investment*. In determining whether sufficient investment risk has been assumed by the insurer, several criteria must be met:

- (1) the value of the contract must not vary according to the investment experience of any separate investment account;
- (2) the insurer, for the life of the contract, guarantees the principal amount of the purchase payment and interest, and credits a specified rate of interest to net purchase payments and interest credits; and
- (3) the insurer guarantees that the rate of any interest paid in excess of the guaranteed minimum will not be modified more than once per year.

As discussed above, the 2002 decision in *Malone v. Addison Insurance Marketing, Inc.* n430 illustrates the fact that not all questions were answered by Rule 151, although in that case the court also went on to analyze the facts under Rule 151, coming to the independent conclusion that the safe harbor applied as well. In another case, *Otto v. Variable Annuity Life Ins. Co.*, n431 the court found no sufficient retention of investment risk by the insurer where there was no meaningful control on the power of the insurer to vary "interest bands" for excess interest on the subject policies and the insurer could eliminate excess interest payments entirely at any time. This power, said the court, left the purchaser with an investment risk significant enough to cast doubt on the insurer's proposition that its "guaranteed" rate of interest, which was in excess of what would be required by Rule 151, should be the focal point. n432

"Charitable Gift Annuities" (CGAs) are widely used by non-profit or charitable organizations as part of their development programs and are attractive to donors as part of an overall estate plan. They may also be offered as investments by foundations and other organizations with no substantial or recognizable charitable track record. In any CGA a purchaser pays money to the sponsoring organization through an irrevocable gift of cash, securities or other assets. In return, the organization pools the money for investment, and promises to pay the donor/purchaser a fixed sum of money on a periodic basis, for life. In addition to an income stream for life, the donor/purchaser enjoys significant tax benefits resulting from the purchase of the CGA. Although the return is fixed over the life of the purchaser/donor, CGAs have characteristics of an investment contract under traditional *Howey* analysis. As such, they may be deemed to be securities subject to registration requirements under federal and state securities laws unless an exemption is available.

[x] Insurance Premium Funding Plans. Creative approaches to funding insurance programs through the use of securities and loans collateralized by securities (most often mutual fund shares) prompted securities law concerns. Such plans, often referred to as "life funding" or "secured funding" involve the purchase of securities, the pledge of those securities as collateral for a loan, the proceeds of which are used to pay premiums on life insurance.

The SEC has opined that these funding programs are themselves investment contracts:

The purchaser of the plan depends upon the promoters of the program to perform for him such services as formulating an overall program suitable to his individual needs; acting as a dealer in purchasing the mutual fund securities; securing and renewing loans annually on the plan; holding the

securities pledged to secure such loans; acting as agent in purchasing the insurance policy; and paying the annual insurance premiums as they fall due. ... The several components should thus be considered realistically, as a single investment medium in which the purchaser invests his money and depends upon the efforts of the promoters or other third persons to garner for him the benefits of the enterprise. n433

This "bundled" approach to the components of the program is key to identifying its investment character. Funding programs of more recent vintage have likewise been analyzed under the securities laws as unitary investment vehicles rather than separable services associated with insurance. n434

[xi] Viatical Settlements. Further attention to the possible presence of investment contracts related to insurance has come in the area of viatical settlements. These are transactions or arrangements whereby one or more persons acquire an interest in the future death benefit of the life insurance policy of a terminally ill person in exchange for current payment of some discounted percentage of the future benefit. n435 As investment opportunities, viatical settlements have been offered by promoters who acquire policies, package interests in them, and re-sell them to third parties. The promoters offering interests in viatical settlements undertake to determine life expectancy of the insureds whose policies are purchased, and to provide various post-sale services such as continuing premium payments, tracking the status of the insured, and obtaining payment of death benefits. "Investor" funds are used to maintain the policies in force, and to pay fees and commissions of the offering companies, salespersons, and escrow agents. There are variations in programs, and in the types of services undertaken or offered by promoters. In the main, however, purchasers of interests in viatical settlements expect significant percentage returns on their investments representing the spread between what is currently paid and the death benefit eventually collected.

In *SEC v. Life Partners, Inc.*, n436 a sharply divided federal appeals court held that viatical settlements, or fractional interests in them, are not securities subject to regulation under the federal securities laws. Applying investment contract analysis a majority of the court concluded that pre-purchase services of the promoting company in the evaluation of life expectancy, and largely ministerial post-purchase services were not sufficient to establish that investor profits would flow predominantly from the efforts of others. On the other hand, although the death benefit of each life insurance policy involved in a viatical settlement is fixed, and the investor has no control over the eventual date of death of any insured, actual return to a completely passive investor may be seen as tied to efforts of the promoter company in making evaluations, reviewing policies, negotiating the actual purchase of policies and drafting necessary documents. These are managerial or entrepreneurial efforts that are not insubstantial. Moreover, viatical settlements may be offered and sold as investments, advertising high rates of return and thus inviting investor protection expectations.

The *Life Partners* decision turned on the court's assessment that there was no "venture" associated with the ownership of an insurance contract from which the profit depended entirely upon the mortality of the insured. The court concluded that there was no significant post-purchase activity associated with the purchase of a viatical contract. This view applied generally to viaticals has not fared well in subsequent federal court analyses. In *SEC v. Mutual Benefits Corp.* n437 for example, the Eleventh Circuit rejected any notion that the investment contract elements established by the Supreme Court in *Howey* and *Edwards* "[r]equire such a clean distinction between a promoter's activities prior to his having use of an investor's money and his activities thereafter." n438 The court opined that there is no basis for excluding pre-purchase managerial activities from investment contract analysis. Significant pre-purchase managerial activities undertaken to insure the success of the investment, said the court, may also satisfy *Howey*. The court explained:

[T]he investors' expectations of profits in this case relied heavily on the pre- and post-payment efforts of the promoters in making investments in viatical settlement contracts profitable. The investors selected the "term" of their investment, and submitted completed agreement forms and money. Thereafter, MBC selected the insurance policies in which the investors' money would be placed. MBC bid on the policies and negotiated purchase prices with the insureds. MBC determined how much money would be placed in escrow to cover payment of future premiums. MBC undertook to evaluate the life expectancy of the insureds--evaluations critical to the success of the venture. If MBC underestimated the

insureds' life expectancy, the chances increased that the investors would realize less of a profit, or no profit at all... . There were important post-purchase managerial efforts of MBC as well. Often, life expectancy evaluations were not completed until after closing on a policy. And, after closing on a policy, MBC assumed the responsibility of making premium payments. n439

All of this, said the court, amounted to a classic investment contract. Another federal court rejected *Life Partners* on the same grounds, concluding that economic realities dictate against a narrow approach to the "efforts of others" element of *Howey*, and that viatical settlement contracts represent an opportunity to contribute or invest money into a common enterprise, and to share profits, with the critical aspects of a successful investment riding on the efforts of the promoter. n440

Moreover, many state regulators and legislatures have responded to the offer and sale of viatical settlements, and to the potential for fraud or abuse that exists by reason of risks of which investors may not be aware, and the potential for unscrupulous promoters to misrepresent them, by subjecting viatical settlements to regulation as securities under Blue Sky laws. Any consideration of viatical programs must take the continuing role of state securities regulation into account. n441 And state courts almost uniformly apply investment contract analysis to conclude that viatical settlements contracts are securities within the ambit of Blue Sky laws. n442

[xii] Bank and Thrift Deposit Relationships. In *Marine Bank v. Weaver*, n443 the Supreme Court held that a six-year certificate of deposit issued by a federally regulated and insured bank was not a security. Chief among the reasons for so holding was that the holders of such certificates are "abundantly protected" under the federal banking laws. As previously seen, n444 a certificate of deposit is an "evidence of indebtedness" within the definition in Section 2(1) of the Securities Act, just as a savings account passbook is an evidence of indebtedness. Yet, neither is a security. n445 It is the character of the transaction and the commercial relationship between the institution and the depositor that controls. The commercial relationship between a depositor and a bank or thrift institution can be altered to create investment risk. For example, "certificates of deposit" offered and sold through a brokerage firm program that emphasized liquidity through a secondary trading market were held to be securities in *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* n446 The court found that purchasers were buying something more than certificates of deposit and that the opportunity to participate in a secondary trading market made by the sponsor was the key consideration since it created liquidity that would not otherwise exist.

An investment program tied to a Mexican bank account was held to be an investment contract in *SEC v. Deyon*. n447 Investors required to make minimum \$25,000 deposits were induced to leave their funds on deposit to earn a 25% per month interest return. The bank account program was plainly promoted as a security, but the promised fixed rate of return was argued in contravention of any "common enterprise" assertion. The court rejected the assertion, however, noting that investors faced the possibility that the interest rate could fall significantly and imperil their expected return. Vertical commonality was present, said the court, because the promoters not only stood to gain more as more investors made deposits, but also could also be left without any profits. The determination that securities law protections were needed was no doubt colored by pervasive misrepresentations and underlying questions concerning the legitimacy of the bank account. However, the case illustrates that unorthodox deposit relationships can be transformed into circumstances fully demonstrating the need for "investor" protection.

In the usual depositor relationship, there are no genuine "investment" characteristics if for no other reason than the presence of federal deposit insurance, which eliminates any possible investment *risk*. n448 The federal securities laws do not regulate insured bank deposits. In recognition of the comprehensive scheme of other regulation of these financial institutions under federal and state laws, even conventional securities issued by banks and most thrift institutions are specifically exempt from coverage under the Securities Act. n449

Tcherepnin v. Knight, n450 perhaps best illustrates that as circumstances vary from a conventional banking relationship, so may the investment characteristics of a deposit instrument. In *Tcherepnin*, the Supreme Court held that

"withdrawable capital shares" in a state-chartered savings and loan association were securities for purposes of the antifraud provisions of the Exchange Act. Depositors were "members" of the association; they received no fixed rate of interest but, rather, received dividends in amounts dependent upon earnings of the association. The Court principally applied investment contract analysis in reaching the conclusion that the shares were securities but noted that they "fit well" within several of the terms contained in the corresponding Exchange Act definitional provision. n451 In the end, the essential reality of the *Tcherepnin* situation was this: "Petitioners are participants in a common enterprise -- a money lending operation dependent for its success upon the skill and efforts of the management of City Savings in making sound loans." n452

In *Marine Bank*, the Supreme Court specifically distinguished conventional deposit relationships from *Tcherepnin*, where investment risk is clearly in evidence. n453 There are few objective criteria for use in the analysis apart from the fixed versus variable rate of return and, now, post-*Marine Bank*, the extent of "other" protection. What is certain is that context will either establish or preclude requisite investment risk in a deposit relationship. The modern phenomena of "brokered" deposits and publicly offered programs for sharing in pools of "jumbo" certificates of deposit, for example, must be examined for characteristics separate and apart from the underlying instruments. Where a separate security is found, it will be as a result of factually distinguishing *Marine Bank*. n454

[xiii] Investment Programs in Personal Property. Sales of items of personal property touted in marketing campaigns as investments and coupled with some "repurchase guarantee" or other mechanism for enhancement of investment potential have often been deemed to be sales of securities. With the focus on the induced expectation of purchasers and the coupled mechanisms or "services," investment contract analysis may be applied. n455 Without question, the 2004 decision of the U.S. Supreme Court in *SEC v. Edwards* n456 has cemented the role of the federal securities laws in these circumstances. *Edwards* is discussed in more detail below. At the outset, however, certain essential elements of an investment contract must be reviewed.

In the application of investment contract analysis to these programs two considerations predominate: (1) What is the real impact of the coupled mechanism or services, i.e., are they truly value determinative or merely promotional; and (2) Is there a *common enterprise*? It is the absence of a common enterprise that most often precludes securities law protection in this setting. Purchasers of items of personal property may well expect to profit from their purchase, as with appreciation in value of precious metals or gemstones, and their profit potential may in fact be linked in a facilitative way to the anticipated efforts of the seller to do something. The relationship between the purchaser and seller, however, is often a *unitary* one in which the fortunes of other purchasers of the same or other items are not intertwined and in which there is no pooling among the "investors." n457

The unitary nature of a purchaser/seller relationship may be viewed differently in circumstances of a large-scale marketing effort built around "investment" potential and where the item of property involved has no special or unique character. If a promoter of such a program sells services and expertise as a main ingredient of profit potential to purchasers, common interests of those purchasers emerge despite the fact that there is no pooling among them. Precious metals or gemstones have often formed the bases of such programs that have been deemed to create securities as a matter of both state and federal securities laws. n458 The critical consideration in these situations is whether the value of the thing involved depends on market fluctuations or the managerial effort of the promoter. n459

Repurchase guarantees, standing alone, may or may not convert the sale of personal property into the sale of a security. Such an arrangement at a price unrelated to market value is likely to result in a security where promotional materials utilize the repurchase feature to tout investment potential. n460 Programs built upon the sale and "leaseback" of personal property have been found to create securities in various factual settings, n461 and it is here that the most recent pronouncement of the U.S. Supreme Court has its greatest impact.

In *SEC v. Edwards* n462 the Defendant was the chairman, chief executive officer and sole shareholder of ETS Payphones, Inc., which offered and sold pay telephones to the public through independent distributors. The payphones

were offered with an agreement under which ETS leased back each payphone from the purchaser for a fixed monthly payment, thereby providing the purchasers a fixed 14% annual return on their investment. The payphone package included a site lease, a five year leaseback and management agreement, and a repurchase agreement. Although other package options were offered, all but a tiny fraction of purchasers chose this package. Under it, purchasers were not involved in the day-to-day operation of the payphones. ETS selected the site, installed the equipment, arranged for connection and long distance service, collected coin revenues and repaired the telephones. Under the repurchase agreement ETS promised to refund the full purchase price of the package at the end of the lease or within 180 days of a purchaser's request.

The ETS payphones did not generate enough revenue for ETS to make monthly lease payments, and the company ultimately filed bankruptcy. The SEC brought an enforcement action against Edwards alleging, among other things, that ETS had sold unregistered securities and violated antifraud provisions of the federal securities laws. The ultimate question before the Supreme Court was whether the sale and leaseback program, which provided a fixed rate of return, created an investment contract. The Court concluded that it did. Applying long-standing *Howey* principles, the Court opined that there is no reason to distinguish between promises of fixed returns and promises of variable returns when assessing the "profits" from the efforts of others element of *Howey*. The fact that investors have bargained for a return on their investment, said the Court, does not mean that the return is not also expected to come solely from the efforts of others. Any other conclusion would allow unscrupulous marketers of investments to evade the securities laws by picking a rate of return to promise. n463

It was significant in *Edwards* that ETS had aggressively marketed pay telephones as an exciting business opportunity, in which the investing public was invited to "watch the profits add up." n464 Promotional characteristics and induced investment expectations are important in identifying an investment contract and determining the need for securities law protection. The *Edwards* Court noted in particular that investments pitched as low risk, such as those offering a "guaranteed" fixed return are attractive to persons more vulnerable to investment fraud, including older and less sophisticated investors. Not every business opportunity involving a fixed rate of return will be deemed to be an investment contract after *Edwards*, but those in which a passive purchaser/lessor is induced to buy in the context of a packaged plan tied to the success of the seller/lessor will evoke securities law concerns. n465

Animal "syndications" or breeding programs have likewise triggered securities law concerns. n466 A major factor in all of these findings is the manner of marketing and the vitality of the observation decades ago that "[i]n the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be." n467

[xiv] Management "Services" Generally. Whether programs involving the sale of personal property constitute securities is entirely dependent upon the nature of management or services tied to the sale. Where the "service" becomes the prime value determinant, a security is likely to be found. "Services" generally merit closer attention, as a service itself may be deemed to be a security. In usual service or "management" scenarios, the relationship between the service provider and the "purchaser" is unitary. Pooling arrangements, as with the condominium cases, can alter that relationship. n468 But, for the most part, one-on-one, service, or asset management relationships do not suggest the existence of a security for want of "horizontal" commonality among a group of investors. *Deckebach v. La Vida Charters, Inc.* n469 illustrates the point. Plaintiffs purchased a yacht, entering into a management relationship with the seller whereby seller would produce income from charters. Affirming dismissal of securities law claims, the court of appeals characterized the relationship involved as follows:

[T]he Deckebachs had to know from the outset that their relationship with La Vida was essentially a one-one vertical relationship and constituted essentially the hiring of an independent contractor to perform services for them to produce rental income to permit ultimate payment and retention of the yacht for personal use. The Deckebachs were not required to use La Vida, and once choosing La Vida, they were not required to remain with it if dissatisfied. The Deckebachs also offered insufficient evidence to

support their burden to show that the choice of another management company was not practical or economically feasible; that it was a de facto "tie-in." We find no error in the district court's conclusion that this purchase/management arrangement was not demonstrated by plaintiffs to rise to the level of a contribution or pooling of venture capital by a number of investors for a common and joint enterprise. n470

Outside the asset purchase setting, "services" may have a plain "investment" connection but, nevertheless, not trigger securities law concerns. Investment management services, for example, have typically not involved the creation of a separate security. n471 Services in the administration of dividend reinvestment programs and other shareholder programs such as fractional share repurchase programs have likewise escaped security status where the sponsor of such programs performs only ministerial services as agent for participants. n472 Structured litigation settlement services or claims settlement programs, in which specific interests in a fund are anticipated, and there is some investment aspect to the fund, have also been viewed as not creating securities where interests in the funds are not related to fund earnings. n473 On the other hand, "funding" or prepayment programs for educational expenses may well create a security. n474

Investment services in the establishment or maintenance of discretionary trading accounts for securities or commodity futures require closer scrutiny for investment contract elements and are considered in more detail below. The issue of services or management generally, however, is one usually resolved by the degree of correlation between the service and the value or expected value of an asset purchased, or committed, and the power of the purchaser to control the relationship.

[xv] Securities and Commodity Trading Accounts: "Horizontal" vs. "Vertical" Commonality. The significance of common enterprise as an element of an investment contract is well illustrated in the line of cases that consider whether discretionary trading accounts in securities or commodity futures are themselves securities. Most cases hold that such accounts are not securities for want of "*horizontal commonality*," that is, a pooling of multiple customer accounts or some other interrelationship among them that ties the separate accounts to some common program. n475

The typical broker/customer relationship, whether or not involving discretionary trading authority, is a unitary one. The relationship is one of "*vertical commonality*" to the extent of a shared interest in successful trading but not necessarily in an *economic* sense. A minority of courts recognizes vertical commonality as sufficient common enterprise for investment contract analysis. n476 But even those courts recognize that the relationship must still be tied to an enterprise. In a broker/customer relationship, the broker will be compensated through commissions despite trading losses suffered by the customer. It is only where the broker and customer are truly engaged in a common enterprise that either form of commonality can be found. n477 Where, for example, an investment manager had a bonus arrangement with a brokerage firm that was directly tied to the success of accounts controlled by him, vertical commonality was shown. n478 Where a broker or investment manager controls multiple accounts invested uniformly pursuant to a specific model or trading program, horizontal commonality *among the investors* may be shown. n479

Whichever view of requisite commonality is accepted, the essence of the relationship must be a shared economic fate. A security is not created in the engagement of an agent to provide a service, even though the service is intended to achieve a profitable result. The discretionary trading account cases teach that common enterprise means just that, and that a "security," for all of its other characteristics, is first and foremost an economic relationship. n480

[12] The "Risk Capital" Alternative in Determining the Existence of a Security.

Among the federal courts, the tripartite *Howey* "test" for determining the existence of a security in the form of an investment contract is a talisman. However, unshackled from the required adherence to *Howey*, state courts have enjoyed greater flexibility in approaching the definition of a security. *Howey* has been a dominant influence in the state courts, but as a creative departure from controlling emphasis that is placed on "common enterprise" and efforts "solely"

by others in the federal cases, the "risk capital" definition has emerged. The "risk capital" approach focuses upon the solicitation of venture capital and the subjection of an investor's money to the risks of an enterprise without regard to these traditional investment contract elements.

In *State of Hawaii v. Hawaii Market Center, Inc.*, n481 the elements of the "risk capital" approach were identified as follows:

- (1) an offeree furnishes initial value to an offeror;
- (2) a portion of this initial value is subjected to the risks of the enterprise;
- (3) the furnishing of the initial value is induced by the offeror's promises or representations that give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and
- (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

The "Risk Capital" approach was first articulated in *Silver Hills Country Club v. Sobieski*, n482 in which the California Supreme Court applied it:

[T]o protect the public against spurious schemes, however ingeniously devised, to attract risk capital ... [and] to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another. n483

The *Howey* "common enterprise" requirement at least implicitly requires that the buyer receive a proprietary interest in the subject matter of the enterprise. The "risk capital" approach, on the other hand, departs from that notion and only looks to an induced expectation of "benefit" -- not necessarily traditional profit -- from the conduct of an enterprise over which no *managerial* control is exercised. The critical element of "risk capital" analysis is that a security is created if the capital paid into a business by investors, in order to derive income from the use of that capital in the business, is put at risk in the event the business venture fails. The Hawaii Supreme Court, which has provided the greatest insight into application of risk capital analysis, imparted further guidance in *TriVectra v Ushijima*, n484 in which the Court upheld a determination by the state Securities Commissioner that interests in "online shopping malls" ("OSMs") were securities. Purchasers of interests in OSMs were entitled to host a customized website containing links to brand name retailers such as Disney and Warner Brothers. Members paid \$79.00 for three months of service, which included server hosting and assistance with web design. Terms of the agreements under which "mall" owners operated allowed them to make money either through commissions earned from sales through their site, or by recruiting other people to purchase OSMs. The opportunity to recruit new OSM owners was the primary emphasis. The ability to earn the commissions, however, depended upon TriVectra remaining able to perform, regardless of the fact that individual purchasers had a role to play in their success. The Court explained that under TriVectra's program:

The payment of initial value was required for an individual to participate in the OSM commission program... . While, in order to earn commissions it was necessary that a member make actual sales, by requiring the initial investment payment, TriVectra transformed garden variety sales representatives into equity holders in the enterprise. As such, the members could only realize a return if TriVectra remained viable and sufficiently capitalized to honor its OSM commitments. Accordingly, the commission was not wrong in concluding that the member's initial value investments were subject to the risks of the enterprise. n485

A "risk capital" gloss applied by state courts has played a helpful role in formulating the baseline characteristics of all securities. In *Grand Prairie Savings and Loan Ass'n v. Worthen Bank & Trust Co., N.A.* n486, for example, the Arkansas Supreme Court identified five "significant common factors" of any security: (1) the investment of money or money's worth; (2) investment in a venture; (3) the expectation of some benefit to the investor as a result of the investment; (4) a contribution towards the risk capital of the venture; and (5) the absence of direct control over the investment or policy decisions concerning the venture. n487 This amalgam of risk capital and *Howey* investment contract elements was expressly endorsed by a Tennessee criminal appeals court as the "*Howey*-risk capital test, as stated in *Hawaii Market*," and as best effectuating the remedial purpose of Blue Sky laws to protect the public from fraud. n488 The Tennessee court characterized the combined approach as being slightly more liberal than that which federal authorities standing alone would apply, and as allowing for more explicit statements of elements, in layman's terms, that are important in the instruction of juries.

Though not specifically adopted as the sole basis of decision by any federal court, n489 "risk capital" analysis has been influential in several cases that, like *Hawaii Market Center* and *TriVectra*, involved pyramid sales programs in which some involvement by the purchaser was attached to the success of the enterprise. For example, in *SEC v. Glen W. Turner Enterprises, Inc.*, the prominent multilevel distributorship decision of the Ninth Circuit discussed earlier, the court held, in effect, that if someone other than the investor is responsible for the managerial efforts that determine the success or failure of a venture, a security may be found even though the investor plays a role and is not solely dependent on the efforts of others for profits. n490

The state law antecedents of the "risk capital" approach to defining a security teach that investment risk is risk to *initial value* as capital for an enterprise rather than the risk of the future operation of that enterprise. The expectation of future profit gives way to only an expectation of some valuable benefit, with initial risk to invested capital being paramount.

The "membership" case that first enunciated the approach focused entirely upon capital formation. n491 Where one provides the risk capital that is to be used to form and develop an enterprise, it is the initial risk that is meaningful, and it is only because of that risk that there is any chance that there will be a future enterprise capable of producing any benefit. Rather than focusing on the expected future return, the concern in risk capital analysis is for the original value given by the buyer that could be lost because of the failure of an enterprise over which he exercises no managerial control.

"Risk capital" may be a more fluid and flexible approach, but its emphasis on "managerial" control can be misapplied. A virtue of the *Howey* investment contract "test" is that it is an analytical tool capable of consistent application. It produces a conclusion that investment risk is present rather than starting from that point. "Risk capital" works well in the initial capital formation setting, where "risk" is identifiable; however, not every risk to capital gives rise to the need for special protection under the securities laws. As the "economic realities" of a security transaction continue to evolve, there is surely a place for the "risk capital" view. As a matter of federal law, it at least augments *Howey* analysis by tempering any perceived rigidity of the elements of the "test" for an investment contract. In state court applications, it clearly allows for broader enforcement initiatives under Blue Sky laws that are consistent with the traditional state role in securities regulation.

FOOTNOTES:

(n1)Footnote 1. Section 2(1), of the Securities Act, reprinted in the Primary Law Sourcebook, Volume A, Section B, 15 U.S.C. § 77(b)(1) provides:

[U]nless the context otherwise requires--

[T]he term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust

1-2 Federal Securities Act of 1933 § 2.01

certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The Securities Exchange Act of 1934 ("Exchange Act" or "1934 Act") contains its own definition of "security" in Section 3(a)(10), 15 U.S.C. § 78c(10), which is virtually identical to that in the Securities Act as to enumerated instruments and categories. The Exchange Act definition differs, however, in its express exclusion from the definition of security of certain financial instruments generally described under the heading of short term "commercial paper." The Securities Act deals with such instruments in its classification of exempt securities in § 3, specifically § 3(a)(3) (any "note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months..."). The practical effect of the differing approaches of the two acts is the same. The treatment of short term commercial paper under the securities laws generally is considered further in § 2.01[1][d] *infra*.

(n2)Footnote 2. H.R. Rep. No. 85, reprinted in the Primary Law Sourcebook, Volume A, Section E of the 1933 Act, 73d Cong., 1st Sess. 11 (1933). "The Securities Act of 1933 describes 'security' very much more broadly than had been the previous interpretation of that term." *SEC v. Starmont*, 31 F. Supp. 264, 266 (E.D. Wa. 1940).

(n3)Footnote 3. See *Reves v. Ernst & Young*, 494 U.S. 56, 60-61, 110 S. Ct. 945, 948, 108 L. Ed. 2d 47, 57 (1990) (citations omitted) (footnote omitted).

(n4)Footnote 4. Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula?, 18 W. Reserve L. Rev. 367, 373 (1967). "A 'security' is a transaction whose characteristics distinguish it from the generality of transactions so as to create a need for the special fraud procedures, protections, and remedies provided by the securities laws." This is necessarily so because the special prohibitions and protections of the securities laws represent a liberalization of remedies available at common law and are meant to apply only when special policy justifications for invoking them are present.

(n5)Footnote 5. *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

(n6)Footnote 6. 346 U.S. 427, 435, 74 S. Ct. 182, 186-87, 98 L. Ed. 168, 175 (1953). Despite the broad remedial purpose of the federal securities laws that is evident in such pronouncements, it is important to recognize that the securities laws were not intended to provide a remedy for all fraud or misconduct arising out of financial transactions or relationships. See *Marine Bank v. Weaver*, 455 U.S. 551, 556, 102 S. Ct. 1220, 1223, 71 L. Ed. 2d 409, 414-15 (1982). The task is to identify those situations in which the need for specialized protection is manifest.

(n7)Footnote 7. To find a "security" is to subject a transaction to regulation governing: (1) the process of the security's creation and distribution; (2) the process of trading in the security; and (3) matters associated with holding the security. The "full disclosure" mechanisms of the 1933 Act assure the availability of adequate information on which to make an investment decision, and further provide for an opportunity to use that information and for liberalized antifraud remedies if it is false or deceptive. The general antifraud provisions of both the 1933 and 1934 Acts protect trading in securities, and the 1934 Act mechanisms for market regulation and control over processes associated with other investment decisions, e.g., the proxy solicitation process, cover the remaining areas of concern. Not every security transaction is subjected to the full range of federal securities law processes and protections. Where, for example, exemptions from 1933 Act registration and prospectus-delivery procedures are provided, it is because the protections

are not needed in particular circumstances.

(n8)Footnote 8. By definition a general partnership is an "association of two or more persons to carry on as co-owners, a business for profit." Uniform Partnership Act Section 18(e). Unless otherwise agreed, all general partners have an equal voice in management and control, regardless of their financial interests. *Id.* Moreover, as a matter of law, each general partner is a principal for himself and an agent for his partners. Uniform Partnership Act § 9(1), (2). In the absence of a contrary agreement, profits are shared equally by the partners regardless of the differences in amounts contributed, and losses are shared in the same proportion as profits. Because of the agency relationship between partners, each is jointly and severally liable for damages caused by an act of a partner within the scope of the partnership business, and general partners are jointly liable for other partnership obligations. *Id.* § 15.

A "joint venture" is defined as a partnership for a single project. It is distinguished from a partnership only in scope and duration. The essential characteristics of a joint venture which are antithetical to a security are the "community of interest" among the participants, the agreement to share gains and losses, and the mutual right of control. *See Sparks v. Baxter*, 854 F.2d 110 (5th Cir. 1988) . Partnerships and joint venture interests as securities are discussed in § 2.01[11][c][ii] *infra*.

(n9)Footnote 9. *Williamson v. Tucker*, 645 F.2d 404, 423-24 (5th Cir.) , *cert. denied*, 454 U.S. 897 (1981) ; *see also Goodwin v. Elkins & Co.*, 730 F.2d 99 (3d Cir. 1984) ("General partners, no matter how many or few they may be, are still as a group, legally responsible for the management of the firm.").

(n10)Footnote 10. *See Youmans v. Simon*, 791 F.2d 341 (5th Cir. 1986) .

(n11)Footnote 11. *See, e.g., Santiago Berrios-Bones v. Nexidis, LLC*, 2007 U.S. Dist. LEXIS 80283 (D. Utah 2007) (Joint Venture" and "General Partner" agreements actually gave the defendants sole discretion over key elements of property management and financial success, and would be examined under investment contract analysis to determine if the transactions in reality were investments).

The critical presumption of the partnership relation is rebutted where an agreement among the parties leaves little meaningful power in the hands of one who is ostensibly a "general partner." Likewise, where it is shown that a partner is incapable of exercising power, or is dependent upon the unique managerial ability of another, there can be no true general partner or joint venture relationship. *SEC v. Shiner*, No. 03-60175-CIV, 2003 U.S. Dist. LEXIS 15607 (S.D. Fla. 2003) ; *Kline Hotel Partners v. Aircoa Equity Interests, Inc.*, 729 F. Supp. 740 (D. Colo. 1989) .

(n12)Footnote 12. In *Caldwell v. State*, 95 S.W.3d 563, 2002 Tex. App. LEXIS 8866 (Ct. App. Tex., 1st Dist., 2002) , a Texas appellate court applying federal investment contract principles affirmed a securities fraud conviction based upon "joint venture" agreements that were held to be investment contracts. The court opined:

Although the joint venture agreements between TDH and its investors did allot certain powers to investors, those powers can hardly be described as "essential managerial efforts which affect the failure or success of the enterprise..." Teams did conduct meetings, elect leaders, perform tax planning, and pool new monies for additional investment. However, these acts were ministerial in light of TDH's exclusive contractual authority to "manage, coordinate, invest, sell, buy, host, and coordinate meetings, arrange meeting places, set goals, advisors, counselors, make deposits, disburse funds, and *do all things that are reasonable and necessary to manage the affairs of the TEAM...* ." Furthermore, TDH expressly agreed to use prudent reliable methods and reasonable care for the safekeeping and proper management of each team's funds and assets. TDH made all of the investment decisions and that investors were not required to do anything more than invest their money. Additionally, many team members neither met nor corresponded with other members of their team. Thus, the "economic reality" is that investors maintained a passive involvement with their investment while expecting profits to be derived solely from the efforts of TDH. 95 S.W.3d at 567 .

(n13)Footnote 13. Much remains to be said of the fact that their "stock" is *literally* a security as defined in § 2(1) and the presence of traditional corporate stock presumptively triggers securities law protection. See § 2.01[2] *infra*. Indeed, the Supreme Court has held that corporate stock having "traditional" attributes such as voting rights, negotiability, and the ability to appreciate in value is a security by definition. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985); *Gould v. Ruefenacht*, 471 U.S. 701, 105 S. Ct. 2308, 85 L. Ed. 2d 708 (1985) (both cases rejecting the "Sale of Business" doctrine, which had denied securities law protections to purchasers of all or substantially all stock of a corporation). The principal inquiry concerning corporate "stock" is whether it truly answers to the label and is present in a setting in which securities law protections legitimately may be expected. The "literal" definition of stock as a security, and the Supreme Court analyses on point, are considered in § 2.01[2] *infra*.

(n14)Footnote 14. 15 U.S.C. § 77(b)(1); n.1 *supra*.

(n15)Footnote 15. An exclusion from the definition of security for promissory notes utilized in certain settings in which context is defined by a "family resemblance" test -- that is, a comparison of a particular instrument and its object with a group or "family" of instruments and settings universally recognized as not involving securities -- is considered in detail in § 2.01[1][b] *infra*.

(n16)Footnote 16. 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943).

(n17)Footnote 17. *C.M. Joiner Leasing Corp.*, 320 U.S. at 348, 64 S. Ct. at 122, 88 L. Ed. at 92.

(n18)Footnote 18. As the Court found in *Joiner*, "[i]t is clear that an economic interest in this [enterprise] ... was what brought into being the instruments that defendants were selling and gave to the instruments most of their value and all of their lure." *Id.* at 349, 64 S. Ct. at 122-23, 88 L. Ed. at 92.

(n19)Footnote 19. 449 U.S. 424, 101 S. Ct. 698, 66 L. Ed. 2d 633 (1981).

(n20)Footnote 20. *Rubin*, 449 U.S. at 431, 101 S. Ct. at 702, 66 L. Ed. 2d at 639.

(n21)Footnote 21. 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946).

(n22)Footnote 22. *Tcherepnin v. Knight*, 389 U.S. 332, 336, 88 S. Ct. 548, 553, 19 L. Ed. 2d 564, 569 (1967) (withdrawable capital shares in a state chartered savings and loan association held to be securities).

(n23)Footnote 23. 540 U.S. 389., 124 S. Ct. 892, 157 L. Ed. 2d 813 (2004).

(n24)Footnote 24. On remand to the Eleventh Circuit U.S. Court of Appeals, the extent to which investors in the ETS pay telephone program relied on the promoter for success was a focal point. ETS investors retained minimal control over the telephones. The managerial control and efforts of the promoter included sole discretion over where to place telephones. This, coupled with the Supreme Court's guidance that investments with a fixed rate of return could constitute investment contracts, led the court on remand to conclude that all elements of an investment contract were present. *SEC v. ETS Payphones*, 408 F.3d 727 (11th Cir. 2005). All of the elements addressed in these most recent analyses of the meaning of "investment contract" in the *ETS Payphones* litigation, and the elements of an investment contract generally, are considered further in § 2.01[11][b] *infra*.

(n25)Footnote 25. See § 2.01[11][c][x] *infra*.

(n26)Footnote 26. See, e.g., *Wuliger v. Anstaett*, 363 F. Supp. 2d 917 (N.D. Ohio 2005), dismissed, *Wuliger v. Ardan Group, Ltd.*, 504 F. Supp. 2d 282, 2007 U.S. Dist. LEXIS 95991; *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005).

(n27)Footnote 27. See *SEC v. ETS Payphones, Inc.*, 408 F.3d 727, 732 (11th Cir. 2005).

(n28)Footnote 28. The broader vertical commonality approach is illustrated in *Hays v. Adam*, 512 F. Supp. 2d 1330 (N.D. Ga. 2007), in which the court observed: "to show a common enterprise under this test, it must be established that 'the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.' "

In *Hays* mobile billboard investments were sold in what was ultimately discovered to be a Ponzi Scheme. Purchasers paid promoters to acquire mobile billboard frames that were to be mounted on the sides of large trucks. The purchase agreements purported to provide participants with several options regarding their billboards. All of them, however, leased the billboards back to the promoter on representations that the promoter would arrange for placement, and make monthly lease payments to the investor, resulting in a fixed return of approximately 13.49% annually. The defendants argued that the billboard purchasers were provided training and information that enabled them to rely on their own expertise, rather than those of a third party, when leasing the billboards. They further asserted that the purchasers were free to lease the billboards to whomever they wanted. However, despite whatever options were theoretically presented to purchasers in the Offering Circular or other materials provided to them, the court concluded that the defendants had not shown any evidence to dispute the realities of the Ponzi scheme's actual operation. Specifically, 100 percent of the purchasers in the Ponzi scheme actually leased their billboards back to a shell company controlled by the promoters, and were dependent on the promoters to manage the billboards and generate their lease payments. Further, the very nature of the Ponzi scheme meant that it was dependent on the promoters attracting newer investors to cover the payments to earlier investors. Thus, according to the court, "the defendants cannot dispute that 'the fortunes of the billboard purchasers were interwoven with and dependent upon the efforts and success' of Outdoor Media and MBA." *Hays*., at 1337.

(n29)Footnote 29. See, e.g., 8 Del. Code Ann. § 341 et seq. (1983) (close corporation law); Ohio Rev. Code § 1705.01 et seq. (1994) (limited liability companies).

The potential impact of "close corporation" agreements in determining whether traditional corporate "stock" is a security is considered further in § 2.01[2][a] *infra*, and membership interests in limited liability companies as securities in § 2.01[11][c][iii] *infra*.

(n30)Footnote 30. 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975).

(n31)Footnote 31. *United Housing Foundation*, 421 U.S. at 851, 95 S. Ct. at 2060, 44 L. Ed. at 631. At the same time, however, the Court noted that while the label affixed to an instrument is not dispositive, neither is it irrelevant to the inquiry: "There may be occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply. *This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.*" *Id.* at 850-51, 95 S. Ct. at 2059-60, 44 L. Ed. 2d at 631 (emphasis added).

(n32)Footnote 32. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985).

(n33)Footnote 33. 471 U.S. 701, 105 S. Ct. 2308, 85 L. Ed. 2d 708 (1985).

(n34)Footnote 34. See *SEC v. National Presto Industries, Inc.*, 486 F.3d 305, 310 (7th Cir. 2007), in which Chief Judge Easterbrook explained the basis of the former sale-of-business doctrine as being "X has the same economic attributes as Y, so X must have the same legal attributes as Y." For purposes of the federal securities laws, however, after *Landreth* form can trump substance when the form makes sense in the context of the statute.

(n35)Footnote 35. *Landreth*, 471 U.S. at 693, 105 S. Ct. at 2305, 85 L. Ed. 2d at 702; *Gould*, 471 U.S. at 704, 105 S. Ct. at 2310, 85 L. Ed. 2d at 711.

See also *Fong v. Oh*, 116 Haw. 187, 172 P.3d 499 (2007) . In *Fong* the Hawaii Supreme Court rejected the argument that the "Risk Capital" approach to defining a security should be applied in a "sale-of-the-business" context to defeat securities law claims over the U.S. Supreme Court's straightforward approach to defining "stock" as a security when its characteristics bear out the label. Because reliance on "risk capital" analysis when the plain focus was on a stock purchase agreement would be incorrect unless it were demonstrated that the stock involved did not have traditional characteristics under *Landreth*, and *Gould*, the Hawaii court reversed summary judgment and sent the case back for determination of whether the instrument qualifies as stock.

(n36)Footnote 36. See § 2.01[2], *infra*.

(n37)Footnote 37. See, e.g., Handy Hardware Wholesale, Inc., SEC No-Action Letter (June 29, 2006) (Common stock issued in connection with reincorporation as a business cooperative did not have the characteristics of securities).

(n38)Footnote 38. The "stock" at issue in *Forman* was offered via an informational brochure--a "bulletin." The nature and content of the bulletin was meaningful in the analysis, as the Court found no doubt that "investors" were attracted solely by the prospect of acquiring a place to live, and not by financial returns on an investment:

Nowhere does the Bulletin seek to attract investors by the prospect of profits resulting from the efforts of the promoters or third parties. On the contrary, the bulletin repeatedly emphasizes the 'non-profit' nature of the endeavor. It explains that if rental charges exceed expenses the difference will be returned as a rebate, not invested for profit. It also informs purchasers that they will be unable to resell their apartments at a profit... .

421 U.S. at 853-54, 95 S. Ct. at 2061, 44 L. Ed. 2d at 633 .

See also Rapp, The Role of Promotional Characteristics in Determining the Existence of a Security, 9 Sec. Reg. L.J. 26 (1981).

(n39)Footnote 39. 494 U.S. at 62, 110 S. Ct. at 949, 108 L. Ed. 2d at 58 (emphasis added).

(n40)Footnote 40. 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990) .

(n41)Footnote 41. *Reves* is considered further in § 2.01[1] *infra* .

(n42)Footnote 42. 320 U.S. 344, 353, 64 S. Ct. 120, 124, 88 L. Ed. 88, 94 (1943) .

(n43)Footnote 43. *Landreth* and *Gould* also firmly dispose of the notion that "stock" which demonstrates traditional characteristics, and which thus falls within the letter of § 2(1), may yet be excluded from the definition as not being within the "spirit" of the federal securities laws. *Leoni v. Rogers*, 719 F. Supp. 555 (E.D. Mich. 1989) ("Those opinions clearly establish that stock which bears the usual characteristics of stock is a security for purposes of the 1933 and 1934 Acts").

(n44)Footnote 44. 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990) .

(n45)Footnote 45. *Danner v. Himmelfarb*, 858 F.2d 515, 518 (9th Cir. 1988) .

(n46)Footnote 46. 494 U.S. at 66-67, 110 S. Ct. at 951-52, 108 L. Ed. 2d at 60-61 .

See, e.g., *Keith v. Black Diamond Investors*, 48 F. Supp. 2d 326 (S.D.N.Y. 1999) , in which the court concluded that ownership interests in a mortgage company acquired by one joint venturer from another in settlement of a lawsuit

between them were not securities. Although the interests represented shares of a company, the court characterized them as "unusual instruments." They were not designed to be traded; were not sold to multiple investors; and were not sold on an "impersonal" public market, such that anyone might warrant protection of the securities laws. The purchaser was not a passive investor, and the transaction was privately negotiated, face-to-face. The court agreed with the Defendants' argument that where "unusual instruments" are involved, circumstantial factors evidencing the proper application of the securities laws must be shown.

(n47)Footnote 47. *Wilko v. Swan*, 346 U.S. 427, 74 S. Ct. 182 (1953); *Rubin v. United States*, 449 U.S. 424, 101 S. Ct. 698, 66 L. Ed. 2d 633 (1981) .

(n48)Footnote 48. The absence of circumstances evidencing the need for special protection is also the key to understanding and applying the scheme of exemptions set forth in §§ 3 and 4 of the Securities Act. An exemption is provided if the objectives of the Securities Act to assure adequate information on which to make investment decisions, and the opportunity to use that information, are achieved through other means, or the circumstances are such that other regulation offers protection. However, while some types of securities and some transactions may be exempt from the registration provisions, virtually none are exempted from coverage of the anti-fraud provisions.

(n49)Footnote 49. Types of notes recognized as being excluded from the definition of security include those given in consumer financing; notes secured by residential mortgages; short term notes secured by a lien on a small business or some of its assets; notes involved in "character" loans to bank customers; notes secured by an assignment of receivables; or notes arising out of open account relationships incurred in the ordinary course of business. These types of settings are simply not sensibly described as involving securities.

(n50)Footnote 50. As *Rubin v. United States*, makes clear, a *pledge* of securities to secure a loan brings the transaction within the ambit of the securities laws because the pledge is deemed to be a "sale" of the pledged securities by the pledgor to the pledgee. 449 U.S. 424, 101 S. Ct. 698, 66 L. Ed. 2d 633 (1981) . It is important to recognize, however, that the presence of a pledge of securities does not operate to convert the underlying loan transaction or the note involved in it into a security. The ultimate disposition of the collateral pledged as security for the loan is what matters in the invocation of securities laws protections, since the lender may properly be viewed as a purchaser of the collateral. The security transaction is not the underlying loan but, rather, the acceptance and disposition of the security that collateralizes it. Pledges of securities and their impact in triggering securities laws protections are considered further in § 2.02[3] *infra* .

(n51)Footnote 51. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351, 64 S. Ct. 120, 124, 88 L. Ed. 88, 93 .

(n52)Footnote 52. 421 U.S. 837, 95 S. Ct. 2051 (1975) .

(n53)Footnote 53. 439 U.S. 551, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979) . In *Daniel*, the Court held that an interest in an involuntary, non-contributory pension plan is not a security. The matter of interests in employee benefit plans as securities generally is considered in § 2.01[11][c][vi] *infra* .

(n54)Footnote 54. 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) .

(n55)Footnote 55. 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990) . To be sure, the Supreme Court has not retreated from expansive decisions of the past, but it has focused attention on the words and the sense of the statutes. In a related definitional matter, for example, the Court, in *Securities Indus. Ass'n v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 104 S. Ct. 2979, 82 L. Ed. 2d 107 (1984) , held "commercial paper" to be a security for purposes of the former Glass-Steagall Act prohibition on bank underwriting activities. In *Rubin v. United States*, 449 U.S. 424, 101 S. Ct. 698, 66 L. Ed. 2d 633 (1981) , the Court held that a pledge of securities was a disposition of the securities "for value," *i.e.*, a sale, so as to trigger antifraud protections. Also, in *United States v. Naftalin*, 441 U.S. 768, 99 S. Ct. 2077, 60 L. Ed. 2d 624 (1979) , the Court extended the antifraud protections of the Securities Act to aftermarket trading frauds. These cases are all grounded in statutory language and assessments of purpose, and, indeed,

there is room for thoughtful expansions of securities law protections. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983), holding that remedies under the securities laws are cumulative, demonstrates the willingness of the Court to act in this regard. *But see Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995), in which the Court determined the scope of the Securities Act Section 12(2) purchasers' remedy for information failures to be limited to public offerings.

(n56)Footnote 56. The Securities Act § 3(a)(3) exemption and the corresponding exclusion from the Exchange Act definition of "security" contained in Section 3(a)(10) of the Exchange Act are considered further in § 2.01[1][d] *infra*.

Courts have made clear that this exemption is intended to apply only short term, high quality instruments issued to fund current operations, and sold only to highly sophisticated investors, *see, e.g., SEC v. J.T. Wallenbrock and Associates*, 313 F.3d. 532 (9th Cir. 2002).

(n57)Footnote 57. 494 U.S. at 56.

(n58)Footnote 58. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985).

(n59)Footnote 59. *Landreth*, 471 U.S. at 694, 105 S. Ct. at 2306, 85 L. Ed. 2d at 703.

(n60)Footnote 60. 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982).

(n61)Footnote 61. *See United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849, 95 S. Ct 2051, 2059, 44 L. Ed. 2d 621, 630 (1975); *Danner v. Himmelfarb*, 858 F.2d 515, 520 (9th Cir. 1988) ("[Plaintiff] sold an asset in exchange for a promissory note secured by a deed of trust. [He] did not 'invest' his money in Empire or in Empire's planned Mexican venture. He did not expect 'profits' in the sense of either capital appreciation or a share of the earnings from a business venture formed with the borrowed capital.").

(n62)Footnote 62. *See Marine Bank v. Weaver*, 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) (other regulation); *see also Wolf v. Banco Nacional de Mexico*, 739 F.2d 1458 (9th Cir. 1984); *Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co.*, 577 F. Supp. 1281 (D. Mass. 1983).

(n63)Footnote 63. *See Kaye v. Pawnee Constr. Co., Inc.* 680 F.2d 1360 (11th Cir. 1982); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981); *Manchester Bank v. Connecticut Bank & Trust Co.*, 497 F. Supp. 1304 (D.N.H. 1980); *but see First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co. of Florida, Inc.*, 1989 U.S. Dist. LEXIS 16404 (E.D.N.C. 1989) (fixed rate debentures held to be securities where the underlying debt was unsecured and heavily subordinated to other creditor claims).

(n64)Footnote 64. *See Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976). "Demand" notes, though generally thought of as being highly liquid, a characteristic inconsistent with investment risk, have nevertheless been brought within the purview of the Securities Act after *Reves* unless "family resemblance" to a recognized class of non-security notes is shown. *See also Bachmeier v. Bank of Ravenswood*, 663 F. Supp. 1207 (N.D. Ill. 1987) (short term, fixed rate instruments held to be securities where the financial context distinguished the transaction from commercial situations, and the deception involved mandated securities law protection).

Term and other risk-reducing attributes of some notes in a post-*Reves* environment are considered further in § 2.01[1][c] *infra*.

(n65)Footnote 65. *See Great Western Bank & Trust v. Kotz*, 532 F.2d at 1258-59; *see also Equitable Life Assurance Soc'y v. Arthur Andersen & Co.*, 655 F. Supp. 1225, 1238-39 (S.D.N.Y. 1987) (insurance company lender imposed significant documentation and control over the business operations of the borrower); *Old Security Life Ins. Co. v. Waugeneux*, 484 F. Supp. 1302 (S.D. Fla. 1980) (retained power to direct investment of note proceeds).

(n66)Footnote 66. See *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984) ; *Sanders v. John Nuveen & Co., Inc.*, 463 F.2d 1075 (7th Cir.) , cert. denied, 409 U.S. 1009 (1972) ; *Van Kampen Merritt, Inc. v. Avondale Properties Partnership*, 702 F. Supp. 1412 (N.D. Ill. 1989) (plan to resell revenue bonds to the general public operated to bring a real estate loan transaction within the ambit of the securities laws).

(n67)Footnote 67. 494 U.S. 56, 68, 110 S. Ct. 945, 953, 108 L. Ed. 2d 47, 92 (1990) .

Other factors that have impacted the determination that a particular instrument is or is not a security, and which bear upon the ascertaining a "family resemblance" in a post-Reves environment, include: (a) its terminology, *Bauer v. Planning Group, Inc.*, 669 F.2d 770, 778 (D.C. Cir. 1981) ; (b) its form, *Floyd v. First Penn Corp.*, 1983 U.S. Dist. LEXIS 19502 (W.D. Okla. Feb. 4, 1983) ; (c) its relative size, *American Nat'l Bank & Trust Co. v. Wallace*, 702 F.2d 93 (6th Cir. 1983) ; or (d) its character as a "cash substitute," *C.N.S. Enters., Inc. v. G & G Enters., Inc.*, 508 F. 2d 1354 (7th Cir.) , cert. denied, 423 U.S. 825 (1975) .

(n68)Footnote 68. 544 F.2d 1126 (2d Cir. 1976) .

(n69)Footnote 69. 494 U.S. at 68, 110 S. Ct. at 953, 108 L. Ed. 2d at 62 .

(n70)Footnote 70. *Reves*, 494 U.S. at 63 .

(n71)Footnote 71. 494 U.S. at 67, 110 S. Ct. at 952, 108 L. Ed. 2d at 61 .

See also *Stoiber v. SEC*, 161 F.3d 745 (D.C. Cir. 1998) , in which the court explained that the presumption that every note is a security may fall away under either step of a two-tiered analysis. The first step is comparison with the *Exchange National Bank* list; the second is also a comparison, but with the *Reves* four factors.

(n72)Footnote 72. 544 F.2d at 1138 ; see also *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984) .

(n73)Footnote 73. 494 U.S. at 66, 110 S. Ct. at 951, 108 L. Ed. 2d at 60 .

(n74)Footnote 74. *Reves*, 494 U.S. at 66-67, 110 S. Ct. at 951-52, 108 L. Ed. 2d at 60-61 .

(n75)Footnote 75. 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) .

(n76)Footnote 76. 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943) .

(n77)Footnote 77. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985) .

(n78)Footnote 78. 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) .

(n79)Footnote 79. Since the *Reves* standards summarily restate virtually all that has ever been determinative of the question, they will surely be broadly applied in the assessment of any supposed security. In *Iacobucci v. Universal Bank of Maryland*, 1990 U.S. Dist. LEXIS 15179 (S.D.N.Y. 1990) , for example, the court concluded that the *Reves* factors indicated that no security was involved in a plan to secure the issuance of credit cards through savings deposits.

(n80)Footnote 80. See *Rayman v. People Sav. Corp.*, 735 F. Supp. 842 (N.D. Ill. 1990) (purchase money notes used in connection with the acquisition of a savings and loan institution and guaranteed by significant shareholders were not securities when viewed under the *Reves* "lens"); *Singer v. Livoti*, 741 F.Supp. 1040 (S.D.N.Y. 1990) (notes secured by a mortgage on residential property match a *Reves* excluded category and are not securities).

(n81)Footnote 81. 494 U.S. at 65, 110 S. Ct. at 951, 108 L. Ed. 2d at 60 (quoting *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir. 1984) .

But see Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808 (2d Cir. 1994) ("notes" representing participations in home mortgages did not sufficiently resemble a traditional note secured by a mortgage to be excluded from coverage of the securities laws).

(n82)Footnote 82. 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) .

(n83)Footnote 83. *Marine Bank*, 455 U.S. at 560, n.11 .

(n84)Footnote 84. 389 U.S. 332, 88 S. Ct. 548, 19 L. Ed. 2d 564 (1967) .

(n85)Footnote 85. 455 U.S. at 556, 102 S. Ct. at 1223, 71 L. Ed. 2d at 415 .

(n86)Footnote 86. See *Bradford v. Moench*, 670 F. Supp. 920 (D. Utah 1987) .

(n87)Footnote 87. 900 F.2d 1485 (10th Cir.) , cert. denied, 111 S. Ct. 386 (1990) .

(n88)Footnote 88. A thorough review of the transaction setting appears in *Holloway v. Peat, Marwick, Mitchell & Co.*, vacated by the Supreme Court and remanded for further consideration in light of *Reves*. 879 F.2d 772 (10th Cir. 1989) , cert. granted and judgment vacated,, 494 U. S. 1014 (1990) , aff'd, 900 F.2d 1485 (10th Cir.) , cert. denied, 111 S. Ct. 386 (1990) . The *Holloway* court, in both its pre- and post-*Reves* evaluations, did not find the existence of a state regulatory scheme sufficient to displace the preeminent protective concerns of the federal securities laws.

(n89)Footnote 89. "Profit" in this context was defined by the Court to mean "a valuable return on an investment." This definition of the term, the Court pointed out, is less restrictive than that used in other settings in which the question is whether an "investment contract" form of security is present. In those analyses, grounded in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946) and *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) , "profit" means either capital appreciation or a participation in earnings. In *Reves*, the Court opined that such a restrictive notion applied to a note would eliminate notes paying interest not keyed to earnings of the borrower's enterprise from the definition of a security. Thus, the Court limited the *Howey* and *Forman* definition of "profit" to application in the investment contract setting. *Reves*, 494 U.S. at 68 n.4, 110 S. Ct. at 952 n.4, 108 L. Ed. 2d at 61 .

(n90)Footnote 90. *Id.*

Assessment of motivation may in many cases result in what one court has called a "washout," in that motivation prompting as transaction on one end may be typical in commercial loan transactions, that is, an effort to raise interim funds to launch a new enterprise. From the other perspective, however, the transaction may well look like one for profit. *Bass v. Janney Montgomery Scott, Inc.*, 210 F.3d. 577 (6th Cir. 2000) .

(n91)Footnote 91. *Stoiber*, 161 F.3d 745 . In *Stoiber* the D.C. Circuit held that promissory notes given for personal loans to finance personal commodity investments by a broker were securities. Among other things, the court found that the purchase of commodities was at the "core" of the defendant's business of trading in them, and that the his use of the money to buy them was thus appropriately viewed as a general business enterprise use which *Reves* distinguished from the kind of commercial purposes which would defeat the presumption that notes are securities. The defendant, said the court, was funding his entire endeavor, not just getting past a cash crunch.

(n92)Footnote 92. *Reves*, 494 U.S. at 67-68, 110 S. Ct. at 952, 108 L. Ed. 2d at 61-62 (footnote omitted).

But see Resolution Trust Corp. v. Stone, 998 F.2d 1534 (10th Cir. 1993) , in which packages of consumer automobile loans offered and sold to financial institutions were held not to be securities under the *Reves* family resemblance test. The motivation of both parties, said the court, was a commercial transaction. The seller was engaged

in selling its "stock in trade" in a normal, on-going business activity. The buyer's expected profit was unrelated to the profitability of the seller. Moreover, the purchasers were sophisticated financial institutions and insurance companies who did not purchase for any potential speculative or trading value.

(n93)Footnote 93. *Singer v. Livoti*, 741 F. Supp. 1040 (S.D.N.Y. 1990) (six-month note and a refinanced note secured by a mortgage on residential real estate under development held not to be a security where the purpose was a temporary loan to solve cash flow difficulties).

See also *Bass v. Janney Montgomery Scott, Inc.*, supra, 210 F.3d 577 (6th Cir. 2000).

(n94)Footnote 94. See *Trust Co. of Louisiana v. N.N.P., Inc.*, 104 F.3d 1478 (W.D. La. 1997) ("LCE's purported purpose in selling the notes was to raise money for the general use of a nonexistent long distance phone company and TCL's purpose in purchasing them was the 16% return promised").

See also *Deal v. Asset Management Group*, 1992 U.S. Dist. LEXIS 13011 (N.D. Ill. 1992) (security motivation present where defendant was alleged to have been raising substantial sums to finance the renovation of a historic property he intended to sell, and the "buyer" of the note was interested in a promised 18 to 20 percent rate of return); *Premier Microwave Corp. v. Comtech Telecommunications Corp.*, 1991 U.S. Dist. LEXIS 846 (S.D.N.Y. 1991) (\$1 million 7-year note given as a portion of the purchase price for the acquisition of the assets of a division of the defendant company did not have an investment motivation); *Prochaska & Assocs., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 798 F. Supp. 1427 (D. Neb. 1992) (three-month note, secured by inventory and other assets would not support an "investment" purpose despite allegation that the buyer's interest was a 10% expected return); *Singer v. Livoti*, 741 F. Supp. 1040 (S.D.N.Y. 1990) (transaction showed "all of the economic context of a temporary loan to solve cash flow difficulties"); *Rayman v. Peoples Sav. Corp.*, 735 F. Supp. 842 (N.D. Ill. 1990) (purpose for the note was to temporarily finance a deal that had originally been planned as all cash).

(n95)Footnote 95. 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943) . *Joiner*, and its focus on not only the manner in which an instrument is offered or characterized but also its fundamental statement concerning the essence of a security transaction, is discussed in § 2.01 supra.

(n96)Footnote 96. 494 U.S. at 66, 110 S. Ct. at 952, 108 L. Ed. 2d at 61 (citation omitted).

(n97)Footnote 97. See note 58, and accompanying text supra.

(n98)Footnote 98. See, e.g., *Singer v. Livoti*, 741 F. Supp 1040 (S.D.N.Y. 1990) . In *Singer*, which held that a short-term note and a refinanced note given in a loan obtained to relieve cash flow difficulties were not securities, the Court made the following observation regarding plan of distribution: "The second factor in the *Reves* analysis ... need not detain us. There was no such plan [T]he borrower followed the traditional process of the market in private, non-institutional, conventional mortgage loans; he went through his lawyer." *Id.*

(n99)Footnote 99. See also *SEC v. R.G. Reynolds Enters., Inc.*, 952 F.2d 1125 (9th Cir. 1991) (promissory notes offered and sold to at least 148 investors in several states in connection with a managed investment program were securities).

(n100)Footnote 100. See *Sotereanos v. Passodelis*, 203 F.3d 818 (3d Cir. 1999) (Loans made on a one-to-one basis between longstanding friends did not involve securities. The notes were not viewed by the parties as "trading or speculation vehicles," but rather only as an indication on paper of oral transactions).

This is surely the message of *Marine Bank v. Weaver*, 455 U.S. 551, 560, 102 S. Ct. 1220, 1225, 71 L. Ed. 2d 409, 417 (1982) as well. Although the Court in *Reves* did not specifically describe distinguishing criteria with the language of *Marine Bank*, it appears certain that the observations the Court made there will best guide applications of the "plan of

distribution" factor.

But see SEC v. Great Lakes Equities Co., 1990 U.S. Dist. LEXIS 19819 (E.D. Mich. 1990) , *aff'd*, 12 F.3d 214 (table) (6th Cir. 1993) (Notes were publicly offered by representatives of the issuer to various individuals in five states, and thus appeared to be instruments in which there was common trading for investment).

(n101)Footnote 101. *See, e.g.* Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985) ; National Bank of Yugoslavia v. Drexel Burnham Lambert, Inc., 768 F. Supp. 1010 (S.D.N.Y. 1991) ("A debt instrument may be distributed to but one investor, yet be a 'security' "); Vicente v. Obenauer, 736 F. Supp. 679 (E.D. Va. 1990) .

(n102)Footnote 102. *See* Roer v. Oxbridge, Inc., 198 F.Supp. 2d 212 (E.D.N.Y. 2001) ; *see also* Bass, 210 F.3d 577 (Unique transaction, negotiated term by term, rather than being offered in a wholesale or potentially wholesale fashion plainly militates against finding a security).

(n103)Footnote 103. 494 U.S. at 66, 110 S. Ct. at 952, 108 L. Ed. 2d at 61 .

(n104)Footnote 104. *Reves*, 494 U.S. at 66 . In these circumstances, said the Court, "it would be reasonable for a prospective purchaser to take the Co-Op at its word." *Id.* at 69, 110 S. Ct. at 953, 108 L. Ed. 2d at 62 .

See also Deal v. Asset Management Group, 1992 U.S. Dist. LEXIS 13011 (N.D. Ill.1992) , where a written project summary characterized the rate of return as an "investors rate of return," and there was nothing alleged which would lead a reasonable investor to question the characterization.

(n105)Footnote 105. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353, 64 S. Ct. 120, 124, 88 L. Ed. 88, 94 (1943) ; *see also* Gomez v. Leonzo, 788 F. Supp. 604 (D.D.C. 1992) . The significance of "holding out" could not be any clearer than as presented in *Gomez*: LIC held itself out as an investment concern, as its middle name indicates, and advertised in the phone book as "Latin Investments and Savings." In actual practice as well, LIC functioned as an investment business. Its customers were guaranteed a rate of return higher than that offered by banks and savings and loan companies; and even more tellingly, LIC offered its customers the prospect of earning dividends from investment of their pooled funds. LIC customers were also given the opportunity of placing their funds in accounts that would be invested in local Hispanic-owned businesses. All of these factors suggest that LIC was issuing its customers securities.

See also Stas v. Pennsylvania Sec. Comm., 910 A. 2d 125 (Pa. Commw. Ct. 2006) (Rejecting the assertion that only "personal loans" were involved where "private placement investment agreements" and "private tax-free agreements" paying interest rates ranging from nine to twenty percent over terms of six months to five years were offered).

(n106)Footnote 106. *See* Mercer v. Jaffe, Snider, Raitt & Heuer, P.C., 736 F. Supp. 764 (W.D. Mich. 1990) . In *Mercer*, mortgage-backed notes were held to be securities because they were offered and sold on a mass market basis. The court viewed *Reves* as holding that such notes are excluded from the definition of security only in the context of a "traditional face-to-face loan transaction between a borrower and a commercial or consumer lender, not in the present context of a transaction between an individual investor and a broker/dealer selling the notes on a mass market basis." *Id.* at 769 .

(n107)Footnote 107. 741 F. Supp. 1040 (S.D.N.Y. 1990) .

(n108)Footnote 108. 27 F.3d 808 (2d Cir. 1994) .

(n109)Footnote 109. *See also* Roer, 198 F.Supp. 2d 212 , in which Plaintiffs entered into notes under the belief that they would receive fixed returns of fifty to seventy-five percent return on their "investment," as well as an interest in net profits. The fixed interest rate did not alter reasonable expectations of the investors pursuing what was believed to be an investment.

But see Jeanne Piaubert, S.A. v. Sefrioui, 2000 U.S. App. LEXIS 2462 (9th Cir. 2000) , cert. denied, 531 U.S. 1073, 121 S. Ct. 765, 148 L. Ed. 2d 666 (2001) (Promissory note was not a security when the note was issued by a high risk venture, but [paid a below market rate of interest, and the purchaser apparently took the note for commercial reasons rather than for investment purposes).

(n110)Footnote 110. *Leemon v. Burns*, 175 F.Supp. 2d 551 (S.D.N.Y. 2001) .

(n111)Footnote 111. *See generally* § 2.01 *supra*; *see also National Bank of Yugoslavia v. Drexel Burnham Lambert, Inc.*, 768 F. Supp. 1010 (S.D.N.Y. 1991) , in which the court could only speculate what the "investing public" would expect about notes evidencing \$71 million of time deposits placed with the Drexel firm by a foreign central bank for a fixed-rate, short term investment; however, the court concluded the bank "might reasonably view" this as involving a security. The court observed:

[T]he Bank placed its funds with Drexel, at the time a major investment banking and securities underwriting firm, in return for a fixed rate of interest. The funds were to be invested in particular, safe securities. Thus the transactions (if accurately described in the complaint), were investment instruments, rather than consumer or commercial bank loans or financing.

Id. at 1016 .

(n112)Footnote 112. 439 U.S. 551, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979) . *Daniel* and the status of employee benefit plans as securities generally are discussed in § 2.01[11][c][vi] *infra*.

(n113)Footnote 113. 900 F.2d 1485 (10th Cir.) , cert. denied, 111 S. Ct. 386 (1990) .

(n114)Footnote 114. *But see Wolf v. Banco Nacional de Mexico*, 739 F.2d 1458 (9th Cir. 1984) (holder of certificate of deposit issued by a Mexican bank was "virtually guaranteed" repayment by reason of the Mexican banking regulatory structure).

(n115)Footnote 115. Decisions since *Reves* have focused primarily on the impact of other regulation instead of the broader notion of a risk-reducing factor. However, in *Reves*, the Supreme Court spoke of another regulatory scheme only as an example of a factor that could significantly reduce the risk of the instrument: "[W]e examine whether some factor *such as* the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." 494 U.S. at 67, 110 S. Ct. at 952, 108 L. Ed. 2d at 61 (emphasis added).

(n116)Footnote 116. *See, e.g., Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993) , in which the court considered the existence of collateral to be a risk-reducing factor, which favored a finding that automobile loan packages sold to financial institutions are not securities.

See also Bass v. Janney Montgomery Scott, Inc., 210 F.3d 577 (6th Cir. 2000) (The existence of collateral is significant as a risk-reducing factor, and the notes were heavily secured).

But see SEC v. J.T. Wallenbrock and Associates, 313 F.3d. 532 (9th Cir. 2002) , in which promissory notes that were purportedly secured by accounts receivable of a manufacturer were nevertheless held to be securities. The court found the purported collateralization to be a fiction.

(n117)Footnote 117. *See, e.g., Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976) . When considering bargained-for protections as risk-reducing factors it is well to keep in mind, however, the observation in *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) , which is now implicit in *Reves*, that:

"While banks are in a favored position to obtain disclosure, the target [of the antifraud provisions] ... is fraud, which a bank's ability to obtain disclosure cannot always prevent." 544 F.2d at 1137 .

(n118)Footnote 118. See, e.g., *Holloway v. Peat, Marwick, Mitchell & Co.*, 900 F.2d 1485 (10th Cir.), cert. denied, 111 S. Ct. 386 (1990) (the exception for short term notes is limited to "prime quality negotiable commercial paper" of a type not ordinarily purchased by the general public); *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531 (S.D.N.Y. 1990) (bankers' acceptances with maturities not exceeding nine months are exempted from the definition of securities under Exchange Act § 3(a)(10)); see also Sec. Act Rel. No. 4412, 1961 SEC LEXIS 72 (Sept. 20, 1961) .

The differing treatment of commercial paper between the two acts has little practical impact in determining the existence of a security. However, the exemption/exclusion distinction between the two does impact application of antifraud provisions. The scheme of the Securities Act is such that short-term commercial paper is exempted from registration requirements of the Securities Act but not the main antifraud remedy in § 12(a)(2). The Exchange Act, on the other hand, excludes these instruments from the definition of a security and, thus, from coverage of the Securities Act, including the available Exchange Act antifraud remedies.

(n119)Footnote 119. "In light of Congress' broader purpose in the Acts of insuring that investments of all descriptions be regulated to prevent fraud and abuse, we interpret the exception not to cover the demand notes at issue here. Although the result might be different if the design of the transaction suggested that both parties contemplated that demand would be made within the statutory period, that is not the case before us." 494 U.S. at 73, 110 S. Ct. at 955, 108 L. Ed. 2d at 65 .

(n120)Footnote 120. *Reves*, 494 U.S. at 75, 110 S. Ct. at 956, 108 L. Ed. 2d at 66 (Stevens, J., concurring).

(n121)Footnote 121. 266 Va. 170, 580 S.E.2d 850 (Va. 2003) .

(n122)Footnote 122. Other debt instruments, such as debentures, included in § 2(1) historically have been evaluated under the same tests or criteria applicable to notes. See, e.g., *First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co. of Florida, Inc.*, 1989 U.S. Dist. LEXIS 16404 (E.D.N.C. 1989) (fixed rate debentures held to be securities under commercial/investment and investment contract tests).

(n123)Footnote 123. The form of an instrument has always been a part of the transactional setting. However, terminology used in an instrument may evidence the character of a transaction. See, e.g. *B.K. Medical Systems, Inc. v. Clesh*, 1984 U.S. Dist. LEXIS 17460 (W.D. Pa. April 19, 1984) (language on certificate referred to note and debenture, the form and substance of which embodied characteristics commonly associated with securities); *Bauer v. Planning Group, Inc.*, 669 F.2d 770, 778 (D.C. Cir. 1981) (existence of a security was conclusively shown on the face of the instrument); *Ohio v. Crofters, Inc.*, 525 F. Supp. 1133 (S.D. Ohio 1981) (form of note imposed no financial obligation on the maker and could only be viewed as evidencing a "risk capital" investment transaction).

(n124)Footnote 124. See *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992) (short-term loan participations arranged by a commercial lender to increase the line of credit available to a borrower to facilitate current operations held not to be a security where each participant made its own credit analysis, had its own responsibility for "due diligence," and where no fundamental "investment" characteristics were evident); *Developer's Mortgage Co. v. TransOhio Sav. Bank*, 706 F. Supp. 570 (S.D. Ohio 1989) (participation interests in bank loans were not securities because, among other reasons, the contingencies for return to the participant were those associated with any normal commercial loan); *First State Bank of Wheatland v. American Nat'l Bank*, 690 F. Supp. 967 (D. Wyo. 1988) (certificates of participation represented only a commercial loan transaction).

See also *Signature Bank v. Marshall Bank*, CCH Blue Sky L.Rep. P74,599, at 79,045 (Minn. App. 2006). As to the particular loan participation agreement the Court observed:

The overall motivation of the parties was to finance the borrowers' commercial purposes of acquiring one hockey team and refinancing debts relating to another; the participation agreement was offered to financial and commercial institutions, and not to the general public; appellant received ample notice that the participation agreement was a participation in a loan and not an investment in a business; and, as appellant acknowledges, the Office of the Comptroller of the Currency has issued policy guidelines that address the sale of loan participations. Signature Bank., at 79,048.

(n125)Footnote 125. *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263, 1267 (S.D.N.Y. 1978) .

(n126)Footnote 126. 455 U.S. 551, 560 n.11, 102 S. Ct. 1220, 1225 n.11, 71 L. Ed. 2d 409, 417, n.11 (1982) .

(n127)Footnote 127. *But see First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A.*, 919 F.2d 510 (9th Cir. 1990) (if the underlying note is not a security, a loan participation involving it should not be one either unless "investment contract" criteria are demonstrated).

(n128)Footnote 128. This distinction was critical to the district court's determination, affirmed by the Second Circuit, in *Banco Espanol*, that no security was present. The district court observed: "[B]ecause the Plaintiffs here did not receive an undivided interest in a pool of loans, but rather purchased participations in a specific, identifiable, short-term ... loan, the loan participation did not have an identity separate from the underlying loan. Since the underlying loan is not a security, neither is the participation therein." 763 F. Supp. 36, 42 (S.D.N.Y. 1991) , *aff'd*, 973 F.2d 51 (2d Cir. 1992) .

See also Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985) (undivided interest in a pool of certificates of deposit held to be a security).

(n129)Footnote 129. *Fulton Bank v. McKittrick & Briggs Sec., Inc.*, 1990 U.S. Dist. LEXIS 11371 (E.D. Pa. 1990) .

(n130)Footnote 130. 1989 SEC No-Act. LEXIS 834 (July 10, 1989) .

(n131)Footnote 131. *Id.* at 79,210.

(n132)Footnote 132. *Zolfaghari v. Sheikholeslami*, 943 F.2d 451 (4th Cir. 1991) .

A separate definition of "mortgaged related security" appears in Section 3(a)(41) of the Exchange Act. This definition, adopted in connection with other federal legislation aimed at facilitating the burgeoning secondary market in "securitized" mortgages, is designed to establish a particular status for interests in pools of mortgages comprised of notes that are secured in a particular manner. The status as a "mortgage related security" has significance for other regulation and laws, but has no impact on the fundamental status of such pools or participations as securities under the basic definition provisions of either the Securities Act or the Exchange Act.

(n133)Footnote 133. *But see Steinhardt Group, Inc. v. Citicorp*, 126 F.3d 144 (3d Cir. 1997) . In *Steinhardt*, the court concluded that the securitization of a pool of delinquent residential mortgage loans and real estate owned by Citicorp as a result of foreclosures did not result in the creation of an investment contract. The limited partnership vehicle by which the plaintiff acquired its interest in the pool allowed the purchaser to exercise considerable powers over the business plan, to the extent that the court concluded that the plaintiff had pervasive control over the management of the partnership. 126 F.3d at 154 . The plaintiff's involvement was deemed significant enough to place it outside the role of a passive investor.

(n134)Footnote 134. *See also First Fin. Fed. Sav. & Loan Ass'n v. E.F. Hutton Mortgage Corp.*, 652 F. Supp. 471

(*W.D. Ark.*) , *aff'd*, 834 F.2d 685 (8th Cir. 1987) (purchaser of specific mortgages, among other things, retained the right to on-site inspection and to reject any loan that did not meet its conditions).

(n135)Footnote 135. The use of notes or other instruments as a "cash substitute," as when given as an earnest money deposit, or as given to a broker in satisfaction of a deficiency upon liquidation of an account does not involve the creation of a security. *See C.N.S. Enters., Inc. v. G & G Enters., Inc.*, 508 F.2d 1354 (7th Cir.) , *cert. denied*, 423 U.S. 825 (1975) (earnest money note was merely a cash equivalent); *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378 (S.D.N.Y.) , *rev'd on other grounds*, 696 F.2d 227 (2nd Cir. 1982) ("purchase money" note secured by letter of credit and given for the purchase of business assets was not a security). In circumstances like these, the use of cash is considered to be the norm, and the introduction of a note does nothing to alter the character of the transaction.

(n136)Footnote 136. *Guidry v. Bank of LaPlace*, 740 F. Supp. 1208 (E.D. La. 1990) ; *see also Reeder v. Succession of Palmer*, 736 F. Supp. 128 (E.D. La. 1990) .

(n137)Footnote 137. *Crim v. E.F. Hutton, Inc.*, 381 S.E.2d 492 (S.C. 1989) .

See also Chavin v. Cole Taylor Bank, 2007 U.S. Dist. LEXIS 10483 (N.D. Ill. 2007) (Social security checks are not securities under the Securities Exchange Act of 1934, as they fall within the exclusion for any currency, note or draft with a maturity of not more than nine months).

(n138)Footnote 138. *See Tafflin v. Levitt*, 865 F.2d 595 (4th Cir. 1989) , *aff'd on other grounds*, 493 U.S. 455 (1990) (certificates of deposit issued by a state-chartered savings and loan association were not securities in light of a comprehensive regulatory and insurance system).

(n139)Footnote 139. Taken together, Securities Act §§ 3(a)(2) and 3(a)(5) identify as exempt securities any security issued by a bank or a savings and loan association or similar institution that is supervised and examined by state or federal regulatory authorities.

(n140)Footnote 140. *Dubach v. Weitzel*, 135 F.3d 590 (8th Cir. 1998) .

(n141)Footnote 141. This view has extended to programs or plans involving the use of deposit relationships to secure other credit relationships. *See Iacobucci v. Universal Bank of Maryland*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,075 (S.D.N.Y. 1991) ("cash management account" opened by individuals to secure credit cards issued to them held not to be securities under *Reves* factors).

Certificates of deposit insured by the FDIC have also been excluded from the definition of "security" by the Office of Thrift Supervision (OTS). OTS supervises, examines and regulates federal savings associations. Under OTS regulations, "security" does not include an account insured in whole or part by the FDIC, *see 12 C.F.R. § 561.44*. In *State Farm Bank v. Burke* , 445 F.Supp. 2d 207 (D. Conn. 2006) , the court recognized that the OTS exclusion is consistent with federal securities laws, as interpreted in *Marine Bank v. Weaver*, *supra*. The court thus concluded that the OTS exclusion trumped a state law definition of "security" that included jumbo certificates of deposit that were only partially insured by FDIC within the definition. Apart from the preemptive impact of the OTS regulations, the court concluded that while the existence of FDIC insurance was a factor in the Supreme Court's assessment in *Marine Bank* that a certificate of deposit was not a security, it was not the determinative factor, and that partial FDIC insurance is sufficient to exclude a bank certificate of deposit from the definition of security.

See also Reiswig v. Dept. of Corporations, 144 Cal. App. 4th 327, 50 Cal. Rptr. 3d 386 (4th App. Dist. 2006) (CD-plus-bonus package was not a security because investor funds were used to purchase, virtually risk free, federally insured certificates of deposit, and the package did have requisite elements of an investment contract).

(n142)Footnote 142. 900 F.2d 1485 (10th Cir.) , *cert. denied*, 111 S. Ct. 386 (1990) .

(n143)Footnote 143. The court incorporated its discussion and findings in pre-Reves opinion in the same case, see *Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772 (10th Cir. 1989) , *cert. granted and judgment vacated*, 494 U.S. 1014 (1990) , *aff'd*, 900 F.2d 1485 (10th Cir.) , *cert denied*, 111 S. Ct. 386 (1990) . It must also be remembered that in *Tcherepnin v. Knight*, 389 U.S. 332, 88 S. Ct. 548, 19 L. Ed. 2d 564 (1967) , the Supreme Court held that "withdrawable capital shares" issued by a savings and loan institution were securities for purposes of the antifraud provisions of the Exchange Act. In doing so, the Court found that the instruments were akin to stock in all meaningful characteristics

(n144)Footnote 144. 977 F. Supp. 510 (D. Me. 1997) .

(n145)Footnote 145. *Levine v. Diamantheset, Inc.*, 722 F. Supp. 579 (N.D. Cal. 1989) , *rev'd on other grounds*, 950 F.2d 1478 (9th Cir. 1991) .

(n146)Footnote 146. "Guarantees" as one of the specifically enumerated securities in § 2(1) of the Securities Act are considered further in § 2.01[6] *infra* .

(n147)Footnote 147. *Diaz Vicente v. Obenauer*, 736 F. Supp. 679 (E.D. Va. 1990) (separate letter guaranteeing an obligation represented by a note was a security where it represented the obligation involved in a transaction where there was a clear investment purpose).

(n148)Footnote 148. *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983) .

(n149)Footnote 149. 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) .

(n150)Footnote 150. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985) .

(n151)Footnote 151. *But see Seger v. Federal Intermediate Credit Bank of Omaha*, 850 F.2d 468 (8th Cir. 1988) (lender's class B stock, purchased by borrowers as a condition to obtaining a loan, held not to be a security); *Dau v. Federal Land Bank of Oklahoma*, 627 F. Supp. 346 (N.D. Iowa 1985) ("stock" purchased in connection with obtaining a bank loan evidenced no characteristics of stock under a *Forman* analysis). There will be situations in which the involvement of "stock" is entirely incidental to the main purpose of a transaction, as in *Forman*. Additionally, it is unclear what impact, if any, negotiated stockholder relationships, e.g., "close corporation" agreements, which alter the premises underlying stock as the paradigmatic security, will have.

(n152)Footnote 152. *United Housing Foundation*, 421 U.S. at 851, 95 S. Ct. at 2060, 44 L. Ed. 2d at 631-32 .

(n153)Footnote 153. *United Housing Foundation*, 421 U.S. at 850, 95 S. Ct. at 2059-60, 44 L. Ed. 2d at 631 .

Shares denominated "common stock," and which create the right to receive dividends dependent upon profits, have voting rights, are transferable, and carry the capacity to appreciate in value bear out the usual characteristics of stock and produce a justifiable expectation that the federal securities laws apply. *Mercer v. Jaffe, Snider, Raitt & Heuer, P.C.*, 736 F. Supp. 764 (W.D. Mich. 1990) .

See also Nelson v. Stahl, 173 F. Supp. 2d 153 (S.D.N.Y. 2001) (Ordinary common stock, whether in a publicly held company or a closely held corporation, constitutes a security governed by the federal securities laws).

(n154)Footnote 154. 421 U.S. at 858, 95 S. Ct. at 2063, 44 L. Ed. 2d at 635 .

The reasoning in *Forman* was subsequently extended to "stock" involved in private housing cooperatives as well. *See Grenader v. Spitz*, 537 F.2d 612 (2d Cir.) , *cert. denied*, 429 U.S. 1009 (1976) ; *Shichman v. 40 Schenck Owners, Inc.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,924 (E.D.N.Y. June 12, 1992) ; *Heese v. DeMatteis Dev. Corp.*, 417 F. Supp. 864 (S.D.N.Y. 1976) . Of course, none of this is to say that transactions anchored in real estate can never

involve securities. Quite the contrary, "investment contracts" arising out of real estate settings are common. See § 2.01[11][c] *infra*. However, the essential investment character of a transaction must be shown. Where the principal motivation is obtaining a place to live, that requirement will not be met.

(n155)Footnote 155. "[I]n searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin*, 389 U.S. at 336, 88 S. Ct. at 553, 19 L. Ed. at 569 .

In *Forman*, the Court drew upon this caveat to emphasize that the essential attribute of a security--the "touchstone" for all of the Court's decisions defining a security--is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. See 421 U.S. at 852, 95 S. Ct. at 2060, 44 L. Ed. 2d at 632 .

See also *Beber v. Kanarick*, 1992 U.S. Dist. LEXIS 258 (S.D.N.Y. 1992) (purchase of stock involved a security as a matter of economic reality.)

(n156)Footnote 156. See, e.g., *Jeanne Piaubert, S.A. v. Sefrioui*, (S.D.N.Y. 2000) (Complaint sufficiently alleged that stock possessed all of the characteristics usually associated with common stock).

(n157)Footnote 157. *Walsh v. Emerson*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,962 (D. Ore. 1990).

(n158)Footnote 158. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985) .

(n159)Footnote 159. 471 U. S. 701, 105 S. Ct. 2308, 85 L. Ed. 2d 708 (1985) .

(n160)Footnote 160. *Landreth*, 471 U.S. at 687, 105 S. Ct. at 2302, 85 L. Ed. 2d at 698 ("[I]t is undisputed that the stock involved here possesses all of the characteristics we identified in *Forman* as traditionally associated with common stock. ... Moreover, unlike in *Forman*, the context of the transaction involved here--the sale of stock in a corporation--is typical of the kind of context to which the Acts normally apply.") (citation omitted).

(n161)Footnote 161. *Landreth*, 471 U.S. at 687-88, 105 S. Ct. at 2302, 85 L. Ed. 2d at 698 (citations omitted). After *Landreth*, an investment in common stock is presumed to be an investment in a security. *Jabend, Inc. v. Four-Phase Systems, Inc.*, 631 F. Supp. 1339 (W.D. Wash. 1986) .

(n162)Footnote 162. See *Seeger v. Federal Intermediate Credit Bank of Omaha*, 850 F.2d at 468 (8th Cir. 1988) .

See also *American Re Corp.*, SEC No Action Letter (May 15, 1998), in which shares of preferred stock of a holding company were to be purchased in order to secure insurance coverage at reduced rates, and involved no traditional attributes. The SEC Staff agreed that Securities Act compliance in the offer and sale of the shares would not be required because, among other things, any dividends distributed to policy holders would be allocated pursuant to a predetermined formula based upon the policy holder's loss experience.

(n163)Footnote 163. Contrasting *Forman*, in which purchasers of "stock" could not reasonably believe they had acquired an investment security, the Court in *Landreth* found that it was "much more likely" that a purchaser of actual corporate stock would expect the securities laws to apply. "[P]ersons trading in traditional stock have a high expectation that their activities are governed by the Acts." 471 U.S. at 693, 105 S. Ct. at 2305, 85 L. Ed. 2d at 702 . The Court embraced Professor Loss's view that save for stock involving the "residential wrinkle," the instrument is so "quintessentially a security as to foreclose further analysis." *Id.* at 694, 105 S. Ct. at 2306, 85 L. Ed. 2d at 702 (quoting L. Loss, *Fundamentals of Securities Regulation* 212 (1983)).

(n164)Footnote 164. *Front Street Supermarket, Inc.*, 1982 SEC No-Act. LEXIS 3000 (Nov. 15, 1982) .

See also Share Loan Serv. Corp., 1984 SEC No-Act. LEXIS 2737 (Oct. 18, 1984) ("stock" of a loan service company formed to make loans to housing cooperatives was not a security because the only purchasers were housing cooperatives, no dividends would be paid, shares were non-transferable and were redeemable only at par value at the option of the board of directors); California Ammonia Co., 1983 SEC No-Act. LEXIS 2395 (May 27, 1983) (shares of a fertilizer cooperative were not securities where ownership was limited to users and suppliers of the cooperative's products, transfer was limited and restricted to qualified purchasers, the shares carried no dividend rights, and share price appreciation merely reflected a discounted present value of the cost savings associated with ownership of the cooperative); Attorneys' Title Guaranty Fund, Inc., 1983 SEC No-Act. LEXIS 2269 (Apr 29, 1983) .

But see Rochester Drug Coop., Inc., 1991 SEC No-Act. LEXIS 1107 (Sept. 20, 1991) (common stock may be a security where shares were transferable to persons not involved in the pharmacy business, and which could be resold at a profit); Mutual Serv. Coop., SEC No-Action Letter, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,033 (June 25, 1982), in which the SEC staff determined that stock in a cooperative of insurance companies that acted as a fiscal agent and as a general agency to place insurance not written by members may be a security, noting that:

- (1) payment of shareholder dividends was permitted, although represented as unlikely;
- (2) the stock was transferable upon approval of the cooperative's board of directors; and
- (3) the stock could be resold at a profit.

See also Associated Grocers of Florida, Inc., SEC No-Action Letter, 16 Sec. Reg. & L. Rep. (BNA) 215 (1984) (co-op stock possessed many indicia of a security).

(n165)Footnote 165. *198 F.3d 685 (8th Cir. 1999)* .

See also Hackford v. First Sec. Bank of Utah, N.A., 1983 U.S. App. LEXIS 30924 (10th Cir. Jan. 31, 1983) (shares of stock in a range corporation that entitled holders to grazing rights were not securities since there were no investment expectations, the only benefit was the use of property, any enhancement in value was purely incidental, and there were no promotional characteristics).

(n166)Footnote 166. *Great Rivers Cooperative of Southeastern Iowa supra*, 198 F.3d at 699 .

(n167)Footnote 167. *Great Rivers Cooperative at 700*.

See also Erica Enders Racing, LLC., SEC No-Action Letter (Nov. 21, 2006) (Non-equity memberships in a fan club evidenced by a "stock" certificate that entitled each new member certain benefits was not a security where the stock was non-transferable, non-redeemable and could not appreciate in value due to the prospective issuance of millions of certificates).

(n168)Footnote 168. *See Goodman v. DeAzoulay*, 554 F. Supp. 1029 (E.D. Pa. 1983) .

Whether joint venture or partnership interests may themselves be deemed to be securities is considered in § 2.01[11][c][ii] *infra* .

(n169)Footnote 169. *See, e.g., Doherty v. Kahn*, 289 Ill. App.3d 544, 682 N.E.2d 163 (Ill. App. 1997) . These approaches involve application of a joint venture gloss in particular settings, and are discussed further in 1 *Blue Sky Regulation* § 2.02 (Matthew Bender 1999).

(n170)Footnote 170. 807 F.2d 33 (2d Cir. 1986) . See also *One-O-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.D.C. 1988) (option to purchase stock of a closely held corporation held to be a security).

(n171)Footnote 171. See, e.g., 8 Del. Code Ann. § 351 (1983); see also *Ohio Rev. Code* § 1701.591 (Page, 1992).

(n172)Footnote 172. Many of the same considerations of flexibility in structure and management of an enterprise are also involved in assessments of membership units or interests in a "limited liability company." Also creations of state law, limited liability companies allow "members" to enjoy limited liability associated with the corporate form of organization, while at the same time permitting taxation as a partnership. Limited liability company statutes, and "operating agreements" among members which prescribe management roles or rights, clearly impact the status of membership interests in them as securities, all of which is considered further in § 2.01[11][c][iii] *infra* .

(n173)Footnote 173. 320 U.S. 344, 352-53, 64 S. Ct. 120, 124, 88 L. Ed. 88 (1943) .

(n174)Footnote 174. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 690, 105 S. Ct. 2297, 2304, 85 L. Ed. 2d 692, 700 (1985) .

(n175)Footnote 175. *Joiner*, 320 U.S. at 351, 64 S. Ct. at 123, 88 L. Ed. at 93 .

(n176)Footnote 176. 471 U.S. 701, 704, 105 S. Ct. 2308, 2310, 85 L. Ed. 2d 708, 711 (1985) .

(n177)Footnote 177. 471 U.S. at 693, 105 S. Ct. at 2305 ,, 85 L. Ed. 2d at 702 (citation omitted). The *Landreth* focus on the name and "usual characteristics" of an instrument has been extended beyond stock to application to the Securities Act Section 2(1) category of "fractional undivided interest ... in mineral rights." In *Cascade Energy & Metals Corp. v. Banks*, 896 F.2d 1557 (10th Cir. 1990) , the court applied *Landreth* in concluding that there was no evidence that working interests in a mining claim were anything other than what they purported to be, and as such were plainly within the statutory definition. Fractional undivided interests in mineral rights as securities are considered further in § 2.01[11] *infra* .

(n178)Footnote 178. See, e.g., *Cohen v. William Goldberg & Co.*, 262 Ga. 606, 423 S.E.2d 231, 233 (1992) ("The appropriate test to be employed is whether the ... stock bears such characteristics usually associated with common stock that a purchaser justifiably may assume that appropriate security laws apply").

See also *Carver v. Blanford*, 288 S.C. 309, 342 S.E.2d 406 (1986) ; but see *Anderson v. Heck*, 554 So. 2d 695 (La. App. 1989) (whether stock is a security depends upon circumstances that evidence need for protection of investors who are not in a position to protect themselves from fraud).

(n179)Footnote 179. *Forman* dictates that the fact that instruments bear the label "stock" is not sufficient to invoke coverage. The task, said the Court, is to determine whether the instruments bearing the label possess some of the significant characteristics typically associated with stock. *Forman*, said the Court, does not foreclose the possibility that "stock" can be held to be a security "simply because it is what it purports to be." The ultimate inquiry is whether the actual characteristics of the instrument make it so, and where that is shown, the inquiry ends. See, e.g. *Schaafsma v. Morin Vermont Corp.*, 802 F.2d 629 (2d Cir. 1986) (stock with traditional characteristics held to be a security "as a matter of law").

(n180)Footnote 180. But see *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003) , in which the court held that a plaintiff's interest in a telecommunications company was not "stock" when it was not called stock, and did not evidence certain characteristics of stock, namely, negotiability and proportional participation in company profits. Courts clearly will engage in transaction-specific assessments where the instrument does not on its face claim or answer to the name.

(n181)Footnote 181. 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) .

(n182)Footnote 182. *Id.* at 556, 102 S. Ct. at 1223, 71 L. Ed. 2d at 414-15 .

(n183)Footnote 183. These instruments are discussed in § 2.01[1] *supra*.

Debentures, a separate § 2(1) category of securities, are often imprecisely characterized as bonds. Their more varied usages, however, may lead to more substantive analysis on the question of their status as securities. *See, e.g.*, First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co. of Florida, Inc., 1989 U.S. Dist. LEXIS 16404 (E.D.N.C. 1989) .

(n184)Footnote 184. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,038 (S.D. Tex. 1988) .

(n185)Footnote 185. First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co. of Florida, Inc., 1989 U.S. Dist. LEXIS 16404 (E.D.N.C. 1989) (unsecured and transferable, fixed-rate "debentures" purchased as a condition to obtaining business were securities and not merely evidence of a commercial loan relationship).

(n186)Footnote 186. *See* § 3(a)(2), discussed in § 3.03 *infra*. Exchange Act §§ 3(a)(12) and (29) similarly exempt federal, state, and municipal bonds from certain Exchange Act provisions.

Outside the traditional corporate and government bond areas, forms of "church bonds" have often been used for financing construction of facilities by religious groups or congregations. Under both state and federal securities laws, exemptions from statutory coverage may be available under certain circumstances. *See, e.g.*, Securities Act § 3(a)(4), discussed in § 3.05 *infra* (exempting securities issued by a "person" organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes).

But see SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976) (religious organization offering of interest bearing notes through a general public solicitation held to have violated antifraud provisions).

(n187)Footnote 187. Section 12(a)(2), a general antifraud provision that creates an express right of action for purchasers of securities to obtain rescission or damages for misrepresentations, contains an exception for government and bank securities exempt from the registration provisions under § 3(a)(2) of the Securities Act. Section 12(a)(2) is discussed in § 9.04 *infra*.

See SEC v. Capital Counselors, Inc., 332 F. Supp. 291 (S.D.N.Y. 1971) (enjoining the operation of an unregistered plan for trading in exempt federal government securities. The plan, designed to take profitable advantage of fluctuations in interest rates was, was held to be an investment contract); Imperial Bank, SEC No-Action Letter (Div. Corp. Fin. 1982) ("pass through certificates" offered by a bank as evidencing fractional undivided interests in a pool of tax exempt obligations issued by states, political subdivisions and public instrumentalities were deemed to be separate securities).

(n188)Footnote 188. 421 U.S. 837, 850-51, 95 S. Ct. 2051, 2059-60, 44 L. Ed. 2d 621, 631 (1975) .

(n189)Footnote 189. In a bond "workout" situation, rights and arrangements regarding the underlying instruments may, as a matter of economic reality, also trigger Securities Act concerns. *See, e.g.*, Green-Wood Assocs., SEC No-Action Letter, [1990- 1991 Transfer Binder] 1990 SEC No-Act. LEXIS 1099 (Sept. 12, 1990) ("deferred payment rights" issued in connection with the redemption of bonds appeared to be an evidence of indebtedness issued in exchange for the bonds, and could constitute a security in its own right).

(n190)Footnote 190. Sec. Act Rel. No. 97, 1933 SEC LEXIS 101 (December 28, 1933) .

(n191)Footnote 191. *Corporation Trust Co. v. Logan*, 52 F. Supp. 999 (D. Del. 1943) .

See also Kinsey v. Knapp, 154 F. Supp. 263 (E.D. Mich.) , vacated and remanded on other grounds, 249 F.2d 797 (6th Cir. 1957) , cert. denied, 356 U.S. 935 (1958) .

(n192)Footnote 192. See *Dewing*, The Financial Policy of Corporations 211-13 (5th ed. 1953).

(n193)Footnote 193. As provided in Section 2(4) of the 1934 Act, the term "issuer" includes every "person" who issues or proposes to issue any security. "Person" is defined in § 2(2) specifically to include a trust, to the extent that the "interest or interests of the beneficiary or beneficiaries are evidenced by a security."

(n194)Footnote 194. 731 F.2d 349 (6th Cir. 1984) .

(n195)Footnote 195. *Professional Associates*, 731 F.2d at 355 . The court found that promotional materials concerning the "trust accounts" gave rise to an implication that the investors' funds were to be pooled and generated reasonable expectations of profit to be derived from the efforts of others. Classification of the investments as a trust did not prevent them from being securities when the evidence supported the finding.

See also *Melton v. Unterreiner*, 575 F.2d 204 (8th Cir. 1978) (*inter vivos* trust was a security); *SEC v. Heritage Trust Co.*, 402 F. Supp. 744 (D. Ariz. 1975) (revocable *inter vivos* trusts that conferred absolute investment discretion on the trustee to be governed by none of the "usual and ordinary regard for safety" that lies at the heart of a fiduciary relationship were securities).

(n196)Footnote 196. See Merrill Lynch Capital Mkts. Structured Invs. Group, 1989 SEC No-Act. LEXIS 1009 (June 16, 1989) (interests in litigation settlement trusts would not be securities where no "investment" considerations were present and trustee would perform purely ministerial function of distributing income from Treasury securities to beneficiaries).

See also *Investment Co. Inst. v. Conover*, 596 F. Supp. 1496 (D.D.C. 1984) , holding that a trust fund established for the purpose of collective investment of IRA trust assets and administered by a bank was not a security since it was not intended to be an "investment vehicle." The court emphasized that trust assets received for a *true fiduciary purpose* rather than for investment are not securities, and this despite the promotional and marketing efforts for the service that were pursued by the bank. See also *DYR Liquidating Corp.*, SEC No-Action Letter, Sec. Reg. & L. Rep. (BNA) 429 (Div. Corp. Fin. 1987) (interests in a liquidating trust would not be deemed to be securities).

(n197)Footnote 197. *SEC v. Professional Assocs.*, 731 F.2d 349 (6th Cir. 1984) .

See also *Investment Co. Inst. v. Camp*, 274 F. Supp. 624 (D.D.C. 1967) (units of participation in a commingled account for collective investment management by a bank with the objective of capital appreciation and income are securities).

(n198)Footnote 198. 885 F.2d 1034 (S.D.N.Y. 1988) .

(n199)Footnote 199. See *Republic Supply Co. of California v. Richfield Oil Co. of California*, 74 F.2d 907 (9th Cir. 1935) (depository certificates issued by a reorganization committee were securities).

(n200)Footnote 200. "Receipts" issued in connection with security-holders' protective committee activities in the reorganization setting have not been deemed to be certificates of deposit for securities. Suppose, for example, that a bondholders' protective committee solicits voluntary contributions from holders for committee expenses. All bondholders, whether contributing or not, will share in the fruits of the committee's efforts. Receipts given to the contributing bondholders evidencing their contributions would not be securities within § 2(1). To be a security, the "receipt" must represent, or evidence, an interest in a security. Cf. *Newport Metals Co., Inc.*, 1976 SEC No-Act. LEXIS 816 (Mar. 11, 1976) (depository certificates for precious metals are not securities).

(n201)Footnote 201. 1986 SEC No-Act. LEXIS 1978 (April 6, 1986) .

(n202)Footnote 202. 756 F.2d 230 (2d Cir. 1985) .

(n203)Footnote 203. The SEC has defined a "depository share" as "a security, evidenced by an American Depository Share, that represents a foreign security or a multiple of or fraction thereof deposited with a depository." Sec. Act Rel. No. 6459, 48 FR 12346 (Mar. 24, 1983) .

(n204)Footnote 204. Such situations are disposed of upon consideration of the focus of securities law protection--an investment decision. The mere deposit of securities for handling manifests no investment decision and no concern for special protection.

It should also be noted that the principles analyzed in the discussion of receipts and certificates of deposit for securities are equally applicable to the term "temporary or interim certificate for [a security]" as used in § 2(1).

(n205)Footnote 205. Note, however, that "guaranty" is not included in the definition of security under the Securities Exchange Act of 1934, *see* Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10). Thus, in *Financial Security Assurance, Inc. v. Stephens, Inc.*, 500 F.3d 1276 (11th Cir. 2007) , the Court rejected a fraud claim under Exchange Act § 10(b) and *Rule 10b-5* that was premised on the argument that a guaranty qualified as a security.

(n206)Footnote 206. In *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1128 (4th Cir.) , *cert. denied*, 416 U.S. 916 (1974) , the court characterized the Securities Act's inclusion of any guarantee of a security as a security itself in this manner:

The definition of a security expressly includes a guarantee of any of the other devices enumerated in Section 2(1) Therefore, a guarantee cannot have the effect of denying coverage to an instrument that otherwise satisfies the Act's definition of security. Whether the guarantee is part of the production payment or collateral to it is immaterial. In either event the entire transaction, including the guarantee, falls within the statutory definition of security.

(n207)Footnote 207. *See James v. Meinke*, 778 F.2d 200 (5th Cir. 1985) (guarantee agreements executed by investors in consideration for the promise of additional stock of a corporation were not separate securities where the guarantee involved was only an agreement to repay a loan and not an investment of money in a common enterprise).

(n208)Footnote 208. When considering "guarantees" under the Securities Act it is important to distinguish a guarantee of a security from a commercial guarantee representing a security device with respect to an obligation of another. For example, in *Crabtree Invs., Inc. v. Aztec Enters., Inc.*, 479 F. Supp. 448 (M.D. La. 1979) , a guaranty agreement represented a security device but was held not to be a security within the meaning of the federal securities laws.

Compare Ahrendt v. Palmetto Fed. Sav. & Loan Ass'n, 680 F. Supp. 1125 (S.D. Ohio 1987) , in which loan guarantees signed by individuals for a real estate project were accompanied by payment of additional capital for the project. While the court acknowledged the argument that the guarantees were intended only as security for commercial loans, the payment of additional capital made it possible for the guarantees to be deemed separate securities, and a motion to dismiss securities law claims was denied.

See also Diaz Vicente v. Obenauer, 736 F. Supp. 679 (E.D. Va. 1990) (letter guarantee deemed to be a security either independently or as merged with underlying note that was deemed to be a security).

(n209)Footnote 209. The scope of the phrase "right to subscribe to or purchase" any security extends Securities Act coverage not only to warrants and rights as such, but also to such instruments as "repurchase agreements." *See Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13 (2d Cir. 1986) (extending antifraud protections under corresponding Exchange Act definition).

(n210)Footnote 210. 485 F. Supp. 462 (E.D. Pa. 1980) .

(n211)Footnote 211. See also *United California Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9th Cir. 1977) (demand notes coupled with a right to purchase future notes were not securities because no "risk capital" was committed).

(n212)Footnote 212. In the critical definition of the term "sale" for purposes of the Securities Act, § 2(3) operates to render the issuance of a presently exercisable right or privilege to subscribe to another security the sale of the other security as well. An issuance of rights without consideration, or "value," may not involve a sale of the right but may nevertheless constitute a sale of the underlying security. Complete consideration of the elements of a "sale" is undertaken in § 2.02 *infra* .

(n213)Footnote 213. Warrants and rights became popular devices in the defense against unwanted takeover bids. So-called "poison pill" or "springing" warrants distributed to shareholders that convey the right to acquire other securities--even shares of a hostile bidder--on specified terms and upon the happening of a particular event have been allowed as a matter of federal and state law. See, e.g., *Moran v. Household Int'l Corp.*, 500 A.2d 1346 (Del. 1985) ; *Gearheart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984) . However novel their features, these instruments are securities. Because they have generally been distributed to shareholders as stock dividends rather than by "sale," registration under the Securities Act is not required. See § 2.02[b][4] *infra*.

(n214)Footnote 214. These interests are to be distinguished from the stock, units or other interests issued upon the organization of the enterprise. Since the words "certificate" and "subscription" are used in § 2(1), it appears that the definition was intended to embrace both written and oral preorganization interests.

(n215)Footnote 215. See *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965) ("agreement to form a corporation" is a contract to buy shares of stock in a corporation to be formed and, as such, is a preorganization certificate or subscription); *Getchell v. United States*, 282 F.2d 681 (5th Cir. 1960) (alleged criminal violation of Securities Act antifraud provisions in a scheme to sell preorganization subscriptions).

(n216)Footnote 216. Joint venture and partnership interests in § 2.01[11][c][ii] *infra* .

In many pre-formation settings involving small numbers of people, the private offering exemption in § 4(2) of the Securities Act would be relied upon to exempt certificates or subscriptions from registration (but not the antifraud provisions). The private offering exemption is discussed in § 4.02 *infra*. Other exemptions may also be available.

(n217)Footnote 217. A put or call option relates to 100 shares of the underlying stock. Options are structured and traded according to quarterly expiration cycles, i.e., the contracts are available for trading with three quarterly expiration months so that, for example, options listed in January will expire in equal numbers in April, July and October. The technical "issuer" of option contracts is the Options Clearing Corporation, which is responsible for Securities Act registration processes. Options trade on national securities exchanges, and to much more limited degree, over-the-counter.

(n218)Footnote 218. See *Report of the Special Study of the Options Markets to the Securities and Exchange Commission*, (Dec. 22, 1978).

(n219)Footnote 219. See *Commodity Exchange Act* § 2(a)(1)(B)(ii).

(n220)Footnote 220. *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537 (7th Cir. 1989) , *cert. denied sub nom. American Stock Exch., Inc. v. Chicago Mercantile Exch.*, 496 U.S. 936 (1990) ; see also *Messer v. E.F. Hutton & Co., Inc.*, 847 F.2d 673 (11th Cir. 1988) (although Treasury Bonds are government securities, futures contracts on Treasury Bonds are commodities and are subject to regulation under the commodities laws); *Mallen v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 605 F. Supp. 1105 (N.D. Ga. 1985) (stock index futures are not securities).

(n221)Footnote 221. *One-O-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir 1988) (option to purchase stock of a restaurant franchise was a "right to purchase" and hence a security).

(n222)Footnote 222. Well before the specific statutory inclusion, call options offered to the public were deemed to be securities under the Securities Act. See *Dean Witter & Co.*, 1972 SEC No-Act. LEXIS 126 (Jan. 5, 1972) .

(n223)Footnote 223. See e.g., *Taylor v. Bear Stearns & Co.*, 572 F. Supp. 667 (N.D. Ga. 1983) ; *Westlake v. Abrahams*, 565 F. Supp. 1330 (N.D. Ga. 1983) . The consequences of such accounts being deemed to be securities are meaningful. Absent an exemption, the accounts themselves would be subject to the registration and prospectus delivery requirements of the Securities Act. The general antifraud provisions would apply with a considerably broader focus, and further regulation under the Investment Company Act of 1940 could also result.

But see *Xaphes v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 597 F. Supp. 213 (D. Me. 1984) (whether an option trading account is an investment contract is entirely a function of the *Howey* test and, in particular, the element of "common enterprise").

The elements of an "investment contract" as applied to discretionary securities and commodities accounts are discussed in § 2.01[11][c][xiii] *infra*.

(n224)Footnote 224. 2005 U.S. Dist. LEXIS 10995 (N.D. Tex. 2005) .

(n225)Footnote 225. See also *SEC v. Currency Trading International, Inc.*, 2004 U.S. Dist. LEXIS 24992 (C.D. Cal. 2004) (Foreign currency options are securities pursuant to section 2(1) of the Securities Act of 1933).

(n226)Footnote 226. 295 F.3d. 312 (2d. Cir. 2002) .

(n227)Footnote 227. In reaching its conclusion, the Second Circuit distinguished, and rejected in part, *Proctor & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996) , in which a district court opined that an arrangement involving an interest rate swap with "option-like features" was not a security. The transaction in *Proctor & Gamble* involved swaps linked to the price of Treasury notes. The case did not address whether a cash-settled over-the-counter option on a stock is an option, and thus a security. In *Caiola* the Second Circuit also emphasized that there is no textual basis in the definition of security to define "option" as including only transactions that give the holder the right to receive the underlying securities.

(n228)Footnote 228. Even in *Proctor & Gamble* the court emphasized:

It is important to point out that the holdings in this case are narrow; I do not determine that all leveraged derivative transactions are not securities, or that all swaps are not securities. Some of these derivative instruments, because of their structure, may be securities. 925 F.Supp. at 1283 .

See also *Sanderson v. H.I.G.P-XI Holding, Inc.*, 2000 U.S. Dist. LEXIS 10893 ; (E.D. La. 2000) ("Stock appreciation rights" could be considered securities despite the fact that they were not transferable and were the product of a negotiated agreement).

(n229)Footnote 229. Sec. Act Rel. No. 185 (1934). As also indicated in this release, if the *whole* royalty interest of the landowner (or an *entire* lease) is sold, there is no sale of a "fractional undivided interest" within the meaning of § 2(1). Thus, for the sale of an entire lease to involve the sale of a "security," it would have to be labeled an "investment contract." The House Committee Report observed: "It is also intended to apply the Act to interests commonly known as 'securities' *whether or not such interests are represented by any document or not*. [I]ts provisions cannot be evaded by simply refraining from issuing to the subscriber any documentary evidence of his interest." H.R. Rep. No. 1838, reprinted in the Primary Law Sourcebook, Volume A, Section D of the 1933 Act, 73d Cong., 2d Sess. 39 (1934)

(emphasis added).

(n230)Footnote 230. 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943) .

(n231)Footnote 231. C.M. Joiner Leasing Corp., 320 U.S. at 348, 64 S. Ct. at 122, 88 L. Ed. at 92 .

(n232)Footnote 232. See *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314 (S.D.N.Y. 1982) , in which interests in natural resource assets were held to be securities in the form of either fractional interests or investment contracts. The court characterized the plaintiff in the following manner: "[FOF] was not an oil, gas and mineral developer any more than it was a business participant in the various industries in which it purchased common stocks, bonds or notes. FOF's investments were not ordinary commercial financings between knowledgeable industry participants."

See also *Southwest Inv. I v. Midland Energy Co.*, 596 F. Supp. 219 (E.D. Mo. 1984) ; *Ferland v. Orange Groves of Florida, Inc.*, 377 F. Supp. 690 (M.D. Fla. 1974) .

But see *Ratner v. Sioux Nat'l Gas Corp.*, 770 F.2d 512 (5th Cir. 1985) (purchase of 100% working interest in property, subject only to an existing royalty interest, was not the purchase of a security); *Fearneyhough v. McElvain*, 598 F. Supp. 905 (C.D. Ill. 1984) (transfer of an entire oil and gas lease was neither a fractional undivided interest nor an investment contract); *Robertson v. Humphries*, 1978 U.S. App. LEXIS 9196 (10th Cir. 1978) (sale of entire leasehold is not the sale of a security despite the retention of an overriding royalty).

(n233)Footnote 233. *Vale Natural Gas Am. Corp. v. Carrollton Resources 1990, Ltd.*, 795 F. Supp. 795 (E.D. La. 1992) . The distinction between "vertical" and "horizontal commonality" for purposes of defining the existence of a security in the form of an investment contract is considered further in § 2.01[11][b] *infra* .

(n234)Footnote 234. 515 F. Supp. 1062 (D. Colo. 1981) . See also *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459 (9th Cir. 1985) (ore purchase program was based on common enterprise involving a unique ore processing technique, and interests in the program were securities).

(n235)Footnote 235. 551 F. Supp. 281 (C.D. Cal. 1982) . While the fractional interests were, by definition, securities, the turnkey contracts were deemed to be investment contracts. The court so held even though the working interest purchasers retained ultimate control over the leasehold and could determine whether to drill and who the driller would be.

(n236)Footnote 236. Courts have had little difficulty in holding the Securities Act applicable where interests involved are clearly "fractional undivided interests," regardless of the form they assumed. However, the Supreme Court left no doubt in *Joiner* that the fact that oil, gas, or mineral promotions and financing schemes do not answer to the designation does not mean exclusion from statutory coverage. As the Court stated:

It is urged that because the definition mentions "fractional undivided interests in oil, gas or other mineral rights" it excludes sales of leasehold subdivisions by parcels. Oil and gas rights posed a difficult problem to the legislative draftsman. Such rights were notorious subjects of speculation and fraud, but leases and assignments were also indispensable instruments of legitimate oil exploration and production. To include leases and assignments by name might easily burden the oil industry by controls that were designed only for the traffic in securities. This was avoided by including specifically only that form of splitting up of mineral interests which had been most utilized for speculative purposes. We do not think the draftsmen thereby immunized other forms of contracts and offerings which are proved as a matter of fact to answer such descriptive terms as "investment contracts" and "securities".

320 U.S. at 352, 64 S. Ct. at 124, 88 L. Ed. at 93-94 .

(n237)Footnote 237. *Cascade Energy & Metals Corp. v. Banks*, 896 F.2d 1557 (10th Cir. 1990) . See also SEC v. Profit Enters., Inc., 1992 U.S. Dist. LEXIS 17906 (D.D.C. Nov. 16, 1992) ("fractional interest in oil well leases is easily encompassed in Exchange Act definition of security).

(n238)Footnote 238. *Penturelli v. Spector Cohen Gadon & Rosen, P.C.*, 779 F.2d 160 (3d Cir. 1985) . Plaintiff purchased 28 of 60 undivided fractional interests in a coal mine development program. In doing so, plaintiff became a co-owner of the development, was an active participant, and was found to have had considerable means of protecting his investment. Such means included the power to block any major action concerning the development project and the power to sell coal for his own account. This active role precluded any finding of an investment contract.

See also *Sparks v. Baxter*, 854 F.2d 110 (5th Cir. 1988) ; *Power Petroleum, Inc. v. P & G Mining Co.*, 682 F. Supp. 492 (D. Colo. 1988) (interest in a mining partnership was not a security where the investor had substantial managerial powers as a general partner); *Deutch Energy Co. v. Mazur*, 813 F.2d 1567 (9th Cir. 1987) (general partnership's purchase of oil well leases did not involve the purchase of securities since the partners had significant managerial powers and general business expertise); *Ballard & Cordell Corp. v. Zoller & Dannenberg Exploration Ltd.*, 544 F.2d 1059 (10th Cir. 1976) , cert. denied, 431 U.S. 965 (1977) .

(n239)Footnote 239. However, the precise characteristics of "fractional undivided interest[s] in oil, gas or other mineral rights" may not be so well established as to mandate security status in the post-*Landreth* environment. Other approaches may be necessary or desirable. See, e.g., *Simon Oil Co. v. Norman*, 789 F.2d 780 (9th Cir. 1986) ("risk capital" analysis applied to fractional interests in oil and gas rights).

(n240)Footnote 240. 93 F.2d 844 (7th Cir. 1937) .

(n241)Footnote 241. See also *Parvin v. Davis Oil Co.*, 524 F.2d 112 (9th Cir. 1975) ; *The Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970) ; *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093 (5th Cir. 1973) , cert. denied, 415 U.S. 977 (1974) ; *Nicewarner v. Bleavins*, 244 F. Supp. 261 (D. Colo. 1965) ; *SEC v. MacElvain*, 299 F. Supp. 1352 (D. Ala.) , aff'd, 417 F.2d 1134 (5th Cir. 1969) , cert. denied, 397 U.S. 972 (1970) ; *Mansfield v. United States*, 155 F.2d 952 (5th Cir. 1946) .

(n242)Footnote 242. See *Feldberg v. O'Connell*, 338 F. Supp. 744 (D. Mass. 1972) .

(n243)Footnote 243. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351, 64 S. Ct. 120, 88 L. Ed. 88, 93 (1943) .

(n244)Footnote 244. To a lesser extent the "catchall" characterization could also be applied to "transferable shares," "evidence of indebtedness," and "any interest or instrument commonly known as a security" as these terms appear in Section 2(1).

(n245)Footnote 245. But see *SEC v. Addison*, 194 F. Supp. 709, 722 (N.D. Tex. 1961) ("The legislative history of the Securities Act of 1933 makes it clear that this statute cannot be circumvented by simply refraining from issuing a written instrument evidencing the security transaction. The statute applies regardless of whether such securities are represented by any document.").

(n246)Footnote 246. 1987 U.S. Dist. LEXIS 890 (S.D.N.Y. Feb. 10, 1987)

(n247)Footnote 247. But see *Aiena v. Olsen*, 69 F. Supp. 2d 521 (S.D.N.Y. 1999) (Ten year certificates given in connection with a non-compete/consulting agreement by retired directors, given in exchange for stock previously owned by the directors, and which conferred the right to receive installment payments based upon the company's future dividend stream were investment contract securities and not "personal service contracts").

(n248)Footnote 248. 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946) .

(n249)Footnote 249. *W.J. Howey*, 328 U.S. at 298-99, 66 S. Ct. at 1102-03, 90 L. Ed. at 1249 . The Court's definition of "investment contract" was expressly recognized as reflecting *economic reality*. The Court observed:

"[The term 'investment contract'] was common in many state 'blue sky' laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and the emphasis was placed upon economic reality." *Id.* at 298, 66 S. Ct. at 1102, 90 L. Ed. at 1249 .

(n250)Footnote 250. Indeed, the U.S. Supreme Court has stated: In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," and determined that the best way to achieve its goal of protecting investors was "to define the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a 'security.'" Congress therefore did not attempt precisely to cabin the scope of the Securities Act. Rather, it enacted a definition of "security" sufficiently broad to encompass virtually any instrument that might be sold as an investment. *Reves*, 494 U.S. 56, 60-61, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990) (citations omitted).

See also SEC v. SG Ltd, 265 F.3d. 42 (1st Cir. 2001) (The notion of a security encompasses the total universe of financial instruments available to investors).

(n251)Footnote 251. The definition of "investment contract" under *Howey* is not impermissibly vague for application in state criminal prosecutions, *see Digman v. Quartermain*, 2006 U.S. Dist. LEXIS 62726 (W.D. Tex. 2006) . In *Digman* the court rejected the contention that the *Howey* definition of a security was intended for "regulatory purposes" and is too vague for application to a Texas criminal prosecution. The court observed: "An effective regulatory scheme includes imposing and enforcing penalties to uphold the law." The petitioner's activity plainly qualified for creation of an investment contract under *Howey*. It would be reasonable for a state court to use the definition where the penalties of the state securities law are specific enough to give notice of what is considered criminal conduct, without producing a chilling effect.

(n252)Footnote 252. *W.J. Howey*, 328 U.S. at 299-300, 66 S. Ct. at 1103, 90 L. Ed. at 1250 (emphasis added).

See also United Housing Foundation Inc. v. Forman, 421 U.S. 837, 90 L. Ed. at 1250 (1975) .

(n253)Footnote 253. *See 421 U.S. at 852, 95 S. Ct. at 2060, 44 L. Ed. 2d at 632 .*

(n254)Footnote 254. *See Heine v. Colton, Hertnick, Yemin & Sheresky*, 1992 U.S. Dist. LEXIS 2825 (S.D.N.Y. Mar. 9, 1992) (no business underlying the purported investment of money); *Wabash Valley Power Ass'n, v. Public Serv. Co. of Indiana, Inc.*, 678 F. Supp. 757 (S.D. Ind. 1988) (purchase of percentage interest in project to construct a nuclear power plant was motivated by desire to consume the energy to be produced, and success in sale of other energy output would not be due solely to efforts of others); *Stowell v. Ted S. Finkel Inv. Serv., Inc.*, 489 F. Supp. 1209 (S.D. Fla. 1980) .

See also C.N.S. Enters., Inc. v. G & G Enters., Inc., 508 F.2d 1354, 1359 (7th Cir.) , *cert. denied*, 423 U.S. 825 (1975) ; *Ticket Reserve, Inc.*, SEC No-Action Letter (Div. Corp. Fin., Sept. 11, 2003) (No "investment medium" involved--a seat ticket or right to acquire a seat ticket to an event is a commodity purchased for use or consumption).

It also means that there must be an actual investment decision. If, for example, participation in an Employee Stock Ownership Plan (ESOP) is mandatory, there is no voluntary investment choice, *see Matassarin v. Lynch, Trustee*, 174

F.3d 549 (5th Cir. 1999) (Mandatory employer-funded ESOP did not involve any voluntary investment choice and the first Howey element could not be met).

(n255)Footnote 255. *438 F. Supp. 2d 1122 (C.D. Cal. 2006)* . The application of investment contract analysis to employee benefit plans generally, and the investment decision element in particular, are *considered in detail in § 2.01[11][c][vii], infra*.

(n256)Footnote 256. *540 U.S. 389, 124 S. Ct. 892 (2004)* .

(n257)Footnote 257. *Edwards* and the investment contract analysis applicable to investment schemes involving personal property generally, are discussed specifically in § 2.01[11][c][xii] *infra* .

(n258)Footnote 258. *320 U.S. 344, 348, 64 S. Ct. 120, 122, 88 L. Ed. 88, 92 (1943)* .

(n259)Footnote 259. See *SEC v. The Infinity Group*, 212 F.3d. 180 (3d Cir. 2000) ; *Wagman v. FSC Sec. Corp.*, 1985 U.S. Dist. LEXIS 17610 (N.D. Ill. July 22, 1985) . *Heine v. Colton, Hertnick, Yemin & Sheresky*, 1992 U.S. Dist. LEXIS 2825 (S.D.N.Y. Mar. 9, 1992) .

See also *SEC v. U.S. Funding Corp.*, 2006 U.S. Dist. LEXIS 24789 (D.N.J. 2006) ("Accounts Receivable Purchase Agreements" promising 20% to 25% returns involved pooling of funds into a single bank account to purchase new accounts receivable on which profits would be generated wholly by the efforts of the promoter); *SEC v. Global Express Capital Real Estate Investment Fund I, LLC*, 2006 U.S. Dist. LEXIS 96477 (D. Nev. 2006) (Investor funds pooled to enable investors to diversify their investments over a number of mortgage loans, and distributions were derived from income generated by the pooled Fund assets).

(n260)Footnote 260. *Broadview Fin., Inc. v. Entech Management Servs. Corp.*, 859 F. Supp. 444 (D. Colo. 1994) .

See also *Mace Neufield Prods., Inc., v. Orion Pictures Corp.*, 860 F.2d 944 (9th Cir. 1988) (a private television series production agreement, negotiated directly by the parties, was an agreement that could not ordinarily or commonly be thought to be a security); *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144 (7th Cir. 1984) ; *Hart v. Pulte Homes of Michigan Corp.*, 735 F.2d 1001 (6th Cir. 1984) ; *Dahl v. English*, 578 F. Supp. 17, 20 (N.D. Ill. 1983) ("[M]ost indicative of the unitary nature of the instant transactions is that each purchaser's success depends on the marketability and public acceptance of his particular art work and not on the success of any other purchaser's artwork"); *First Nat'l Bank & Trust of Oklahoma City v. Thoele*, 1982 U.S. Dist. LEXIS 15626 (W.D. Okla. 1982) ; *Deckebach v. LaVida Charters, Inc.*, 867 F.2d 278 (6th Cir. 1989) (purchase/management arrangement was a one-on-one vertical relationship which did not rise to the level of a contribution or pooling of venture capital).

But see *Aiena v. Olsen*, 69 F. Supp. 2d 521 (S.D.N.Y. 1999) (Personal consulting agreement did not negate investment contract determination for an associated certificate entitling former directors to receive future "shadow dividend" payments).

(n261)Footnote 261. *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994) (citations omitted).

(n262)Footnote 262. See *SEC v. Professional Assocs.*, 731 F.2d 349 (6th Cir. 1984) ; *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977) ; *First Nat'l Bank & Trust of Oklahoma City v. Thoele*, 1982 U.S. Dist. LEXIS 15626 (W.D. Okla. 1982) ; *Barry v. Ceres Land Co.*, 1978 U.S. Dist. LEXIS 16356 (D. Minn. 1978) ; *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972) , *aff'd*, 491 F.2d 752 (3d Cir. 1973) ; *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.) , *cert. denied*, 409 U.S. 887 (1972) ; *Commercial Iron & Metal Co. v. Bache & Co.*, 478 F.2d 39 (10th Cir. 1973) .

(n263)Footnote 263. *864 F. Supp. 784 (N.D. Ill. 1994)* .

(n264)Footnote 264. *See also SEC v. Banner Fund International*, 211 F.3d 602 (D.C. Cir. 2000) (Simply placing investors' funds into individual trusts did not change the pooled nature of the program, the very premise of which was that funds from small investors would be combined).

(n265)Footnote 265. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974) .

See also Vale Natural Gas Am. Corp. v. Carrollton Resources, Inc., 795 F. Supp 795 (E.D. La. 1992) ; *Long v. Schultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989) , *reh'g denied*, 896 F.2d 85 (5th Cir. 1990) ; *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978) ; *Booth v. Peavey & Co. Commodities Servs.*, 430 F.2d 132 (8th Cir. 1970) ; *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974) ; *Hector v. Wiens*, 533 F.2d 429 (9th Cir. 1976) ; *Westlake v. Abrahams*, 504 F. Supp. 337 (N.D. Ga. 1980) .

(n266)Footnote 266. *See Kaplan v. Shapiro*, 655 F. Supp. 336 (S.D.N.Y. 1987) .

(n267)Footnote 267. *SEC v. Eurobond Exch., Ltd.*, 13 F.3d 1334 (9th Cir. 1994) ; *see also SEC v. Comcoa Ltd.*, 855 F. Supp. 1258 (S.D. Fla. 1994) (each investor dependent upon the success of the defendant in preparing, filing, and obtaining licenses in application service program for certain FCC licenses and in post-licensing marketing activities); *Long v. Schultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989) , *reh'g denied*, 896 F.2d 85 (5th Cir. 1990) .

(n268)Footnote 268. *See Kline Hotel Partners v. Aircoa Equity Interests, Inc.*, 729 F. Supp. 740 (D. Colo. 1989) (existence of a federal security requires the presence of "passivity-in-fact"--an investor who is unable to exert any significant or essential managerial efforts).

(n269)Footnote 269. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852, 95 S. Ct. 2051, 2060, 44 L. Ed. 2d 621, 632 (1975) .

See also Odom v. Slavik, 703 F.2d 212 (6th Cir. 1983) (minority partner voluntarily entered into a partnership with the power to participate in affairs of the enterprise and the kind of leverage and ability to protect himself that precludes a security); *Perry v. Gammon*, 583 F. Supp. 1230 (N.D. Ga. 1984) (delegation of management over real estate properties did not alter ability to control); *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1260-61 (9th Cir. 1976) (Wright, J., concurring).

(n270)Footnote 270. *See SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476 (9th Cir.) , *cert. denied*, 414 U.S. 821 (1973) ; *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974) .

(n271)Footnote 271. *Teague v. Bakker*, 35 F.3d 978 (4th Cir. 1994) .

(n272)Footnote 272. 320 U.S. 344, 353, 64 S. Ct. 120, 124, 88 L. Ed. 88, 94 (1943) .

(n273)Footnote 273. *See Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036 (10th Cir. 1980) (promotional emphasis by the developer of a real estate project was central to the inquiry, whether lot sales were securities).

(n274)Footnote 274. *In re Gardner*, Fed. Sec. L. Rep. (CCH) P 96,757 (N.Y. Sup. Ct. 1979) .

(n275)Footnote 275. *SEC v. SG Ltd.*, 265 F.3d. 42 (1st Cir. 2001) .

See also In re Professional Fin. Management, Ltd., 692 F. Supp. 1057 (D. Minn. 1988) (argument that subject transactions were arms-length between prudent business people was not reasonable in light of prospectus and promotional materials which created investment expectations). In an otherwise close case, the manner of promotion may be determinative. *See generally Rapp, The Role of Promotional Characteristics In Determining the Existence of a Security*, 9 Sec. Reg. L.J. (1981).

(n276)Footnote 276. 993 F.Supp. 321 (E.D. Pa. 1998) , *aff'd*, 212 F.3d 180 (3d Cir. 2000) .

(n277)Footnote 277. See *DeWitt v. Firststar Corp.*, 879 F. Supp. 947 (N.D. Iowa 1995) (no dependence on promoter to make decisions essential to success of cattle program); *Villeneuve v. Advance Business Concepts Corp.*, 698 F.2d 1121 (11th Cir. 1983) , *aff'd en banc*, 730 F.2d 1403 (11th Cir. 1984) (purchaser required to make "substantial efforts" toward achieving desired profit); *Christy v. Cambron*, 710 F.2d 669 (10th Cir. 1983) (purchaser actively involved in operation and management of the enterprise); *Darrah v. Garrett*, 1984 U.S. Dist. LEXIS 18649 (N.D. Ohio 1984) (purchaser performed significant managerial duties and had extensive control over the profit and loss potential of the investment); *Coffin v. Tricoli*, 470 F. Supp. 7 (E.D. Va. 1977) (individual with 50% management control could not claim reliance on the managerial efforts of others); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981) .

(n278)Footnote 278. See *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533 (10th Cir. 1987) ; *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo.1970) , *aff'd*, 460 F.2d 666 (10th Cir. 1972) ; *Nash & Assocs., Inc. v. Lum's of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973) ; *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183 (9th Cir. 1974) ; *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877 (11th Cir. 1978) ; *The Plum Tree, Inc. v. Frasz*, 433 F. Supp. 537 (E.D. Pa. 1977) ; *Higbie v. Kopy-Kat, Inc.*, 391 F. Supp. 808 (E.D. Pa. 1975) ; *Schuler v. Better Equip. Laundry Ctr., Inc.*, 1973 U.S. Dist. LEXIS 12690 (D. Mass. 1973); *Wieboldt v. Metz*, 355 F. Supp. 255 (S.D.N.Y. 1973) .

(n279)Footnote 279. *SEC v. Friendly Power Co., L.L.C.*, 49 F.Supp. 2d 1363 (S.D. Fla. 1999) .

See also *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d Cir.) , *cert. denied sub nom. Hecht v. SEC*, 459 U.S. 1086 (1982) (license to sell dental products with the seller of the license available as an "optional" sales agent was a security since the typical investor would be expected to accept the option, and thus remain passive).

(n280)Footnote 280. See *Miltland Raleigh-Durham v. Myers*, 807 F. Supp. 1025 (S.D.N.Y. 1993) ; *SEC v. Interlink Data Network of Los Angeles, Inc.*, 1993 U.S. Dist. LEXIS 20163 (C.D. Cal. 1993) (by definition, limited partnership interests are investment contracts); *Sommer v. PMEC Assocs. & Co.*, 1993 U.S. Dist. LEXIS 12749 (S.D.N.Y. 1993) ; *Henkind v. Brauser*, 1989 U.S. Dist. LEXIS 5344 (S.D.N.Y. 1989) ("Virtually by definition... because of their restrictions on participation, limited partnership interests usually qualify as securities for purposes of the federal securities laws"); *Dooner v. NMI Ltd.*, 725 F. Supp. 153 (S.D.N.Y. 1989) (limited partnership with only a single limited partner was a security).

(n281)Footnote 281. Uniform Partnership Act § 18(e).

(n282)Footnote 282. Uniform Partnership Act § 18(a), (e). Unlimited and unconditional liability was considered determinative in rejecting an attempt to characterize additional capital contributions to a partnership as the purchase of securities. See *Klaers v. St. Peter*, (8th Cir. Aug. 22, 1991)).

(n283)Footnote 283. Uniform Partnership Act §§ 9(1), 9(2) and 15.

(n284)Footnote 284. A joint venture is defined as a partnership for a particular purpose. It has also been defined as a partnership for a single transaction or project. In other words, features that most distinguish a partnership from a joint venture are scope and duration. It has long been recognized that partnership law governs joint venture relationships.

For analyses of joint venture relationships under the *Howey* test, see *Sparks v. Baxter*, 854 F.2d 110 (5th Cir. 1988) (parties were involved in a joint effort in which the expectation of profits was a result of joint work efforts, and it was manifest from the evidence that no investment contract existed); *Youmans v. Simon*, 791 F.2d 341 (5th Cir. 1986) (joint venture agreement permitted investors too much power to satisfy *Howey* test); *Sleven v. Pedersen Assocs., Inc.*, 540 F. Supp. 437 (S.D.N.Y. 1982) (if there is no written statement that delineates the intent of the parties at the time an investment is made, the intent becomes clear from the relationship the parties accepted thereafter; thus, a plaintiff who

felt free to work directly in a project to develop prefabricated homes in which he invested, and who rendered his services freely, purchased an interest in a joint venture and not a security); *Goodman v. DeAzoulay*, 539 F. Supp. 10 (E.D. Pa. 1982) (plaintiff's interest in a corporation, although evidenced by "stock" was in fact a joint venture interest since plaintiff was an active participant in the venture); *McLish v. Harris Farms, Inc.*, 507 F. Supp. 1075 (S.D. Cal. 1980) (investment in a joint venture involving cattle was a security where essential managerial efforts came from the promoter who exercised daily control over the cattle and who had absolute control over the removal of the cattle from his custody); *Oxford Fin. Cos. v. Harvey*, 385 F. Supp. 431 (E.D. Pa. 1974) (joint venture interest not a security where the investor had substantial managerial control coupled with the power to control disbursement of funds); *Polikoff v. Levy*, 55 Ill. App. 2d 229, 204 N.E.2d 807 (Ill. App. Ct.) , cert. denied, 382 U.S. 903 (1965) (unit interests in joint venture were not securities).

(n285)Footnote 285. See *Casablanca Prods., Inc. v. Pace Int'l, Inc.*, 697 F. Supp. 1563 (D. Ore. 1988) (plaintiff may have been a passive general partner but one who nevertheless had significant managerial powers); *Reeves v. Teuscher*, 881 F.2d 1495 (9th Cir. 1989) (general partners had equal rights to manage and control); *Matek v. Murat*, 862 F.2d 720 (9th Cir. 1988) (general partnership agreement gave all partners access to information and the ability to protect their investments); *Stone v. Millstein*, 804 F.2d 1434 (November 24, 1986) (no security where plaintiffs had an equal partnership interest and participated fully in the formation of the partnership, the acquisition of the partnership property, and the partnership's management); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 650 F. Supp. 1378 (W.D.Va. 1986) (plaintiffs retained significant powers to control the partnership venture and were capable of exercising their powers).

But see *McGill v. American Land & Exploration Co.*, 776 F.2d 923 (10th Cir. 1985) (investment in a joint venture held to be a security where economic reality mandated a conclusion that *Howey* criteria were met).

(n286)Footnote 286. 126 F.3d 144 (3d Cir. 1997) .

(n287)Footnote 287. *Id.*, at 155 .

See also *Bamco 18 v. Reeves*, 675 F. Supp. 826 (S.D.N.Y. 1987) , in which a limited partnership interest was not a security where the investor was, in effect, the sole limited partner and played a role in operation and management of the partnership enterprise.

(n288)Footnote 288. "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." Uniform Limited Partnership Act § 7.

(n289)Footnote 289. See *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978) (limited partnership interest held to be a security as a matter of law); *Dooner v. NMI Ltd.*, 725 F. Supp. 153 (S.D.N.Y. 1989) ; *Henkind v. Brauser*, 1989 U.S. Dist. LEXIS 5344 (S.D.N.Y. 1989) (limited partnership interests were securities even though two limited partners held 99% ownership interest).

See also *L & B Hospital Ventures, Inc. v. Healthcare Int'l, Inc.*, 894 F.2d 150 (5th Cir. 1990) ; *Ethanol Partners v. Weiner, Zuckerbrot, Weiss & Brecher*, 635 F. Supp. 18 (E.D. Pa. 1985) ; *Felkay v. ZB Ltd. Partnership No.1*, 1983 U.S. Dist. LEXIS 16172 (S.D.N.Y. 1983) ; *Mayer v. Oil Field Sys. Corp.*, 721 F.2d 59 (2d Cir. 1983) ; *Murphy v. Gutfreund*, 583 F. Supp. 957 (S.D.N.Y. 1984) .

The fact that a limited partner holds an option to buy out the general partners, thus terminating the partnership and changing his relationship to the real estate that forms the basis for the partnership enterprise, does not represent sufficient control to prevent the limited partnership interest from being a security. *Rodeo v. Gillman*, 787 F.2d 1175 (7th Cir. 1986) .

(n290)Footnote 290. *Tcherepnin v. Knight*, 389 U.S. 332, 336, 88 S. Ct. 548, 553, 19 L. Ed. 2d 564, 569 (1967) .

(n291)Footnote 291. *Goodwin v. Elkins & Co.*, 730 F.2d 99 (3rd Cir.) , cert. denied, 469 U.S. 831 (1984) .

(n292)Footnote 292. *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.) , cert. denied, 454 U.S. 897 (1981) .

See also SEC v. Telecom Marketing, Inc., (N.D. Ga. 1995) (*Pro forma* evidence that partners possessed real powers was overcome by the fact that investors were targeted for their ignorance of the industry and applicable law and accounting); *Bergsma v. Wood*, 1989 U.S. Dist. LEXIS 16014 (W.D. Mich. 1989) (general partnership could be a security where the partner's interest involved little power and left him totally dependent upon the managerial skill and integrity of the managing general partner); *Kline Hotel Partners v. Aircoa Equity Interests Inc.*, 729 F. Supp. 740 (D. Colo. 1989) ; *McConnell v. Frank, Howard & Allen Co.*, 574 F. Supp. 781 (N.D. Cal. 1983) (general partnership interest held to be a security where the partnership agreement left little control in the hands of non-managing partners and investors were unsophisticated with respect to exercise of the powers they did have); *Koppel v. Wien*, 575 F. Supp. 960 (S.D.N.Y. 1983) (participations in a hotel partnership were securities despite alleged "fundamental" powers reserved to investors); *Wagner v. Bear, Stearns & Co.*, 1982 U.S. Dist. LEXIS 16813 (N.D. Ill. 1982) (general partnership interest held to be a security).

(n293)Footnote 293. See, e.g., SEC v. Shiner, No. 03-60175-CIV, 2003 U.S. Dist. LEXIS 15607 (S.D. Fla. 2003) (Any power the investors exercised was illusory).

See also SEC v. Shreveport Wireless Cable Television Partnership, 1998 U.S. Dist. LEXIS 23086 (D.D.C. 1998) (Partners' power and interests were significantly diluted, and agreements conferred no managerial power beyond that of a limited partner); *Holden v. Hagopian*, 978 F.2d 1115 (9th Cir. 1992) .

(n294)Footnote 294. *Pfohl v. Pelican Landing*, 567 F. Supp. 134 (N.D. Ill. 1983) (under *Williamson*, whether a general partnership interest is a security is a factual question); see also *Cohen v. Goodfriend*, 642 F. Supp. 95 (E.D.N.Y. 1986) (general partner believed he was a limited partner, and economic reality was that in fact he was sold a limited partnership interest); *Stewart v. Germany*, 631 F. Supp. 236 (S.D. Miss. 1986) .

(n295)Footnote 295. *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 650 F. Supp. 1378, 1383-84 (W.D. Va. 1986) ; see also *Casablanca Productions, Inc. v. Pace Int'l, Inc.*, 697 F. Supp. 1563 (D. Or. 1988) .

For a thorough analysis of the various approaches to general partnership interests as securities and persuasive reasoning against any "bright line" rule, see *Matek v. Murat*, 862 F.2d 720 (9th Cir. 1988) . See also *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982) (although the written agreements for real estate partnerships gave an investor control through voting power over the fate of his investment, the defendant's represented unique knowledge and expertise on which the investor relied created a factual question concerning the existence of a security); *Morrison v. Pelican Land Dev. Co.*, 1982 U.S. Dist. LEXIS 15843 (N.D. Ill. 1982) (an interest in a general partnership could be deemed to be a security since the plaintiff-partner alleged that he was too inexperienced to participate in the partnership's affairs, that he relied totally on the unique talents of the managing partners, and that he was incapable of exercising meaningful partners); *Pawgan v. Silverstein*, 265 F. Supp 898 (S.D.N.Y. 1967) ("It is obvious that this venture was not a general partnership in the accepted sense, and calling it one does not properly reflect its business form").

But see *Odom v. Slavik*, 703 F.2d 212 (6th Cir. 1983) , in which the court held that despite the fact that the plaintiff had no opportunity to exercise any power normally accorded a general partner, he was an experienced professional who knowingly entered into the partnership agreement and a minority position; hence, his general partnership interest would not be deemed to be a security.

See also *Darrah v. Garrett*, 1984 U.S. Dist. LEXIS 18649 (N.D. Ohio 1984) (purchasers of limited partnership interests in fact had extensive control over profit and loss potential of the investment, and their interests were not

securities).

(n296)Footnote 296. 483 F. 3d 747 (11th Cir. 2007) .

(n297)Footnote 297. N. 284, *supra*.

(n298)Footnote 298. See also *Toothman v. Freeborn & Peters*, 80 P.3d 804 (Colo. App. 2002) . In *Toothman* the defendants organized and sold interests in 53 limited liability partnerships to some 5000 investors. The court opined that application of investment contract principles would defeat any presumption that limited liability partnerships are not securities. The relevant inquiry, said the court, is whether the "partners" expected profits from the essential managerial efforts of someone else, and whether the partners had any substantial power to affect the success of the enterprise.

(n299)Footnote 299. See, e.g., *Colo. Rev. Stat. § 7-80-401(1)*.

(n300)Footnote 300. "Close corporation agreements" and their potential impact in the determination whether corporate stock should be deemed to be a security, are discussed in § 2,01[2][a], *supra*.

(n301)Footnote 301. See, e.g., *Burnett v. Rowzee*, 2007 U.S. Dist. LEXIS 74275 (C.D. Cal. 2007) . In *Burnett* the operating agreement in an LLC delegated all management authority to the managing member and left no right of control over the LLC's investments in the hands of individual members. Plaintiffs expected profits from their investment to come from their managing member's efforts and not their own. They were the functional equivalent of limited partners, i.e., passive investors in the scheme who relied upon another's managerial efforts.

See also *Days Inn Worldwide, Inc. v. Sonia Investments LLC*, 2006 U.S. Dist. LEXIS 80118 (N.D. Tex. 2006) (Investment in LLC with the expectation of being a passive investor with no operational role was sufficient to demonstrate the existence of a genuine issue with the LLC membership qualified as an investment contract).

(n302)Footnote 302. 48 F. Supp. 2d 326 (S.D.N.Y. 1999) .

(n303)Footnote 303. 48 F.Supp. 2d at 333 . The same conclusion was reached in *Endico v. Fonte*, 485 F.Supp. 2d 411 (S.D.N.Y. 2007) , in which a member of a limited liability company unsuccessfully claimed protection of the antifraud provisions of the federal securities laws in connection with the inducement to sell his two-thirds membership interest in the LLC. The plaintiff seller was not a passive investor, as he exercised financial control in the operation of the enterprise. While the LLC operating agreement designated the defendants as the Managing Members, with power and authority to manage the business, it also included a significant limitation on the exercise of that authority by requiring unanimous consent of the members, including the plaintiff, to sell or mortgage company property. This, coupled with the fact that the plaintiff exercised sole signatory authority for disbursement of company funds, ran directly contrary to the claim that plaintiff was a passive member.

See also *Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F.Supp. 2d 376 (D. Del. 2000) (Powers held by members, including the power to remove managers without cause, vested in the members the power to directly affect the profits received, and precluded finding a security); *Robinson v. Glynn*, 349 F.3d. 166 (4th Cir. 2003) (No security where members were active participants in the business); *Nelson v. Stahl*, 173 F. Supp. 2d 153 (S.D.N.Y 2001) (LLC agreement granted members direct authority over management).

(n304)Footnote 304. See *In re Express Communications, Inc.*, Ga. Comm'r of Sec., No. 50-93-0095 (Apr. 14, 1994).

(n305)Footnote 305. See, e.g., *Ohio Rev. Code § 1707.01(B)*; *Mich. Comp. Laws § 450.5103*; *New Mexico Stat. Ann. § 58-13B-2(V)* ("unless the context otherwise requires"); *Wis. Stat. § 551.02(13)(b)-(c)* (presumption in certain circumstances).

North Carolina, by rulemaking, has established a rebuttable presumption of security status, *see* Blue Sky Regulations, Rule.1510; and Indiana, while including LLCs within the statutory definition, provides an exclusion where all members are actively engaged in management, *Ind. Code* § 23-2-1-1(k).

(n306)Footnote 306. 1 L. Ribstein and R. Keatinge, *Ribstein and Keatinge on Limited Liability Companies*, § 14.02, at 14-5 (McGraw-Hill 1994).

(n307)Footnote 307. *See SEC v. Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939) , *cert. denied*, 308 U.S. 622 (1940) (memberships in the "Universal Order of Plenocrats," touted as offering a 30% annual return); *Davenport v. United States*, 260 F.2d 591 (9th Cir. 1958) , *cert. denied*, 359 U.S. 909 (1959) (memberships in a plywood cooperative); *United States v. Davis*, 40 F. Supp. 246 (N.D. Ill. 1941) .

See also United States v. Monjar, 47 F. Supp. 421 (D. Del. 1942) , *aff'd*, 147 F.2d 916 (3d Cir. 1946) , *cert. denied*, 325 U.S. 859, 89 L. Ed. 1979 (1945) (receipts issued to club members for personal loans held to be investment contracts and evidences of indebtedness within § 2(1)).

(n308)Footnote 308. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906 (Cal. 1961) . Country Club memberships were sold, and the proceeds were used by the promoter to finance completion of the club facilities. Purchasers of memberships received no interest in the assets or financial success of the club, only the right to use its facilities when opened. While future "profits" could not be the focus of the purchasers' decision, the risk to capital being furnished was apparent. This risk was isolated by the court as the most important aspect of the transaction, and the memberships were held to be securities under the state Blue Sky Law.

(n309)Footnote 309. American Stock Exchange, Inc., SEC No Action Letter, [1998 Transfer Binder] Fed.Sec.L.Rep. (CCH) [par] 77,472 (Sept. 15, 1998).

See also Marine Preservation Ass'n, 1991 SEC No-Act. LEXIS 1085 (Sept. 16, 1991) (memberships in non-profit corporation formed to promote welfare of petroleum and energy industries in regard to oil spills); Front Street Supermarket, Inc., 1982 SEC No-Act. LEXIS 3000 (Nov. 15, 1982) (membership interests in a worker cooperative organized to operate a supermarket); Attorneys' Title Guar. Fund, Inc., 1983 SEC No-Act. LEXIS 2269 (Mar 31, 1983) (stock sales as a requirement for membership in a title insurance company comprised solely of attorneys; Home Mortgage Access Holding Corp., 1984 SEC No-Act. LEXIS 1968 (Feb. 22, 1984) (company formed to provide member builders with access to mortgage funds); American Hardware Supply Co., 1984 SEC No-Act. LEXIS 1521 (Jan. 4, 1984) (nontransferable membership shares in a business cooperative for hardware and lumber dealers were not securities).

(n310)Footnote 310. 2007 N.Y. Misc. LEXIS 7829, 238 N.Y.L.J. 95 (Sup. Ct. N.Y. County 2007) .

(n311)Footnote 311. Boca Lago Country Club, Inc., 1981 SEC No-Act. LEXIS 4200 (Oct. 14,1981) .

But see Diamond Dealers Club, Inc., 1984 SEC No-Act. LEXIS 2342 (Div. Corp. Fin., July 9,1984) (bonds sold to members of a non-profit organization on a *mandatory* basis to finance a 20 year lease on facilities would be deemed to be sale of securities).

(n312)Footnote 312. *See SEC v. International Loan Network, Inc.*, 968 F.2d 1304 (D.C. Cir. 1991) ("Memberships" that entitled the purchaser to discounts and other services did not constitute securities themselves, but the linked program in which members earned profits through recruiting of new members and subsequent fees paid by new members constituted an investment contract).

(n313)Footnote 313. Investment clubs have raised such issues. *See* Investors Fin. Servs., Inc. SEC No-Action Letter, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,357 (July 28, 1986) ("Small Savers Investment

Group" sponsored by an investment adviser would result in the creation of a security); *see also* Sharp Inv. Club, SEC No-Action Letter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,803 (Dec. 4, 1980) (whether investment club membership is a security depends in large measure on the manner in which investment decisions are made); TGI Friday's, Inc., SEC No-Action Letter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,841 (Feb. 17, 1981) (interests in a club formed to pool savings to invest in large denomination certificates of deposit could be deemed to be securities depending upon the level of participation by group members in operations).

See also *Caldwell v. State*, 95 S.W.3d 563 (Tex. App. 2002) (Defendant recruited people to join an "investment club" by paying an annual fee, joining a team and giving the team money for investment, with an expectation of profits from 100 to 300 percent).

(n314)Footnote 314. *United Housing Foundation*, 421 U.S. 837 .

(n315)Footnote 315. *See also* *Field v. 104-108 Reade Street Assocs.*, 1987 U.S. Dist. LEXIS 3450 (S.D.N.Y. May 4, 1987) (shares in a partnership whose purpose was to acquire title to property, in which the four partners had occupancy rights and shared management responsibilities, did not involve a security).

The approach has been extended to residential leases. *See* *Waldo v. Central Indiana Lutheran Retirement Home*, 1979 U.S. Dist. LEXIS 8516 (S.D. Ind. 1979) (lifetime lease of apartment in a retirement health care facility was not a security); *Aschenbach v. Covenant Living Centers-North, Inc.*, 482 F. Supp. 1241 (E.D. Wis. 1980) (residency contract not a security).

Expectations which defeat security status in these circumstances need not be confined to "residence." *See, e.g., Weiss v. Lehman*, 713 F. Supp. 489 (D.D.C. 1989) (motives for purchasing real estate included tax benefits and expected appreciation from development in which purchasers would be involved; *see also* *Westchester Corp. v. Peat, Marwick, Mitchell & Co.*, 626 F.2d 1212 (5th Cir. 1980) (sale of developed property in fixed intervals at fixed prices was "merely a contract for purchase of land in phases" and not a security); *Lopez v. Richards*, 594 F. Supp. 488 (S.D. Miss. 1984) (sale of an interest in a land purchase option as part of a venture to profitably resell the option was not a security).

(n316)Footnote 316. *Gordon v. Terry*, 684 F.2d 736, 741, n.4 (11th Cir. 1982) ; *see also* *McCown v. Heidler*, 527 F.2d 204, 208 (10th Cir. 1975) (Simply because a purchaser expects or hopes that the value of land purchased under a land contract will increase does not convert the transaction into a security).

But see *Santiago Berrios-Bones v. Nexidis, LLC*, 2007 U.S. Dist. LEXIS 80283 (D. Utah 2007) (Investments in real estate by means of "Joint Venture" or General Partner" agreements could be deemed to be securities where defendants had sole control over key elements of the real estate purchases and the success of the enterprise).

(n317)Footnote 317. *See* SEC v. Kirkland , 521 F.Supp. 2d 1281 (M.D. Fla. 2007) .

(n318)Footnote 318. Sec. Act Rel. No. 5347, 1973 SEC LEXIS 2120 (Jan. 4, 1973) . Distinguishing situations in which no investment oriented promotion is involved, the Commission would in those situations permit a non-pooled rental arrangement with an agent not designated or required to be used as a condition of the purchase.

See also *Bhatla v. Resort Dev. Corp.*, 701 F. Supp. 501 (W.D. Pa. 1989) ; *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir. 1989) , (en banc) cert. denied, 494 U.S. 1078 (1990) (each case requires an analysis of how the condominium was promoted in order to determine whether an optional rental pool creates a security); *Wooldridge Homes, Inc. v. Bronze Tree, Inc.*, 558 F. Supp. 1085 (D. Colo. 1983) (investment in a condominium held to be an investment contract, with emphasis on defendant's construction financing initiatives and expected managerial services).

For consideration of other resort/leisure real estate under the Securities Act, *see* *Cameron v. Outdoor Resorts of Am., Inc.*, 608 F.2d 187 (5th Cir. 1979) (condominium campsite units held to be securities); *Jenne v. Amrep Corp.*, [1978

Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,343 (D.N.J. 1978).

(n319)Footnote 319. *Id.*

(n320)Footnote 320. *838 F. Supp. 676 (D. Mass. 1993)* .

(n321)Footnote 321. [1] *But see Garcia v. Santa Maria Resort, Inc., CCH Fed. Sec.L.Rep. 94,541, 2007 U.S. Dist. LEXIS 86193 (S.D. Fla. 2007)*, where condominium purchase contracts did not emphasize investment value, and each plaintiff specifically confirmed that s/he was purchasing the condominium for "personal use," and there was no expectation of profit other than that which would be realized from the plaintiffs' own actions and from appreciation in market value wholly outside of defendants' control.

(n322)Footnote 322. *Revak v. SEC Realty Corp., 18 F.3d 81 (2d Cir. 1994)* .

See also Pliskin v. Bruno, 838 F. Supp. 658 (D. Me. 1993) (fixed rental and buyback payments were not dependent upon developer's success or managerial expertise); *Lavery v. Kearns, 792 F. Supp. 847 (D. Me. 1992)* (no indication of either vertical or horizontal commonality).

(n323)Footnote 323. *See Sec. Act Rel. No. 4877, 1967 SEC LEXIS 32 (Aug. 8, 1967)* .

(n324)Footnote 324. *See Horowitz v. AGS Columbia Assocs., 700 F. Supp. 712 (S.D.N.Y. 1988)* (while land which was the subject of the transaction was not a security, limited partnership units were investment contracts by reason of the purchasers reliance on the seller to realize a return on the real estate project).

(n325)Footnote 325. *558 F. Supp. 1085 (D. Colo. 1983)* .

(n326)Footnote 326. *See Adams v. Cavanagh Communities Corp., 847 F. Supp. 1390 (N.D. Ill. 1994)* ("The success of Plaintiffs' investments rested on the common improvement of the properties through Defendants' promised provision of infrastructure, golf courses, and other amenities").

(n327)Footnote 327. *990 F.2d 7 (1st Cir. 1993)* .

(n328)Footnote 328. With respect to interval ownership--"time sharing" plans--the SEC has declined to take no-action positions. *See Sec. Act Rel. No. 6253, 1980 SEC LEXIS 443 (Oct. 28, 1980)* ; *see also The Innisfree Corp., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 2252 (Apr. 5, 1973)* ; *The Innisfree Corp., 1974 SEC No-Act. LEXIS 2425 (June 12, 1974)* .

(n329)Footnote 329. Interests in pools of mortgages, often represented by "pass-through certificates" or "mortgaged-backed" certificates, which are collateralized by underlying properties, insured, and are offered and sold to financial institutions, have been held not to be securities. *See, e.g., National Mortgage Equity Corp. Sec. Litig., 723 F. Supp. 497 (C.D. Ca. 1989)* ; *EPIC Mortgage Ins. Litig., 710 F. Supp. 1192 (E.D. Va. 1989)* ; *but see Securities Indus. Ass'n v. Clarke, 885 F.2d 1034 (S.D.N.Y. 1988)* (private mortgage-backed pass-through certificates issued by a bank represent an investment within the *Howey* and *Forman* parameters).

In contrast, publicly offered pass-throughs or other participations in huge mortgage pools through FNMA or GNMA programs, or privately sponsored mortgage investment programs, unquestionably do involve securities and are subject to the full range of securities law protections. *See SEC v. G. Weeks Sec., Inc., 483 F. Supp. 1239 (W.D. Tenn. 1980)* , *aff'd in part, 678 F.2d 649 (6th Cir. 1982)* ; *Abrams v. Oppenheimer Gov't. Sec., Inc., 737 F.2d 582 (7th Cir. 1983)* . Exchange Act § 3(a)(41) prescribes a definition for "mortgage-related securities" which impacts offerings of certain types of such securities, primarily by qualifying them for "shelf registration" under the Securities Act. *See, e.g., Comfed Fed. Bank, SEC No-Action Letter, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,876 (Sept. 29, 1988)*.

(n330)Footnote 330. See *Elson v. Geiger*, 506 F. Supp. 238 (E.D. Mich. 1980) (sale and leaseback arrangement did not create an investment contract where the purchaser's return consisted of a lessee's fixed rental payment and was independent of the lessee's profits or management expertise).

See also *Sire Plan Portfolios, Inc. v. Carpentier*, 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956) (issuer of undivided fractional interests in property, taken back under lease, who agreed to manage the property for a percentage of rental income and distribute profits to interest holders sold investment contracts under Illinois securities law); Fritz Scharenberg, SEC No-Action Letter (Div. Corp. Fin. 1983) (sales of condominiums with mandatory 15-year leaseback arrangement were securities); *Sunshine Kitchens v. Althaus Corp.*, 403 F. Supp. 719 (S.D. Fla. 1975) (sale and leaseback arrangement not a security).

(n331)Footnote 331. Other types of programs and offerings involving real estate mortgages or related services have also come under securities law scrutiny. See, e.g., *SEC v. Lake Havasu Estates*, 340 F. Supp. 1318 (D. Minn. 1972) (sale of notes and land contracts of land purchasers to public investors); *United States v. Farris*, 614 F.2d 634 (9th Cir. 1980) (sale of mortgage notes to the public under a plan in which the seller acted as a collection service and made certain guarantees of principal); *Wright v. Schock*, 571 F. Supp. 642 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984) (promissory notes secured by deeds of trust, for which the seller provided collection services).

(n332)Footnote 332. 24 F.3d 1016 (7th Cir. 1994) .

See also *FDIC v. Eagle Properties, Ltd.*, 664 F. Supp. 1027 (W.D. Tex. 1985) (sale and leaseback of real estate did not constitute the sale of security since the purchaser partnership retained ultimate control over the property and contributed essential efforts affecting the success or failure of the enterprise).

(n333)Footnote 333. *Lopez v. Richards*, 594 F. Supp. 488, 492-93 (S.D. Miss. 1984) .

(n334)Footnote 334. As an alternative argument for securities law protection, the plaintiffs in *Forman* urged that "stock" in the housing cooperative was an investment contract. The assertion was based upon the possibility of "net income" from leasing by the co-op of commercial space for offices, for parking, and from the operation of laundry facilities. The Supreme Court rejected this possibility of income as an "expectation of profit" within the contemplation of investment contract analysis: "The short of the matter is that the stores and services in question were established not as a means of returning profits to tenants, but for the purpose of making essential services available... . [T]he possibility of some rental income is not an 'expectation of profit' in the sense found necessary in *Howey*." 421 U.S. 837, 856-57, 95 S. Ct. 2051, 2062-63, 44 L. Ed. 2d 621, 635 (1975) .

(n335)Footnote 335. *Perry v. Gammon*, 583 F. Supp. 1230 (N.D. Ga. 1984) .

(n336)Footnote 336. Terrace Hill Condominiums, SEC No-Action Letter (Div. Corp. Fin. 1983).

(n337)Footnote 337. *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982) (articulating a "forced reliance" exception to the principle that investor control precludes a security).

See also *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.) , *cert. denied*, 454 U.S. 897 (1981) ; *Alexandria Assocs., Ltd. v. Mitchell Co.*, (S.D. Miss. July 9, 1992) . The practical aspects of "control" as a factor in determining whether partnership interests are securities is discussed in § 2.01[c][ii] *infra*.

(n338)Footnote 338. Alert, "Tenancy-in-Common Interests as Securities," Wash. Dept. of Fin Institutions Sec. Div. (Sept. 8, 2005).

(n339)Footnote 339. See, e.g., Triple Net Leasing, Inc., SEC No-Action Letter Denied (Aug. 23, 2000). The SEC staff disagreed with a conclusion that exchanges of replacement properties through master leases in transactions structured to qualify for tax deferral under Section 1031 of the Internal Revenue Code would not involve a security.

Sponsors of the program claimed that in an exchange transaction there was no "profit" as contemplated in investment contract analysis, and that there is no "development"--only the exchange of improved commercial real estate subject to a long-term master lease. Based upon the staff's disagreement with this proposition, no-action relief was denied. Although not articulated, the basis for the staff's disagreement necessarily was grounded in the fact that replacement properties would be separately managed, and that exchangers relied upon that management as a value determinant associated with the property.

(n340)Footnote 340. *See, e.g.,* United States v. Faulhaber, (1st Cir. Mar. 21, 1991) (mutual funds); Investors Fin. Servs., Inc., 1986 SEC No-Act. LEXIS 2715 (July 28, 1986) (collective investment program sponsored by an investment adviser would not only involve creation of a security but an investment company as well).

Other regulation may also apply. The capital formation aspects of a commodity pool are subject to the Securities Act, while the *operation* of the pool and its promoters are subject to regulation under the Commodity Exchange Act. *See* Commodity Exchange Act § 4m.

But see In re Federal Bank & Trust Co., 1984 U.S. Dist. LEXIS 16185 (D. Or. June 4, 1984) (managed trading accounts for investments in treasury bills and GNMA certificates organized as a tax sheltered investment program were not securities for want of a common enterprise under either the vertical or horizontal commonality approach).

For a security to be present in any pooled fund arrangement, there must actually be "pooling." In *Perez-Rubio v. Wyckoff*, 718 F. Supp. 217 (S.D.N.Y. 1989), investments in off-shore companies formed for the purpose of investing in American securities were held not to be securities where no actual pooling was shown. No interdependence between the investor and the promoter was present. However, the pooling of assets of several off-shore companies in which individual investments were made, for the purpose of then investing the pooled assets, did involve a security.

(n341)Footnote 341. *See* Merrill, Lynch, Pierce, Fenner & Smith, Inc., 1982 SEC No-Act. LEXIS 3036 (Oct. 28, 1982). In determining that such a program would involve issuance of securities, the Staff noted that the sponsors of the program: (1) created the opportunity for investors to share in higher rates of return available on the large denomination certificates; (2) selected the banks in whose certificates of deposit the funds would be placed; and (3) selected the custodian to whom investors would look for payment. An additional factor was the intention of the sponsors to make a secondary market in the interests.

See also Management Corp. of America, SEC No-Action Letter, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,210 (Mar.8, 1982) (participation in a fund of monies pooled to purchase "jumbo" certificates of deposit could involve creation of a security).

(n342)Footnote 342. *See* Shawmut Worcester County Nat'l Bank, SEC No-Action Letter (Div. Corp. Fin. 1982) (collective investment plan for IRA and Keogh plans would not create a security); Republic Nat'l Bank of New York, SEC No-Action Letter (Div. Corp. Fin. 1982) (bank-sponsored IRA investment plan would create a separate security and an investment company); Florida Nat'l Banks of Florida, 1983 SEC No-Act. LEXIS 2240 (Mar. 23, 1983); First Commerce Trust Co., 1983 SEC No-Act. LEXIS 1879 (Jan. 28, 1983) (collective trust fund for investment of self-directed IRA assets would involve the sale of a security); Lincoln First Bank, N.A., SEC No-Action Letter (Div. Corp. Fin. 1983) (collective trust fund for investments by employee pension and profit-sharing plans would not create a security).

See also Walker Bank & Trust Co., 1980 SEC No-Act. LEXIS 3291 (offer and sale of individual retirement accounts in which participants would determine investments to be made for each account within the range of elections established by the plan would not involve creation of a security).

Common trust funds organized by banks for the collective investment of trust assets are exempted from Securities Act

via § 3(a)(2) (interest or participation in a common trust fund or similar fund maintained by a bank solely for the collective investment and reinvestment of assets received as trustee, executor, administrator or guardian), discussed in § 3.03 *infra*.

With respect to bank involvement in the promotion of collective investment accounts as a matter of federal banking law, and the lines between banking and securities activities, see *Investment Co. Inst. v. Camp*, 401 U.S. 617, 91 S. Ct. 1091 (1971) .

(n343)Footnote 343. *Investment Co. Inst. v. Conover*, 790 F.2d 925 (D.C. Cir. 1986) (bank-sponsored program for commingling and collective investment of IRA trust assets did not involve the creation of a security for purposes of Glass-Steagall Act prohibitions); see also *Morgan Shareholder Servs. Trust Co.*, 1988 SEC No-Act. LEXIS 869 (May 6, 1988) (package of services for dividend reinvestment programs and other investment programs for shareholders of participating issuers, and shareholder interest in any programs offered, would not be securities).

(n344)Footnote 344. *Levine v. Diamantheset, Inc.*, 722 F. Supp. 579 (N.D. Cal. 1989) (confirmations of demand deposits in depository banks were not securities where services were pursuant to a separate contract and banks were not involved in an actual investment or promise of profits).

(n345)Footnote 345. *SEC v. Professional Assocs.*, 731 F.2d 349 (6th Cir. 1984) (monies commingled in an "escrow account" for investment in a money market fund deemed to be a security where promotional characteristics supported the conclusion that horizontal commonality existed among investors).

Professional Associates highlights the manner of promotion as a factor in characterizing a collective investment mechanism as a security. Much earlier, in Sec. Act Rel. No. 4589, 1963 SEC LEXIS 141 (Mar. 11, 1963) , the Commission cautioned that both the Securities Act and the Investment Company Act would be applicable to any contemplated "merchandising" of interests in collective investment funds by banks. If the principal distinction is "true fiduciary" services versus the establishment of an "investment vehicle," the role of promotional characteristics is easily seen.

Investment management programs that involve only *individualized* services and advice, and which do not involve commingling or custody of client funds, are not likely to raise securities law concerns. See *Scudder Fund Management Serv.*, 1988 SEC No-Act. LEXIS 1054 (Aug. 17, 1988) .

(n346)Footnote 346. *But see Feret v. Corestates Financial Corp.*, 1998 U.S. Dist. LEXIS 11512 (E.D. Pa. 1998) , in which the court determined that interests of officers and other "key employees" in a long term discretionary incentive stock option plan gave participants the characteristics of investors. The plan, said the court, was specifically designed to provide incentives and rewards that associated the participants more closely with stockholders of the company. The plan was not governed by ERISA, and could not, on a motion to dismiss, be said not to be a security.

(n347)Footnote 347. *Walsh v. Emerson*, 1990 U.S. Dist. LEXIS 19921 (D. Ore. 1990) .

(n348)Footnote 348. For analysis of whether a "sale" is involved in the distribution of stock through various forms of employee benefit or participation plans, see § 2.02[6] *infra*.

See also *Peyton v. Morrow Elec. Corp.*, 587 F.2d 413 (9th Cir. 1978) (an employment contract granting employee the right to purchase stock from an employee plan, if created, held not to be an investment contract).

(n349)Footnote 349. In a hybrid situation, however, interests in an employee stock ownership plan (ESOP) denominated as "stock" were held to the label and considered securities. *Hood v. Smith's Transfer Corp.*, 762 F. Supp. 1274 (W.D. Ky. 1991) . The interests in the plan were prominently and repeatedly referred to as "stock," and were indicated to have traditional characteristics of stock, namely, assigned par value, future possibility of dividends, the

capacity to appreciate, and voting rights. The Court viewed the company and the ESOP as "[p]lainly creating expectations in participants that their interests were securities."

See also Walsh v. Emerson, 1990 U.S. Dist. LEXIS 19921 (D. Ore. 1990) (a company's stock in its retirement plan is a security).

(n350)Footnote 350. 751 F.2d 555 (2d Cir. 1985) .

(n351)Footnote 351. *Id.* at 559-60 .

(n352)Footnote 352. *Uselton v. Commercial Lovelace Motor Freight*, 940 F.2d 564 (10th Cir. 1991) .

(n353)Footnote 353. *Matassarin v. Lynch*, 174 F.3d 549 (5th Cir. 1999) ; *Childers v. Northwest Airlines, Inc.*, 688 F. Supp. 1357 (D. Minn. 1988) .

See also *In re Cendent Corp. Sec. Lit.*, 76 F. Supp. 2d 539 (D.N.J. 1999) (No purchase involved in a compulsory, non-contributory plan). The "no sale" doctrine applied in benefit plan scenarios, and the definition of "sale" for purposes of Securities Act coverage generally in this context, are examined more closely in § 2.02[6] *infra* .

(n354)Footnote 354. The term "employee benefit plan" means a pension, profit-sharing, thrift or similar plan. It does not include welfare or related plans that provide for hospitalization or disability benefits, funeral expenses, or social or cultural pursuits. These latter plans historically have raised no question or concern under the federal securities laws because they do not resemble an "investment" and do not involve any expectation of financial return by the employee. *See* Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

(n355)Footnote 355. *But see* *Simon v. Fribourg*, 650 F. Supp. 319 (D. Minn. 1986) . An employee's interest in a company profit-sharing plan was neither a certificate of participation in a profit-sharing agreement nor an investment contract. A profit-sharing plan, according to the court, is not an example of a profit-sharing "agreement" within the contemplation of the securities laws. Moreover, said the court, the employee could have no *Howey* expectation of profit through the efforts of others that would be necessary to find an investment contract.

(n356)Footnote 356. *See* *Uselton v. Commercial Lovelace Motor Freight, Inc.*, 940 F.2d 564 (10th Cir. 1991) (employee interests in a voluntary, contributory ESOP held to be investment contracts).

(n357)Footnote 357. Sec. Act Rel. No. 4790, 1965 SEC LEXIS 17 (July 13, 1965) . Subsequently, in Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) , the Commission reiterated its view that the presence of all or some of these characteristics may create an investment contract. The Commission reasoned that such factors tend to place the employee in a position where he or she is relying on the plan managers to maintain or protect the employee's investment.

Where plan participations are deemed to be securities, they are subject to the registration provisions of the Securities Act in the absence of an available exemption. By reason of the exemption provided in § 3(a)(2) of the Securities Act, these securities generally must be registered only where the plan invests in the employer's securities an amount greater than that contributed to the plan by the employer. *See* discussion of § 3(a)(2) in § 3.03 *infra* . Whether or not registration is required, the antifraud provisions will always apply.

(n358)Footnote 358. 439 U.S. 551, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979) .

(n359)Footnote 359. *See* § 2.02[6] *infra*.

(n360)Footnote 360. 561 F.2d 1223 (7th Cir. 1977) , *rev'd*, 439 U.S. 551, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979) .

(n361)Footnote 361. The Court observed: "In every decision of this Court recognizing the presence of a 'security' under the Securities Act, the person found to have been an investor chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security. ... Looking at the economic realities, it seems clear that an employee is selling his labor to obtain a livelihood, not making an investment." 439 U.S. at 559-60, 99 S. Ct. at 796-97, 58 L. Ed. 2d at 816-17 .

(n362)Footnote 362. *Id.* at 569-70, 99 S. Ct. at 802, 58 L. Ed. 2d at 822-23 .

(n363)Footnote 363. *Id.* at 560, 99 S. Ct. at 797, 58 L. Ed. 2d 17 .

(n364)Footnote 364. The holding in *Daniel* was specifically limited to interests in a *non-contributory, compulsory* pension plan. *Id.* at 570, 99 S. Ct. at 802, 58 L. Ed. 2d at 823 .

See also *Matassarini v. Lynch, Trustee*, 174 F.3d 549 (5th Cir. 1999) (A mandatory employer-funded ESOP did not involve any voluntary investment choice by participants).

(n365)Footnote 365. 686 F.2d 1230 (7th Cir. 1982) .

(n366)Footnote 366. *Id.* at 1237 .

(n367)Footnote 367. See also *O'Neil v. Marriott Corp.*, 538 F. Supp. 1026 (D. Md. 1982) (interests in a voluntary, contributory plan are not securities since no investment was made on the expectation of profit from the efforts of others and the only real determinant of return was an employee's length of participation); *Cunha v. Ward Foods, Inc.*, 545 F. Supp. 94 (D. Haw. 1982) (voluntary, contributory plan had no attributes of an investment contract and ERISA provided all needed regulation); *Black v. Payne*, 591 F.2d 83 (9th Cir. 1979) (interest in a contributory, compulsory plan was not a security since employee had no reasonable expectation of profit from the efforts of others and plan benefits were determined by a statutory formula rather than by income or profit of the plan); *Tanuggi v. Grolier, Inc.*, 471 F. Supp. 1209 (S.D.N.Y. 1979) (interests in a contributory, non-compulsory plan are not securities); *Newkirk v. General Elec. Co.*, (N.D. Cal. 1979) (interests in a contributory, non-compulsory plan are not securities).

(n368)Footnote 368. See also *Peoria Union Stock Yards Co. v. Penn Mut. Life Ins. Co.*, 518 F. Supp. 1302 (C.D. Ill. 1981) . Since a non-contributory, compulsory pension plan is not a security, a contract pursuant to which an employer deposited funds with an insurance company for accumulation of interest for the purpose of funding an employee retirement plan was held not to be a security.

(n369)Footnote 369. Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) ; Sec. Act Rel. No. 6281, 1981 SEC LEXIS 2260 (Jan. 15, 1981) . In Release No. 6281, the Commission Staff clarified the meaning of "voluntary and contributory" for purposes of its position on Securities Act coverage:

Generally it is the Staff's view that the determination of whether a plan is a voluntary contributory one rests solely on whether the participating employees can decide at some point whether to contribute their own funds to the plan. Thus, for example, each of the following types of plans would be considered voluntary and contributory because each permits employees to make a determination, either at the time they join the plan or later, whether they will invest their own money: (1) a plan which is voluntary as to participation and then mandatory as to the amount of contributions, (2) a plan which is voluntary as to participation and which permits employees to make contributions at their option, and (3) a plan which is mandatory as to participation but provides employees with a choice whether or not to invest their own funds.

(n370)Footnote 370. *Diasonics, Inc.*, 1982 SEC No-Act. LEXIS 3286 (Nov. 29, 1982) . Interests in a company-sponsored profit sharing plan built around the mechanism of salary reductions to make contributions to the

plan could create a security. Salary reduction plans do not represent a bonus from the employer, and the contribution is in actuality an out-of-pocket contribution by the employee which suggests an investment decision.

(n371)Footnote 371. SEC No-Action Letter (Div. Corp. Fin. 1983).

(n372)Footnote 372. Sec. Act Rel. No. 6281, 1981 SEC LEXIS 2260 (Jan. 15, 1981) .

(n373)Footnote 373. 695 F. Supp. 138 (S.D.N.Y. 1988) .

(n374)Footnote 374. Keogh plans are tax deferred retirement plans established by self-employed individuals for the benefit of themselves and their employees. Keogh plans were authorized by Congress in 1962 to permit such individuals to share in the favorable tax benefits previously available only in connection with certain corporate plans.

(n375)Footnote 375. Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) . Interests of Keogh plans in collective funding vehicles are seen as "clearly" securities. However, the interests of the Keogh plan participants in their plan are characterized only as "appearing" to be securities where participants make voluntary contributions. For Keogh plans that are deemed to create securities, and for which no exemption is readily available, the staff, as a matter of administrative discretion, will not require registration. *Id.*

(n376)Footnote 376. Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

(n377)Footnote 377. IRAs that involve a direct investment by an individual in an exempt security (such as one issued or guaranteed by a bank) or in a medium not considered to be a security (such as a traditional fixed annuity) need not be registered, and only the former would be subject to the antifraud provisions. In addition, registration is unnecessary for (1) IRAs funded solely by specific mutual fund shares registered under the Securities Act so long as the shares are offered pursuant to current prospectuses that contain appropriate disclosure of the IRAs to which they may be offered; and (2) master trust or prototype plan arrangements used to market IRAs and Keogh plans. *Id.*

(n378)Footnote 378. *Id.*

(n379)Footnote 379. 26 U.S.C. § 401(k).

(n380)Footnote 380. Sec. Act Rel. No. 6281, 1981 SEC LEXIS 2260 (Jan. 15, 1981) .

The Internal Revenue Service has also taken the position that § 401(k) plans are not contributory under the Internal Revenue Code. See *Rev. Rul. 80-16, 1980-1 C.B. 82* .

(n381)Footnote 381. See Merrill Lynch Special Prototype Profit-Sharing Plan, 1988 SEC No-Act. LEXIS 1773 (Dec. 4, 1987) (profit-sharing plan for independent contractors providing services or leased equipment to a motor carrier under which contractors could designate a percentage of amounts paid by carrier for investment in one of three alternatives, including stock of the carrier purchased in open market transactions would not require registration under the Securities Act).

(n382)Footnote 382. See Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

Open market stock purchase programs providing for employer contributions that match or exceed employee contributions, and that otherwise satisfy the conditions set forth in Sec. Act Rel. No. 4790, 1965 SEC LEXIS 17 (July 13, 1965) , relating to participation by an employer, will not be subject to registration under the Securities Act. The Release limits participation by an employer, or an affiliate of an employer, to only ministerial functions in the operation of the program. The principal regulatory concern is to preclude any "solicitation of an offer to buy" the employer's securities. These programs and the impact of the definition of "sale" in § 2(3) of the Securities Act are considered further in § 2.02[6] *infra* .

The Commission's position on open market stock purchase programs does not extend to such plans under which employer contributions fail to match or exceed employee's contributions. Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

(n383)Footnote 383. See *Bauman v. Bish*, 571 F. Supp. 1054 (N.D. W. Va. 1983) . Employees' involuntary participation in employee stock ownership plans cannot be characterized as the purchase of securities. Each participant who meets certain minimum hours would have stock allocated to his or her account. However, there is no investment decision in this process. The securities laws should not be extended to an area extensively regulated by ERISA and within the "sphere of labor relations."

The absence of a "sale" in the context of such plans is also a meaningful consideration. As the court observed in *Bauman*: "There is no furnishing of 'value' by participating employees. ... Instead of giving up some tangible and definable consideration, participants earn stock through labor for the employer. The notion that the exchange of labor will suffice to constitute the type of investment which the Securities Acts were intended to regulate was rejected in *Daniel*. ... [T]he proposed ESOP is a method of deferring income, not reducing wages or paying for stock." *Id.* at 1056 ; compare *Diasonics, Inc.*, 1982 SEC No-Act. LEXIS 3286 (Nov. 29, 1982) .

But see *Foltz v. U.S. News & World Report, Inc.*, 627 F. Supp. 1143 (D.D.C. 1986) , in which the court found that where an employee stock plan is not covered by ERISA, "extension to it of coverage under the securities laws would do violence to no Congressional purpose." *Id.* at 1159 . The court found that the ESOP at issue involved a "hoped for increase" in the value of stock holdings and allowed the plaintiff's antifraud claim to stand. At the same time, however, the court declined to hold that interest in a non-contributory profit-sharing plan were securities.

The Commission generally has not required that stock involved in these plans be registered where the nature of the plan is a bonus and the stock is made available to a broad class of employees. However, if stock is awarded to, or acquired by, employees pursuant to individual employment arrangements, the arrangements are usually deemed by the staff to involve separately bargained consideration and thereby constitute a sale of the stock. See Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

(n384)Footnote 384. 688 F. Supp. 1357 (D. Minn. 1988) .

(n385)Footnote 385. See § 2.01[11][v], *supra*.

Pools of assets managed by others as collective investment vehicles are also generally considered to be "investment companies" subject to regulation under the Investment Company Act of 1940.

(n386)Footnote 386. See *Investment Co. Inst. v. Conover*, 790 F.2d 925 (D.C. Cir 1986) .

(n387)Footnote 387. See *Carter v. Signode Industries, Inc.*, 694 F. Supp. 493 (N.D. Ill. 1988) (employees' decision to exchange general investment fund accounts in a company profit-sharing plan for "guaranteed income contracts" constituted the purchase of a security).

(n388)Footnote 388. 789 F. Supp. 884 (W.D. Mich. 1991) .

(n389)Footnote 389. *Id.* at 888 .

(n390)Footnote 390. But see *Harris v. Republic Airlines, Inc.*, 1988 U.S. Dist. LEXIS 9460 (D.D.C. May 8, 1988) (plaintiff employees believed they would realize profit as a result of the wages they agreed to defer).

(n391)Footnote 391. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 853-54, 95 S. Ct. 2051, 2061, 44 L. Ed. 2d 621, 632-33 (1975) .

(n392)Footnote 392. The application of investment contract analysis in franchise situations generally is discussed in § 2.01[11][a], *supra*.

See also Villanueva v. Advanced Business Concepts Corp., 730 F.2d 1403 (11th Cir. 1984) (en banc).

(n393)Footnote 393. 417 F. Supp. 1225 (E.D.N.Y. 1976) .

(n394)Footnote 394. *Gotham Print, Inc. v. American Speedy Printing Ctrs, Inc.*, 863 F. Supp. 447 (E.D. Mich. 1994) .

(n395)Footnote 395. *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 485 (5th Cir. 1974) .

(n396)Footnote 396. *Id.*

(n397)Footnote 397. *See* Sec. Act Rel. No. 5211, 1971 SEC LEXIS 1933 (Nov. 30, 1971) (applicability of the securities laws to multilevel distributorship and pyramid sales plans).

(n398)Footnote 398. 474 F.2d 476 (9th Cir.) , *cert. denied*, 414 U.S. 821 (1973) .

(n399)Footnote 399. 497 F.2d 473 (5th Cir. 1974) .

(n400)Footnote 400. *Id.*, at 475 .

(n401)Footnote 401. Sec. Act Rel. No. 5211, 1971 SEC LEXIS 1933 (Nov. 30, 1971) .

(n402)Footnote 402. *See, e.g., Koscot*, 497 F.2d at 476 .

(n403)Footnote 403. *Compare Martin v. T.V. Tempo, Inc.*, 628 F.2d 887 (5th Cir. 1980) and *Villeneuve v. Advance Business Concepts Corp.*, 698 F.2d 1121 (11th Cir. 1983) , *aff'd en banc*, 730 F.2d 1403 (11th Cir. 1984) . In distributorships where the purchaser must make a significant effort toward any profit, an agreement will not be deemed to be an investment contract.

(n404)Footnote 404. 497 F.2d at 480 .

(n405)Footnote 405. *Id.* *See also* SEC v. International Loan Network, Inc., 297 U.S. App. D.C. 22 (D.C. Cir. July 10, 1992) (pyramid sales program in which profits would primarily be derived from fees paid by "downline" members who recruited additional members); SEC v. Bull Inv. Group, Inc., 1975 U.S. Dist. LEXIS 13449 (D. Mass. 1975) (franchise agreement entitling "dealers" to recruit prospective franchisees to attend promotional meetings run by franchisors constituted an investment contract).

(n406)Footnote 406. 950 F.Supp. 1306 (S.D. W.Va. 1997) , *aff'd in part, rev'd in part*, 1997 U.S. App. LEXIS 33599 (4th Cir. 1997) .

(n407)Footnote 407. *Holtzclaw*, 950 F.Supp. at 1316 .

(n408)Footnote 408. *See* § 2.01[11][b][ii], *supra*.

(n409)Footnote 409. *See also*, Omnitron Int'l Inc., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,425 (N.D. Ca. 1994) (distributors and supervisors required to engage in retail selling in order to qualify for bonuses and overrides on lower level participants' activities).

(n410)Footnote 410. *See Wilkins v. M & H Fin., Inc.*, 476 F. Supp. 212 (E.D. Ark. 1979) (retail grocer's investment was in his own enterprise over which he had exclusive control); *Gowdish v. Eaton Corp.*, 1981 U.S. Dist.

LEXIS 11470 (M.D. N.C. 1981) (conventional franchise arrangement was not a security); *Howard v. Chrysler Corp.*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,306 (D. Colo. 1977) (automobile dealer franchise was not a security).

(n411)Footnote 411. *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, (2d Cir.) , cert. denied sub nom. *Hecht v. SEC*, 459 U.S. 1086 (1982) .

(n412)Footnote 412. See H.R. Rep. No. 85, reprinted in the Primary Law Sourcebook, Volume A, Section E of the 1933 Act, 73d Cong., 1st Sess. 15 (1933).

However, the Commission expressed this caveat concerning the scope of the § 3(a)(8) exemption: "[The] provision was intended only to exempt an insurance policy or contract under which a policyholder has a fixed benefit and does not share in the investment experience of an equity portfolio and as to which the insurance company assumes the risk of loss." Sec. Act Rel. No. 5360, 1973 SEC LEXIS 3258 (Jan. 31, 1973) .

(n413)Footnote 413. Where the focal point of the purchase is entirely upon obtaining insurance there is little, if any, likelihood of a security being found. See, e.g., *Dryden v. Sun Life Assurance Co. of Canada*, 737 F. Supp. 1058 (S.D. Ill. 1988) (Whole life insurance policies held not to be securities where a "true underwriting of risks" was present). This is so even where, for example, obtaining the insurance involves contributing capital to a "captive" insurance company. See also Investment Company Institute, 1987 SEC No-Act. LEXIS 38 (Div. Inv. Management/Div. Corp. Fin. 1987) (purpose of a capital contribution was to obtain insurance and not to obtain an investment return); AAI Holdings Corp., 1991 SEC No-Act. LEXIS 845 (Div. Corp. Fin. July 1, 1991) (Deposit and debenture interests were part of an insurance program and not securities).

(n414)Footnote 414. See *Malone v. Addison Insurance Marketing, Inc.*, 225 F. Supp. 2d 743, 749 (W.D. Ky. 2002) :

A variable annuitant thus assumes much greater risk than the holder of a fixed annuity who is provided with a guarantee. The holder of a variable annuity cannot look forward to a fixed monthly or yearly amount... [I]t may be greater or less depending on the wisdom of the investment policy.

See also *Gilmore v. MONY Life Insurance Co. of America*, 165 F. Supp. 2d 1276 (M.D. Ala. 2001).

(n415)Footnote 415. 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959) .

(n416)Footnote 416. *Id.* at 71-72, 79 S. Ct. at 621-22, 3 L. Ed. 2d at 644-45 .

(n417)Footnote 417. In *Luzerne County Retirement Board v. Markowski*, 2007 U.S. Dist. LEXIS 87246 (M.D. Pa. 2007) , the court distinguished between annuity contracts in which funds could be allocated by the purchaser to guaranteed funds and/or variable pooled funds. Assets placed in a guaranteed fund were held by the insurance company in its general account. Pooled funds, on the other hand, were invested through separate accounts and were subject to the risk of the particular fund's investment experience rather than being a fixed annuity contract obligation of the insurance company.

(n418)Footnote 418. *Id.*

The decision in *VALIC* prompted further skirmishing with respect to the applicability of the Investment Company Act of 1940 to variable annuities. In a 1963 confrontation with Prudential Insurance Company of America over the sale of variable annuity contracts to the public, the SEC determined that the Securities Act would apply. Inv. Co. Act Rel. No. 3620, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,891 (Jan. 22, 1963). The determination was upheld in *Prudential Ins. Co. of America v. SEC*, 326 F.2d 383, (3d Cir. 1964) . In so holding, the court observed that the *fund*

created by the sale of annuities, which was used for investment purposes, gave rise to a separate investment company that was the issuer of the securities (variable annuities) for purposes of the Investment Company Act. *Id.* at 388. The Supreme Court denied *certiorari*. 377 U.S. 953 (1964).

In 1970, the Investment Company Act was amended to exempt certain variable annuities issued before the *VALIC* decision from the operation of both the Securities Act and the Investment Company Act. The exemption, § 29 of the Investment Company Act, is limited to funds issued prior to March 23, 1959, to which (1) the form of the contract was approved by a state insurance commissioner; and (2) not more than 49% of premiums are allocated to a separate account or fund. The amendments also granted insurance companies an exemption from the Investment Company Act for "separate accounts" established for management of certain employee benefit plans as well as Keogh plans.

(n419)Footnote 419. 387 U.S. 202, 87 S. Ct. 1557, 18 L. Ed. 2d 673 (1967).

(n420)Footnote 420. The manner of marketing played a meaningful role in the Court's rationale. Justice Harlan (who had dissented in *VALIC*) spoke for the majority in *United Benefit*. He drew upon the caveat in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943), that promoters' offerings should be judged by what they are represented to be and concluded: "Contracts such as the 'Flexible Fund' offer important competition to mutual funds and are pitched to the same consumer interest in growth through professionally managed investment. It seems eminently fair that a purchaser of such a plan be afforded the same advantages of disclosure which inure to a mutual fund purchaser under § 5 of the Securities Act." 387 U.S. at 211, 87 S. Ct. at 1562, 18 L. Ed. 2d at 680 (citation omitted).

See also *SEC v. National Sec., Inc.*, 393 U.S. 453, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969) (regulation of the relationship between a stockholder and an insurance company in which he holds stock is not insurance regulation but securities regulation).

(n421)Footnote 421. *Id.* at 211, 87 S. Ct. at 1562, 18 L. Ed. 2d at 680.

(n422)Footnote 422. *Associates in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561, 566 (7th Cir. 1991), *aff'd* 729 F. Supp. 1162 (N.D. Ill. 1989), *cert. denied*, 502 U.S. 1099, 112 S. Ct. 1182 (1992) (citations omitted) ("Flexible Annuity" involving a guaranteed annual interest rate declared at the beginning of each policy year was not a security).

(n423)Footnote 423. *Id.* The court observed: "The Flexible Annuity... resembled nothing so much as a series of fixed annuities, each one year in duration, with the purchaser having an option to renew. That the return is fixed for such a short period does not make the instrument less an annuity." 941 F.2d at 567.

(n424)Footnote 424. "Other regulation" is often a key consideration, as "insurance" is entirely a matter of state regulation and the § 3(a)(8) exemption is dependent upon it. The Supreme Court observed in *VALIC*: "While the term 'security' as defined by the Securities Act is broad enough to include any 'annuity' contract ... the scheme of exemptions lifts *pro tanto* the requirements to the extent that respondents are actually regulated by the States as insurance companies" 359 U.S. at 67-68, 79 S. Ct. at 620, 3 L. Ed. 2d at 642-43 (footnotes omitted). However, the distinction may be difficult to make. See *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (7th Cir. 1987).

(n425)Footnote 425. Although the National Securities Market Improvements Act of 1996 (NSMIA) fundamentally re-ordered securities regulatory roles of the SEC and the states, and largely preempted the latter from regulation of mutual funds, it remains that as to the *insurance* aspects of such products as variable annuities, the regulatory responsibility lies with the states by virtue of the McCarran-Ferguson Act, 15 U.S.C. § 1012(b).

(n426)Footnote 426. See *SKJ Commodities Corp.*, 1987 SEC No-Act. LEXIS 2827 (Nov. 13, 1987) (staff unwilling to grant no action advice where an annuity program would be publicly offered and incorporated a

discretionary commodities futures account as a feature).

(n427)Footnote 427. *225 F. Supp. 2d 743 (W.D. Ky. 2002)* .

(n428)Footnote 428. *Malone, 225 F.Supp. 2d at 751* ("Because the Defendants assumed a much greater risk, Plaintiff's investment seems a lot more like insurance and less like an investment for Plaintiff").

(n429)Footnote 429. *CCH Fed. Sec.L.Rep. 94,512, 2007 U.S. Dist. LEXIS 91522 (C.D. Ill. 2007)*.

(n430)Footnote 430. *Malone, 225 F.Supp. 2d 743* .

(n431)Footnote 431. *814 F.2d 1127 (7th Cir. 1987)* .

(n432)Footnote 432. *But see Associates in Adolescent Psychiatry S.C. v. Home Life Ins. Co., 729 F. Supp. 1162 (N.D. Ill. 1989)* , *aff'd*, *941 F.2d 561 (7th Cir. 1991)* , *cert. denied*, *112 S. Ct. 1182 (1992)* (flexible annuity contract purchased by a pension plan to fund benefit guarantees was not a security by reason of qualification under Rule 151).

(n433)Footnote 433. Sec. Act Rel. No. 4491, 1962 SEC LEXIS 112 (May 22, 1962) . The Commission further noted that such programs "may result in the creation of an investment company as defined in the Investment Company Act of 1940. Accordingly, the requirements of that Securities Act, including particularly §§ 7, 26 and 27 thereof should be considered by the sponsors of these plans." *Id.*

See also Sec. Act Rel. No. 5209, 1971 SEC LEXIS 1934 (Nov. 8, 1971) (guide to preparation of registration statements relating to insurance premium funding programs); Zenith American Funding Corp., SEC No-Action Letter (Div. Corp. Fin. 1974) (Securities Act requires that each participant in an insurance premium funding plan receive a current prospectus when the offer is annually renewed).

(n434)Footnote 434. *See Inv. Co. Act Rel. No. 13,632, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,454 (Nov. 23, 1983)*

(n435)Footnote 435. Evolving variants on viatical settlements include such things as "senior settlements," based on the purchase life insurance contracts held by elderly persons and marketing of interests in them in the same manner as viatical settlements.

(n436)Footnote 436. *87 F.3d 536 (D.C.Cir. 1996)* , *reh'g denied*, *102 F.3d. 587 (D.C. Cir. 1996)* , *mot. for leave to amend denied*, *986 F.Supp. 644 (D.D.C. 1997)* .

(n437)Footnote 437. *408 F.3d. 737 (11th Cir. 2005)* .

(n438)Footnote 438. *Mutual Benefits Corp., 408 F.3d at 743* .

(n439)Footnote 439. *Mutual Benefits Corp., 408 F.3d at 743-44* .

(n440)Footnote 440. *Wuliger v. Anstaett, 363 F. Supp. 2d 917, 921-22 (N.D. Ohio 2005)* ; *see also Wuliger v. Mann, CCH Fed.Sec.L.Rep. P 93,284, 2005 U.S. Dist. LEXIS 13021 (N.D. Ohio 2005)*

(n441)Footnote 441. For a thorough examination of the extent of state securities regulatory attention to viatical settlements *see* Miriam R. Albert, "The Future of Death Futures: Why Viatical Settlements Must be Classified Securities," *19 Pace L. Rev. 345 (Spring 1999)*.

(n442)Footnote 442. *See, e.g., Siporin v. Carrington, 200 Ariz. 97, 23 P.3d 92 (Ariz. App. 2001)* ; *Rumbaugh v. Ohio Dept. of Commerce, 155 Ohio App. 3d 288, 800 N.E. 2d 780 (10th Dist. App. 2003)* ; *Accelerated Benefits Corp. v. Peaslee, 818 N.E.2d 73, 2004 Ind. App. LEXIS 2317 (Ind. App. 2004)* .

(n443)Footnote 443. 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) .

(n444)Footnote 444. See § 2.01[1] *supra*.

(n445)Footnote 445. *But see Holloway v. Peat, Marwick, Mitchell & Co.*, 900 F.2d 1485 (10th Cir.) , cert. denied, 111 S. Ct. 386 (1990) (passbook savings certificates issued by finance and trust subsidiaries of a bank holding company held to be securities under *Reves v. Ernst & Young* criteria).

(n446)Footnote 446. 756 F.2d 230 (2d Cir. 1985) .

(n447)Footnote 447. 977 F. Supp. 510 (D. Me. 1997) .

(n448)Footnote 448. *Ayala v. Jamaica Sav. Bank*, 1981 U.S. Dist. LEXIS 17994 (E.D.N.Y. 1981) (time certificate of deposit issued by a savings bank and federally insured was not a security).

See also *Tafflin v. Levitt*, 865 F.2d 595 (4th Cir. 1989) (certificates of deposit issued by a state-chartered savings and loan association held not to be securities by reason of comprehensive *state* regulation of the insurance system); *Sanderson v. Roethenmund*, 682 F. Supp. 205 (S.D.N.Y. 1988) (unregulated international certificates of deposit offered and sold to more than 1000 persons held to be securities); *but see West v. Multibanco Comerex S.A.*, 807 F.2d 820 (9th Cir. 1987) (certificates of deposit issued by a Mexican bank and purchased by U.S. investors held not to be securities since Mexican banking laws and regulation provided protections equivalent to those for regulated U.S. banks).

(n449)Footnote 449. Section 3(a)(2) of the Securities Act, reprinted in the Primary Law Sourcebook, Volume A, Section C exempts securities issued or guaranteed by any bank, and, with certain limited exceptions, § 3(a)(5) provides a similar exemption for securities issued by a savings and loan association or similar institution supervised and examined by state or federal authorities having supervisory jurisdiction over them. These exemptions are discussed in §§ 3.03 and 3.06 *infra* .

See also *Hamblett v. Board of Sav. & Loan Ass'ns*, 472 F. Supp. 158 (N.D. Miss. 1979) (passbook or time deposit on which a fixed rate of interest is paid and which gave holder no voice in management of the issuing association is not a security); *Canadian Imperial Bank of Commerce Trust Co. v. Fingland*, 615 F.2d 465 (7th Cir. 1980) ; *Hendrickson v. Buchbinder*, 465 F. Supp. 1250 (S.D. Fla. 1979) (time deposits and passbooks issued by off-shore banks are not securities).

But see SEC v. First American Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973) (passbook savings accounts, notes and "investment" certificates held to be sale of securities).

(n450)Footnote 450. 389 U.S. 332, 88 S. Ct. 548, 19 L. Ed. 2d 564 (1967) .

(n451)Footnote 451. While applying the *Howey* test with no difficulty, the Court went on to observe: "Clearly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in Section 3(a)(10) and as it was defined in *Howey*. But we need not rest our decision on that conclusion alone. ... For example, the petitioners' shares can be viewed as 'certificates of interest or participation in any profit sharing agreement.' " 389 U.S. at 339-40, 88 S. Ct. at 554-55, 19 L. Ed. 2d at 571 .

(n452)Footnote 452. *Id.*

(n453)Footnote 453. In *Marine Bank*, the Court characterized the capital shares in *Tcherepnin* as much more like "the ordinary concept of a security" because they paid dividends based on the profits of the savings and loan association, rather than a fixed rate of interest, and carried voting rights. *Marine Bank*, 455 U.S. at 557, 102 S. Ct. at 1224, 71 L. Ed. 2d at 415 .

(n454)Footnote 454. In *Gary Plastic Packaging Corp. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), the Second Circuit emphasized that in *Marine Bank*, the Supreme Court specifically left open the possibility that in other circumstances a certificate of deposit might be deemed to be a security. In holding the certificates of deposit offered under the brokerage firm program to be securities, the Second Circuit distinguished *Marine Bank* as focusing upon a "conventional" certificate of deposit as to which an investor's risk of loss was eliminated through banking regulation and deposit insurance.

(n455)Footnote 455. There is a fundamental caution that applies in all of this:

The expansion of the scope of the securities laws sought by plaintiff herein seems to be unwarranted and perhaps even detrimental to the common good. In our mercantile economy, we should not try to turn every "thing" which might be purchased and sold into a security. If we did, every commercial contract would end up being enforced in the Federal Courts in what some plaintiffs and their attorneys would turn into class actions. Clearly this is not what was intended by Congress in passing the securities laws.

Mechigian v. Art Capital Corp., 612 F. Supp. 1421, 1428 (S.D.N.Y. 1985) (sale of lithographic plate or original artwork was not the sale of a security despite alleged fraudulent inducement and the purchaser's expectation of profit on resale); see also *Faircloth v. Jackie Fine Arts, Inc.*, 682 F. Supp. 837 (D.S.C. 1988) (purchase of art master did not involve an investment contract).

(n456)Footnote 456. 540 U.S. 389, 124 S. Ct. 892, 157 L. Ed. 2d 813 (2004).

(n457)Footnote 457. But see *Newmeyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385 (6th Cir. 1989), in which standard form lease end security agreements for interests in postage stamp printing plates were seen as presenting the elements of an investment contract. Commonality could be established through distribution and marketing arrangements benefiting individual lessees. The divergent approaches to requisite commonality are discussed in § 2.01[11][b] *supra*.

(n458)Footnote 458. See, e.g., *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459 (9th Cir. 1985) (ore purchase program involving promotional literature which evinced a clear expectation of profit was an investment contract); *In re Gardner*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,757 (N.Y. Sup. Ct. 1979) (diamond sales program involving "investment" promotion was the sale of securities); *SEC v. Western Pac. Gold & Silver Exch.*, 1975 U.S. Dist. LEXIS 14083 (Corp., D. Nev. 1975) (sale of gold coins and silver bars involved the sale of securities); *SEC v. Brigadoon Scotch Distribs., Ltd.*, 388 F. Supp. 1288 (S.D.N.Y. 1975) (sale of rare coin portfolios coupled with services was the sale of securities).

(n459)Footnote 459. As illustrated in *SEC v. Belmont Reid & Co., Inc.*, 794 F.2d 1388 (9th Cir. 1986), the focus is on whether profits depend on fluctuations in the market rather than the managerial efforts of others. As the court observed:

[T]he purchasers were speculating in the world gold market. Admittedly, one can do much the same thing by buying a share in a company mining gold. However, that is not what was done here. To the extent the purchasers relied on the managerial skill of CMC they did so as an ordinary buyer, having advanced the purchase price, relies on an ordinary seller.

See also *Svets v. Osborne Precious Metals, Co.*, 1992 U.S. Dist. LEXIS 15266 (10th Cir. June 5, 1992) (profits depended upon fluctuations of the market).

But see *In re Application of Frank W. Leonesio*, Exch. Act Rel. No. 23,524, 1986 SEC LEXIS 1009 (Aug. 11, 1986) (program whereby investors would provide funds to a company ostensibly for contracts to purchase gold but would actually be advancing funds for the company to speculate in the precious metals markets would involve a security); see

also *Connors v. Lexington Ins. Co.*, 666 F. Supp. 434 (E.D.N.Y. 1987) (a "buy-back, redelivery, rebate program" in which the promoter purchased and stored precious metals was an investment contract).

(n460)Footnote 460. *Longines Symphonette Soc'y*, 1972 SEC No-Act. LEXIS 4252 (Nov. 10, 1972) . A program offering gold and silver commemorative medallions was deemed to be the sale of securities. The medallions were offered and sold with a "repurchase guarantee" at the sale price plus 10% in a mass merchandising effort using literature that characterized the program as an "investment plan" and that emphasized the profit potential of purchases.

But see *Noa v. Key Futures, Inc.* 638 F.2d 77 (9th Cir. 1980) (sale of silver bars with a repurchase guarantee at the spot market price at the time of repurchase was not the sale of securities); accord *Dept. of Commerce v. DeBeers Diamond Inv., Ltd.*, 280 N.W.2d 547 (Mich. App. 1979) (no security present in a program involving sale of diamonds with a repurchase guarantee at market price).

(n461)Footnote 461. See *En Yun Hsu v. Leaseway Transp. Corp.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,043 (N.D. Cal. 1985) (program for truck purchase, leasing, and management agreement constituted a security); *United States v. Jones*, 712 F.2d 1316 (9th Cir. 1983) . A sale and leaseback program involving the purchase of trailers and leaseback to a trucking company was the sale of securities. Purchaser/lessors were dependent upon the fortunes of the promoter/lessee.

See also *Cruise America, Inc.*, 1990 SEC No-Act. LEXIS 736 (May 2, 1990) (sale and leaseback program for recreational vehicles could be deemed to involve a security); *International, Inc.*, SEC No-Action Letter (Div. Corp. Fin. 1977) (sale and leaseback program for modular motel units involved the sale of securities); *Financial Analytics Corp.*, 1973 SEC No-Act. LEXIS 3347 (July 16, 1973) (program for sale and leaseback of electronic data processing equipment was the sale of securities since purchaser/lessors relied solely on the efforts of the promoter/lessee for their return).

(n462)Footnote 462. 124 S. Ct. 892 .

(n463)Footnote 463. On remand of *Edwards* to the Eleventh Circuit U.S. Court of Appeals, the court of appeals completed the *Howey* analysis, concluding that investors in the ETS pay telephone program retained minimal control over the telephones. Once an investor leased the telephone back to the promoter, the investor relied on the promoter for profits. *SEC v. ETS Payphones, Inc.*, 408 F.3d. 727 (11th Cir. 2005) .

(n464)Footnote 464. See 124 S. Ct. at 897 .

(n465)Footnote 465. See also *Albanese v. Florida Nat'l Bank of Orlando*, 823 F.2d 408 (11th Cir. 1987) (sale of ice machines coupled with a leaseback arrangement and management agreement left purchasers with "illusory" control); *David K. Lindemuth Co. v. Shannon Fin. Corp.*, 660 F. Supp. 261 (N.D. Cal. 1987) (sale and leaseback arrangement for oil pipeline inspection equipment in which profits depended on seller's management skills). See also *Dove Publishing Co.*, 1980 SEC No-Act. LEXIS 3968 (Oct. 20, 1980) (sale of gift plaques at wholesale prices coupled with seller's program to form organization and assist in marketing may involve the sale of securities because of the "related" services).

(n466)Footnote 466. See, e.g., *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1990) (cattle feeding "consulting" agreements held to be securities); *Eberhardt v. Watters*, 901 F.2d 1578 (11th Cir. 1990) (sale of cattle embryos as part of a breeding and maintenance program); *Sheets v. Dziabis*, 738 F. Supp. 307 (N.D. Ind. 1990) (syndication interests in Thoroughbred stallions were securities); *Seale v. Miller*, 698 F. Supp. 883 (N.D. Ga. 1988) (cattle feeding program); *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979) (earthworm program); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974) .

But see *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp. 6 (E.D. Ky. 1985) (horse syndication agreement was not a

security where each purchase of a fractional interest was unitary and the syndicate manager did not provide significant service); *Tanenbaum v. Agri-Capital, Inc.*, 885 F.2d 464 (8th Cir. 1989) (reasonable minds could find that investor possessed such requisite business experience to enable him not to be dependent upon seller to manage cattle embryos and breeding program).

(n467)Footnote 467. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 353, 64 S. Ct. 120, 124, 88 L. Ed. 88, 94 (1943) .

The manner of presentation clearly works both ways. In *Nakagawa v. Ellis & Ellis Assocs., Inc.*, 1986 U.S. Dist. LEXIS 25540 (D. Haw. May 13, 1986) , for example, the content of an "information memo" unambiguously made clear the fact that profits from the lease of a stamp master device that allowed plaintiffs to print and market postage stamps would come solely from their own efforts during the term of the lease. It was clear from the document that the plaintiff lessees had the power to decide how to produce their own profits without any involvement of the lessor, and the presentation of this fact defeated any claim that a security was involved.

(n468)Footnote 468. *See also SEC v. Alliance Leasing Corp.*, 2002 U.S. App. LEXIS 153 (9th Cir. 2002) (Equipment leasing program involved pooling of investors' interests and sharing in profits).

(n469)Footnote 469. 867 F.2d 278 (6th Cir. 1989) .

(n470)Footnote 470. *Deckebach*, 867 F.2d 278 .

(n471)Footnote 471. *See Qualivest Capital Management, Inc.*, 1990 SEC No-Act. LEXIS 1035 (July 30, 1990) ; *Scudder Fund Management Serv.*, 1988 SEC No-Act. LEXIS 1054 (Aug. 17, 1988) .

(n472)Footnote 472. *See Morgan Shareholder Servs. Trust Co.*, 1988 SEC No-Act. LEXIS 869 (Apr. 28, 1988) (dividend reinvestment program); *Fractional Share Repurchase Program*, 1992 SEC No-Act. LEXIS 908 (Aug. 24, 1992) .

(n473)Footnote 473. *See Fibreboard Corp.*, 1988 SEC No-Act. LEXIS 1169 (Aug. 31, 1988) ; *Merrill Lynch Capital Mkts. Structured Invs. Group*, 1989 SEC No-Act. LEXIS 1009 (June 16, 1989) .

(n474)Footnote 474. *See, e.g., First American Collegiate Fund, Inc.*, 1991 SEC No-Act. LEXIS 1410 (Dec. 30, 1991) .

(n475)Footnote 475. *See Lenczycki v. Shearson Lehman Hutton, Inc.*, 1990 U.S. Dist. LEXIS 12924 (S.D.N.Y. Sept. 29, 1990) ; *Poindexter v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 684 F. Supp. 478 (E.D. Mich. 1988) ; *Mordaunt v. Incomco*, 686 F.2d 815 (9th Cir. 1982) ; *Meyer v. Thomson & McKinnon Auchincloss Kohlmeyer, Inc.*, 686 F.2d 818 (9th Cir. 1982) ; *Salcer v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459 (3d Cir. 1982) ; *Holtzman v. Proctor, Cook & Co.*, 528 F. Supp. 9 (D. Mass. 1981) ; *Gonzalez v. Paine, Webber, Jackson Curtis, Inc.*, 1982 U.S. Dist. LEXIS 15844 (S.D.N.Y. 1982) ; *Sennett v. Oppenheimer & Co.*, 502 F. Supp. 939 (N.D. Ill. 1980) ; *Darrell v. Goodson*, 1980 U.S. Dist. LEXIS 10947 (S.D.N.Y. 1980) ; *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, (7th Cir. 1977) ; *Meredith v. Conticommodity Servs., Inc.*, 1980 U.S. Dist. LEXIS 15193 (D.D.C. 1980) ; *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.) , cert. denied, 409 U.S. 887 (1972) .

Where commodities futures accounts are involved, another dimension was added in *Burton v. Heinold Commodities, Inc.*, 646 F. Supp. 360 (E.D. Va. 1986) , in which the court held that no security was present not only for want of requisite commonality but also because other regulation--the federal commodities laws--controlled, and provided whatever protection was available to the plaintiffs.

(n476)Footnote 476. *SEC v. R.G. Reynolds Enters., Inc.*, (9th Cir. Dec. 30, 1991) ("managed account" for stock and future trading); *see Levine v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 639 F. Supp. 1391 (S.D.N.Y. 1986) ("A

discretionary stock option account, where the investment is made by one person and complete discretion over the management of the account is in the hands of someone else, is an investment contract"); *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974) ; *Marshall v. Lamson Bros. & Co.*, 368 F. Supp. 486 (D. Iowa 1974) ; *Taylor v. Bear Stearns & Co.*, 572 F. Supp. 667 (N.D. Ga. 1983) ; *Christensen Hatch Farms, Inc. v. Peavey Co.*, 505 F. Supp. 903 (D. Minn. 1981) ; *Troyer v. Karcagi*, 476 F. Supp. 1142 (S.D.N.Y. 1979) .

(n477)Footnote 477. In *Silverstein v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 618 F. Supp. 436 (S.D.N.Y. 1985) , the court held that a discretionary commodities futures account was not a security for want of horizontal or vertical commonality. The court reasoned that under any formulation of common enterprise the fortunes of participants must be related to each other. There can be no common enterprise in a broker/customer relationship where the only financial interest of the broker is in earning commissions. On the other hand, in *SEC v. R.G. Reynolds Enters., Inc.*, (9th Cir. Dec. 30, 1991) , compensation of the promoter/manager was based on a percentage of profits.

(n478)Footnote 478. *Savino v. E.F. Hutton & Co., Inc.*, 507 F. Supp. 1225 (S.D.N.Y. 1981) .

(n479)Footnote 479. The Commission has taken the position that mass marketing of discretionary accounts by investment advisers or broker-dealers can create an investment contract. See *SEC v. First Nat'l City Bank*, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,952 (S.D.N.Y. 1970); *Robert W. Baird & Co.*, 1971 SEC No-Act. LEXIS 1565 (Div. Corp. Fin. 1971) . The key consideration is the uniformity of advice and treatment of accounts, that is, the selection of the same securities for all, or all identifiable groups of, accounts. Where, for example, multiple investors' accounts are maintained and traded according to a model account designed to achieve a particular objective, an investment contract is created. *Jacobs, Persinger & Parker*, 1971 SEC No-Act. LEXIS 2612 (Feb. 4, 1971) .

(n480)Footnote 480. An Illinois state appeals court held that the opportunity to participate in investments in cash foreign currencies traded on the interbank foreign exchange market (the "Forex" market) created an investment contract, despite the fact the currencies themselves are not securities. The transactions involved discretionary trading accounts in which the broker's commission was a percentage of profits realized by investors rather than a flat fee for services. This, said the court, created vertical commonality, established a common enterprise, and thus satisfied the second prong of the *Howey* test for an investment contract. As for the control element, the court found that the success of the enterprise depended primarily on the investment decisions made by the company offering the program. See *Integrated Research Services, Inc. v. Illinois Secretary of State*, 201 Ill.2d 570, 786 N.E.2d 184 (Ill App. 2002) .

(n481)Footnote 481. 52 Haw. 642, 485 P.2d 105 (1971) .

(n482)Footnote 482. 55 Cal. 2d 811, 361 P.2d 906 (Cal. 1961) .

(n483)Footnote 483. The test has been adopted as such in several states. See *Mazza v. Kozel*, 591 F. Supp. 432 (N.D. Ohio 1984) (applying Ohio law and the four-point test of *Hawaii Market Center* to hold that undivided interests in a joint venture were investment contracts); *State v. George*, 50 Ohio App. 2d 297, 362 N.E.2d 1223 (Ohio Ct. App. 1975) ; *State ex rel. Healy v. Consumer Business Sys., Inc.*, 5 Or. App. 19, 482 P.2d 549 (Or. Ct. App. 1971) ; *Frye v. Taylor*, 263 So.2d 835 (Fla. App. 1972) ; *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906 (Cal. 1961) .

It has also met with approval by the SEC. See Sec. Act Rel. No. 5211, 1971 SEC LEXIS 1933 (Nov. 30, 1971) (the conclusion in *Hawaii Market Center* is "fully consistent with the remedial approach" of the federal securities laws).

(n484)Footnote 484. 112 Haw. 90, 144 P.3d 1 (2006) .

(n485)Footnote 485. *TriVectra*, 112 Haw. at 100.

(n486)Footnote 486. 298 Ark. 542, 769 S.W. 2d 20 (1989) .

(n487)Footnote 487. *Grand Prairie*, 769 S.W. 2d at 20.

(n488)Footnote 488. *State v. Brewer*, 932 S.W. 2d 1 (Tenn. Crim. App. 1996) .

(n489)Footnote 489. *But see American Bank & Trust Co. v. Wallace*, 702 F.2d 93 (6th Cir. 1983) ("Application of the risk capital test substantiates the District Court's conclusion that the Wallace's promissory note evidenced a loan and not an investment, a commercial note and not a security"); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174 (6th Cir.) , cert. denied, 454 U.S. 1124 (1981) (risk capital criteria applied to find no security); *Home Guar. Ins. Corp. v. Third Fin. Servs., Inc.*, 667 F. Supp. 577 (M.D. Tenn. 1987) (risk capital analysis applied in holding "mortgage packages" to be securities).

See also Keys v. Wolfe, 709 F.2d 413 (5th Cir. 1983) (landowners purchased a security by making tracts of land part of a water district under which they became subject to new risks of loss of the property).

(n490)Footnote 490. 348 F. Supp. 766 (D. Or. 1972) , aff'd, 474 F.2d 476 (9th Cir. 1973) . The Ninth Circuit declined to adopt the risk capital approach taken by the district court. Rather, the court was careful to point out: "Nor does our holding represent any real departure from the Supreme Court's definition of an investment contract in *Howey*. We hold only that the requirement that profits come 'solely' from the efforts of others would, in circumstances such as these, lead to unrealistic results if applied dogmatically, and that a more flexible approach is appropriate." *Id.* at 483 .

But see Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) (risk capital test applied in examining whether a note may be deemed to be a security). The risk capital approach as utilized in note cases is discussed in § 2.01[1][c] *supra*.

(n491)Footnote 491. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906 (Cal. 1961) .

Later "membership" cases have focused principally on the expectations of purchasers where the issue is not clearly capital formation. *See, e.g., Riviera Operating Co.*, SEC No-Action Letter (Div. Corp. Fin. 1978) (country club membership may be deemed to be a security if it is freely transferable and evidences an expectation of profit); *LaSalle Club, Inc.*, SEC No-Action Letter (Div. Corp. Fin. 1984) (golf club membership is not a security where it represents only a right to use facilities, is not transferable and precludes any profit motive).



27 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 2 Applicability of the Act: "Security" and "Sale"

1-2 Federal Securities Act of 1933 § 2.02

AUTHOR: Robert N. Rapp This chapter was prepared by Robert N. Rapp (A.B., 1969, J.D., 1972, Case Western Reserve University; M.B.A., 1989, Cleveland State University), partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation*, Second Edition (LexisNexis Matthew Bender, 2003).

§ 2.02 The Meaning of "Sale" -- Section 2(3)

To engage in the "sale" of a security is to undertake any attempt to dispose of the security *for value*. To offer a security for sale is to confront another with an investment decision. The Securities Act protects investment decisions by assuring the availability of adequate information upon which to make an informed judgment, the opportunity to use that information, and by liberalized antifraud remedies where the information is deficient or fraudulent. n1 The Supreme Court of Washington perhaps most cogently made the point in *Kinney v. Cook*, n2 by stating that absent "a sale, or offer to sell, there is no investment and thus no investors to protect." Although *Kinney* addressed the meaning of "sale" in the state securities law context, there are no elements unique to state law. Plaintiffs in *Kinney* paid a promissory note they had signed years before to borrow money to contribute in exchange for a 50% ownership interest in a business, for which they received 50% of the stock. Years later, after litigation left the plaintiffs still holding the stock and owing on the note, they paid the note and then brought a claim under the Washington Securities Act, alleging that their payment had been wrongfully induced, and that it represented payment of the purchase price for the stock representing the 50% ownership interest in a business for which they had borrowed the money from the co-owner years earlier. Their argument that payment of the note was the equivalent of a purchase of the stock was rejected by the Washington Supreme Court:

The Kinneys paid Cook because they were bound by the terms of a promissory note they signed in 1993, not as consideration for an investment made in 2000. As a result of the judgment they owned the stock before they made the payment. The payment satisfied a debt the Kinneys were legally obligated to pay as a result of a litigation they initiated and a judgment they had helped craft; there was no offer, no contract, no bargain, and no sale of a security. Nor was the payment of the note a purchase or sale of the note itself. n3

Kinney well illustrates that the essence of any "sale," and the setting in which securities law protections operate, is an actual *attempt to dispose* of a security, and conversely, an actual choice to part with value to acquire it. "Sale," and its related terms are defined terms in the Securities Act. Section 2(3) states in part:

The term "sale" 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. ... n4

The principal characteristic of a sale is the presence of "value" -- something given up either for or in connection with the receipt of a security. The presence of value is not determined by consideration in the traditional contract sense, but rather in a manner consistent with the intended protections of the Securities Act. First and foremost is the presence of an investment decision brought about by any set of circumstances in which a purchaser meaningfully alters an economic position or interest in reliance upon the value of the security received. This may occur with the payment of money, but it may as easily occur with an exchange of securities. It may occur with "bonus" distributions of stock, or indeed, even with the "free" distribution of stock, warrants or rights.

On-line "free" stock promotions, and regulatory responses to them illustrate the breadth of the meaning of sale in the application of securities law protections. In a series of no-action letters the SEC cautioned that the distribution of "free" stock to individuals who visit or register on Internet sites constitutes a sale of those shares within the purview of Section 2(3) where there is in fact something given up in order to obtain them, or when a valuable benefit accrues to the issuer in the distribution. Requiring cash payments to defray the cost of processing "free" shares, or requiring the purchase of a product or service, n5 or even the simple requirement that an individual register on a company web site may create an event of sale. n6 Gifts, bonuses and "free" distributions of securities generally are considered in more detail later. n7 What must be clear at the outset is that this and all definitions must be applied so as to achieve the fundamental protective goals of the Securities Act in the setting in which it was intended to operate.

The object of securities law protection is an investment decision. Securities Act provisions for full disclosure of material information through the registration and prospectus delivery requirements of Section 5, for regulation of the selling process, and for liberalized antifraud remedies are all targeted at that event. The presence of a "security" is an essential predicate to securities law protection, but it is the offer to sell or the sale of that security that is the triggering event--that which presents an *investment decision* or is the prelude to one. n8 Where no investment decision is presented, the Securities Act has no mission. However, because the focus of the Securities Act is on circumstances in which such a decision is presented, rather than where an actual transaction occurs, the meaning of "sale" under Section 2(3) necessarily transcends an ordinary understanding of the term. It will be seen, for example, that the essential element of "value" involved in a sale may be that obtained by the "seller," whether or not it is represented by anything tangible actually given up by the buyer. This is particularly well illustrated in "free" stock and other "bonus" promotions involving the distribution of shares.

There are two important, and independent, aspects to "sale" analysis under the Securities Act. The first is that which identifies the event itself, for that event is the trigger for statutory protections. The second aspect, the scope of *liability* under the Securities Act, flows from the event but is a separate consideration. Civil liability prescribed under Sections 12(a)(1) and 12(a)(2) of the Securities Act for violations of Section 5, or for an information failure in the offer or sale of a security, respectively, turns on the question of who may be deemed to be a "seller" in the fact setting of a particular transaction. The general antifraud prohibitions of Section 17(a) of the Securities Act likewise involve assessments of individual acts and conduct in a transactional setting. Case law notions about "seller" status and the scope of liability under the Securities Act often complement analyses of the triggering events themselves, but broader analysis of roles in the sale process for purposes of liability determinations is undertaken elsewhere in this treatise. n9

The statutory definition of "sale" illuminates two constituent considerations: (1) the process leading up to or bringing about an investment decision; and (2) an actual disposition of the security *for value*. In the analysis of each, it is essential to recognize that the terms "sell" and "sale" are intended to be used in a broad sense. As the U.S. Supreme Court observed in *United States v. Naftalin*: n10 "The statutory terms ["offer" and "sell"], which Congress expressly intended to define broadly, are expansive enough to encompass the entire selling process ..." Thus, courts will look to

any attempt to dispose a security, and to find "value," in ways that will best effectuate investor protection by requiring Securities Act compliance and by allowing operation of liberalized antifraud protections. n11

Though intentionally expansive, there is insight into identification of the contours of the definition to be found in considering what is either expressly excluded from, or presumptively included within it. Situations expressly declared *not* to involve a sale or offer to sell are:

- (1) Preliminary negotiations or agreements between an issuer and underwriter, or among underwriters who are or are to be in privity of contract with an issuer; and
- (2) The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert it into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date.

On the other hand, a sale will occur at the time of actual issuance or transfer of such a security pursuant to the exercise of a right, conversion, or subscription in the future. Moreover, as for the present, 'Section 2(3) declares: '[a]ny security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, *shall be conclusively presumed* to constitute a part of the subject of such purchase and to have been offered and sold for value."

The statutory exclusions plainly evidence an intended scope of coverage encompassing an actual investment decision by one so situated as to need the protection of the Securities Act. Preliminary negotiations and agreements among underwriters who will engage or participate in the distribution of securities only serve to create the process by which persons will ultimately be offered the opportunity to consider and to make an actual investment decision. The practical effect of giving a present right to make a future decision is no different. It is only when the ultimate decision is made by one so situated as to need special protection that the Securities Act should apply.

An investment decision connotes a change of position or, more precisely, the conscious acceptance of, or change in, an investment *risk*. The essential point is best illustrated in cases involving significant modifications in the rights of existing security holders in an enterprise, which, if amounting to the "sale" of a new security, impact both Securities Act and Exchange Act rights and remedies. In *Ingenito v. Bermac Corp.*, n12 plaintiff investors alleged that modification of their underlying investment contracts constituted the sale of a new security. The modifications involved the creation of fresh rights or obligations in regard to increasing equity and investment risk. The court held that a substantial modification impacting the rights and obligations, for which an investor gives some consideration either in the form of a promise to make future payments or the relinquishment of a significant right, is a new investment decision and, hence, the sale of a security. n13 On the other hand, modifying a partnership agreement to permit the addition of more partners and the expansion of its enterprise was held not to involve the kind of change in the investment or its risk as to amount to a sale in *Abrahamson v. Fleschner*. n14

As will be seen below, the "for value" element of the definition implies the same notion. Committing to an investment risk means subjecting some value to the risks of an enterprise. A transaction need not involve cash consideration to constitute a sale under Section 2(3). However, there must be some identifiable economic change of position in relation to investment risk or what the security represents. Thus, a stock split that simply distributes two or more pieces of paper for one cannot be deemed to be a "sale." n15 But it will also be seen that for purposes of Section 2(3), "value" may be related to induced expectations of the putative purchaser or to value on the other side of the transaction, that is, value that comes as consequence of or is generated for the benefit of one inducing a decision. "Value" is a two-sided concept. The disposition or attempted disposition of a security may be for value that is substantially, if not entirely, meaningful only to the seller, as, for example, in the creation of a trading market for shares distributed to the public through a stock dividend to holders of shares of a shell corporation where the intent is to avoid compliance with provisions of the

Securities Act. n16

Where the focus is on an actual investment decision, the question of *when* the decision is made, *i.e.*, when the sale occurs, is often meaningful in the application of antifraud remedies that require proof of some causal connection between an information failure and that investment decision. After *Pinter v. Dahl*, n17 civil liability of a "seller" under Section 12 of the Securities Act, and under other general antifraud provisions of the federal securities laws, requires some meaningful causal involvement in the selling process. n18 When a sale actually occurs may dictate the scope of such liability. Thus, courts have determined for purposes of the antifraud provisions that a "sale" occurs when the parties to a transaction become committed to one another or when there occurs "[a] meeting of the minds of the parties ... mark[ing] the point at which the parties obligated themselves to perform what they had agreed to perform even if the formal performance of their agreement is to be after a lapse of time." n19 At the same time, civil liability for violating the registration and prospectus delivery requirements of Section 5 of the Securities Act, as prescribed in Section 12(a)(1), may key on an act at "any integral stage" of a sale. The time at which a "sale" occurs in the context of civil liability analysis is considered later. n20

Against this backdrop, the meaning of "sale" in a variety of contexts in which it has important consequences may be considered further. In all of it, the constant key to application, as with the critical definition of "security" in Section 2(1) of the Securities Act, is identification of those circumstances in which the need for specialized securities law protection is manifest.

[1] Gifts, Bonuses and Free Stock Distributions

Consider the following: Smith, a successful alumnus of X University, donates 1000 shares of ABC Corporation common stock to the University in grateful recognition of his educational experience and training. Has Smith "sold" the securities to the university? Plainly, she has made a *gift* of the shares and, absent other considerations, no concerns for investor protection under the federal securities laws are present. A bona fide gift of a security is not a sale of that security because there is *no disposition for value*: no investment decision is presented. n21

"Value" is not defined in the Securities Act, yet it is clearly a fundamental point for determining the reach of the Securities Act's protections. There may be value in a transaction in the traditional contract consideration sense. There may also be intangibles. In the above hypothetical, however, whatever intangible "value" may be involved for Smith, it is clear that the educational institution, merely the recipient of Smith's beneficence, has parted with nothing in exchange. In these and similar circumstances, the SEC has agreed that a true gift of securities to an educational or charitable institution or a family trust does not involve a sale of securities within the meaning of the Securities Act. n22

Although a fundamental characteristic of a "sale" is that a "purchaser" parts with something in exchange for a security, an ostensible "gift" of securities can plainly be seen as a sale for value when other considerations are involved. For example, the "gift" is effected with payment of "administrative fees" or "transfer fees" that exceed the actual cost of the transfer, and actually represent payment for the securities, or that are part of an inducement program for the purchase of further shares. n23 Similarly, "promotional" gifts of stock, in exchange for visiting a resort development, have been deemed to be sales. n24 Additionally, the distribution of gift shares by a privately held shell corporation without remuneration has been held to be the sale of those shares where economic benefits were obtained *by the seller*, even though the benefits flowed indirectly from the marketplace rather than directly from the recipients of the stock. In *Capital Gen. Corp. v. Utah* n25 the court rejected an assertion that a "good faith gift" was involved in these circumstances, and agreed with an administrative determination that: "CGC's veiled but fairly obvious purpose was to advance its own economic objectives rather than to make a gift for reasons of simple generosity." In an administrative proceeding arising out of the same situation, the SEC concluded that the distribution of "gift" shares was a sale within the meaning of the Securities Act because of the value which accrued to the issuer by virtue of creating a public market for its securities. n26

These practical "value" assessments are at the heart of determinations involving distributions of "free" stock in on-line Internet promotions or programs. Issuers involved in such programs normally receive some valuable benefit, despite the ostensibly "free" distribution of shares to on-line recipients. Free stock programs or promotions might, for example, be utilized to generate valuable customer databases where recipients of shares are required to register on a web site and provide personal information as a condition to receiving shares. Free stock issuers may in fact be devices to generate interest in a planned public offering, or as a mechanism to set up investments in another enterprise. n27

"Free" stock programs associated with Internet web site registrations and linked purchases of merchandise have been discussed earlier. n28 These promotions may also be touted as free "investment" opportunities, promoting an expectation of financial gain and inducing a perception of value on the basis of false or misleading information. The unbounded potential of the Internet for dissemination of such offerings to millions of people as vehicles designed to benefit issuers, if only to create publicity and increase web site traffic, will attract increasing regulatory scrutiny. Traditional "value" assessments involved in identifying a sale for purposes of securities law protections will be given new meaning through the emphasis placed on value obtained in a distribution *process* rather than a transaction supported by particular consideration. n29

Although policing impersonal Internet promotions and programs involving "free" stock requires an evolving notion of value, gifts or bonuses of stock in an employment setting are more focused on orthodox considerations. For example, a "gift" of company stock to employees whose compensation has been reduced in such an amount as to indicate a relationship between the reduction and the stock is indicative of a "sale" rather than a bona fide gift. n30

"Bonus" dispositions of securities are expressly addressed in Section 2(3):

"[A]ny security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value." The focus here is plainly upon the value given up in the context of the transaction and, as with "gift" securities transferred in connection with promotional campaigns, inducements, or purchases of something else, the presence of value is a function of the entire transactional context. n31 The objective is to identify those settings in which Securities Act protection is necessary and appropriate. A parent company plan to issue American Depositary Receipts (ADRs) for its stock to a broad class of employees of the company and its subsidiaries, at no direct cost to such individuals (but subject to a vesting schedule) as an additional incentive to make their maximum contribution to the growth and development of the company, was viewed as not triggering investor protection concerns and not involving a sale within the ambit of Section 2(3). n32 As will be seen, however, other employment-related situations could involve an investment-oriented election to receive shares, and trigger concern for protection. In *Feret v. Corestates Financial Corp.*, n33 for example, company employees who voluntarily entered into agreements under which they received incentive stock options in exchange for continuing services were deemed to be purchasers for purposes of asserting antifraud claims despite the fact that they did not make any direct payment to obtain the options. The court was satisfied that an employment agreement containing stock options constitutes a sale. n34

In the general corporate environment, bonus or other forms of dispositions of securities involving employees or existing shareholders also raise important questions concerning "value," only some of which are addressed by Section 2(3). The statutory definition further provides:

The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security; but the issue or transfer of such other security upon the exercise of such

right of conversion or subscription shall be deemed a sale of such other security.

While the definition addresses "bonus" shares and some forms of "rights" distributed to existing shareholders, there are numerous, and much more prevalent, forms of dispositions that have been left to the courts and the SEC to address. These are considered below.

[2] Stock Dividends and Related Distributions

An ordinary stock dividend, dividend "in kind" or stock split, is not a disposition for value. The recipient gives up nothing and remains in the same position vis-a-vis the issuing corporation. n35 This conclusion is the same even where the corporation makes the dividend payable in cash or securities at the election of the shareholder. In making the election, the shareholder neither gives up nor alters any vested right but merely elects the form of a distribution. This is so even though it is clear that the recipient shareholder is surrendering a claim to cash. As early as 1936 the General Counsel of the SEC articulated a "no sale theory" in these circumstances, as follows:

[E]ven though under ordinary circumstances the waiver of a right would in my opinion constitute "value", I do not believe that that term should be regarded as comprehending within its meaning the action of a stockholder to whom alternative rights have been granted without consideration, in electing to exercise one such right, even though under the terms of the grant, such election will have the effect of causing the lapse of the right not exercised. n36

A "sale" presumes a decision to give up something. If a dividend is first declared payable in cash and a shareholder is *subsequently* given the choice to take stock instead, value has been given. The shareholder has now altered a vested right. On this point the SEC General Counsel offered the further observation:

[I]t is well settled in general law that upon public declaration of a cash dividend out of surplus, the holders of the stock ... acquire immediately the rights of creditors of the corporation and cannot be divested of these rights by subsequent action of the board of directors. If therefore, there is declared a cash dividend payable to all stockholders, and if the board thereafter determines to grant to stockholders the opportunity to waive their pre-existing and vested rights to payment of the dividend in cash, and to receive the dividend in the form of securities, the stockholders electing to take securities would in my opinion be regarded as giving value for the securities so received. n37

Whatever the specific context, the central question for there to be a sale is whether one makes an investment decision that changes the nature of an asset or right and any risk associated with it. n38 The point is well illustrated by *Isquith v. Caremark International, Inc.*, n39 in which the court held that no sale was involved in the spin-off of a corporate subsidiary, in which shareholders received one share of stock in the newly independent company for every four shares they held in the former parent. A recipient shareholder sought to maintain class action antifraud claims on allegations that the true purpose for the spin-off transaction had been misrepresented, and that overall shareholder value ultimately suffered. Plaintiff claimed that the distribution of shares in the spin-off amounted to a "forced" sale, and that shareholders had to buy the shares through payment of the alleged reduction in value of their continuing share ownership in the former parent. The Seventh Circuit Court of Appeals affirmed dismissal of the claims on the simple point that no one was confronted with any choice. The plaintiff made no investment decision. The distribution of shares was no different than a stock dividend, and shareholders who received the shares no more "bought" the stock, said the court, than the recipient of a stock dividend buys the stock received as a dividend.

The court also rejected the argument that there was a fundamental change in the plaintiff's holdings by reason of the spin-off transaction such that a forced sale might be found. The court explained:

In a spin-off there is no exchange, no forced exit from the corporation, but merely the receipt by the corporation's shareholders of additional stock. Only the form in which members of the class owned

Baxter's assets was changed; it was changed from stock in one corporation to stock in two corporations. After the change the class members owned the same proportion, carrying the same rights, of the same pool of assets. Before, their ownership interest was denominated in shares of Baxter; after, in shares of Baxter and Caremark; the interest itself -- the amount of assets owned by the members of the class -- was unchanged. n40

Reconciling "no sale" conclusions where spin-offs and stock dividends are involved versus sale findings associated with "free" or "gift" share distributions discussed earlier is a matter of underlying motivation and economic consequences. Free stock distributed in response to a specific action by one who has no prior ownership interest involves a choice and a change of position, with value flowing directly to the distributing entity being the motivation for the "gift." Circumstances give rise to investor protection concerns where there is in fact a plan of distribution involving an invitation to tens of thousands of individuals to acquire shares for little or no orthodox consideration, but who may be led to expect future financial gain, and who may become pawns in other schemes. Existing shareholders in the circumstances of corporate transactions illustrated by *Caremark* make no choice of action in response to any inducement. Securities law protections are triggered where the opportunity to make a choice amounting to an investment decision is presented. An induced belief that one may receive stock for nothing by making a choice of action so simple as registering on an Internet website, and referring others who register, presents no less concern than if the stock were offered and sold in the same manner for cash without Securities Act compliance when in fact there is demonstrable value flowing to the distributor of the stock as a result of the induced actions of the public.

In other corporate settings there are hybrid situations in which programs for share distributions have been examined under Section 2(3). Many companies, for example, have instituted direct dividend reinvestment plans (DRIPs) open to all record holders of their stock. These plans typically provide that participating shareholders, instead of receiving cash dividends, are credited with stock of the company purchased for them by a trustee or an unaffiliated agent. Some plans further provide for the addition of cash payments by the shareholder to increase the amount of the investment. Clearly, there is an election to participate in the program, and in so doing an election to forego cash dividend payments. In considering these plans, however, whether there is a "sale" within the meaning of Section 2(3) turns on the extent of involvement by the issuer or an affiliate of the issuer in the operation of the plan. The concern in this context is whether there is such conduct as to amount to a solicitation of an offer to buy the securities. In two interpretive releases, the SEC has provided some guidance on the permissible role of an issuer or affiliate. Minor administrative and communication activity does not indicate any solicitation, and, as further clarified, if only "bookkeeping and similar administrative functions" were involved, it is likely that no "sale" will be found. n41

The approach here clearly illustrates the scope of Section 2(3), and the intended scope of Securities Act protection, to encompass a "selling process." The SEC has taken the position that these plans do involve sales *if* they provide that the shares may be purchased by the trustee from the issuing company or its affiliates. Where this is the case, the issuer is deemed to have solicited an offer to buy and is engaged in the distribution of its shares through the trustee, who becomes a statutory underwriter. n42 Where the plan provides that the trustee may not purchase shares from the issuer or an affiliate, there is no "sale" by the issuer. n43 Attempts to modify dividend reinvestment plans to allow for non-shareholders to become shareholders through the plan have met with mixed results. n44

[3] Reorganization Distributions

Closely related to spin-offs and other types of corporate transactions in which there is no "value" element necessary to find a sale for purposes of the Securities Act are liquidating or other reorganization-related distributions of securities. Where there is no disposition for value as, for example, in the case of a liquidating distribution to shareholders who merely receive in liquidation that which they already own as part of a reorganization, and the distributing entity receives no value in making the distribution, no "sale" will be found. n45 The SEC Staff has recognized that no offer or sale is involved when a reorganizing transaction involves no meaningful change in the nature or amount of the securities in which the shareholders are invested. n46 These conclusions are based on the fact that where there is no meaningful

change in the underlying beneficial ownership of securities, no new investment decision, and no meaningful change in those bearing the economic risk of the securities, there is no essential "value" element for finding a sale. Where stockholders are asked to make a new investment decision regarding a new or different security, or must give up value as consideration for acquiring a new security, the circumstances are clearly different. However, reorganizing transactions that have no economic significance to the stockholder present no need for Securities Act protection through registration. n47

[4] Pledges

In *Rubin v. United States*, n48 the Supreme Court held that a pledge of stock as collateral for a bank loan was a disposition of an interest in the stock and, hence, an "offer" or "sale" of the stock for purposes of Section 17(a) of the Securities Act. n49 Despite the fact that the pledge of stock conveyed only a conditional, defeasible right to ownership in the event of a default by the borrower, the Court saw no meaningful difference in the positions of a pledgee and an actual purchaser. As the Court observed: "The economic considerations and realities present when a lender parts with value and accepts securities as collateral for a loan are similar in important respects to the risk an investor undertakes when purchasing shares. Both are relying on the value of the securities themselves, and both must be able to depend on the representations made by the transferor of the securities. ..." n50 In this the pledgee of securities stands on equal footing with a normal investor who purchases shares outright.

Although in the past, a pledge of securities, under some circumstances been deemed to constitute a "sale" of the securities for purposes of other provisions of the Securities Act, most notably for the definition of an "underwriter" and in the examination of securities distributions carried out through pledgees in violation of the registration and prospectus delivery provisions, n51 *Rubin* focused entirely upon the status of a pledgee as one seeking to invoke special protection. The pledge of stock was viewed as "unmistakably" being a disposition for value, not only because of the language of Section 2(3) but also because the pledgee was entitled to protection in making an investment decision.

A vital aspect of *Rubin* is the Court's recognition that characterizing a pledge as an "offer" or "sale" under the Securities Act is consistent with the purposes of the Securities Act to protect against fraud and promote the free flow of information. n52 For the pledgee in *Rubin*, investment risk of mis-valued securities was present. This is the investment risk faced by any purchaser of securities, and the nature of the ownership "interest" acquired does not alter it. Analysis in the post-*Rubin* environment also applies to hold that a defaulting pledgor of stock is a seller of the securities when the pledgor's stock is sold to pay off the loan against which the stock was pledged. n53 Thus, where a pledge is induced by fraud or information failure, the subsequent foreclosure sale of the stock will support invocation of antifraud remedies. However, the foreclosure sale is not a separate sale from the pledge itself. The foreclosure is the execution of the sale imbedded in the pledge, and, thus, applicable limitations on remedies are keyed to the event of the pledge. n54

The result in *Rubin* has met some resistance. One lower court decision asserts that the Supreme Court ignored the economic "context" of a pledge transaction in favor of an inappropriately "literal" approach. n55 On balance, however, post-*Rubin* decisions underscore the element of investment risk present in pledge transactions and the appropriateness of extending securities law protections to them. n56

[5] Changes in Securities Provisions; Exchanges of Securities

A modification in the terms of a security that makes a fundamental change in the nature of the investment it represents is a disposition of the modified security for value and a resultant "sale" of that security. Such modifications may involve terms (as with the interest rate on a debenture), appurtenant rights (voting rights, for example), or any other alteration in the character of the security held. There need not be a transaction, i.e., an actual exchange of instruments, for a "sale" to occur by reason of a change in the provisions of a security. n57 However, when issuance of a new security is effected by an actual exchange of instruments, a sale will be found if there is any form of value given in the transaction. n58

"Value" in the exchange or modification setting comes with a change in the investment. If two economically equivalent securities are exchanged, or if the holder's investment position in the issuer is the same following an exchange, it can be said that no value has been given up by the holder. Consider the following possible transactions:

- (1) A parent corporation issues its securities in exchange for those of its wholly-owned subsidiary; or
- (2) A corporation offers to exchange its par value shares for shares having no par value; or
- (3) A corporation effects a 2:1 stock split; or
- (4) In a merger, X Corporation common shares are exchanged for Y Corporation common shares on a 1:1 basis; or
- (5) A corporation exchanges voting common stock for a new class of non-voting preferred stock.

In these and other situations, the inquiry is whether something of value is given up by a security holder. Stock splits, changes in name or par value, or exchanges between a parent and subsidiary that is only a transfer between corporate pockets do not constitute material alterations in the nature of the investment. n59 Even if such corporate actions are submitted to a shareholder vote, the holder parts with no value since the residual claim to underlying assets of the corporation has not changed. This is so even when it occurs in the context of a significant corporate restructuring.

In *Gelles v. TDA Industries, Inc.*, n60 plaintiff sought to recover under Exchange Act Section 10(b) and SEC Rule 10b-5 for alleged deception in connection with exchanges of shares with a shell corporation to effectuate a change of control as part of a "going private" scenario. Plaintiff alleged he was induced to agree to the transactions in reliance upon misrepresentations and claimed that the exchanges of shares amount to sales so as to confer standing to sue under the Exchange Act antifraud provisions. Affirming dismissal of plaintiff's claims, the Second Circuit found, among other things:

Neither of these exchanges modified the underlying assets upon which Gelles relied for the residual claim to which he was entitled through his shares. The only effect of the exchanges was to alter the insiders' voting power with respect to TDA Gelles held literally the exact same shares before and after the transaction... . n61

As a general matter, the U.S. Supreme Court has held that an exchange of shares in a merger qualifies as a purchase or sale of the securities for purposes of securities law antifraud provisions when shareholders become shareholders in a new company. n62 The essential question in exchange scenarios, however, is whether there has been a fundamental change in the nature of the investment or in the investment risks.

Where a shareholder vote for approval of a transaction involving an exchange of securities is required, one may speak of an investment decision being made. n63 However, it is the effect of the transaction that ultimately controls. If a security that is originally purchased by an investor provides for modification of its terms, the later modification would not constitute a "sale" since no alteration of rights occurs. However, if the provision for subsequent modification is made subject to a vote of holders, the situation takes on the attributes of a sale in the decision to make the modification. n64 Once again, the notion of a "vested" or contract right emerges. An agreement providing for the conversion of preferred stock to common stock, for example, has been held to be a purchase or sale of the common shares by reason of the contract right to acquire them. n65

In any event, where holders are asked to surrender a right or privilege by way of a charter amendment or otherwise, a "sale" will be found. Suppose, for example, that X Corporation purchases the assets of Y Corporation and guarantees the bonds of Y Corporation in consideration for a reduction in the interest rate of the bonds. The alteration in terms of

the bonds, effectively, would create a new security in the hands of Y Corporation holders. The newly guaranteed bonds would be exchanged for the old ones. Similarly, if the terms of a class of preferred stock are modified to eliminate the right to accumulated dividends or the right to elect a majority of the board of directors, the reality is that holders have a new class of stock and a "sale" occurs. In this context, the notion of "value" in Section 2(3) appears to be akin to *consideration*. Thus, in *United States v. Riedel*, the court observed: "[O]ne may sell a security and be paid therefor in cash, or in another security, or in any other object of value such as a house, a horse, etc." n66

If an exchange of securities is deemed to be a "sale," it may nevertheless be exempted from the registration (but not antifraud) provisions of the Securities Act. Of particular importance in this connection is the exemption afforded by Section 3(a)(9) of the Securities Act n67 and, to a lesser extent, that in Section 3(a)(10). n68

[6] Warrants and Rights; Conversion Privileges

By definition, warrants and rights, which represent the right to acquire a security, are themselves securities. A convertible security is one convertible into another, usually on set terms, as, for example, with debentures convertible into common stock at a fixed "conversion" price.

Under Section 2(3), the distribution of warrants or rights will not constitute a "sale" unless there is a disposition for value. However, any examination of rights must also include the related or underlying security. If a form of right is immediately exercisable or, in the case of a convertible security, the conversion privilege is immediately exercisable, the distribution of the right or convertible security constitutes an "offer" or "sale" of the *underlying* security. n69 The fact that the distribution of the right was not itself a disposition for value is of no consequence. In the absence of an exemption, the distribution of the underlying security brought about by the distribution of rights or another convertible security must be carried out in compliance with the registration provisions of the Securities Act. n70

Where a form of right, or a convertibility feature, is not exercisable until a future date, the entire regulatory focus is on the right itself for determining the presence of "value." Obviously, if shareholders pay to acquire the right, as in the familiar "rights offering" context, there is a sale. On the other hand, if warrants or rights are distributed as a "bonus" or dividend to existing shareholders, there is no disposition for value, and thus no sale. n71

As a caveat on "no value" distributions of warrants or rights to acquire securities, *Diskin v. Lomasney & Co.* n72 makes clear that the exclusion from the Section 2(3) definition of sale will not be applied to allow circumvention of the protections of the Securities Act in circumstances where those protections are intended to apply:

Manifestly, Congress did not intend that a sale of a few shares of a registered security ... should enable a dealer to offer the purchaser the "right to subscribe" to thousands of shares of some gamy unregistered issue without conforming with the requirements of the statute -- thereby opening not a mere hole but a large sluice in the protection the Securities Act was intended to afford. The exclusion must be read as limited to rights or privileges embodied in or annexed to the security itself. For example, if a corporation issued bonds together with rights, not immediately exercisable, for common stock of the corporation. ... n73

[7] Employee Benefit Plans and Related Distributions

International Brotherhood of Teamsters v. Daniel n74 set the stage for determining not only when an interest in an employee benefit plan may itself be deemed to be a security but also for assessing the investment characteristics of benefit plans generally, including those providing for employee stock ownership. These plans take many forms, but all involve the distribution of shares of the employer's stock either directly to an employee or indirectly for the employee's account or benefit. If such a distribution of stock constitutes a "sale," the regulatory mechanisms of the Securities Act are brought to bear on the plan.

A significant aspect of the Supreme Court's analysis in *Daniel* was the assessment of whether any "tangible and definable consideration" had been given for the interest in the non-contributory pension plan that was alleged in the case to be a security. The employee contended that, in effect, he had given his labor as "value" in exchange for his interest in the plan. But the Court observed: "Only in the most abstract sense may it be said that an employee exchanges some portion of his labor in return for the possible benefits. He surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security." n75

The principle enunciated in *Daniel* is extremely important in the assessment of stock distributions to employees. For purposes of defining "sale," it is clear after *Daniel* that an employee does not *by her labor alone* give value in exchange for stock distributed by the employer. Thus, where stock is distributed as a bonus, no "sale" takes place. n76 However, where the focus of stock distributions to employees changes from a bonus plan to incentive *compensation*, the result can be different.

Stock distributed to certain employees in lieu of a cash payment may be deemed to be a sale of the stock. n77 Provision for an investment-oriented "election" by an employee to receive shares is not unlike providing for a previously declared cash dividend to subsequently be taken in stock, the essential point being that the recipient has seen a pre-existing right altered. n78

Moreover, if a stock bonus is awarded only to certain individuals, the transactions suggest individual bargaining and, thus, the possibility of individual consideration. An employment agreement explicitly exchanging one's services for stock options constitutes a sale of those options so as to trigger antifraud remedies. n79 And even though incentive stock options are granted to employees for no direct payments, exchanging services in return for them constitutes a sale within the meaning of securities law definitions, and standing requirements imposed as a matter of law. n80

Decisions holding that a security is sold in these circumstances are based on the notion that a *quid pro quo* is offered to induce one to enter into employment, or to change employment status in return for bargained-for individually compensation. However, an existing employee, who remains as an at-will employee with the same responsibilities and compensation, is not a purchaser. n81 For a sale to be present in any of these circumstances there must be some investment decision. The "no sale" doctrine applied by courts presumes that employees give up no specific consideration or added value in return for a separable financial interest with the characteristics of a security. n82

Employee *purchase* plans, by definition, involve a sale of stock and necessitate compliance with the registration mechanisms of the Securities Act in the absence of an exemption *if* the employer/issuer is deemed to be soliciting or making the "sale." Payroll deduction plans for the purchase of a company's stock may not be deemed to be a sale by the company where the focus of the plan is open market acquisition of shares, the company has only ministerial involvement in the operation of the plan, and purchases are handled by an independent broker or other agent of the *employees*. n83

Employee Stock Ownership Plans ("ESOPs") and other benefit plans built around contributions of the employer's stock or, in some instances, cash used to purchase the company's stock generally do not involve "sales" given the absence of any investment decision by the employee beneficiaries. n84 If the plan is *contributory*, or if employees otherwise must make an investment decision in the conversion of another plan into an ESOP, a "sale" will occur. The process of converting a non-contributory plan in which employees are given a choice between investing their funds in a new plan or receiving the funds or benefits from the old one has been deemed to involve a sale. In these circumstances, where employees are given a choice in the matter, they have the opportunity to make an investment decision and the essential element of a sale is presented. n85

Consideration of employee benefit plans illustrates the breadth of the Section 2(3) definition. Securities Act protections are triggered by any attempt to dispose of a security for value. A solicitation of an offer to buy a security is an "offer for

sale" under Section 2(3). The establishment of a "benefit" plan, and the manner of its operation, may be deemed to be that solicitation, and it is important from the employer's perspective to disengage from any role in the operation of a plan that is anything more than ministerial. Recognizing that some participation by the employer company or an affiliate will exist in almost every such plan, the SEC Staff has instructed that whether or not a sale is involved will turn upon the degree and type of participation by such persons in the particular program. Circumstances under which an employer's involvement in a stock purchase plan would be considered sufficiently limited so as *not* to trigger the registration requirement by reason of a solicitation of an offer to buy have been articulated as follows:

- (1) The employer company or an affiliate announces the existence of the plan.
- (2) The employer company makes payroll deductions at the request of employees for the purpose of participating in the plan.
- (3) The names and addresses of employees are made available to the broker or other agent for direct communications by it to such employees regarding the plan. This may take the form of addressing the communication to be sent by the broker or other agent, the inclusion of the broker's communication with the announcement by the employer company, or the holding of an initial meeting of employees at the company's premises.
- (4) The employer company or an affiliate pays no more than its expenses of payroll deductions and the reasonable fees and charges of the broker or other agent for brokerage commissions and bookkeeping and custodial expenses. n86 To these prescriptions, the SEC subsequently added two more:
- (5) The plan should be limited solely to employees, franchisees, and independent sales representatives who have essentially the same degree of access to information regarding the company as do its employees; and
- (6) The employer must not make contributions to the plan to defray the cost of the stock or lend money to employees to facilitate the stock purchase, except where an employee elects to supplement his personal contributions to the plan with his portion of profits distributable from the employer's profit-sharing plan. n87

In the post-*Daniel* era, the principal regulatory focus under the Securities Act relating to distributions of employer stock is upon the contributory or noncontributory form of a plan. Where an employee is offered the opportunity to purchase stock and that employee gives value to make the purchase, the concerns for investor protection which underlie the Securities Act are no less than in any other setting. *Daniel* has simply brought about a more precise focus on what it is that the Securities Act protects, that is, an investment decision. An involuntary and noncontributory plan does not involve that investment decision. *Daniel* teaches that the securities laws have a role that is limited, at best, in the field of employee benefits. A pension plan can involve an "investment" decision but not necessarily the type of decision the securities laws are intended to protect. n88 On the other hand, stock ownership programs present a true investment setting.

Equity-Based Compensation. Equity-based compensation awards by employer-issuers have also been evaluated in the context of Securities Act section 2(a)(3) as to whether a sale or an offer to sell securities is involved. In No-Action Letters the SEC Staff has confirmed "no sale" in connection with equity-based awards to employees in the form of restricted stock units when no investment decision is required by the employee recipient. n89 In *Verint Systems, Inc.*, n90 for example, the Staff agreed not to recommend enforcement action if an issuer awarded restricted stock units and deferred stock to its non-management employees without registration. The company proposed to award these grants to a broad group of employees for compensatory purposes. No employee was required to surrender cash, securities or any other property in exchange for the award, or to enter into any agreement or covenant in exchange for the award. There

was, however, a forfeiture provision relating to continued employment. The grants would vest based on the passage of time. In granting no-action advice, the Staff agreed with the company's view that recipients of the grants would not be making any investment decision, would not be providing any value to the company in return, and would have no control over vesting other than in connection with termination of employment. n91

For any plans that do involve "sales" of employer stock, one or more exemptions from registration under the Securities Act may be available under Sections 3 and 4. n92 Regardless of whether registration is required, the antifraud provisions will apply.

[8] Spin-offs and the "Shell" Game: The Instant Public Market

The occurrence of a "sale" is a trigger for Securities Act compliance responsibilities. The registration and prospectus delivery mechanisms of Section 5 of the Securities Act assure the availability of information on which investment decisions may be made and the opportunity to use that information in making them. The public distribution of securities may not take place without compliance with Section 5 unless the circumstances demonstrate that there is no need for the registration procedures, in which case an exemption would be available. Where required, the burden of compliance with Section 5 is substantial.

Since the applicability of the Securities Act is not triggered except by an attempt to dispose of a security *for value*, efforts to publicly distribute securities, i.e., create a public market, have involved utilization of what are ostensibly no-value distributions of stock to shareholders of dormant or "shell" corporations. The process has most often involved the acquisition of a controlling interest in such a shell corporation (having "public" shareholders) followed by a merger of a privately-held company into a subsidiary of the shell. The shell then distributes the shares of the subsidiary to its shareholders as a dividend in kind, thus "spinning-off" the shares and placing them in the hands of the investing public without Securities Act compliance. Control of the newly "public" company remains with those in control of the shell by virtue of the prior controlling interest in the private company.

The key to the so-called "shell game" is the disposition of shares, via the dividend, for no value. A corporate spin-off through the use of a stock dividend or dividend in kind does not, ordinarily, constitute a "sale" of the securities involved. There is no transfer of value by the recipient shareholder. However, use of the dividend as a device for circumvention of the Securities Act in circumstances unquestionably demonstrating the need for investor protection prompted strong regulatory and judicial responses that added a new dimension to the concept of "value" for purposes of Section 2(3).

In *SEC v. Harwyn Industries Corp.*, n93 a company spun-off four subsidiaries in consummation of arrangements under which individuals had acquired control of the subsidiaries. The stock of the subsidiaries was all spun-off to "public" shareholders of Harwyn, a corporate "shell." The result was a public trading market in the shares of each of the former privately-held companies. Similarly, in *SEC v. Datronics Engineers Inc.*, n94 the spin-off of nine newly created subsidiaries of a shell corporation resulted in the formerly private companies becoming public ones entirely outside the mechanisms of the Securities Act. In both cases, the results were defended as involving only stock dividends -- a "change in the form of ownership." It was clear in both cases that the recipient shareholders had not themselves given anything in exchange for what they received. It was also clear that there was no independent business purpose for the spin-offs and that they were undertaken solely as devices to create public trading markets for the stock of the spun-off companies.

The nature of the stock dividends notwithstanding, the courts in both cases found requisite value to hold the distributions to be unlawful sales of securities. The value flowed to those distributing the securities, and came not from the recipient shareholders, as the result of the scheme by: (1) creating a trading market for securities where none existed; (2) by making it easier for those retaining control to have access to and obtain financing; and (3) by saving the expense associated with Securities Act compliance. In short, these courts found value *somewhere* in the setting to be

sufficient for making a disposition of securities into a "sale."

In a 1969 release addressing the concerns for investor protection in spin-off distributions of securities through inactive or shell corporations, the SEC warned that such devices contravene the purpose and specific provisions of the Securities Act. n95 The Commission emphasized that the focus in these transactions must be upon the entire process; that is, beyond the distribution of the securities to recipients of the "dividend" lies the *redistribution* in the trading markets that is the real objective of the plan. It is this point that destroys supposed reasoning that no investment decision, and no consequent need for protection, is involved. The Commission observed:

This reasoning fails ... to take into account that there is a sale by the issuer and the distribution thereafter does not cease at the point of receipt by the initial distributees of the shares but continues into the trading market involving sales to the investing public at large. Moreover, it ignores what appears to be primarily the purpose of the spin-off in numerous circumstances which is to create quickly, and without the disclosure required by registration, a trading market in the shares of the issuer. n96

The motivation for the spin-off takes on much importance. The Commission made it clear that "conventional" spin-offs, which "do not involve a process of purchase of securities by a publicly-owned company followed by their spin-off and redistribution in the trading markets," are not the focus of concern. n97

The role of market professionals was emphasized as a principal line of defense against improper spin-off distributions:

The activities discussed above generally can only be successfully accomplished through the efforts of brokers and dealers. Accordingly, brokers and dealers are cautioned to be particularly mindful of their obligations under the registration and antifraud provisions of the Federal securities laws with respect to effecting transactions in such securities. In this connection, where a broker or dealer receives an order to sell securities of a little-known, inactive issuer, or one with respect to which there is no current information available except possibly unfounded rumors, care must be taken to obtain sufficient information about the issuer and the person desirous of effecting the trade in order to be reasonably assured that the proposed transaction complies with the applicable requirements. Moreover, before a broker or dealer induces or solicits a transaction he should make diligent inquiry concerning the issuer, in order to form a reasonable belief for his recommendation, and fully inform his customers of the information so obtained. ... n98

[9] When a "Sale" Occurs

In the context of Securities Act Section 5 compliance issues, the question of when an actual sale occurs is not particularly meaningful. Compliance responsibilities under the registration and prospectus delivery provisions of the Securities Act are triggered by an "attempt to dispose," or a disposition, of a security for value, whenever that may be. However, for purposes of civil liability to purchasers under Section 12(a)(1) of the Securities Act for violations of the registration and prospectus delivery provisions of Section 5, and Section 12(a)(2), the general antifraud provision, determination of when a sale occurs often becomes critical in assessing the scope of liability. In *Westinghouse Electric Corp. v. "21" International Holdings, Inc.*, n99 for example, asserted liability under former Section 12(2) for information failures was countered with the contention that disclosures or omissions on which the claims were based occurred after the securities were "sold." Defining sale in terms of the "commitment theory," defendants in the case urged that no liability could attach to alleged misstatements and omissions made after the plaintiff's investment decision and irrevocable commitment to the transaction. Plaintiff argued that the "sale" did not occur until closing, until which time it had the opportunity to back out of the transaction. On a motion for summary judgment, plaintiffs persuaded the court that there was sufficient evidence of an opportunity to "re-commit" to the transaction based upon a later disclosure document; thus, the Section 12(2) claim was deemed viable for trial. The case illustrates the fundamental role played by the Section 2(3) definition in setting parameters for liability wholly apart from the Section 5 registration and prospectus

delivery compliance environment. n100

As noted earlier, the "sale" definition also operates to control the scope of civil liability under both Sections 12(a)(1) and 12(a)(2) through the express statute of limitations for those private rights of action prescribed by Section 13, which is keyed to the "violation." n101 In that analysis, the definition of a sale has been interpreted to mean "any integral stage" of the sale including, for example, the remittance of funds for the purchase or the mailing of a confirmation of purchase. n102

In all Securities Act liability and compliance analyses, the nature and scope of a "sale" must be evaluated in varying contexts involving such things as "conditional" sales, installment payments of purchase consideration, continuing capital contributions, capital "calls," "stand-by" commitments, or deferred payments pursuant to notes. In these analyses, the question generally is not whether a sale has occurred but, rather, whether it is completed or whether any new transaction has occurred. n103 There is no clear guidance in the case law. However, it is certain that the scope of the term is interpreted no less broadly than in the basic definitional context and that courts look to applications that will best effectuate investor protection by looking to determine whether any new investment decision is involved.

It is clear that a contract or agreement to purchase a security constitutes a sale of that security under the statutory definition. An agreement to make an investment by purchasing stock to be issued involves no less an investment decision than the transaction itself. n104 However, in the context of negotiations for a transaction, a *letter of intent* is not an agreement or contract for a sale within the ambit of the Securities Act where it does not bind a party to a proposed transaction. n105

FOOTNOTES:

(n1)Footnote 1. As discussed further below, liability under antifraud provisions and civil remedies of the Securities Act is generally dependent upon one being characterized as a "seller" of securities in a transaction involving an information failure. The definition of "seller" for purposes of civil liability has evolved through case law, and is considered in detail in Chapter 9--Civil Liabilities *infra*. However, the elements of a "sale," as discussed here, are extremely useful in understanding the scope of "seller" liability generally.

(n2)Footnote 2. 159 Wn 2d 837, 154 P.3d 206 (2007) .

(n3)Footnote 3. *Id.*, 159 Wn. 2d at 845 (emphasis by the Court).

(n4)Footnote 4. The definition of "sale" under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume A, Section B § 3(a)(14) does not include the "for value" qualifier, nor does it include "offer to sell," "offer," or "offer for sale" expressly within the definition, leading some courts to conclude that the definition is more liberal and that no consideration is necessary for either a purchase or sale to occur. *See, e.g., Rathborne v. Rathborne*, 683 F.2d 914, 920 (5th Cir. 1982) ; *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 281 (2d Cir. 1975) ; but see *Lawrence v. SEC*, 398 F.2d 276 (1st Cir. 1968) (no reason to believe that Congress intended to dilute the meaning of the term in the Exchange Act). Still, where standing to invoke Exchange Act antifraud protections is predicated on one being either a purchaser or seller, a "value" focus is inescapable. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975) . *See, e.g., Carter v. Signode Indus., Inc.*, 694 F. Supp. 493 (N.D. Ill. 1988) (plaintiff's standing to sue predicated upon giving up "something of appraisable value" to participate in a general investment fund or purchase a guaranteed investment contract).

(n5)Footnote 5. *American Brewing Co.*, 1999 SEC No-Act. LEXIS 87 (Jan.27, 1999) ("Free" share of non-voting common stock for each case of issuer's beer purchased at retail would constitute a sale).

(n6)Footnote 6. In *Vanderkam & Sanders*, 1999 SEC No-Act. LEXIS 96 (Jan. 27, 1999) , for example, a company proposal to operate and maintain an internet-based auto referral service in which shares of the company's common stock would be issued to any person who registered on the site was viewed by the SEC staff as an event of sale. There was no

cash, property or services required to receive shares of the stock, which, when issued, would have been uncertificated and non-transferable. However, the company proposed to issue additional shares in exchange for referrals of others to its web site. The SEC staff was satisfied that the issuance of the shares in consideration of registration on or visit to the web site constituted a sale, and declined no-action advice that the company could proceed without compliance with the registration provisions of the Securities Act.

See also Andrew Jones, 1999 SEC No-Act. LEXIS 555 (June 8, 1999) (Issuance of non-transferable free shares of common stock to the first one million people registering on a linked web site, and additional shares to persons who refer others to the web site would constitute an event of sale whether or not the distribution was through the issuer's web site).

(n7)Footnote 7. *See* Section 2.02[1] *infra*.

(n8)Footnote 8. Even assuming the existence of a "sale" or "offer to sell," the security in question may be exempted from the registration and prospectus delivery requirements of Section 5 of the Securities Act, reprinted in the Primary Law Sourcebook, Volume A, Section B under § 3 ("Exempted Securities"), or the transaction may be one exempted from coverage under § 4 ("Exempted Transactions"). These exemptions are considered elsewhere in the text. *See* § 3.01 *infra* and § 4.01 *infra* . In addition, the definition of "sale" and "offer to sell" for purposes of specific Securities Act § 5 considerations and processes (prefiling period, "waiting period," etc.), is given separate and detailed treatment in that part of the text dealing with the registration process. *See* §§ 7A.03 and 7A.04 *infra* .

(n9)Footnote 9. *See* §§ 9.03[5] and 9.04[5] *infra* for discussion of the scope of "seller" liability under §§ 12(1) and 12(2) of the Securities Act. Section 17(a) is considered further in § 9.06 *infra* .

(n10)Footnote 10. 441 U.S. 768, 773, 99 S. Ct. 2077, 2081, 60 L. Ed. 2d 624, 629 (1979) (citations omitted); *see also* *Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) . In *Pinter*, the Supreme Court considered the scope of "seller" liability under Securities Act § 12 as including persons who actively solicit a buyer.

(n11)Footnote 11. *Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151 (S.D. Tex. 1989) ; *Hocking v. DuBois*, 885 F.2d 1449 (9th Cir. 1989) , *cert. denied*, 494 U.S. 1078 (1990) (the term "offer" has a far different and far broader meaning in securities law than in contract law); *Raiford v. BusLease, Inc.*, 825 F.2d 351 (11th Cir. 1987) . *See also* *Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) . In *Pinter*, the Supreme Court observed that the statutory definitions of "sale" and "sell" are expansive and intended to encompass the entire selling process.

For consideration of what constitutes an "attempt to dispose" of a security in the specific context of registration statement and prospectus delivery requirements of § 5 of the Securities Act, particularly as related to the prefiling period of the registration process, and the problem of "gunjumping" generally, *see* § 7A.02[2] *infra*.

(n12)Footnote 12. 376 F. Supp. 1154 (S.D.N.Y. 1974) .

(n13)Footnote 13. *Id.* at 1179-82 ; *see also* *Gelles v. TDA Indus., Inc.*, (2d Cir. 1994) (court must decide whether there has occurred such a significant change in the nature of the investment or in the investment risks as to amount to a new investment).

(n14)Footnote 14. 568 F.2d 862 (2d Cir. 1977) . *See also* *Panos v. Island Gem Enterprises, Ltd., N.V.*, 880 F. Supp. 169 (S.D.N.Y. 1995) (amendments to rental pool disbursement terms did not significantly change the nature of the investment).

(n15)Footnote 15. *See* *Gurvitz v. Bregman & Co.*, 379 F. Supp. 1283 (S.D.N.Y. 1974) .

(n16)Footnote 16. *See* § 2.02[7] *infra*.

(n17)Footnote 17. 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) .

(n18)Footnote 18. *See also SEC v. Follick*, 2002 U.S. Dist. LEXIS 24112 (S.D.N.Y. 2002) (Evidence showed that broker participated in a fraudulent scheme and acted with *scienter* even though he did not actually solicit any of the subject transactions).

See also Daniels v. Blount Parrish & Company, Inc., 308 F.Supp. 2d 886 (N.D. Ill. 2004) (Underwriter sold securities only to dealers and not to plaintiffs); *Starr v. They, Inc.*, 2003 U.S. Dist. LEXIS 8698 (N.D. Ill. 2003) , (Corporate officers did not engage in solicitation or sale of securities to plaintiffs); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854 (5th Cir. 2003) (Corporate officers who signed a registration statement but did not solicit sales were not sellers).

(n19)Footnote 19. *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972) ; *see also Goodman v. Epstein*, 582 F.2d 388, 410-14 (7th Cir. 1978) ; *Adams v. Cavanaugh Communities Corp.*, 847 F. Supp. 1390, 1402 (N.D. Ill. 1994) .

(n20)Footnote 20. *See § 2.02[8] infra.*

(n21)Footnote 21. *Portnoy v. Memorex Corp.*, 667 F.2d 1281 (9th Cir. 1982) ; *Pollution Research & Control Corp.*, 1971 SEC No-Act. LEXIS 3687 (Oct. 5, 1971) .

A bona fide gift presumes that nothing has been given up by the recipient. Stock "given" to automobile dealers would be deemed to constitute a sale of the stock where it was issued as an inducement by an insurance company to dealers to sell insurance policies that are reinsured through the insurance company. *Gulf Capital Life Ins. Co.*, 1982 SEC No-Act. LEXIS 2639 (Div. Corp. Fin. 1982) .

See also Ocean Express Seafood Restaurants, Inc., 19 Sec. Reg. & L. Rep. (BNA) 537 (Div. Corp. Fin. 1987) (issuer's one time gift of stock to friends and business associates of the issuer's founder would not be a sale triggering registration requirements of the Securities Act).

(n22)Footnote 22. *Mundy Gen. Inc.*, 1978 SEC No-Act. LEXIS 1367 (May 11, 1978) .

(n23)Footnote 23. *In re Offering of Securities by Wade Bruce Cook, Ariz. Corp.* Comm. Dec. No. 56492, Blue Sky L. Rep. (CCH) P 72,976 (1989).

(n24)Footnote 24. *In re Strack Sec. Serv. Corp.*, Pa. Sec. Comm. Dkt. No. 8812-25, Blue Sky L. Rep. (CCH) P 72,979 (1989).

The transfer of shares of stock as either "boot" or a commission for a real estate transaction has been held to be the sale of the securities for value where they were given or delivered with the purchase of another thing offered and sold for value. *Dean v. Humphries*, Blue Sky L. Rep. (CCH) P 73,026 (Idaho 1989).

(n25)Footnote 25. 777 P.2d 494 (Utah App. 1989) .

(n26)Footnote 26. *In re Capital General Corp.*, Sec. Act Rel. No. 7008, 1993 SEC LEXIS 1880 (1993) .

Ostensibly valueless dispositions of stock for the purpose of establishing a body of public shareholders, and thus creating a trading market, are considered further in § 2.02[7] *infra* .

(n27)Footnote 27. *See, e.g., In re Joe Loofbourrow*, Sec. Act Rel. No. 7700, 1999 SEC LEXIS 1419 (July 21, 1999) ; *In re Web Works Marketing.Com, Inc.*, Sec. Act Rel. No. 7703, 1999 SEC LEXIS 1424 (July 21, 1999) .

(n28)Footnote 28. *See notes 3-4, supra.*

See also Simplystocks.com, SEC No Action Letter (Feb. 4, 1999); WowAuction.com, Inc., Sec. Act Rel. No.7702, 1999 SEC LEXIS 1420 (July 21, 1999) ; Sotirakis, Sec. Act Rel. No. 7701, 1999 SEC LEXIS 1414 (July 21, 1999) .

(n29)Footnote 29. The SEC has raised no objection to issuance of "free" shares to persons who register on web sites, or who refer others to register, where the stock involved is distributed pursuant to a registration statement filed under the Securities Act. See DoctorSurf.com, Inc., registration statement filed on EDGAR, available on the Internet at HYPERLINK <http://www.sec.gov> and YouNetwork Corp. registration statement, filed on EDGAR, and available at the same web site.

(n30)Footnote 30. Solid State Scientific Devices Corp., 1971 SEC No-Act. LEXIS 3082 (Div. Corp. Fin. 1971) .

(n31)Footnote 31. "This [bonus portion of § 2(3)] means, for example, that a package transaction which includes the sale of a horse for \$100 and a gift of a security to the purchaser nevertheless constitutes an offer and sale of the security for value within the meaning of the Securities Act of 1933." *SEC v. Addison*, 194 F. Supp. 709, 722 (N.D. Tex. 1961) . But stock given as a bonus to employees may or may not involve a "sale." See discussion under "Employee Participation Plans," § 2.02[b][6] *infra* .

See also *Lawrence v. SEC*, 398 F.2d 276, 280 (1st Cir. 1968) ; *Diskin v. Lomasney & Co.*, 452 F.2d 871 (2d Cir. 1971) .

(n32)Footnote 32. MCA Inc., 1992 SEC No-Act. LEXIS 678 (May 26, 1992) .

(n33)Footnote 33. 1998 U.S. Dist. LEXIS 11512 (E.D. Pa. 1998) .

(n34)Footnote 34. But see *Beebe v. Compaq Computer Corp.*, 940 S.W.2d 304 (Tex. App. 1997) (No investment decision, and thus no sale, possible when plaintiffs' employment terminated with them holding options that never vested).

(n35)Footnote 35. "The House provision exempting stock dividends ... is omitted from the substitute [bill], since stock dividends are exempt without express provision, as they do not constitute a sale, not being given for value." H.R. Rep. No. 152, reprinted in the Primary Law Sourcebook, Volume A, Section E of the 1933 Act, 73d Cong., 1st Sess. 25 (1933).

Gurvitz v. Bregman & Co., 379 F. Supp. 1283 (S.D.N.Y. 1974) (a stock split is simply the distribution of two more pieces of paper for one, and does not involve a "sale" under the Securities Act).

(n36)Footnote 36. Sec. Act Rel. No. 929, 1936 SEC LEXIS 395 (July 29, 1936) .

See also *J DN Realty Corp.*, 1999 SEC No-Act. LEXIS 858 (Oct. 26, 1999) (Dividend declaration allowing election of payment in securities or cash does not constitute a sale).

A stock dividend undertaken to effect a "spin-off" of a subsidiary by a parent corporation of the stock of a subsidiary does not constitute a sale of the stock. See, e.g., *Employers Ins. Co.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) P 76,782 (Div. Corp. Fin. 1982). However, spin-offs designed to create a public market in securities in circumvention of the protections of the Securities Act are treated much differently. These "Shell-game" transactions are discussed in § 2.02[7] *infra*.

(n37)Footnote 37. Sec. Act Rel. No. 929 , *supra*.

See also *CNA Income Shares Inc.*, 1977 SEC No-Act. LEXIS 2978 (Oct. 31, 1977) ; *Harwood Cos.*, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2024 (Feb. 15, 1983) . No "sale" would occur in corporate action offering shareholders alternative rights, after a merger transaction, to tender their shares for cash or to retain their shares and

receive additional shares. The decision put to shareholders was not whether to buy a security but rather a decision to sell. The waiver of a right to receive cash by electing to remain a shareholder does not represent value.

(n38)Footnote 38. *See Ahern v. Gaussoin*, 611 F. Supp. 1465, 1478 (D.Or. 1985) .

(n39)Footnote 39. 136 F.3d 531 (7th Cir.) , cert. denied, 525 U.S. 920 (1998) .

(n40)Footnote 40. 136 F.3d at 534 .

(n41)Footnote 41. *See* Sec. Act Rel. No. 4790, 1965 SEC LEXIS 17 (July 13, 1965) ; Sec. Act Rel. No. 5515, 1974 SEC LEXIS 2946 (Aug. 8, 1974) .

See also Fractional Shares Repurchase Program, 1992 SEC No-Act. LEXIS 908 (Aug. 24, 1992) (sales of stock on behalf of participants in a fractional share repurchase program would not constitute a "sale" by the issuer for purposes of § 5 of the Securities Act where the issuer's role is de minimis and the program is conducted by an outside manager acting as agent for the shareholders).

See also First Arkansas Bankstock Corp., 1971 SEC No-Act. LEXIS 2481 (Div. Corp. Fin 1971) (degree of participation or administration by the corporation is a key consideration).

(n42)Footnote 42. General Motors Corp., 1972 SEC No-Act. LEXIS 4492 (May 10, 1972) . A statutory "underwriter" is defined in § 2(11) of the Securities Act as including any person who "participates or has a direct or indirect participation" in the distribution of a security, as well as any person who offers or sells for an issuer in connection with any distribution of a security. The presence of an "underwriter" is indicative of a distribution of securities and triggers the registration and prospectus delivery process under § 5. The concept of a statutory "underwriter" and its impact are discussed in § 7A.01[2][c] *infra*.

(n43)Footnote 43. J.P. Morgan & Co., Inc., 1971 SEC No-Act. LEXIS 3535 (Sept. 22, 1971) .

See also J.P. Morgan & Co., Inc., 1972 SEC No-Act. LEXIS 2426 (June 22, 1972) (addition to plan of cash contribution feature not subject to registration).

(n44)Footnote 44. *See* Walt Disney Prods., 1981 SEC No-Act. LEXIS 2796 (Dec. 3, 1980) (a dividend reinvestment plan modified to allow non-shareholders to become shareholders through the plan by delivering funds to purchase shares would be an "offer to sell").

But see Hannaford Bros. Co., 1981 SEC No-Act. LEXIS 4396 (Nov. 16, 1981) (plan to allow non-shareholder employees to become shareholders through limited purchases of shares through the company's dividend reinvestment plan would not constitute a "sale" under § 2(3)); McDonalds Corp., 1985 SEC No-Act. LEXIS 2684 4 (Aug. 13, 1985) (corporation plan could include franchisees, their employees, and proposed IRA accounts).

(n45)Footnote 45. *See, e.g.,* Triad Guaranty, Inc., 2005 SEC No-Act. LEXIS 686 (Aug. 22, 2005) (Liquidation of a subsidiary followed by pro rata distribution of new shares in the reorganized company would not constitute a sale of the new shares).

(n46)Footnote 46. *See* Jaymark, Inc., 2000 SEC No-Act. LEXIS 747 (Available July 21, 2000) ; TB & C BancShares, Inc., 2001 SEC No-Act LEXIS 664 (Available July 25, 2001) .

(n47)Footnote 47. "Value" considerations in additional types of reorganizing transactions or exchanges of securities are discussed further in § 2.02[5], "Changes in Securities Provisions; Exchanges of Securities," *infra*.

(n48)Footnote 48. 449 U.S. 424, 101 S. Ct. 698, 66 L. Ed. 2d 633 (1981) .

(n49)Footnote 49. Section 17(a), a general antifraud provision, is discussed in § 10.01[2] *infra*. In *Rubin*, the Government asserted violations of § 10(b) of the Exchange Act, along with SEC Rule 10b-5, and § 17(a). A "sale" is a necessary element of all of the antifraud provisions.

(n50)Footnote 50. 449 U.S. at 431, 101 S. Ct. at 702, 66 L. Ed. 2d at 639 .

See also *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.) , cert. denied, 469 U.S. 884 (1984) (pledge of stock as guarantee for a loan was a sale); *Harmsen v. Smith*, 693 F.2d 932 (9th Cir. 1982) (pledge of shares held to be a sale); *Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981) (note secured by one-half of company stock involved a sale).

In *United States v. Kendrick*, 692 F.2d 1262 (9th Cir. 1982) , the pledge of securities to a broker-dealer as collateral for margin borrowing by a customer was held to be a sale of the securities. The court analyzed the "value" element of the situation as follows:

It was not the fact that the securities were in the possession of Dean Witter that gave Dean Witter an interest in them. It was the fact that they were subjected as collateral to the new loans and that Dean Witter thereby acquired an interest in them in an amount equal to the amounts loaned. There was testimony ... that in issuing the checks drawn on the margin accounts Dean Witter engaged in an investment decision as to whether the stocks it already held were sufficient to cover its loss should the borrower default. Dean Witter gained an additional interest in the collateral as a result of the loans. When that interest was created, the "sale" occurred.

The issue of whether a pledge of securities to secure a loan is a security is separate from the question of whether a note given in a loan transaction may be deemed to be a security. Notes given for loans may be deemed to be securities, and the giving of a note in such a transaction is a "sale." See *SEC v. Addison*, 194 F. Supp. 709 (N.D. Tex. 1961) ("The giving of personal loan notes ... constitutes sales of securities because ... it amounts to a disposition or giving of a security for value"). Similarly, the exchange of securities in satisfaction of a debt is a sale. The release of the obligation represents "value" given. See *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1955) .

(n51)Footnote 51. See *SEC v. Guild Films Co., Inc.*, 279 F.2d 485 (2d Cir.) , cert. denied, 364 U.S. 819 (1960) (bank "purchased" the stock pledged to secure a loan).

(n52)Footnote 52. The Court characterized the economic considerations and realities of a pledge transaction as similar in important respects to the risk faced by any investor when evaluating a purchase of securities. "Both are relying on the value of the securities themselves, and both must be able to depend on the representations made by the transferor of the securities, regardless of whether the transferor passes full title or only a conditional and defeasible interest to secure repayment of a loan." 449 U.S. at 431, 101 S. Ct. at 702, 66 L. Ed. 2d at 639 .

(n53)Footnote 53. See *Madison Consultants v. Federal Deposit Ins. Corp.*, 710 F.2d 57 (2d Cir. 1983) ; *Eastwood v. National Bank of Commerce*, 673 F. Supp. 1068 (W.D. Okla. 1987) .

(n54)Footnote 54. *TCF Banking & Sav., F.A. v. Arthur Young & Co.*, 706 F. Supp. 1408 (D. Minn. 1988) .

(n55)Footnote 55. *Shelter Mutual Ins. Co. v. Water Supply District No.7*, 569 F. Supp. 310 (E.D. Mo. 1983) ("Whether a pledgee can ever acquire the pledged securities is solely dependent on default by the pledgor of the commercial loan, not on any decision to invest.").

(n56)Footnote 56. See *Trust Co. of Louisiana v. N.N.P., Inc.*, 103 F.3d 1478 (5th Cir. 1997) (obtaining funds secured by a pledge of securities involves a "contract to buy, purchase or otherwise acquire" a security and the pledgee is, therefore, within the definition of purchaser for purposes of invoking antifraud remedies).

(n57)Footnote 57. *SEC v. Associated Gas & Elec. Co.*, 99 F.2d 795 (2d Cir. 1938) (decided under the Public Utility Holding Company Act's similar definition of "sale").

(n58)Footnote 58. *Carter v. Signode Indus., Inc.*, 694 F. Supp 493 (N.D. Ill 1988) (relinquishment of retirees general investment fund accounts in exchange for "guaranteed income contracts" represented a fundamental change in the nature of the investment and the risk involved).

In some cases involving exchanges of securities, the issue arises in a reverse manner, *i.e.*, whether a purchase has occurred, such that the purchaser may invoke protections under the Securities Act. *See, e.g., Ahern v. Gaussoin*, 611 F. Supp. 1465 (D. Or. 1985). The analysis is no different, except that the examination of the transaction for value focuses heavily on whether the putative purchaser has made an investment decision and whether there is a significant change in the nature of the investment or in the investment risk.

(n59)Footnote 59. *See Rathborne v. Rathborne*, 683 F.2d 914 (5th Cir. 1982). In the context of allegations under the antifraud provisions, a transfer of securities from a wholly controlled subsidiary to its parent or between two corporations wholly owned by a third does not constitute a sale (or purchase) of the securities. A stock-for-assets "trade" between the corporate entities represented a mere "transfer between corporate pockets."

See also Worldwide Energy Co., 1972 SEC No-Act. LEXIS 811 (Jan. 24, 1972) (exchange of shares pursuant to a plan of reorganization effecting a change of domicile is one of form and not substance); *Gurvitz v. Bregman & Co.*, 379 F. Supp. 1283 (S.D.N.Y. 1974) (stock split does not qualify as a sale); *cf. Sacks v. Reynolds Sec., Inc.*, 593 F.2d 1234 (D.C. Cir. 1978) (a sale involves a change in the nature of an investment); *Garner v. Enright*, 1977 U.S. Dist. LEXIS 14848 (E.D.N.Y. 1977) (a sale means a "fundamental change" in the interest of a party).

(n60)Footnote 60. (2d Cir. 1994).

(n61)Footnote 61. *Id.* at 91,333.

(n62)Footnote 62. *SEC v. National Securities, Inc.*, 393 U.S. 453, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969).

(n63)Footnote 63. Where certain forms of corporate reclassifications or reorganization transactions are involved and are submitted for shareholder approval, the former "no sale" theory of Rule 133 under the Securities Act has been discarded. Rule 145 under the Securities Act of 1933, reprinted in the Primary Law Sourcebook, Volume A, Section C, now recognizes such transactions, and the shareholder vote on which they are based involves a sale of securities for purposes of the registration provisions.

(n64)Footnote 64. *See* Securities Act Rule 145, discussed in § 7.04 *infra*.

(n65)Footnote 65. *FS Photo, Inc. v. Picturevision, Inc.*, 61 F.Supp. 2d 473 (E.D. Va. 1999).

(n66)Footnote 66. 126 F.2d 81, 83 (7th Cir. 1942).

Changes in the rights of a security holder will qualify as a sale and, conversely, a purchase by the holder, where there is such a significant change in the nature of the investment or in the investment risks as to amount to a new investment. *See Perez-Rubio v. Wyckoff*, 718 F. Supp. 217 (S.D.N.Y. 1989). However, modifications in the rights of an investor that have been anticipated by the parties have been held not to amount to a sale. *Department of Economic Dev. v. Arthur Andersen & Co.*, 683 F. Supp. 1463 (S.D.N.Y. 1988).

See also United States v. Wernes, 157 F.2d 797 (7th Cir. 1946) (offer to exchange beneficial trust certificates for limited partnership trust certificates in oil leases held to constitute a sale). *Cf.*, generally, *Hayes v. Sampson*, 1980 U.S. Dist. LEXIS 15034 (S.D.N.Y. 1980). In an action under § 16(b) of the Exchange Act, an exchange of an issuer's "old" debentures for new ones bearing a higher rate of return and longer term was *not* a sale in the absence of evidence that

the new debentures were materially more valuable, or that the continuous investment represented by the debentures had been interrupted.

(n67)Footnote 67. *See* § 3.09 *infra*.

(n68)Footnote 68. *See* § 3.10 *infra*.

(n69)Footnote 69. Section 2(3) provides in pertinent part:

[T]he issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security... or giving a right to subscribe to another security of the same issuer or of another person, which right *cannot* be exercised until some future date, shall not be deemed to be an offer or sale of such other security. ... (emphasis added).

The legislative history of this portion of § 2(3) demonstrates the intention of Congress to avoid requiring registration of securities prior to the time they are actually offered to the public. It is at the time that warrants or rights become exercisable that any investment decision--the decision to exercise a right--is made. *See* H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).

Where warrants are immediately exercisable but, for tax or other reasons, will not be exercised for a specified period of time, the Commission has taken the position that both the warrants and the underlying shares must be registered. Sec. Act Rel. No. 3210, 1947 SEC LEXIS 1422 (Apr. 9, 1947) .

(n70)Footnote 70. Sec. Act Rel. No. 3210, 1947 SEC LEXIS 1422 (Apr. 9, 1947) . Immediately exercisable transferable warrants and the underlying stock must be registered. Usually, the registration statement includes the rights to provide for the sale of those rights by controlling persons and others.

It should also be kept in mind that all of these principles apply with equal force to *conversion* privileges. Thus, an offering of preferred shares that are immediately convertible into common shares constitutes an offering of the common. Where any security is immediately convertible into another, both must be registered at the time of the offering. Sec. Act Rel. No. 4162, 1959 SEC LEXIS 353 (1959) . "A security which is immediately convertible consists of the convertible security and a right to acquire the underlying security, thus involving a continuous offering by the issuer of the underlying security. ..." *Id.* Where a conversion cannot be effected until a date subsequent to the offering of the convertible security, there is no sale until that time. Whether registration is required at the time of conversion is considered in § 6B.02[4][d][ii] *infra* .

(n71)Footnote 71. *See* Registration of Rights Issuable Pursuant to Stockholder Rights Plans, SEC Interpretive Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,411 (Jan. 7, 1987). The staff opined that rights issued to shareholders which involve substantially "out-of-the money" exercise prices, little likelihood of exercise, and which relate to stock that would be the subject of a registration statement in any event, would not be a "sale" of the rights or an "offer to sell" the underlying stock.

(n72)Footnote 72. 452 F.2d 871 (2d Cir. 1971) .

(n73)Footnote 73. *Diskin*, 452 F.2d at 874 .

(n74)Footnote 74. 439 U.S. 551, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979) .

(n75)Footnote 75. *Id.* at 560, 99 S. Ct. at 797, 58 L. Ed. 2d at 817 (footnote omitted).

See also *Bauman v. Bish*, 571 F. Supp. 1054 (N.D. W. Va. 1983) (no sale of securities in involuntary participation in an employee stock ownership plan).

(n76)Footnote 76. Even before *Daniel*, the Commission took the position that stock bonus plans involving no "cash option" feature do not involve sales. See *Howmedica, Inc.*, 1971 SEC No-Act. LEXIS 4084 (Oct. 27, 1971) (issuance of shares as bonuses to reward outstanding service was not a sale).

See also *MCA Inc.*, 1992 SEC No-Act. LEXIS 678 (May 26, 1992) (non-contributory stock bonus plan does not involve a sale); *Midwest Grain Prods., Inc.*, 1989 SEC No-Act. LEXIS 1272 (Dec. 19, 1989) (non-contributory, involuntary stock bonus plan does not involve a sale); *Frank B. Hall & Co.*, 1980 SEC No-Act. LEXIS 3583 (July 30, 1980) (distribution of shares pursuant to an executive incentive plan as "performance share awards" could be made without registration); *PPG Indus., Inc.*, 1980 SEC No-Act. LEXIS 3850 (Sept. 19, 1980) (distribution of shares as awards for company growth and profitability would not involve a sale).

(n77)Footnote 77. *Missouri Research Lab.*, 1972 SEC No-Act. LEXIS 3513 (Aug. 29, 1972) .

(n78)Footnote 78. See discussion of stock dividends in § 2.02[2] *supra* .

In an early published opinion of the Assistant General Counsel, the Commission underscored the importance of the *volitional* act that evidences an investment decision, and thus a sale:

As to the question of finding a "sale" within the meaning of Section 2(3) of the Securities Act, it is our position that, wherever a plan involves an investment contract, or a certificate of interest or participation in a profit-sharing agreement and the employees have a choice whether or not to make contributions, there is obviously an "attempt or offer to dispose of ... a security ... for value." On the other hand, it is because of the language of Section 2(3) that we have taken the position in the past that no "offer" or "sale" is involved in the case of a non-contributory plan, where the employees are not requested to make any contributions, or in the case of a compulsory plan, where there is no element of volition on the part of employees whether or not to participate and to make contributions.

Op. Asst. Gen. Counsel, Fed. Sec. L. Rep. (CCH) P 75,195 (1941).

(n79)Footnote 79. *Yoder v. Orthomolecular Nutrition Institute*, 751 F.2d 555, 559 (2d Cir. 1985) ; *Rudinger v. Insurance Data Processing, Inc.*, 778 F. Supp. 1334 (E.D.Pa. 1991) .

(n80)Footnote 80. *Feret v. Corestates Financial Corp.*, 1998 U.S. Dist. LEXIS 11512 (E.D. Pa. 1998) (employees who received incentive stock options satisfied purchaser/seller requirement for asserting claims under Exchange Act Section 10(b) and SEC Rule 10b-5 where agreement provided for exchange of services in return for options).

See also *Rudinger v. Insurance Data Processing, Inc.*, 778 F.Supp. 1334 (E.D. Pa. 1991) ; *Collins v. Rukin*, 342 F.Supp. 1282 (D. Mass. 1972) .

(n81)Footnote 81. *In re Cendant Corp. Sec. Lit.*, 76 F.Supp. 2d 539 (D.N.J. 1999) .

(n82)Footnote 82. See, e.g., *Folz v. U.S. News & World Report, Inc.*, 627 F.Supp. 1143, 1157-58 (S.D.N.Y. 1986) ; *Compass Group PLC*, SEC No Action Letter (May 13, 1997).

See also *In re Cendant Corp. Sec. Lit.*, 81 F. Supp. 2d 550 (D.N.J. 2000) (Employee's decision to accept or reject option modifications is not a voluntary investment decision to trade particular consideration in return for a financial interest).

The SEC has opined that a "sale" occurs in benefit plans where there is *both* an investment decision and the furnishing of value by a participating employee. Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) . In most instances, stock bonus and similar plans evidence neither. The Commission noted, however, that to avoid "sale" determinations, a stock bonus plan should be directed to a relatively broad class of employees.

(n83)Footnote 83. Sec. Act Rel. No. 4790, 1965 SEC LEXIS 17 (July 13, 1965) . The Commission's position is equally relevant to the question of whether such plans create separate securities. Both issues turn on the extent of participation by the employer/issuer. In the area of employee benefit plans there is significant overlap between the issues of "security" and "sale." Most of the factors viewed as determinative of whether interests in a plan are securities also determine the existence of a sale. *See, e.g.,* Diasonics, Inc., 1982 SEC No-Act. LEXIS 3286 (Nov. 29, 1982) . To find a "sale" in this context is to find an *investment decision*; *see, e.g., Carter v. Signode Indus., Inc., 694 F. Supp 493 (N.D. Ill 1988)* . Whether interests of employees in benefit plans are "securities" under the Securities Act is discussed in § 2.01[c][5] *supra*.

(n84)Footnote 84. *See* Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

But see Lubbock Radio Paging Services, Inc., 2000 SEC No-Act LEXIS 268 (Feb. 9, 2000) (Conversion of Company Contribution Accounts to Profit-Sharing Plan accounts pursuant to a special one-time election does not constitute the offer or sale of a security when participants in the profit-sharing plan will not be given the right to choose between receiving a distribution of the corporate contributions held in plan accounts or having them invested in company stock under the ESOP).

(n85)Footnote 85. Sec. Act Rel. No. 6281, 1981 SEC LEXIS 2260 (Jan. 15, 1981) .

(n86)Footnote 86. Sec. Act Rel. No. 4790, 1965 SEC LEXIS 17 (July 13, 1965) .

(n87)Footnote 87. Sec. Act Rel. No. 6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

See also Clifton Forge-Waynesboro Tel. Co., 1981 SEC No-Act. LEXIS 4403 (Nov. 18, 1981) (customer stock purchase plan operated in accordance with Rel. No. 4790 parameters, except that customers rather than employees would be given the opportunity to participate, would not involve an "offer for sale" under § 2(3)); Hannaford Bros. Co., 1981 SEC No-Act. LEXIS 4396 (Nov. 16, 1981) (dividend reinvestment and cash stock purchase plan operated in compliance with Rel. No. 4790 could be amended to allow for limited participation by non-shareholder employees without registration).

But see Dranetz Engineering Labs., 1983 SEC No-Act. LEXIS 2701 (Div. Corp. Fin. 1983) , in which an issuer's plan to reimburse employees with a portion of the purchase price of company common stock acquired in the open market was viewed by the Staff as constituting a solicitation of an offer to buy. However, the Staff did opine that the issuer could give each employee ten shares of company stock to introduce the employees to the notion of stock ownership and that such a disposition of shares would be considered a bonus.

(n88)Footnote 88. *See Bauman v. Bish, 571 F. Supp. 1054 (W. D. Va, 1983)* . On allegations by union members of deception in connection with the presentation of a proposed employee stock ownership plan (a leveraged ESOP) formed for the purpose of acquiring stock of a new employee-owned company, the court made this observation in dismissing the claims:

In light of the extensive regulation of ESOPs under ERISA, the Court is not inclined to endorse a theory extending Securities Act coverage to the plans considered here. ... [T]o the extent that the instant issue involves a Union leadership recommendation to membership and an election proposed to modify an existing collective bargaining agreement, the Court believes that comprehensive legislation governing such activities limits the extension of the applicability of the Securities Acts to this sphere of labor relations.

571 F. Supp. at 1064-65 .

(n89)Footnote 89. *See, e.g.,* Goldman Sachs Group, Inc., SEC No-Action Letter, 1998 SEC N-Act LEXIS 852 (Aug. 24, 1998).

(n90)Footnote 90. SEC No-Action Letter, CCH Fed.Sec.L.Rep P79,622 (May 24, 2007).

(n91)Footnote 91. *See also* MCA, Inc., SEC No-Action Letter, 1992 SEC No-Act LEXIS 678 (May 26, 1992) (Registration not required for American Depository Receipts issued under a voluntary, non-contributory bonus plan offered to a broad class of employees who did not bargain to contribute cash or other definable consideration); Farmers Group, Inc., SEC No-Action Letter, 1995 SEC No-Act LEXIS 678 (Dec. 1, 1995) (Registration not required where a grant is made to employees who do not individually negotiate or bargain to contribute cash or other definable consideration).

(n92)Footnote 92. Principal exemptions for plans instituted in the typical setting include: § 3(a)(2) for certain single employer and self-employed plans (*see* § 3.03 *infra*); § 3(a)(8) for certain types of insured plans (*see* § 3.09 *infra*); § 3(a)(11) for plans which are limited to employees residing in the state in which the issuer is a resident or is incorporated or doing business (*see* § 3.12 *infra*); § 3(b) and Regulation A thereunder (*see* ch. 5 *infra*) where the maximum potential employees' contributions do not exceed \$1,500,000 each year, or under provisions of Regulation D (*see* § 4.02A *infra*) for amounts up to \$5,000,000, under controlled circumstances; and § 4(2) for plans that are offered privately to a limited number of qualified employees, also under controlled circumstances (*see* § 4.02 *infra*).

(n93)Footnote 93. 326 F. Supp. 943 (S.D.N.Y. 1971) .

(n94)Footnote 94. 490 F.2d 250 (4th Cir.) , *cert. denied*, 416 U.S. 937 (1973) .

See also Lowther v. United States, 455 F.2d 657 (10th Cir. 1972) (criminal action stemming from shell situation).

(n95)Footnote 95. Sec. Act Rel. No. 4982, 1969 SEC LEXIS 703 (1969) .

(n96)Footnote 96. *Id.*

(n97)Footnote 97. "This release does not attempt to deal with any problems attributable to more conventional spin-offs, which do not involve a process of purchase of securities by a publicly-owned company followed by their spin off and redistribution in the trading markets." *Id.* (emphasis added).

See also CACI, Inc., 1977 SEC No-Act. LEXIS 2688 (Oct. 12, 1977) (merger and spin-off deemed to constitute a registrable distribution); Fansteel, Inc; H.K.Porter, Co., Inc., 1983 SEC No-Act. LEXIS 2348 (Div. Corp. Fin. 1983) (spin-off of 96% of equity interest in a 1934 Act reporting company, and utilizing a disclosure document, would not require registration); Mountain States Overthrust Oil & Gas, Inc., 1983 SEC No-Act. LEXIS 2768 (Div. Corp. Fin. 1983) (proposed transfer of oil and gas properties to a newly formed corporation in exchange for the new corporation's common stock, 40% of which would then be distributed as a stock dividend to shareholders, could be carried out without registration since the distribution would be made pursuant to a disclosure document and the shares distributed would be registered under § 12 of the Exchange Act); Peoples Energy Corp., 1981 SEC No-Act. LEXIS 3989 (Aug. 10, 1981) (spin-off of shares to create a new subsidiary could be carried out without registration).

(n98)Footnote 98. *Id.*

Focusing on market professionals as the first-line defense against the "shell game, the Commission adopted Rule 15c2-11 under the Exchange Act in 1971. Sec. Exch. Act Rel. No. 9310 (1971), as amended in Sec. Exch. Act Rel. No. 21470, effective Jan. 15, 1985, 1984 SEC LEXIS 2511 (1984) . The rule generally prohibits a broker-dealer from

entering quotations for the purchase or sale of an over-the-counter security that has not previously been the subject of continuous quotations, unless (1) the issuer has filed a registration statement under the Securities Act or has a class of securities registered under the Exchange Act, and is current in filing reports required under the Exchange Act; or (2) the broker-dealer has obtained and makes available to any person on request certain relatively current financial information, and other information relating to the issuer. The rule requires, as a condition to entering quotes, that the broker-dealer have no reasonable basis for believing that information concerning the issuer of the securities is not true and correct, and that it was obtained from sources reasonably believed to be reliable.

(n99)Footnote 99. 821 F. Supp. 212 (S.D.N.Y. 1993) .

(n100)Footnote 100. See also *Pell v. Weinstein*, 759 F. Supp. 1107 (M.D. Pa. 1991) , *aff'd*, 961 F.2d 1568 (3d Cir. 1992) . Central to analyzing the impact of defining when a "sale" occurs for Section 12(2) of the Securities Act, reprinted in the Primary Law Sourcebook, Volume A, Section B, liability determinations is the principal of *causal connection* between an information failure and a purchaser's decision. Although Section 12(2) of the Securities Act contains no express reliance requirement, Section 12(b) requires proof of loss causation. This and other critical aspects of liability under Section 12(a)(2) are discussed in § 9.04[4] *infra*.

(n101)Footnote 101. Section 13 is discussed more thoroughly in § 9.05 *infra* .

(n102)Footnote 102. *Raiford v. BusLease, Inc.*, 825 F.2d 351, 352, 354-55 (11th Cir. 1987) . The "last integral act" interpretation on the scope of sale for purposes of Section 12(1) actions differs from the "commitment" principle articulated in *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876 (2d Cir. 1972) , with the latter being construed as more appropriate to limitations on antifraud remedies. Considering a registration-related (§ 5) violations as carrying strict liability under § 12(1), the *Raiford* court concluded that the definition of "sale" should be given its broadest interpretation, so as to cover all sales activity, including that which occurs after the date of contract or commitment.

(n103)Footnote 103. See, e.g., *LaSee v. Johnson*, 991 F.2d 801 (8th Cir. 1993) (outstanding offer to repurchase securities did not alter the fact that a security sale is complete when title transfers to the purchaser); *Holloway v. Combined Equities, Inc.*, 628 F. Supp. 59 (M.D. La. 1986) (sale took place on the date of agreement between the parties on the object and price, and not when final payment was made on a note given for the purchase price).

The notion of "continuing" offers or sales may be advanced as the basis for tolling the running of the § 13 limitations period. *But see Davis v. Whatley*, 1985 U.S. Dist. LEXIS 19175 (N.D. Ga. 1985) .

(n104)Footnote 104. *Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151 (S.D.Tex. 1989) ; *but see Kagan v. Edison Bros. Stores, Inc.*, 907 F.2d 690 (7th Cir. 1990) (*Unenforceable* oral agreement to purchase securities is not a "contract" within the definition of sale for purposes of the Exchange Act antifraud provisions).

(n105)Footnote 105. *Southwest Realty Ltd. v. Daske*, 1990 U.S. Dist. LEXIS 9497 (N.D. Tex. May 9, 1990) .



28 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 3.syn

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.syn Synopsis to Chapter 3: Exempt Securities under Section 3 of the Securities Act

§ 3.01 Introduction

§ 3.02 Availability of Exemption; Burden of Proof

§ 3.03 Securities of Governments, Banks, and Employee Benefit Plans--Section 3(a)(2)

[1] Government Securities

[a] Federal Government.

[b] State and Local Governments.

[2] Industrial Development Bonds

[3] Bank Securities

[a] Bank Issued Securities.

[b] Common Trust Funds.

[c] Foreign Banks.

[d] International Development Banks.

[4] Employee Benefit Plans

1-3 Federal Securities Act of 1933 3.syn

[a] Keogh Plans.

§ 3.04 Short-Term Commercial Paper--Section 3(a)(3)

§ 3.05 Securities of Charitable Organizations--Section 3(a)(4)

§ 3.06 Securities of Savings and Loan Associations and Similar Institutions--Section 3(a)(5)

§ 3.07 Securities of Railroad (Common Carrier) Equipment Trusts--Section 3(a)(6)

§ 3.08 Certificates of Receivers and Trustees--Section 3(a)(7)

§ 3.09 Insurance Policies and Annuity Contracts--Section 3(a)(8)

§ 3.10 Voluntary Exchanges Between Issuer and Security Holders--Section 3(a)(9)

[1] In General

[2] Statutory Requirements

[a] Single Issuer.

[b] Exchange of Securities.

[c] Existing Security Holders Exclusively.

[d] No Commission or other Remuneration for Soliciting the Exchange.

[e] Good Faith Exchange.

[3] Resales

§ 3.11 Securities Issued in Judicially or Administratively Approved Exchanges--Section 3(a)(10)

[1] In General

[2] Statutory Requirements

[a] Approval Authority.

[b] Fairness Hearing.

[3] Resales

§ 3.12 Intrastate Offerings--Section 3(a)(11)

[1] In General

[2] Statutory/Rule 147 Requirements

[a] Part of an Issue.

[b] Offers and Sales to Residents Only.

[c] Issuer Residence.

[d] Issuer Doing Business Within.

[e] Use of Proceeds.

[3] Precautionary Measures

[4] Resales

[5] Location of Underwriters and Brokers

§ 3.13 Securities Issued in Connection with Certain Bank Holding Company Acquisitions -- Section 3(a)(12)

§ 3.14 Securities Issued by Church Plans, Companies or Accounts that are Excluded from the Definition of an Investment Company

§ 3.15 Security Futures Products and Standardized Options

§ 3.16 Section 3(b) General Exemption Authority

§ 3.17 Section 3(c) Exemption Authority

Robert N. Rapp, Esq. n*

FOOTNOTES:

(n1)Footnote *.

This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.



29 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.01

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.01 Introduction

Exemptions from registration requirements of the Securities Act of 1933 ("Securities Act") are available for certain classes of securities and certain transactions in securities as defined in the statutes and rules. Although an exemption may be available under the Securities Act, other securities laws may apply to aspects of a proposed transaction. For example, the Trust Indenture Act or the Investment Company Act may apply. If so, a determination must be made as to whether an exemption is available under such other laws. More commonly, counsel must consider whether similar exemptions also exist under state Blue Sky laws. n1 Although much state authority to require registration and qualification of securities offerings deemed national in character was preempted by the National Securities Market Improvements Act of 1996 (NSMIA), n2 the availability of a federal exemption for securities or transactions under the Securities Act does not provide any exemption under state securities laws for securities or offerings that remain subject to state authority.

In the scheme of exemptions under the Securities, Section 3(a) of the Act exempts certain securities from the provisions of the Securities Act, while Section 4 exempts certain securities transactions, but not the securities themselves. n3 This distinction is important because the exempt status of a particular security remains with that security as long as it exists, whereas the exemption of a transaction applies only to the qualifying transaction and not automatically to any subsequent transaction. The distinction is also important because certain exemptions under Section 3 are actually transaction exemptions.

Also, in the exemptive scheme only Sections 3(a)(2) through 3(a)(8) and Sections 3(a)(12) through 3(a)(14) provide exemptions based on the nature of the securities themselves and, thus, afford so-called permanent exemptions. Subsections 3(a)(9), 3(a)(10), 3(a)(11), 3(b), and 3(c) on the other hand provide exemptions for transactions and belong more properly in Section 4 because it is clear that Congressional focus was on transaction circumstances rather than particular characteristics of securities themselves. n4 The Securities and Exchange Commission ("SEC" or "Commission") early on took the position that only Sections 3(a)(2) through 3(a)(8) are actual securities exemptions. In an early release, the General Counsel of the Commission stated: n5

[T]he fact that the securities in question fall within section 3(a) does not necessarily preclude consideration of the necessity of their registration before certain transactions therein can be effected. Sections 3(a)(2) to 3(a)(8) inclusive describe classes of securities which are of such an intrinsic nature that Congress felt that, regardless of the character of the transaction in which they have been or are to be issued or publicly offered, their registration was not necessary for the protection of investors... [T]here is nothing in the intrinsic nature of securities falling within Section 3(a)(1) or Section 3(a)(9) which justifies their permanent exemption from registration.

Although the General Counsel referred to sections 3(a)(1) n6 and 3(a)(9), these remarks apply equally to the sections 3(a)(10) and 3(a)(11) exemptions n7 as well as sections 3(b) and 3(c).

There is an important caveat here. Qualification for *any* security exemption established under section 3 of the Securities Act may require an assessment of transactional circumstances. Section 3(a)(3), for example, exempts commercial paper and is considered to be a permanent exemption that is controlled by the characteristics of the security itself. Nevertheless, widespread abuse of the exemption for the offer and sale of short term, high risk promissory notes and other evidences of indebtedness possessing none of the quality characteristics implicit in section 3(a)(3) led courts and regulators to construe the exemption as applying narrowly to high grade commercial paper. n8 Now, as a matter of case law and regulatory interpretations, there are decidedly transactional characteristics that are applied in determining the availability of the exemption, as well as an examination of particular characteristics of the instrument involved. Section 3(a)(4), the exemption for securities issued by charitable and other eleemosynary institutions or organizations, is not a blanket exemption. The qualifying characteristics of an issuer may be much in issue, and particular circumstances in which an offering is made may control its availability. n9 Securities exemptions are based on the notion that certain instruments have risk-reducing or other characteristics that eliminate the need for investor protections created by the securities laws. Where those characteristics are altered, or are indeed not to be found at all, an ostensible exemption for the security will give way to the reality of the instrument itself and the circumstances in which it is used.

In any case, if the securities themselves are exempt, whether the transaction in which they are offered or sold is exempt is immaterial. However, if a transaction is exempt but the securities are not, each future transaction involving the securities must also qualify as an exempt transaction if registration is to be avoided. For example, if securities are sold under the section 3(a)(11) intrastate exemption, future sales of those securities are not exempt unless they also qualify as exempt transactions. This is because the exemption does not rely on the nature of the security, but rather on the circumstances of the particular transaction. If the securities in the intrastate sale were themselves considered to be exempt (as they might appear to be since the exemption is authorized by section 3(a), which is entitled "Exempted Securities"), any purchaser could immediately resell to a resident of another state without registration or other limitation, a result clearly contrary to the intent of the Securities Act and the Section 3(a)(11) exemption.

An important limitation on the exemptions under Section 3 is that, with one exception, the exemptions do not extend to the civil liability and fraud sections of the Securities Act. Section 12(a)(2), the civil liability section, is applicable to all securities except those exempt under section 3(a)(2), which exempts the securities of governments, banks, and certain employee benefit plans, and section 3(a)(14), covering qualified security futures products. n10 Section 17, the general antifraud provision of the Securities Act, is applicable to all securities, regardless of their exempt status. n11 Because the language of Section 3(a) specifically provides an exemption only from the provisions of the Securities Act, except as otherwise provided in Sections 12(a)(2) and 17, exempt securities under Section 3(a) are also subject to Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and *Rule 10b-5* promulgated thereunder. n12 Accordingly, where an exemption applies, counsel must give consideration to what disclosures should be made to purchasers in order to protect against claims under the civil liability and antifraud provisions.

FOOTNOTES:

(n1)Footnote 1. *See* Rapp, Blue Sky Regulation, Chs. 7-9 (Matthew Bender 2003) for a detailed discussion of securities and transactions exempt under state securities laws.

(n2)Footnote 2. Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

(n3)Footnote 3. *See* Ch. 4 *infra* for an analysis of exempt transactions under § 4 of the Act. The Securities Act is reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

(n4)Footnote 4. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 40 (1934).

(n5)Footnote 5. Op. Gen. Counsel, Sec. Act Rel. No. 33-646, 1936 SEC LEXIS 484 (Feb. 3, 1936) .

(n6)Footnote 6. Section 3(a)(1) was deleted by Pub. L. No. 100-181, § 203, 101 Stat. 1249 (1987) because it applied to pending offers of securities at the time of the enactment of the 1933 Act and no longer had any relevance.

(n7)Footnote 7. Sections 3(a)(9) and 3(a)(10) were originally contained in § 4(3); § 3(a)(11) was originally § 5(c).

(n8)Footnote 8. The § 3(a)(3) exemption for commercial paper, and the extent to which it has been limited, is discussed in detail in § 3.04 *infra*.

(n9)Footnote 9. Section 3(a)(4) and the exemption for securities of eleemosynary institutions and organizations is discussed in § 3.05 *infra*.

(n10)Footnote 10. Section 12(a)(2) provides: "Any person who... offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraphs (2) and (14) of subsection (a) thereof)... ."

(n11)Footnote 11. Section 17(c) states: "The exemptions provided in section 3 shall not apply to the provisions of this section."

(n12)Footnote 12. Section 3(a) provides: Except as hereinafter expressly provided, the provisions of this title [Securities Act of 1933] shall not apply to any of the following classes of securities.

See Leoni v. Rogers, 719 F. Supp. 555 (E.D.Mich. 1989) , in which the court rejected the argument that a purely intrastate transaction was not governed by federal securities laws and concluded that Section 3(a)(11) only exempts securities from the registration and prospectus requirements of the Securities Act and not from Section 10(b) or *Rule 10b-5*; *Kelly v. West Printing Co.*, 1974 U.S. Dist. LEXIS 9199 (E.D. Mich. 1974) , in which the court stated that the plaintiff was correct that the Section 3(a) exemption could not possibly bar a Section 10(b) claim under the Exchange Act, because, under the language of the statute, the exemption is only from the provisions of the Securities Act.

See also Sec. Act Rel. No. 33-5450, 1974 SEC LEXIS 3579 (Jan. 7, 1974) : "Section 3(a)(11) is not an exemption from the civil liability provision of Section 12(2) or the antifraud provisions of Section 17 of the Act or of Section 10(b) of the Securities Exchange Act of 1934."



30 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.02

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.02 Availability of Exemption; Burden of Proof

Prior to the offer or sale of an interest to the public, however made, counsel must ascertain whether such interests proposed to be offered or sold qualify for an exemption under the provisions of Section 3. If there is any doubt as to whether a specific interest qualifies as an exempt security, counsel may consider presenting the facts and circumstances to the SEC Division of Corporation Finance for an informal interpretation. The Commission has indicated that in some, but not necessarily all cases, the staff will respond to counsel's request for a "no-action" letter. Under this procedure, counsel presents the facts and circumstances in written form, gives an opinion that, based upon the information supplied, the exemption in question is available, and requests the staff to confirm that no enforcement action would be recommended if the transaction as described proceeds. If the staff of the Commission agrees, it will issue a no-action letter stating that, on the basis of the facts presented and in reliance on the opinion of counsel for the issuer (or other seller), the staff will not recommend that the Commission take enforcement action if the offer and sale of the securities proceed without registration under the Securities Act. Note, however, that this determination is not a conclusion of law and the Commission is not necessarily bound by it. n1

In all cases, the person who claims an exemption has the burden of proving its availability. A general rule of statutory construction requires that the one who claims the benefits of an exception from the provisions of a statute must prove its availability as to the particular facts and circumstances. n2 In deciding the availability of a Section 4 exemption, the United States Supreme Court stated in *SEC v. Ralston Purina*: n3 "Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable." n4 Thus, once a plaintiff has introduced evidence that the registration provisions of the Securities Act have been violated, the burden then shifts to the defendant to show entitlement to an exemption. n5 Of course, this result applies not just to issuers, but to all those who claim an exemption under the Act. n6

FOOTNOTES:

1-3 Federal Securities Act of 1933 § 3.02

(n1)Footnote 1. The Staff will not issue no-action letters with respect to certain transactions. See Sec. Act Rel. No. 33-6253, 45 FR 72644 (Oct. 28, 1980) . For example, the Staff will not express any view on the availability of the § 3(a)(4) non-profit security exemption unless an issuer can demonstrate that it has received a favorable ruling from the Internal Revenue Service that it qualifies as a tax exempt organization. The Commission also announced in 1986 that it will no longer issue No-Action letters with respect to the § 3(a)(2) exemption for securities of branches or agencies of foreign banks. See § 3.03[3] *infra*.

(n2)Footnote 2. See *F.T.C. v. Morton Salt*, 334 U.S. 37, 44-45, 68 S. Ct. 822, 92 L. Ed. 1196 (1948) .

(n3)Footnote 3. 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .

(n4)Footnote 4. *Ralston Purina*, 346 U.S. at 126, 73 S. Ct. at 985, 97 L.Ed. at 1499 .

(n5)Footnote 5. *SEC v. Murphy*, 626 F.2d 633, 641 (9th Cir. 1980) .

See also *SEC v. Cavanagh*, 445 F.3d 105, 111, n.13 (2d Cir. 2006) ("Once a prima facie case has been made, the defendant bears the burden of proving the applicability of an exemption"); *In re NBW Commercial Paper Litigation*, 813 F.Supp. 7, 17 (D.D.C. 1992) .

(n6)Footnote 6. *Gilligan, Will & Co. v. S.E.C.*, 267 F. 2d 461, 466 (2d Cir.) , *cert. denied*, 361 U.S. 896, 80 S. Ct. 200 (1959) . The court found that the burden of proof was on the broker-dealer who claimed a transaction exemption under § 4(1).



31 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.03

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.03 Securities of Governments, Banks, and Employee Benefit Plans--Section 3(a)(2)

of the Securities Act is a complex, multi-part exemption from registration provisions of the act for securities that have special quality characteristics by reason of the issuer involved, and a presumption that protection of investors through the imposition of registration requirements is not needed. Securities issued or guaranteed by banks, for example, are within the protective umbrella of another regulatory scheme. Securities issued in connection with certain types of employee benefit plans involving a single trust fund or collective trust fund maintained by a bank likewise fall within the exemption. The most common focus under section 3(a)(2) is on "government securities," which encompass a considerable range of federal, state and local government issuers or guarantors, which are discussed in further detail in subpart [1] below.

[1] Government Securities

Section 3(a)(2) of the Securities Act provides an exemption from registration requirements for securities issued or guaranteed by federal and state governments, and their political subdivisions, agencies or instrumentalities. Section 3(a)(2) n1 exempts

Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing... n2

The section 3(a)(2) exemption is based on the presumed creditworthiness of government issuers or government guarantors, and a recognition that the protections afforded by registration of such securities are not needed given the quality of the securities themselves. Events associated with the world financial markets crisis, particularly in regard to

"government sponsored enterprises" discussed further below, have challenged the validity of that presumption. Additionally, unlike other securities exempt from registration under section 3(a) of the Act, securities covered by section 3(a)(2) are excluded from the private antifraud remedy prescribed in section 12(a)(2) of the Act. n3 However, there is no exclusion from other general antifraud provisions applicable to these securities. Section 17(a) of the Act n4 expressly makes clear that exemption from registration under any part of section 3 of the Act does not exempt the security from coverage of the antifraud prohibition. n5 And the private right of action implied under section 10(b) of the Securities Exchange Act, and SEC *Rule 10b-5*, is available to purchasers and sellers without regard to any exemption from registration provided in the Securities Act.

[a] Federal Government. The exemption applying to securities issued or guaranteed by the federal government includes all agencies and instrumentalities of the government. n6 Thus, for example, the securities issued or guaranteed by the Government National Mortgage Association and the Federal National Mortgage Association are exempt, even though the latter is a government sponsored private corporation (government sponsored enterprise), and the securities of which are not "guaranteed" as such by the United States government. n7 The scope of the exemption under section 3(a)(2) for securities which are guaranteed by the U.S. government is illustrated by the no-action response in *Postal Square Limited Partnership*, n8 in which the SEC staff confirmed that the exemption would apply to non-recourse bonds issued to finance the renovation of a U.S. Post Office facility. n9

This exemption for securities issued or guaranteed by the federal government has been broadened by provisions of other federal legislation that specifically add to the exemption under Section 3(a)(2). These additional exemptions have been carved out because of other legislative provisions that, in effect, guarantee the payment of the principal and interest on a debt security. Section 304(a)(5) of the Trust Indenture Act of 1939, in effect, adds to the language of Section 3(a)(2) by exempting securities issued pursuant to a mortgage indenture to which a contract of insurance under the National Housing Act exists. n10 Likewise, section 304(a)(10) of The Trust Indenture Act exempts any mortgage or trust deed indenture as to which a contract of insurance under title XI of the National Housing Act is in effect. n11

[b] State and Local Governments. The exemption for securities of states and their political subdivisions also includes the authorities and districts created by or under the power of the states. n12 These securities are generally grouped under the term "municipal securities." Congress intended for the exemption to be broadly available, as indicated in the House Committee Report:

The term "political subdivision" carries with it the exemption of such securities as county, town, or municipal obligations, as well as school district, drainage district, and levee district, and other similar bonds. The line drawn by the expression "political subdivision" corresponds generally with the line drawn by the courts as to what obligations of States, their units and instrumentalities created by them, are exempted from Federal taxation. n13

Municipal securities are generally classified into two categories: general obligation bonds, which are backed by the full faith and credit of the governmental body; and revenue bonds, which are backed by the revenues of the project for which the bonds are sold. In the latter case, the terms of the bond indenture generally limit recourse specifically to the revenues generated by the project. n14

In general, a municipal bond exempt under the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"), will also be exempt under Section 3(a)(2). The Commission has taken the position that the exemption is available where the municipal guarantee is absolute and unconditional. n15 The Securities Acts Amendments of 1975 n16 subjected municipal bond dealers to registration and other regulation under the Exchange Act. n17 In addition, those amendments also created a new self regulatory organization, the Municipal Securities Rulemaking Board, which has created rules for the municipal securities industry, but which is expressly prohibited by the Exchange Act from requiring issuers of municipal securities to file pre-offering documents with the Commission. n18 In 1984, the Government Accounting Standards Board (GASB) was created to establish and improve standards of state and local

governmental accounting and financial reporting that will result in useful information for users of financial reports and guide and educate the public, including issuers, auditors, and users of those financial reports. The GASB promulgates generally accepted accounting principles for municipalities, although compliance with its principles is voluntary. Compliance with GASB's standards, however, is enforced through the laws of some individual states and through the audit process, when auditors render opinions on the fairness of financial statement presentations in conformity with GAAP.

[2] Industrial Development Bonds

Industrial development bonds, one type of municipal revenue bond, are usually issued by a political subdivision of a state to finance a specific industrial project owned by the municipality, which is then leased to one or more private companies. The bonds are amortized by the application of lease payments received from the private companies. Importantly, however, SEC Rule 131 under the Securities Act n19 provides that any part of an obligation evidenced by any bond, note, debenture, or other evidence of indebtedness issued by any governmental unit specified in section 3(a)(2) of the Act which is payable from payments to be made in respect of property or money which is or will be used, under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise, is deemed to be a *separate* security issued by the lessee or obligor under the lease, sale or loan arrangement. In general, Rule 131 results in the section 3(a)(2) exemption being unavailable to cover the separate security. The issuer of the separate security is the private party who is the lessee or obligor under the lease, sale, or loan arrangement. n20

However, Rule 131 deems obligations not to be separate securities where the obligation is payable from the general revenues of a governmental entity that has other resources for such payment, the governmental entity has ownership and control of the project, or where a private enterprise is a lessee with control over a facility but the governmental entity has ownership and control of the project as a whole. n21

Subsequent to the promulgation of Rule 131, small issues of industrial development bonds were exempted by separate language within Section 3(a)(2), added by Section 401 of the Employment Security Amendments of 1970: n22

[A]ny security which is an industrial development bond (as defined in section 103(c)(2) of Title 26 [Internal Revenue Code of 1954]) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security... .

This portion of Section 3(a)(2), in effect, exempts certain small issue industrial revenue bonds, which under the current provisions of the Internal Revenue Code cannot exceed \$10 million. Generally, for such small issues, if the interest on the bonds is excludable from gross income under the Internal Revenue Code, the issue itself will be exempt from the registration requirements of the Securities Act. n23 However, a guarantee of an exempt industrial development bond has been viewed as a separate security. n24 Also, where an obligor under a lease securing exempt industrial development bonds intended to solicit the bondholders for an assignment of the obligations, it was found that the solicitation could be deemed to involve the offer of a security. n25

[3] Bank Securities

[a] Bank Issued Securities. Section 3(a)(2) provides an exemption for "[A]ny security issued or guaranteed by any bank..." n26 The term "bank," except as used in connection with common n27 and collective trust funds, n28 is defined as follows:

For the purposes of this paragraph [Section 3(a)(2)], a security issued or guaranteed by a bank shall not include any interest or participation in any collective trust fund maintained by a bank; and the term "bank" means any national bank, or any banking institution organized under the laws of any State,

Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official... .

This exemption is based on the fact that banks are subject to extensive government regulation, both federal and state. n29 However, since there are many institutions that engage in financing activities that are not so heavily regulated, the limiting language in the above definition has been fairly strictly construed. n30 The question as to what institutions are entitled to the exemption is partially answered by the limiting language in the above definition, "the business of which is substantially confined to banking." Securities of finance companies, small loan companies, investment banks, and bank holding companies are outside the definition for the reason that such institutions are not in the strict sense primarily engaged in the banking business and, in most cases, cannot use the word "bank" in their names. n31 The exemption for securities guaranteed by a bank has been interpreted to include irrevocable letters of credit, without regard to whether a technical guaranty relationship exists. n32 However, the Commission has refused to issue a No-Action Letter in a situation where a county proposed to issue industrial development bonds where the principal of and interest on such bonds was guaranteed by a private business corporation. n33 Travelers checks, which are guaranteed as to payment by a bank, are also exempted securities under Section 3(a)(2). n34

It is noted that, even though the securities of a banking institution are exempt from registration under Section 3(a)(2), certain bank activities relating to securities may not be exempt from the definition of a "broker" or a "dealer" under the Exchange Act. n35

[b] Common Trust Funds. Section 3(a)(2) describes common trust funds of banks which are exempt as follows:

any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator or guardian

Section 3(a)(2) further defines the term "bank" as it pertains to common trust funds as follows:

[I]n the case of a common trust fund or similar fund, or a collective trust fund, the term "bank" has the same meaning as in the Investment Company Act of 1940.

The definition of a bank in Section 2(a)(5) of the Investment Company Act is broader than that contained within Section 3(a)(2) of the Securities Act in that it includes trust companies that are subject to the same regulatory oversight as banks. n36

A common trust fund is maintained by a bank as an investment vehicle solely for trusts, estates, or similar entities for which the bank acts in a bona fide fiduciary capacity. n37 The exemption for common trust funds clearly exists in recognition of the fiduciary activities of banks and trust companies as trustees, executors, administrators, and guardians. In all such cases, the institutions are exercising investment discretion, although they may employ an investment adviser so long as the final decisions are made by the institution. This exemption does not and need not extend to the custodial accounts of such institutions because, with respect to those accounts, investment discretion remains with the account owner and the institution's actions are limited to safekeeping and clerical tasks. Under Rule 132, the Commission has expanded the meaning of "common trust fund" to include those funds that are maintained for the collective investment of banks that are part of an affiliated group, as defined in *Section 1504(a) of the Internal Revenue Code*. n38

The Commission has provided no-action letters in connection with various savings trusts designed to be qualified state tuition programs within the meaning of *Section 529 of the Internal Revenue Code*. A state university organizes the trust plan, the university, as trustee for the savings trust, enters into participation agreements with participants in the program for the benefit of designated beneficiaries and the participants retain ownership of contributions made to the program for investment by the trustee. The Commission has issued several no action letters allowing such trusts an exemption

pursuant to Section 3(a)(2). n39

[c] Foreign Banks. Because of the increasing activity of foreign banks in the United States and the steadily increasing demand for No-Action Letters, the Commission issued a release in 1986 addressing the question whether the securities of such institutions can qualify for the banking exemption under Section 3(a)(2). n40 The question derives from the fact that foreign banks are doing business in the United States, under a license, as branches and agencies of foreign banks, not as separate legal entities. They are not national banks or banks organized under the laws of any state and, therefore, technically do not fall within the definition of a bank under Section 3(a)(2). However, favorable No-Action letters had been issued prior to the 1986 release where, in the opinion of counsel, the nature and extent of federal and state regulation and supervision of a foreign bank were substantially equivalent to that applicable to domestic banks doing business in the same jurisdiction.

In the 1986 release, the Commission specifically adopted the position that it deems a branch or agency of a foreign bank located in the United States to be a national bank or a banking institution organized under the laws of any state, territory, or the District of Columbia provided that there is substantially equivalent regulation. The Commission no longer issues No-Action Letters on this question; banks must rely on the opinion of counsel as to whether they meet the criteria set forth in their lease.

[d] International Development Banks. Congress has specifically added securities issued or guaranteed by certain international development banks to the list of securities exempted under Section 3(a)(2). These international development banks are: the International Bank for Reconstruction and Development, n41 the Inter-American Development Bank, n42 the Asian Development Bank, n43 the African Development Bank, n44 the International Finance Corporation, n45 and the European Bank for Reconstruction and Development. n46 However, each of these entities is subject to special reporting requirements, which are contained in Regulations BW, n47 IA, n48 AD, n49 AFDB, n50 IFC, n51 and EBRD. n52

[4] Employee Benefit Plans

The portion of Section 3(a)(2) that exempts participations in employee benefit plans includes three different vehicles for such plans: single trust funds, n53 collective trust funds maintained by a bank, n54 and insurance company contracts. n55 Keogh Plans are specifically excluded, as they are addressed in separate language under Section 3(a)(2). The statutory language in Section 3(a)(2) exempting employee benefit plans is as follows: n56

[A]ny interest or participation in a single trust fund, or in a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with

(A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under *section 401 of the Internal Revenue Code of 1954...* ,

(B) an annuity plan which meets the requirements for the deduction of the employer's contributions under *section 404(a)(2)* of such Code or

(C) a governmental plan as defined in *section 414(d)* of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (A), (B), or (C) of this paragraph:

(i) the contributions under which are held in a single trust fund or in a separate account maintained by an insurance company for a single employer and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust or separate account itself) issued by the employer or any company directly or indirectly controlling, controlled by, or under common control with the employer,

(ii) which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code [Keogh Plans], or

(iii) which is a plan funded by an annuity contract described in section 403(b) of such Code [Annuity Plans of *IRC § 501(c)(3)* tax exempt organizations].

With respect to most employee benefit plans, two types of interests are distinguishable: the interests of the plans themselves in investment vehicles; n57 and the interests of the employees in the plans. As to the latter, the initial question is whether employee interests or participations in such plans are securities within the meaning of Section 2(1) of the Securities Act. n58 If not, they are outside the purview of the Securities Act and even the anti-fraud provisions of the securities laws are inapplicable. The Commission has indicated that interests in Employee Stock Ownership Plans ("ESOPs") are securities exempted under Section 3(a)(2). n59 In *International Brotherhood of Teamsters v. Daniel*, n60 the Supreme Court held that the federal securities laws did not apply to employee interests in a noncontributory, compulsory pension plan. Subsequent to *Daniel*, the Commission expressed the view that employee interests in an employee benefit plan are securities only when the interests in the plan are both voluntary and contributory. n61

Section 3(a)(2), as it was amended in 1970, codified in part the Commission's long standing administrative position that interests or participations issued in connection with employee benefit plans need not be registered unless employee-contributed funds are used to purchase employer securities. n62 Although the statutory language does not address whether interests of participants in plans covered by Section 3(a)(2) are exempt from registration, the staff of the Commission continues to view the exemption as applying to both the employee benefit plan's interest in a funding vehicle and the interests of participants in the plan itself, in spite of dictum in *Daniel* disapproving such a broad view of the exemption. n63

The term "bank" in the clause "a collective trust fund maintained by a bank" is a bank as defined in Section 2(a)(5) of the Investment Company Act and therefore, includes trust companies. n64 The term "insurance company" is defined in Section 2(13) of the Act to mean a company organized as an insurance company, subject to the supervision of an insurance commissioner of a state or territory, and whose primary activity is the writing of insurance or reinsurance. n65

The Section 3(a)(2) exemption contains three exclusions: the first relates to interests in plans, contributions to which are held in a single trust fund or separate account for a "single employer" and which permit amounts in excess of the employer's contribution to be used to purchase securities of the employer or its affiliates; the second relates to interests in Keogh plans; n66 and the third relates to annuity plans of charitable organizations that are tax exempt under *Section 501(c)(3) of the Internal Revenue Code*.

[a] Keogh Plans. Separate language within Section 3(a)(2) allows the Commission to exempt Keogh Plans, also known as H.R. 10 plans, to the extent that it finds it necessary or appropriate. This portion of Section 3(a)(2) is as follows:

The Commission, by rules and regulations or order, shall exempt from the provisions of section 5 of this title any interest or participation issued in connection with a stock bonus, pension, profit-sharing, or

annuity plan which covers employees some or all of whom are employees within the meaning of *section 401(c) (1) of the Internal Revenue Code of 1954*, if and to the extent that the Commission determines this to be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

The Commission has made exemptions for Keogh Plans available under Rule 180. The rule exempts from the registration requirements of Section 5 plans that are "qualified plans" under the Internal Revenue Code of 1986 n67 and unqualified plans that meet certain criteria. The Rule includes a provision that the employer or its financial adviser have sufficient expertise to adequately represent the interests of the employer and its employees in the plan. n68 When Rule 180 was adopted, the Commission stated that the exemption applied both to the interest of the plan in an investment account and the employee's voluntary contributions to the plan. n69

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. §77c(a)(2) (2000)*.

(n2)Footnote 2. *See, e.g.,* Federal Deposit Insurance Corporation, SEC No-Action Letter (Nov. 24, 2008). As an example of the application of section 3(a)(2), the SEC Staff granted no-action advice to the FDIC to confirm the section 3(a)(2) exempt status of certain senior unsecured debt to be issued by eligible entities pursuant to the Debt Guaranty Program component of the Temporary Liquidity Guarantee Program of the FDIC. Confirming the exemption, the Staff observed:

The Final Rule provides that the FDIC will fully and unconditionally guarantee Senior Unsecured Debt issued between October 14, 2008 and June 30, 2009 by eligible entities pursuant to the Debt Guarantee Program component of the Temporary Liquidity Guarantee Program, through the earlier of the maturity of such Senior Unsecured Debt or June 30, 2012 and on the terms and conditions set forth in the Final Rule. The Division concurs that such Senior Unsecured Debt that is fully and unconditionally guaranteed by the FDIC under the Debt Guarantee Program component of the Temporary Liquidity Guarantee Program and has a maturity that ends on or before June 30, 2012 will be considered guaranteed by an instrumentality of the United States for purposes of Section 3(a)(2) of the Securities Act of 1933.

(n3)Footnote 3. *15 U.S.C. §77k(a)(2) (2000)*. Subject to certain conditions, Section 12(a)(2) creates an express private right of action for a purchaser to obtain rescission or damages as a rescission equivalent from a person who offers or sells a security by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. However, section 12(a)(2) expressly excludes securities exempted by Section 3(a)(2) of the Act from coverage.

(n4)Footnote 4. *15 U.S.C. §77p(a) (2000)*.

(n5)Footnote 5. *See* Securities Act §17(c), *15 U.S.C. §77p(c) (2000)* ("The exemptions provided in S shall not apply to the provisions of this section").

(n6)Footnote 6. *See, e.g.,* *Dau v. Federal Land Bank of Omaha*, 627 F. Supp. 346 (N.D. Iowa. 1985) (Stock issued by a federal land bank association is exempt from registration under sSection 3(a)(2) because the association is an instrumentality of the United States).

See also Creech v. Federal Land Bank of Wichita, 647 F. Supp. 1097 (D. Colo. 1986) (Banks in the federal Farm Credit System have federal agency status).

(n7)Footnote 7. 12 U.S.C.A. § 1717(c)(1) (1989).

See Bache Halsey Stuart, Inc. v. Affiliated Mortgage Investment, Inc., 445 F. Supp. 644 (N.D. Ga. 1977) (future delivery of mortgage-backed certificates guaranteed by GNMA is within the 3(a)(2) exemption because the delivery does not constitute a separate contract); E.F. Hutton Co., 1976 SEC No-Act. LEXIS 990 (May 3, 1976) (portions of loans guaranteed by Farmers Home Administration are exempt from the registration requirements both when the loans are made and when they are marketed); IDS Mortgage Corporation, 1971 SEC No-Act. LEXIS 4090 (Nov. 29, 1971) (both GNMA certificates and the bank accounts in which deposited funds could be automatically used to purchase such certificates were exempt).

(n8)Footnote 8. SEC No_Action Letter (May 24, 1990).

(n9)Footnote 9. *See also* DOE Guaranteed Loans, SEC No-Action Letter (June 26, 1979) (Portions of loans sold by private lenders that were guaranteed by the U.S. Department of Energy would qualify for the section 3(a)(2) exemption).

But see SBA Guaranteed Loans, SEC No-Action Letter (Nov. 8, 1974) (The guaranteed portion of Small Business Administration Loans made by non-bank lenders to business borrowers would not qualify under section 3(a)(2) because the SBA guarantee did not protect borrowers in all circumstances).

(n10)Footnote 10. Section 304(a)(5), 15 U.S.C. § 77ddd(a)(5) (2000), provides:

[A]ny security issued under a mortgage indenture as to which a contract of insurance under the National Housing Act is in effect; and any such security shall be deemed to be exempt from the provisions of the Securities Act of 1933 to the same extent as though such security were specifically enumerated in section 3(a)(2) of such Act...

(n11)Footnote 11. Section 304(a)(10), 15 U.S.C. § 77ddd(a)(10) (2000), provides:

[A]ny security issued under a mortgage or trust deed indenture as to which a contract of insurance under title XI of the National Housing Act is in effect; and any such security shall be deemed to be exempt from the provisions of the Securities Act of 1933 to the same extent as though such security were specifically enumerated in section 3(a)(2), as amended, of the Securities Act of 1933.

(n12)Footnote 12. The text of this portion of § 3(a) of the Act (*see* § 3.03[1] *supra*) includes securities issued or guaranteed by the District of Columbia, as well as political subdivisions and public instrumentalities of states and territories. Territories are defined in § 2(6) of the Securities Act to include Puerto Rico, the Virgin Islands, and the insular possessions of the United States.

(n13)Footnote 13. H.R. Rep. No. 85, 73d Cong., 1st Sess. 14 (1933).

See, e.g., Newman & Associates, Inc., SEC No-Action Letter (July 16, 1987) (Bonds issued by a city, country, public agency, authority, or non-profit corporation to finance construction of a multi-family housing project would qualify for the section 3(a)(2) exemption).

See also Finance Authority of Maine, SEC No-Action Letter (Feb. 4, 1994) (Portions of loans or certificates

evidencing fractional undivided interests in pools of loans insured guaranteed by state finance authority would qualify for section 3(a)(2) exemption).

(n14)Footnote 14. Industrial development bonds are a particular type of revenue bonds involving the participation of private parties. Because their exemption depends on separate language within Section 3(a)(2), they are discussed separately in § 3.03[2] *infra* .

(n15)Footnote 15. State of New Jersey, 1984 SEC No-Act. LEXIS 1480 (May 21, 1984) .

(n16)Footnote 16. Pub. L. No. 94-29, 89 Stat. 97 (1975).

(n17)Footnote 17. Exchange Act § 15B(b).

(n18)Footnote 18. Exchange Act § 15B(d).

(n19)Footnote 19. 17 C.F.R. §230.131.

(n20)Footnote 20. Rule 131(a) provides:

Any part of an obligation evidenced by any bond, note, debenture, or other evidence of indebtedness issued by any governmental unit specified in section 3(a)(2) of the Act which is payable from payments to be made in respect of property or money which is or will be used, under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise, shall be deemed to be a separate "security" within the meaning of section 2(1) of the Act, issued by the lessee or obligor under the lease, sale or loan arrangement.

(n21)Footnote 21. Rule 131(b) provides:

An obligation shall not be deemed a separate "security" as defined in paragraph (a) of this section if, (1) the obligation is payable from the general revenues of a governmental unit, specified in section 3(a)(2) of the Act, having other resources which may be used for payment of the obligation, or (2) the obligation relates to a public project or facility owned and operated by or on behalf of and under the control of a governmental unit specified in such section, or (3) the obligation relates to a facility which is leased to and under the control of an industrial or commercial enterprise but is a part of public project which, as a whole, is owned by and under the general control of a governmental unit specified in such section, or an instrumentality thereof.

(n22)Footnote 22. Employment Security Amendments of 1970, Pub. L. No. 91-373, 84 Stat. 695 (1970).

(n23)Footnote 23. Sec. Act Rel. No. 33-5103, 1970 SEC LEXIS 655 (Nov. 6, 1970) . Several changes have been made to the Internal Revenue Code since 1970. Under the Internal Revenue Code of 1986, § 103 excludes interest on state and local bonds from gross income, except for private activity bonds that are not qualified within the meaning of § 141. § 144(a) defines qualified small issue bonds.

(n24)Footnote 24. County of Yellowstone, 1976 SEC No-Act. LEXIS 1692 (Aug. 16, 1976) .

(n25)Footnote 25. ICI Am., Inc., 1979 SEC No-Act. LEXIS 3003 (June 21, 1979) . A significant factor in this matter was that the bonds, although exempt because they were issued prior to the adoption of Rule 131, would not qualify for an exemption if they were being issued currently.

(n26)Footnote 26. Section 3(a)(2) contains a separate clause for "any security issued by or representing an interest

in or a direct obligation of a Federal Reserve bank." Understandably, there appears not to have been any interpretative questions with respect to this clause.

(n27)Footnote 27. *See* § 3.03[3][b] *infra*.

(n28)Footnote 28. *See* § 3.03[4] *infra*.

(n29)Footnote 29. For additional analysis of exemptions for banks, *see generally*, DiLorenzo, et al., Banking Law, Ch. 99, Regulation and Reporting Requirements of the 1933 Securities Act, (Matthew Bender).

(n30)Footnote 30. *Capital Funds, Inc. v. SEC*, 348 F. 2d 582 (8th Cir. 1965). The fact that a loan institution performed some banking functions and was subject to the supervision of the state bank commissioner did not entitle it to the exemption afforded by § 3(a)(2). The institution was organized under a state statute that created a clear distinction between industrial loan companies and banks and denied to the former the use of the word "bank" in their names.

(n31)Footnote 31. *Id.*

(n32)Footnote 32. *Frontier Gas Storage Co.*, 1981 SEC No-Act. LEXIS 2797 (Jan. 5, 1981) .

Although no longer currently in use, retail repurchase agreements issued by banks have qualified for exemption under Section 3(a)(2). Retail repurchase agreements are debt obligations of banks or savings and loans issued to the general public, with maturities of less than 90 days, that are collateralized by an interest in a security that is a direct obligation of, or guaranteed by, the federal government or one of its agencies.

See also Sec. Act Rel. No. 33-6351, 1981 SEC LEXIS 669 (Sept. 25, 1981) .

(n33)Footnote 33. *County of Muskingham, Ohio*, SEC No-Action Letter (April 11, 1974).

(n34)Footnote 34. *See American Bankers Club, Inc.*, 1980 SEC No-Act. LEXIS 3427 (May 7, 1980).

(n35)Footnote 35. The Gramm-Leach-Bliley Act (the "GLB") (Rule Law 106-102, 113 Stat. 1338 (1999)) amended the definitions of the terms "broker" and "dealer" in sections 3(a)(4) and 3(a)(5), respectively, of the Exchange Act. These amendments are effective May 12, 2001. Section 3(a)(4) and 3(a)(5) previously provided that banks were specifically excluded from these definitions. However, both Section 3(a)(4) and 3(a)(5) have been amended to provide that only certain specified activities are not included as either broker or dealer activities.

The amendment to Section 3(a)(4) provides an exception to the definition of broker for certain bank activities that include third party brokerage arrangements, trust activities, certain permissible securities transactions and certain stock purchase plans. The activities that will be permissible securities transactions include transactions effected by a bank in commercial paper, bankers acceptance or commercial bills, and exempted securities, as defined in the Exchange Act.

The definition of exempted securities under the Exchange Act is different from the definition of exempted securities in Section 3 of the Securities Act. The Exchange Act definition includes most government securities and municipal securities, interests or participation in common trust funds or single trust funds and securities of pooled income funds, collective trust funds, collective investment funds or similar funds excluded from the definition of any investment company under the Investment Company Act of 1940.

The amendment to Section 3(a)(5) provides an exception to the definition of dealer for certain bank activities which include certain permissible securities transactions, investment, trustee and fiduciary transactions, asset backed transactions, and activities in certain identified banking products. The activities which will be permissible securities transactions include transactions affected by a bank in commercial paper, bankers acceptances or commercial bills, and exempted securities.

(n36)Footnote 36. The full text of Section 2(a)(5) reads as follows:

"Bank" means (A) a depository institution (as defined in Section 3 of the Federal Deposit Insurance Act) or a branch or agency of a foreign bank (as such terms are defined in Section 1(b) of the International Banking Act of 1978) organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

(n37)Footnote 37. Sec. Act Rel. No. 33-6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

(n38)Footnote 38. Rule 132 provides:

The term "common trust fund" as used in section 3(a)(2) of the Act shall include a common trust fund which is maintained by a bank which is a member of an affiliated group, as defined in *section 1504(a) of the Internal Revenue Code of 1954*, and which is maintained exclusively for the collective investment and reinvestment of monies contributed thereto by one or more bank members of such affiliated group in the capacity of trustee, executor, administrator, or guardian, provided that:

(a) the common trust fund is operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining such fund and any other contributing banks were the same entity; and

(b) the rights of persons for whose benefit a contributing bank acts as trustee, executor, administrator, or guardian would not be diminished by reason of the maintenance of such common trust fund by another bank member of the affiliated group.

(n39)Footnote 39. No-Action Letters, Alaska Higher Education Savings Trust, March 8, 2001, College SAVE Trust, August 2, 2001 and Commonwealth Postsecondary Education Prepaid Tuition Trust Fund, September 24, 2001.

(n40)Footnote 40. Sec. Act Rel. No. 33-6661, 1986 SEC LEXIS 729 (Sept. 23, 1986) .

(n41)Footnote 41. Bretton Woods Agreement Act § 15(a), 22 U.S.C. § 286k-1(a) (2000). The exemption for the International Bank for Reconstruction and Development was the first for banks of this type and served as a model for similar subsequent exemptions.

§ 286k-1(a) provides:

Any securities issued by International Bank for Reconstruction and Development (including any guaranty by the bank, whether or not limited in scope), and any securities guaranteed by the bank as to both principal and interest, shall be deemed to be exempted securities within the meaning of subsection (a)(2) of section 77c of Title 15 [3(a)(2)]... .

(n42)Footnote 42. 22 U.S.C. § 283h(a) (2000).

(n43)Footnote 43. 22 U.S.C. § 285h(a) (2000).

(n44)Footnote 44. 22 U.S.C. § 290i-9 (2000).

(n45)Footnote 45. 22 U.S.C. § 282k (2000).

(n46)Footnote 46. 22 U.S.C. § 290 l-7 (2000).

(n47)Footnote 47. 17 C.F.R. § 285 (1993).

(n48)Footnote 48. 17 C.F.R. § 286 (1993).

(n49)Footnote 49. 17 C.F.R. § 287 (1993).

(n50)Footnote 50. 17 C.F.R. § 288 (1993).

(n51)Footnote 51. 17 C.F.R. § 289 (1993).

(n52)Footnote 52. 17 C.F.R. § 290 (1993).

(n53)Footnote 53. A single trust fund is a non-collective trust fund, *i.e.*, a fund which is not established at the instance of, or by, a financial intermediary for the use of separate employers. Under this definition, a single trust fund would include those: (1) for employees of a single employer, (2) for employees of employers so closely related as to be regarded as a single employer *e.g.*, a parent and its subsidiaries; and (3) established and controlled by employers and/or a union representing the employees of such employers. Sec. Act Rel. No. 33-6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

(n54)Footnote 54. A collective trust fund is a trust fund maintained by a bank as an investment vehicle solely for corporate stock bonus, pension, or profit-sharing plans (other than Keogh plans) that meet the requirements for qualification under *Section 401(a) of the Internal Revenue Code. Id.*

"Maintained" means that the bank must exercise substantial investment responsibility, and not function in a mere custodial or similar capacity. *Id.* at 2073-22.

The Commission's Division of Investment Management, in a major 1992 study of the Investment Company Act, has recommended that § 3(a)(2) be amended to remove the exception for interests in collective trust funds and separate accounts in which participant-directed defined contribution plans invest. The Staff prefaced its recommendation with the observation that, for many, choosing where to invest their retirement plan assets is the most important investment decision they will ever make. "Protecting Investors: A Half-Century of Investment Company Regulation" at 179 (1992). The Division's recommendation was not adopted.

(n55)Footnote 55. An insurance company is specifically defined in § 2(13) of the Act:

The term "insurance company" means a company which is organized as an insurance company whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner, or a similar official or agency, of a State or territory or the District of Columbia; or any receiver or similar official or any liquidating agent for such company, in his capacity as such.

(n56)Footnote 56. Because of the length and complexity of this portion of § 3(a)(2), paragraphs indents have been added to the statutory language to aid comprehension.

(n57)Footnote 57. Note that Investment Company Act § 3(a)(11) excludes from the definition of an investment

company specified stock bonus, pension, and profit-sharing trusts and plans described therein.

(n58)Footnote 58. For a discussion of whether employee interests in benefit plans constitute securities, *see* § 2.01[11][c][v] *supra*.

(n59)Footnote 59. GC International, Inc., SEC No-Action Letter (Sept. 19, 1975).

(n60)Footnote 60. 439 U.S. 551, 99 S.Ct. 790, 58 L. Ed.2d 808 (1979) .

(n61)Footnote 61. Sec. Act Rel. No. 33-6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) .

(n62)Footnote 62. Op. Asst. Gen. Counsel, [1941-44 Transfer Binder] Fed. Sec. L.Rep. (CCH) P75,195 (1941).

See Leonard v. Drug Fair, Inc., 1979 U.S. Dist. LEXIS 9045 (D.D.C. 1979) , in which interests in a voluntary, contributory profit-sharing and retirement plan maintained by a bank were exempt from registration under Section 3(a)(2). The plan qualified under *Section 401 of the Internal Revenue Code* and the employer invested less than the total amount of its contributions in employer securities (*i.e.*, employee funds were not used to purchase employer securities).

(n63)Footnote 63. Sec. Act Rel. No. 33-6281, 46 FR 8446 (Jan. 15, 1981) .

In *Daniel, n.53 supra* , the Supreme Court stated that the purpose of the exemption was to relieve banks and insurance companies of certain registration obligations and that the amendment recognized a pension plan's interest or participation in a fund, not prospective beneficiaries' interests in the plan or the plan's assets. 439 U.S. at 565, 99 S. Ct. at 799, 58 L. Ed. 2d at 819 .

(n64)Footnote 64. *See* n.48, *supra.*, for a discussion of single trust funds.

(n65)Footnote 65. *See* n.48, *supra*.

(n66)Footnote 66. *See* Sec. Act Rel. No. 33-6188, 1980 SEC LEXIS 2141 (Feb. 1, 1980) as to the reasons for these first two exclusions from the exemption. This Release also provides interpretations as to availability of the Section 3(a)(2) exemption for employee benefit plans.

(n67)Footnote 67. "Qualified plans" must be pension or profit-sharing plans under § 401 or annuity plans that meet the criteria of § 404(a)(2) and § 401(c)(1).

(n68)Footnote 68. For the full text of Rule 180 *see Federal Securities Act of 1933* (A.A. Sommer, Jr., General Editor) Part 2, § 3 (Matthew Bender).

(n69)Footnote 69. Sec. Act Rel. No. 33-6363, 1981 SEC LEXIS 265 (Nov. 24, 1981) .



32 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.04

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.04 Short-Term Commercial Paper--Section 3(a)(3)

Section 3(a)(3) exempts:

Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal there of the maturity of which is likewise limited.

The exemption covers only "prime quality negotiable commercial paper" n1 -- short term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors. n2 As indicated, the exemption generally refers to an unsecured debt instrument with a maturity date not exceeding nine months that is usually backed by a bank line of credit. The legislative history for the exemption makes clear that the drafters were cognizant of the fact that commercial paper is seldom offered or sold to the general public. n3 The Senate Report on the exemption contains the following explanation:

Notes, drafts, bills of exchange, and bankers' acceptances which are commercial paper and arise out of current commercial, agricultural, or industrial transactions, and which are not intended to be marketed to the public, are exempted... It is not intended under the bill to require the registration of short-term commercial paper which, as is the usual practice, is made to mature in a few months and ordinarily is not advertised for sale to the general public. n4

The House Report adds that "Paragraph (3) exempts short-term paper of the type available for discount at a Federal Reserve bank and of a type which is rarely bought by private investors." n5 The requirement "available for discount at a Federal Reserve bank" was based on the then standard practice by member banks of the Federal Reserve system to discount commercial paper to meet reserve requirements. In its 1961 interpretative release on the subject, the Commission, relying on the legislative history, stated that commercial paper must be "eligible" for discounting by Federal Reserve banks. n6 Both the practice and the requirement have long been abandoned. n7 Because the exemption

was meant for securities "rarely bought by private investors," the courts have had no difficulty in finding that the exemption did not apply in situations where notes have been made available primarily to the general public. n8

The U.S. Supreme Court itself has made clear that in the interpretation of the commercial paper exemption in the Securities Act, and the corollary exclusion from the definition of security provided in section 3(a)(10) of the Exchange Act, n9 courts must guard against manipulation to investors' detriment. In *Reves v. Ernst & Young*, n10 the Court held that demand notes issued by a farmers' cooperative were securities, and thus subject to antifraud provisions of the Exchange Act. In doing so, the Court rejected the proposition that because "demand" notes were involved, their maturity should be interpreted as falling within the nine month period provided in section 3(a)(10) of the Exchange Act. The Court looked to legislative history of the Securities Act section 3(a)(3) exemption to point out that economic reality must be considered in assessing the plain words and intended scope of exceptions or exemptions. On the narrower point of "maturity" of an instrument for purposes of the commercial paper exemption or exclusions, the Court concluded that "demand" notes do not necessarily have short terms. In light of Congress' broader purpose in the federal securities laws to ensure that investments of all descriptions be regulated to prevent fraud and abuse, the Court refused to interpret the nine month maturity element of the commercial paper exemption or exclusion to cover the demand notes involved in the case. n11

It is certain in *Reves* that even if the subject notes had a specific nine month or less maturity, the Exchange Act exclusion and the Securities Act exemption would not apply. The notes were offered as investments, to significant numbers of people, pursuant to a plan of distribution. They were not "commercial paper" within the actual contemplation of either provision. Although the *Reves* Court did not have to address directly the question whether short term notes offered on a large scale to unsophisticated members of the public could ever be eligible for either the Securities Act exemption or the Exchange Act exclusion, the message seems clear enough. It is an increasingly important message, as the use of short term promissory notes offered and sold to unsophisticated individuals to raise risk capital for less than creditworthy enterprises in purported reliance on the section 3(a)(3) federal exemption became rampant, and abuses multiplied. n12

There should be no uncertainty regarding the intended scope of section 3(a)(3). In the leading interpretative release on the topic, the SEC stated that, in order to be exempt, the notes must be "prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper used to facilitate well recognized types of current operational business requirements." n13 The staff of the Commission has indicated that notes issued in small denominations (\$10,000) may make the notes accessible to the general public and, therefore, inconsistent with the Section 3(a)(3) exemption. n14 The requirement for prime quality is not capable of precise interpretation. The courts have held that companies that are either insolvent or experiencing liquidity problems cannot avail themselves of the 3(a)(3) exemption. n15 The difficulty comes with companies that are either not highly rated or unrated, for which favorable No-Action Letters are unlikely. n16

Some difficulty with respect to interpretation of this section has also centered on the term "current transaction." In a 1935 release, the Commission stated that this requirement must be determined in light of the particular facts and business practices of each case. n17 The Commission also stated: n18

In general, it would seem that the proceeds of notes having a maturity of not more than nine months, of the type normally issued by finance companies, may be regarded as used for current transactions if the following conditions are satisfied:

1. The issuer of notes for which exemption is claimed is in the business of making loans on or purchasing notes, installment contracts, or other evidences of indebtedness.
2. The proceeds of the notes for which exemption is claimed are used for current transactions, which may properly include either (a) the making of loans upon or the purchasing of such notes, installment

contracts, or other evidences of indebtedness in the usual course of business, or (b) the payment of outstanding notes exempt under Section 3(a)(3).

No further releases threw any light on the meaning of "current transactions" until a release in 1961, at which time the Commission stated that the 1935 release referred to items composed of assets easily convertible into cash and comparable to liquid inventories of an industrial or mercantile company. n19

The Commission stated in the 1961 release that the staff had interpreted the Section 3(a)(3) exemption requirement of a maturity not to exceed nine months as not being met where there is an automatic rollover in effect. In addition, the Commission specified certain situations which it considered did not satisfy the "current transactions or the proceeds of which have been or are to be used for current transactions" standard: n20

[T]he current transactions standard is not satisfied where the proceeds are to be used for the discharge of existing indebtedness unless such indebtedness is itself exempt under Section 3(a)(3); the purchase or construction of a plant; the purchase of durable machinery or equipment; the funding of commercial real estate development or financing; the purchase of real estate mortgages or other securities; the financing of mobile homes or home improvements; or the purchase or establishment of a business enterprise.

However, the Commission's staff has issued favorable No-Action Letters in connection with short term notes issued to finance leases of non-permanent equipment with original terms of up to nine years. n21

FOOTNOTES:

(n1)Footnote 1. *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079 (7th Cir.), cert. denied, 409 U.S. 1009, 93 S.Ct. 443, 34 L.Ed.2d 302 (1972) .

(n2)Footnote 2. The SEC Staff has relied on several factors to determine whether commercial paper is of "prime" quality, including the financial strength of the issuer, support of the commercial paper by a form of credit enhancement, or rating of the commercial paper by a national rating agency. See Mercury Finance Co., SEC No-Action Letter (Jan. 20, 1989).

(n3)Footnote 3. An additional reason for the exemption may be the relative safety of commercial paper and the fact that risk ratings are readily available for most issuers.

(n4)Footnote 4. S. Rep. No. 47, 73d Cong., 1st Sess. 3-4 (1933).

Although qualifying commercial paper would not be offered to the public as such, issuers may engage in limited advertising, published from time to time, relating to the company's commercial paper programs. General Electric Capital Corp., SEC No-Action Letter (Jul. 13, 1994) (limited advertising of commercial paper programs available only to sophisticated institutional investors).

(n5)Footnote 5. H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933).

(n6)Footnote 6. Sec. Act Rel. No. 33-4412, 1961 SEC LEXIS 72 (Sept. 20, 1961) .

(n7)Footnote 7. 3 Loss and Seligman, Securities Regulation 1190 (3d ed. 1989), quoting SEC, Div. of Corp. Fin. Training Manual, Securities Act of 1933 234 n. 69 (1982), which states that the discounting practice by member banks of the Federal Reserve System had ceased by 1960. The "eligible" requirement apparently lingered, since release 4412 , n.4 *supra*, was issued in 1961.

In *Nomura Securities Int'l*, 1976 SEC No-Act. LEXIS 2389 (Nov. 8, 1976) , the Commission Staff declined to issue a favorable response where Nomura proposed to sell to institutional investors, under a 3(a)(3) exemption, certain Foreign Exchange Bills issued as direct unconditional notes of Japan, the proceeds of which were to be used for current transactions in foreign currencies and with maturities within the nine-month requirement. The letter of inquiry addressed the 'eligible for discounting by Federal Reserve banks' as the only criterion at issue, claiming that the language was illustrative and not a restriction. The Staff gave no indication as to the reason for its unfavorable reply.

(n8)Footnote 8. See *United States v. Hill*, 298 F. Supp. 1221 (D. Conn. 1969) (exemption not available where six month notes with rights attached to apply the principal amounts to the purchase of common stock were sold solely to members of the public and neither parent nor subsidiary had assets easily convertible into cash to support the notes).

See also *S.E.C. v. M.A. Lundy Assoc.*, 362 F. Supp. 226 (D.R.I. 1973) (certificates of beneficial interest in trusts advertised in newspapers of wide general circulation were not exempt under 3(a)(3) because they were issued for sale to the general public); *UBS Asset Management (New York) Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66 (S.D.N.Y. 1996) (Exemption is available only for prime quality commercial paper).

(n9)Footnote 9. 15 U.S.C. § 78c(a)(10). Section 3(a)(10) of the Exchange Act creates an exception from the definition of security for "any note...which has a maturity at the time of issuance not exceeding nine months." The effect of the exclusion in the Exchange Act versus the exemption in the Securities Act is that qualifying instruments under the Exchange Act are outside the ambit of antifraud provisions of that act. The exemption under section 3(a)(3) of the Securities Act, on the other hand, is from registration provisions of the act, but not its antifraud provisions.

(n10)Footnote 10. 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed 2d 47 (1990) .

(n11)Footnote 11. See *Reves*, 494 U.S. at 73 .

(n12)Footnote 12. See, e.g., Allen R. Asker, Init. Decision No. 26, Admin. Proc. File No. 3-7401 (SEC, Feb. 14, 1992) (It is the character of the note, not its maturity date, which determines coverage under the registration provisions of the securities laws).

(n13)Footnote 13. Sec. Act Rel. No. 33-4412, 1961 SEC LEXIS 72 (Sept. 20, 1961) .

(n14)Footnote 14. 1975 SEC No-Act. LEXIS 2025, *Spokane Mortgage Co.*, October 3, 1975 .

(n15)Footnote 15. See *Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1398 (S.D.N.Y. 1974) . Despite a rating of "prime quality" by a national rating service, the court interpreted the word "prime" in Sec. Act Rel. No. 33-4412 *supra*, in its generic usage as meaning excellent quality. The Penn Central commercial paper at issue could not be considered prime because of evidence to the contrary at the time of sale, with the issuer becoming insolvent shortly thereafter.

In *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.) , cert. denied, 409 U.S. 1009, 93 S. Ct. 443, 34 L. Ed. 2d 302 (1972) , the Court found that the company's insolvency made it highly unlikely that paper at issue was either prime quality or issued to facilitate current transactions.

(n16)Footnote 16. Significant factors are likely to be the amount of relevant financial information available to the investors and their financial sophistication.

(n17)Footnote 17. Sec. Act Rel. No. 33-401, 1935 SEC LEXIS 614 (June 18, 1935) .

(n18)Footnote 18. *Id.*

(n19)Footnote 19. *See* Sec. Act Rel. No. 33-4412, 1961 SEC LEXIS 72 (Sept. 20, 1961) .

(n20)Footnote 20. *Id.*

(n21)Footnote 21. No-Action Letter, GATX Leasing Corporation, May 20, 1980.



33 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.05

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.05 Securities of Charitable Organizations--Section 3(a)(4)

Section 3(a)(4) provides an exemption from registration for certain non-profit organizations as follows:

Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual; or any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940.

The legislative history with respect to this section makes it clear that Section 3(a)(4) exempts "securities of a noncommercial character issued by eleemosynary institutions." n1

As stated in *SEC v. Children's Hospital*, n2 the exemption is not available when the issuing institution is either organized or operated for a substantially non-charitable purpose. This opinion is often cited because of its analysis of the key language in Section 3(a)(4). n3 First, with respect to the word "exclusively," the court referred to prior decisions concerning similar exemptions in other federal laws and held that, if a substantial non-charitable purpose is being served in connection with either an organization or the operation of an issuer of securities, the exemption is not available for the securities of the issuer. n4 With respect to the word "organized," the court pointed out that corporate charter and by-laws are not the sole determinants as to whether a corporation is organized for charitable purposes and that the court can determine the true corporate objective from all available facts.

With respect to "charitable... purposes," the court observed that the term requires dedication to a general public purpose for the benefit of an indefinite number of persons who are not required to give adequate consideration for benefits received, but that, as in this case, a hospital not conducted for the profit of anyone connected therewith can be a charitable institution irrespective of whether patients are required to pay for services rendered. Finally, "pecuniary profit" was construed to encompass profit, not only from net earnings, but from any source, arrangement, or

manipulation, whether such profit inures to anyone directly or indirectly connected with the corporation. Thus, in the case at bar, "pecuniary profit" encompassed the promoters' anticipated profit from the organization and promotion of the institution and from the construction of the facilities.

In *Children's Hospital*, the facts and circumstances furnished a fairly obvious basis for the court's finding of a substantial non-charitable purpose. In *S.E.C. v. Shreveport Medical Hospital*,ⁿ⁵ a subsequent case not involving any allegations of fraud, the promoter of a proprietary hospital had his debts assumed by a charitable organization that took over the venture and issued bonds to pay for the project. Even though the promoter had no role in the bond issue, the part of the proceeds from the bonds to be used to pay off the promoter's debt was interpreted by the court to constitute a substantial non-charitable purpose that made the Section 3(a)(4) exemption unavailable. Therefore, it is clear that, no matter how noble the goal of a nonprofit institution, the criteria for the exemption will be strictly applied.ⁿ⁶ The meaning of the word "fraternal" in the statutory language appears to be analogous to its interpretation in similar situations under federal tax law, and the position of the Commission is that the exemption is not available for securities of nonprofit organizations that are organized primarily for social, athletic, or recreational purposes.ⁿ⁷

The Commission has stated in an interpretative release that pooled income funds of public charities will be exempt provided certain criteria are met.ⁿ⁸ Pooled income funds are trusts through which a person transfers property to a public charity, giving an irrevocable remainder interest to the charity and retaining an income interest for one or more beneficiaries living at the time of transfer. Among the requirements under federal tax law, the fund must be maintained by the charity and the properties transferred to it must be commingled. The Staff of the Commission will not recommend any enforcement action if the following three criteria are met:

- (1) the fund must qualify as a recipient of the deductible contributions under *section 642(c)(5) of the Internal Revenue Code*;
- (2) each prospective donor must be furnished written disclosures that fully and fairly describe the operation of the fund; and
- (3) each person soliciting gifts by means of the fund must be either a volunteer, or a person who is employed in the public charity's overall fundraising activities who receives no commissions or other special compensation based on the amount of gifts transferred to the pooled income fund.ⁿ⁹

Section 3(a)(4) was amended by the Philanthropy Protection Act of 1995, to incorporate any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940. Without an exemption from the Investment Company Act, common investment pools formed for the purpose of investing and reinvesting in securities could be subject to registration requirements under the Investment Company Act, and the particular regulatory provisions applicable to investment companies. Section 3(c)(10) excludes from the definition of investment company, among others, "any company organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes no part of the net earnings of which inures to the benefit of any private shareholder or individual." The incorporation of section 3(c)(10) of the investment Company Act into section 3(a)(4) of the Securities Act is central to the ability of charitable entities to pool assets in common investment pools in order to benefit from greater economies of scale and the possibility of access to better investment managers.

As it has addressed considerations specifically under section 3(a)(4) of the Securities Act for charitable pooled funds, the SEC staff has often granted no-action advice under applicable provisions of the Investment Company Act.ⁿ¹⁰ No action advice under the Investment Company Act is premised on representations by charitable entities that they will not assign, encumber, or otherwise transfer any part of their interests in common investment pools. These "Charitable Pooling Representations" are intended to ensure that the fundamental characteristics of the common investment pools remain charitable in nature. The Charitable Pooling Representations made for purposes of the Investment Company Act

exemption track and expand criteria articulated by the SEC staff discussed above. n11

FOOTNOTES:

(n1)Footnote 1. H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933). Securities to be issued by a social or recreational organization, such as a golf and country club or a skeet shooting organization, even if no member expects to make a profit on the ownership of that security, do not fit within this exemption. See SEC No-Action Letters, Western American Communities (March 3, 1981) and National Skeet Shooting Association (June 5, 1979).

See also *In re Calozza Litig.*, 1995 U.S. Dist. LEXIS 22470 (W.D. Wash. 1995) ("Sons of Norway" fraternal benefit society organized to provide insurance benefits to its member-owners was not organized or operated for pecuniary profit, and its securities would be exempt from registration under section 3(a)(4)).

(n2)Footnote 2. *214 F. Supp. 883 (D. Ariz. 1963)* .

(n3)Footnote 3. *Children's Hospital*, *214 F. Supp. 883* . The promoters of a children's hospital had offered and sold unregistered first mortgage bonds to residents of several states through advertisements, brochures, and sales letters containing untrue, deceptive and misleading statements of material facts and omitting facts of material significance. The promoters each received monthly salaries and planned to set aside 10 percent of the total proceeds of the bond issue for overhead, promotion and cost of sales. The portion of the 10 percent not so expended was to be retained by the promoters as compensation for their services. The compensation was increased to allow for a contractor's profit when the promoters, without bidding, assumed the contract for construction of the hospital. A permanent injunction was granted after a default by the defendants who had not filed an answer to the complaint.

(n4)Footnote 4. The court cited to *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283, 66 S. Ct. 112, 114, 90 L. Ed. 67, 71 (1945) : "[T]he presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes." *214 F. Supp. at 888* .

(n5)Footnote 5. Litig. Rel. 2498, 1963 SEC LEXIS 819 ; 2514, 1963 SEC LEXIS 835 (W.D. La. 1963) .

(n6)Footnote 6. See *S.E.C. v. American Foundation for Advanced Education of Arkansas*, *222 F. Supp. 828 (W.D. La. 1963)* in which a nonprofit organization, organized essentially to provide a means for assisting parents to pay for higher education, was found to be not operating exclusively for educational purposes because it returned its profits to its members, whose principle motivation in purchasing the organization's securities was the element of profit.

See also *Topeka Chamber Industrial Development Corporation*, 1979 SEC No-Act. LEXIS 3008 (July 12, 1979) in which a tax exempt business league utilized fund raising to improve and develop industrial property for the betterment of the community. A proposed issue of debentures to sophisticated business entities under the 3(a)(4) exemption did not receive a favorable response from the Commission Staff because the purposes of the league did not appear to be exclusively charitable in nature.

(n7)Footnote 7. *Western American Communities*, 1981 SEC No-Act. LEXIS 3500 (Apr. 30, 1981) .

(n8)Footnote 8. Securities Act Rel. No. 33-6175, 1980 SEC LEXIS 2285 (Jan. 10, 1980) . See also *National Association of Congregational Christian Churches of the United States*, SEC No-Action Letter (Aug. 11, 1995).

(n9)Footnote 9. *Id.*

(n10)Footnote 10. See, e.g., *Mercy Investment Programs, Inc.*, 2003 SEC No-Act. LEXIS 587 (June 12, 2003) .

(n11)Footnote 11. As part of the Charitable Pooling Representations, charitable entities represent that: (1) the common investment pool must be organized and operated at all times exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes; (2) no part of the common investment pool's net earnings may inure to the benefit of a private shareholder or individual; (3) the common investment pool and each participant must be exempt from taxation under *section 501(c)(3) of the Internal Revenue Code*; and (4) each participant may invest only funds over which it has immediate, unrestricted, and exclusive use, benefit and enjoyment; (5) participants will not invest assets that are attributable to a retirement plan providing for employee contributions or variable benefits; (6) certified public accountants annually will prepare a written report on the common investment pool, and will send the report to participants; and (7) each participant will be informed that the common investment pool is not an investment company under the Investment Company Act of 1940. *See* Mercy Investment Programs, Inc. , *supra*.



34 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.06

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.06 Securities of Savings and Loan Associations and Similar Institutions--Section 3(a)(5)

Section 3(a)(5) of the 1933 Act exempts securities issued by savings and loan and similar associations and by farm cooperatives and related organizations. The Section states:

Any security issued (A) by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution; or (B) by (i) a farmer's cooperative organization exempt from tax under *section 521 of the Internal Revenue Code of 1986*, (ii) a corporation described in section 501(c)(16) [Crop Operations Financing Corporation] of such Code and exempt from tax under section 501(a) of such Code, or (iii) a corporation described in section 501(c)(2) [Title-Holding Corporation] of such Code which is exempt from tax under section 501(a) of such Code and is organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization or corporation described in clause (i) or (ii).

The House Committee Report states: "[This provision] exempts the securities of building and loan institutions and similar institutions, but insists that such institutions, as a condition to being exempted from the Act, must do a true building and loan business by confining their business to the making of loans to their members." n1 As pointed out in an opinion by the chairman of the Federal Trade Commission, which at that time had jurisdiction over the Securities Act: "[O]ne of the reasons for the exemption contained in Section 3(a)(5) of the Act was 'a belief that persons joining in such cooperative projects were less likely to need the protection from each other afforded by registration than persons dealing with issuers of the usual type.'" n2

The key requirement as it applies to savings and loan and other associations under Section 3(a)(5)(A) is that they be institutions that are supervised and examined by the federal or state authorities appropriate for this type of organization. Thus, a credit union was able to receive a favorable No-Action Letter where supervision by a state finance department was similar to the supervision given to savings and loan associations and the general purpose and operation of the credit

union was to maintain share accounts for its members and to issue loans to members on approved credit. n3

In one of the few cases to construe Section 3(a)(5), *SEC v. American International Savings & Loan Association*, n4 the court found that the institution was not a savings and loan association within the meaning of the relevant state statute and could not meet the requirement, which was then part of the statutory language for the exemption, n5 that substantially all of its business be confined to the making of loans to members. The court noted that the association was not issuing stock to raise capital for its regular business, only two loans had ever been made by the association, and the indispensable attribute of mutuality was lacking. n6

The securities to be issued by the association must, under the statutory language, represent interests in the association itself. Therefore, an association was able to obtain a favorable No-Action Letter where it proposed to issue retail repurchase agreements as its own securities, not as pass-through certificates or participations in the related government securities purchased by the association. n7 Under the proposed arrangement, purchasers would obtain none of the economic characteristics of ownership of the government securities, including no risk of loss or opportunity for gain from capital value fluctuation, and the interest rate for the agreements was not dependent on the interest rate earned by the government securities. n8 In contradistinction, where an association proposed to make investments in state and local tax exempt bonds available to investors through participation interests in a fiduciary account, whereby the owner of an interest would receive, on a pass-through basis, the owner's pro rata share of principal and interest payments made on collective holdings, the Staff of the Commission was unable to conclude that the participation interests would be deemed securities issued by a savings and loan association. n9 Likewise, if securities are issued without recourse by an association, they very likely fall outside the exemption. n10

If members of an association transfer their securities to a voting trust controlled by the Board of Directors of the association, the Board, not the association, will be considered the issuer of the certificates and the 3(a)(5) exemption will, therefore, not be available. n11 This result is mandated by the definition of "issuer" in Section 2(4) of the 1933 Act: "[W]ith respect to...voting-trust certificates... the term issuer means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued..." n12

FOOTNOTES:

(n1)Footnote 1. 2 H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933).

(n2)Footnote 2. Opinion of F.T.C. Chairman, 1 Fed. Sec. L. Rep. (CCH) P 2065 (Dec. 16, 1933)

(n3)Footnote 3. Idaho Central Credit Union, 1977 SEC No-Act. LEXIS 286 (Feb. 14, 1977) .

(n4)Footnote 4. 199 F. Supp. 341 (D. Md. 1961) .

(n5)Footnote 5. At the time that this case was decided, § 3(a)(5) contained the additional language that an association under (A) must be an association "substantially all the business of which is confined to the making of loans to members." This language derived from the Internal Revenue Code and was deleted from § 3(a)(5) after it was deleted from the Code.

(n6)Footnote 6. 199 F. Supp. at 349-50 .

(n7)Footnote 7. Home Federal Savings and Loan Association, 1981 SEC No-Act. LEXIS 4138 (Oct. 26, 1981) .

(n8)Footnote 8. *Id.* The way in which securities are marketed may offer some insight into whether a proposed security is exempt. In *Home Federal Savings*, the fact that the advertisements for the Agreements would state that they

were uninsured obligations of the association with no mention of a security interest in government securities was likely of some significance in the favorable No-Action letter.

(n9)Footnote 9. Central West End Savings and Loan Association, 1984 SEC No-Act. LEXIS 2390 (July 19, 1984)

(n10)Footnote 10. *See* Security Federal Savings and Loan Association of Albuquerque, 1990 SEC No-Act. LEXIS 1046 (Aug. 17, 1990) , in which the association proposed to sell participations in promissory notes evidencing short-term construction loans to institutional investors. In the event of a default on a loan, the association would foreclose on the mortgage securing the note and pay the investors a pro rata amount of funds realized in the foreclosure action. An unfavorable response to this arrangement by the Staff of the Commission was at least in part due to the fact that the participation interests would be issued without recourse to the association.

(n11)Footnote 11. Uptown Federal Savings and Loan Association, and Niles Federal Savings and Loan Association, 1982 SEC No-Act. LEXIS 2717 (Aug. 30, 1982) .

(n12)Footnote 12. *See also* Sec. Act Rel. No. 33-86, 1933 SEC LEXIS 90 (Dec. 13, 1933) , in which the chairman of the Federal Trade Commission expressed the opinion that securities of a mortgage loan company fell within the meaning of "similar institutions" as used in the section if the stock of the company were issued only to borrowers or if the stock issued to borrowers carried voting rights in the same proportion to their investment as that issued to the organizers, but that voting certificates issued in return for such exempt stock are subject to the registration requirements of the Act.



35 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.07

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.07 Securities of Railroad (Common Carrier) Equipment Trusts--Section 3(a)(6)

Section 3(a)(6) exempts the securities of railroad equipment trusts, which are defined to include common carrier equipment trusts. The exemption covers:

Any interest in a railroad equipment trust. For purposes of this paragraph any "interest in a railroad equipment trust" means any interest in an equipment trust, lease, conditional sales contract, or other similar arrangement entered into, issued, assumed, guaranteed by or for the benefit of, a common carrier to finance the acquisition of rolling stock, including motive power.

The scope of the 3(a)(6) exemption has been severely curtailed since its original enactment. In the wake of the collapse of Penn Central and other railroads in the 1970s, Congress enacted the Railway Revitalization and Regulatory Reform Act of 1976. n1 As part of this legislation, protection of the federal securities laws was extended to investors in securities of railroads by repealing certain exemptions previously afforded to such securities in the securities laws. n2 There remained an exemption for the securities of motor carriers that were subject to Section 214 of the Interstate Commerce Act. n3 However, that portion of the section 3(a)(6) exemption was repealed in 1982, at which time the securities of common carriers became subject to the full requirements of federal securities laws.

All that remains of the section 3(a)(6) exemption today is any interest in a "railroad equipment trust," defined to include equipment trusts of common carriers. The Interstate Commerce Commission ("ICC") is empowered to determine that a railroad equipment trust interest is an exempt security under 3(a)(6). n4 The ICC is also authorized to exempt from Section 5 of the Securities Act securities issued by committees in proceedings under the Interstate Commerce Act. n5

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 94-210, 90 Stat. 31 (1976).

(n2)Footnote 2. S. Conf. Rep. No. 94-595, 94th Cong., 2d Sess. at 168-69 (1976).

(n3)Footnote 3. *49 U.S.C.A. § 314 (1963)* (repealed). The section was succeeded in 1978 by *49 U.S.C.A. § 11302*, which was repealed in 1982.

(n4)Footnote 4. *49 U.S.C.A. § 11367(b)*.

(n5)Footnote 5. *Id.*



36 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.08

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.08 Certificates of Receivers and Trustees--Section 3(a)(7)

Section 3(a)(7) exempts:

Certificates issued by a receiver or by a trustee or debtor in possession in a case under title 11 of the United States Code, with the approval of the court.

Section 3(a)(7) was amended by Section 306(a) of the Bankruptcy Reform Act of 1978, n1 to reflect the exemption provided under that Act for the issuance of non-equity securities. To qualify under Section 3(a)(7), a security must be issued with the approval of a court. n2 If qualified, the security will be an exempt security and may be sold or resold without registering under the 1933 Act.

The exemption should be considered in conjunction with the exemption in Section 364(f) of the Bankruptcy Reform Act for any debt security issued by a trustee to obtain credit. That section provides as follows: n3

(f) Except with respect to an entity that is an underwriter as defined in section 1145(b) of this title, section 5 of the Securities Act of 1933 (*15 U.S.C. 77e*), the Trust Indenture Act of 1939 (*15 U.S.C. 77aaa et seq.*), and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under this section of a security that is not an equity security.

By its terms, Section 364(f) applies only to non-equity securities that are offered or sold under this Section. Thus, unlike securities that qualify as exempt securities under Section 3(a)(7), the Section 364(f) exemption only applies to transactions occurring under this section and, therefore, does not apply to subsequent sales outside this section.

Section 364(f) of the Bankruptcy Reform Act also offers advantages over the provision in Section 3(a)(7). Unlike the Securities Act, Section 364(f) preempts state and local law. Also, securities exempted under Section 364(f) include those issued without the approval of a court under Section 367(a).

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 95-598, 92 Stat. 2674 (1978).

See 8 Collier on Bankruptcy, App. Pt. 4(a) (Matthew Bender 15th ed.).

(n2)Footnote 2. In order to come within the requirements of the 3(a)(7) exemption, the certificates must be issued by a receiver, trustee, or debtor in possession, not by a third party under an agreement with them. *See* O'Neill Bondholders Committee, 1974 SEC No-Act. LEXIS 107 (Aug. 9, 1974) .

(n3)Footnote 3. *11 U.S.C.A. § 364(f) (1993).*

See 8 Collier on Bankruptcy, Ch. 1145 (Matthew Bender 15th ed.) for a complete discussion of the exemption from the securities laws provided by § 1145 of the *Bankruptcy Code*.



37 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.09

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.09 Insurance Policies and Annuity Contracts--Section 3(a)(8)

Section 3(a)(8) exempts insurance policies and certain annuity contracts as follows:

Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

The House Report on this section of the Act explains that: n1

Paragraph (8) makes clear what is already implied in the Act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the Act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the Act, but the specific exemption is included to make misinterpretation impossible.

In light of the legislative history, the Supreme Court and the SEC have acknowledged that insurance policies are excluded from the coverage of the Securities Act. n2 The Section 3(a)(8) exemption has been referred to by a leading authority to be an example of supererogation, meaning that it goes beyond what was necessary to exclude insurance policies from the Securities Act. n3 Indeed, Congress itself explained that section 3(a)(8) "makes clear what is already implied in the act, namely that insurance policies are not to be regarded as securities subject to provisions of the act." n4

Insurance, as such, is not a security. Nevertheless, because modern non-traditional insurance products have "investment" characteristics and are marketed with emphasis on those features, courts have analyzed these products as "investment contracts" under the definition of "security" in section 2 of the Act as well as under the exemption provided in section 3(a)(8). This is particularly the case with variable annuities. Historically, the assessment as to whether a life

insurance policy or annuity contract constitutes an "investment contract," and thus a security, turned on the extent to which there was a significant assumption of both mortality and investment risks by the issuer. In the landmark case of *S.E.C. v. Variable Annuity Life Insurance Company*,ⁿ⁵ the Supreme Court held that a variable annuity under which the purchaser assumes all investment risk concerning both the value of the investor's interest in the annuity and the success of the issuer's investment management was not insurance. The Court found that the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense and that the concept of insurance involves some investment risk taking on the part of the company.ⁿ⁶

In *S.E.C. v. United Benefit Life Insurance*,ⁿ⁷ the Supreme Court expanded on the notion of "investment risk" associated with annuity products in determining whether a security is involved rather than insurance. In *United Benefit*, the issuer provided a low, guaranteed minimum rate of return. The issuer pooled purchasers' premium payments in a separate fund for investment but guaranteed a low minimum rate of return. Whether a purchaser could receive payments in excess of the guaranteed rate depended upon the fund's investment success, and could not be determined until after the purchaser's right of recovery matured. In holding that the flexible fund annuity constituted an investment contract despite the guaranteed minimum return, the Court stated that because the guaranteed rate of return was substantially lower than returns guaranteed by conventional annuities, purchasers necessarily relied upon the investment skills of the issuer to provide the bulk of the return. This product, said the Court, was intended to appeal to the purchaser not on the usual insurance basis of stability and security, but rather on the prospect of growth.ⁿ⁸ The guarantee of cash value was an insufficient investment risk on the part of the insurance company; it only reduced the investment risk of the contract holder.ⁿ⁹

Exposing insurance and annuity products to regulation under the federal securities laws through investment contract analysis brought new attention to the section 3(a)(8) exemption. Approaches to the application of section 3(a)(8) likewise turned on the extent to which the issuer of an "insurance" product significantly assumed both mortality and investment risks.ⁿ¹⁰

In 1986, the Commission adopted Rule 151 under the Securities Act.ⁿ¹¹ Rule 151 creates a safe harbor for annuity and "optional" annuity contracts as exempt securities under section 3(a)(8). Under rule 151, an annuity contract issued by a state-regulated insurance company is deemed to be within Section 3(a)(8) of the Securities Act if (1) the insurer assumes the investment risk under the contract in the manner prescribed in the rule; and (2) the contract is not marketed primarily as an investment. The issuing corporation must be supervised by the insurance or banking commissioner or other agency performing similar functions in a state, territory, or the District of Columbia.ⁿ¹² The contract must *not* be marketed primarily as an investment and the insurer must assume the investment risk with respect to it. The rule specifies the conjunctive criteria under which the insurer will be deemed to have assumed the investment risk, which are:ⁿ¹³

- (1) the value of the contract does not vary according to the investment experience of a separate account;
- (2) the insurer for the life of the contract, guarantees the principal amount of purchase payments and interest and credits a specified rate of interest to the net principal and interest accrued; and
- (3) the insurer guarantees that the rate of any interest paid in excess of the guaranteed minimum will not be modified more than once a year.ⁿ¹⁴

The extent to which the federal securities laws, and the scope of the section 3(a)(8) exemption apply to annuities, took on renewed prominence with the adoption of SEC Rule 151A,ⁿ¹⁵ which defines the terms "annuity contract" and "optional annuity contract" under the Securities Act. The rule, which is effective January 12, 2011, was spawned by marketing of "equity indexed" annuities is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. Section 3(a)(8) of the Securities Act provides an exemption for certain "annuity contracts," "optional annuity contracts," and

other insurance contracts. Rule 151A prospectively defines certain indexed annuities as not being "annuity contracts" or "optional annuity contracts" under this exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s. The central consideration in regard to them, however, is the constant in all assessments of the characteristics of insurance and annuity products--the allocation of risk. Regarding these particular products, the SEC explained:

Individuals who purchase indexed annuities are exposed to a significant investment risk--i.e., the volatility of the underlying securities index. Insurance companies have successfully utilized this investment feature, which appeals to purchasers not on the usual insurance basis of stability and security, but on the prospect of investment growth. Indexed annuities are attractive to purchasers because they offer the promise of market-related gains. Thus, purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts.

When the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract, this indicates that the majority of the investment risk for the fluctuating, securities-linked portion of the return is borne by the individual purchaser, not the insurer. The individual underwrites the effect of the underlying index's performance on his or her contract investment and assumes the majority of the investment risk for the securities-linked returns under the contract. n16

Rule 151A operates simply to define a class of indexed annuities that are outside the scope of Section 3(a)(8). If more often than not the purchaser of an indexed annuity will receive a guaranteed return like that of a traditional fixed annuity, then the instrument will be treated as insurance. On the other hand, if more often than not the purchaser will receive a return based on the value of a security, then the instrument will be treated as a non-exempt security. With respect to the latter group of indexed annuities, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections.

To be sure, the "business of insurance" is generally not a matter for federal regulation. The McCarran-Ferguson Act n17 provides that no federal law may impair or supersede any law enacted by a state for the purpose of regulating the business of insurance. n18 Insurance or insurance-based financial products such as variable annuities that may be considered "insurance," but which have investment characteristics to the extent that they may be subject to regulation as investment contract "securities" set the stage for a clash in many circumstances between the McCarran-Ferguson Act limitation on federal authority and the intended investor protection goals of the federal securities laws. This clash is no more clearly in evidence than in regard to the regulation of "viatical settlements."

A viatical settlement is a contract by which the purchaser acquires an interest in the life insurance policy of a terminally ill person at a discount of some significant percentage amount based upon the life expectancy of the insured. When the insured dies, the purchaser of the viatical settlement receives the full death benefit under the insurance policy, profiting by the difference between the discounted purchase price paid to the insured and the death benefit collected from the insurer, less transaction costs, premiums paid, and other administrative expenses. The treatment of viatical settlements as securities is beyond the scope of this chapter, and is considered specifically in Chapter 2. However, because a critical element of viatical settlements is an insurance policy, in *SEC v. Life Partners, Inc.*, n19 the asserted regulation of the SEC over viaticals under federal securities laws was challenged as amounting to regulation of the business of insurance. Rejecting that challenge, the court opined that the viatical settlements involved did not evidence any risk pooling that is the essential characteristic of insurance. The fact that an insurance policy underlies a viatical settlement is of no consequence, said the court. The "business of insurance" within the ambit of the McCarran-Ferguson Act encompasses the relationship between an insured and an insurance company, not between a promoter and its investors.

Identifying what is or is not "insurance" or an annuity regulated by an appropriate state authority plays an obvious role in applications of the section 3(a)(8) exemption. More often, however, the question will be whether insurance is involved at all.

FOOTNOTES:

(n1)Footnote 1. H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933).

(n2)Footnote 2. *S.E.C. v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 73-74, 79 S.Ct. 618, 623, 3 L. Ed. 2d 640, 646 (1959) (Brennan, J., concurring); *Tcherepnin v. Knight*, 389 U.S. 332, 342 n. 25, 88 S. Ct. 548, 555 n. 25, 19 L. Ed. 2d 564, 572 n. 25 (1967) .

Sec. Act Rel. No. 33-6558 1984 SEC LEXIS 258 (Nov. 21, 1984) .

(n3)Footnote 3. 2 Loss and Seligman, Securities Regulation 1001 (3d ed. 1989).

(n4)Footnote 4. H.R. Rep. No. 73-85, 73rd Cong., 2d Sess., 15 (1933)

(n5)Footnote 5. 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959) .

(n6)Footnote 6. *Variable Annuity Life Insur. Co.*, 359 U.S. at 71 .

(n7)Footnote 7. 387 U.S. 202, 87 S. Ct. 1557, 18 L. Ed. 2d 673 (1967) .

(n8)Footnote 8. *See United Benefit Life Insur.*, 387 U.S. at 210-211 .

(n9)Footnote 9. *See United Benefit Life Insur.*, 387 U.S. at 210-211 .

But see Malone v. Addison Ins. Marketing, Inc., 225 F. Supp. 2d 743 (W.D. Ky. 2005) (Fixed, indexed, deferred annuity contracts that guaranteed a minimum 3% return held to be "fixed annuities" and therefore exempt under section 3(a)(8)).

For further discussion of whether annuities constitute a contract of insurance, *see* § 2.01[11][c][vii] *supra*.

(n10)Footnote 10. *See, e.g., In re Baldwin-United Corp.*, 55 B.R. 885 (S.D. Ohio 1985) , (Single premium deferred annuities were exempt securities since the insurance company underwriting them undertook both a significant investment risk and a meaningful mortality risk).

In a 1979 Release, the SEC issued a general statement of policy regarding the determination of the status under the federal securities laws of certain contracts issued by insurance companies. With the focus on section 3(a)(8), the Commission emphasized that a significant assumption of both mortality and investment risk was critical to the availability of the section 3(a)(8) exemption for insurance and annuity products that would otherwise be subject to regulation as investment contracts. *See* Sec. Act Rel. No. 33-6051 (Apr. 5, 1979). This Release was withdrawn in 1986, coincident with the adoption of Rule 151 under the Securities Act, discussed further below.

(n11)Footnote 11. 17 C.F.R. § 230.151.

(n12)Footnote 12. Both Section 3(a)(8) and Rule 151 refer to "corporations" supervised by the insurance or banking commissioner or similar agency. With respect to pension and profit sharing plans, Section 3(a)(2) refers to a contract issued by an "insurance company," which is specifically defined in Section 2(13) of the Securities Act.

Rule 151 does not establish an all-inclusive definition purporting to encompass every annuity or insurance contract that falls within the section 3(a)(8) exemption. *See* Sec. Act Rel. No. 33-6645 (June 4, 1986). Rather, the rule defines a class of instruments that the SEC believes to be clearly covered by section 3(a)(8). Consequently, a contract that does not fall squarely within the safe harbor of the rule may still be exempt under section 3(a)(8). Additionally, contracts or policies issued before prior to the adoption of Rule 151 are not eligible for consideration under the rule, and will be assessed on the basis of section 3(a)(8) and interpretive case law, *see, e.g.*, *Rothwell v. Chubb Life Ins. Co. of America*, No. 96-83-B, 1998 U.S. Dist. LEXIS 22630 (D.N.H. 1998) .

(n13)Footnote 13. For the full text of Rule 151, *see* Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

(n14)Footnote 14. In *Berent v. Kemper Corp.* 780 F. Supp. 431 (E.D. Mich. 1991) , the court applied Rule 151 to a life insurance policy, under which an insurer assumed the investment risk as required, guaranteed the principal amount of purchase payments and interest less any deductions, and agreed to pay a specified rate of interest under the contract. With these characteristics, the court concluded that the product was an exempt security, since it met the safe harbor requirements of Rule 151..

(n15)Footnote 15. 17 C.F.R. § 230.151A.

(n16)Footnote 16. Sec. Act Rel. No. 33-8996, at 4-5 (Jan. 8, 2009).

(n17)Footnote 17. 15. U.S.C. § 1012(b).

(n18)Footnote 18. *See SEC v. National Securities, Inc.*, 393 U.S. 453, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969) (Statute governing sale and advertising of insurance policies regulates the "business of insurance").

(n19)Footnote 19. 87 F.3d 536 (D.C. Cir. 1996) .



38 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.10

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.10 Voluntary Exchanges Between Issuer and Security Holders--Section 3(a)(9)

[1] In General

Securities Act Section 3(a)(9) provides an exemption from registration for "any security exchanged 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." The Section 3(a)(9) exemption is used primarily for recapitalizations, in which an issuer exchanges one class of securities for another, n1 and for the issuance of new securities upon the exercise of conversion rights by the holders of convertible securities. It is also applicable to more subtle corporate financial transactions that may not initially appear to involve an exchange of securities. For example, a modification of the terms of an existing security, such as the extension of the maturity date on a debt instrument or the extension of the exercise period of warrants, may be considered a sale and exchange of securities that may qualify for an exemption under Section 3(a)(9). n2 The exemption also can be used for the exchange of existing common stock for new notes of the issuer. n3

The exemption under Section 3(a)(9) coexists with the provisions of Rule 145. Rule 145 deems an offer or sale to occur when security holders are asked to give their consent to a proposed transaction and, as a result, they receive a new or different security in exchange for their existing security, on the theory that this constitutes a new investment decision. The Preliminary Notes to the rule state that: n4

Transactions for which statutory exemptions under the Act, including those contained in sections 3(a)(9), (10), (11) and 4(2), are otherwise available are not affected by Rule 145.

...

A reclassification of securities covered by Rule 145 would be exempt from registration pursuant to section 3(a)(9) or(11) of the Act if the conditions of either of these sections are satisfied.

Rule 145 applies, *inter alia*, to reclassifications of securities, which are defined in Rule 145(a)(1) to include the substitution of one security for another, but to exclude a stock split, reverse stock split, or change in par value. Thus, to the extent that an exchange of securities does not qualify under the 3(a)(9) exemption, it is subject to Rule 145. n5

As with all exemptions, consideration should be given to what disclosures should be made in order to avoid violations of the civil liability and antifraud provisions of the Securities Act. In addition, although an exchange of shares may be exempt under Section 3(a)(9), the solicitation of the exchange must comply with the proxy provisions of Section 14(a) of the Exchange Act and the rules promulgated thereunder. n6 Likewise, the rules against market manipulation may come into play. n7

[2] Statutory Requirements

Section 3(a)(9) provides the following exemption: n8

Except with respect to a security exchanged in a case under title 11 of the United States Code, any security exchanged 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.

The statutory language of the Section 3(a)(9) exemption can be divided into four requirements. Availability of the exemption depends on: a single issuer; an exchange of securities; limitation of the exchange to existing security holders only; and no payment of commission or remuneration for solicitation of the exchange. The Commission has implied an additional requirement that the exchange be made in good faith and not as a step in a plan to avoid the registration requirements of the Act.

[a] Single Issuer. The Section 3(a)(9) exemption is by its terms available to single issuers only. The issuer of the securities to be given up must also be the issuer of the new securities. If the exchange is being undertaken to create a new entity, the exemption is not available where the new and old entities will be considered separate issuers. For example, the exemption is not available where general partnership interests are being exchanged for limited partnership interests, because the issuer of the limited partnership interests is a new entity that did not exist prior to the exchange, even though the same principal parties may be acting on behalf of both entities. n9

The continuation of a voting trust may be deemed to be the sale of a security and, unless the continuation is expressly provided for in the original trust instrument, will be considered to create a new trust and, therefore, involve a different issuer. In *Reserve Life Insurance Company v. Provident Life Insurance Company*, n10 the court held that, because a voting trust had an express provision for an extension of ten years beyond its initial period, the continuation of the trust qualified as an exchange under Section 3(a)(9). The continuation provision had been included to give the participants the flexibility to extend the trust for a period that might be reasonably necessary to carry out the trust's purpose of protecting against corporate raids. The trust, as extended, was not considered to be a new legal entity. Therefore, the transaction was considered to involve only a single issuer. n11

It appears that the Staff of the Commission will look beyond form to substance and economic reality in determining the identity of the issuer. Thus, a parent corporation may be considered to be a single issuer in a situation where the securities of one wholly owned subsidiary are exchanged for the securities of another wholly owned subsidiary and the subsidiaries have no economic substance or operations independent from the parent. n12 This is common where financing subsidiaries are involved in reorganizations in which an exchange offer is made between "old" and "new" entities that, as a matter of economic reality, are the same issuer from the perspective of the security holders. n13 However, the exemption is not available for the issuance of common stock by the parent of a subsidiary which issued convertible bonds, guaranteed by the parent, which were convertible into the parent company's common stock. n14

In certain circumstances, a substituted primary obligor of a security will be considered the issuer of that security. Thus,

in a situation where a parent corporation became both the primary obligor with respect to a debt instrument and the issuer of the security resulting from the conversion of that debt obligation, the Commission considered the single issuer requirement to have been met. A significant fact was that the indenture for the debt securities provided for the substitution of the primary obligor without the consent of the security holders. n15 The "same issuer" conclusion in these circumstances is based on the fact that debt security holders of a subsidiary become security holders of the subsidiary's parent for purposes of section 3(a)(9) when the parent assumes joint and several liability with the subsidiary on the debt securities. Thus, when in the course of a reorganization or reclassification transaction, new securities are offered to the debt security holders in an exchange offer, the parent may be considered the same issuer with respect to the former and new securities. n16 However, where an issuer assumes the obligation to issue a substituted underlying security upon the conversion of a convertible debt security, but not the obligation to pay the existing debt obligations according to their terms, the issuer of the underlying security does not meet the single issuer requirement because it has not fully assumed the obligations of the original issuer. n17

A lack of complete identity of an issuer will not preclude the use of section 3(a)(9) where the securities involve substantially similar investments. For example, the SEC Staff has taken a no-action position with respect to an exchange of guaranteed debt securities of a subsidiary in exchange for the securities of the parent company guarantor. n18 This position reflects economic reality, which is further illustrated in a Staff No-Action letter on the use of Section 3(a)(9) where securities issued by a pre-merger entity were exchanged with securities issued by a post-merger entity which had become a joint obligor with respect to the old securities. n19

Where securities are exchanged due to a change in corporate domicile, the entity as incorporated in the new jurisdiction is arguably not the same issuer. n20 However, Rule 145 applies to this situation. Under Rule 145(a)(2), there is a specific exemption where the sole purpose of a transaction is to change an issuer's domicile within the United States. n21 In these situations it is plain that there is one issuer of both the issued and surrendered securities. This is true in most reclassifications as well. n22

[b] Exchange of Securities. The Commission has consistently interpreted the term "exclusively" in the statutory language to modify "any securities exchanged" in addition to modifying "existing security holders." However, this construction of the statutory language is subject to several exceptions, including the provisions of Rules 149 and 150. Greater latitude is given to what issuers may offer in exchange than to what security holders must give up in order to take advantage of the offer.

In general, nothing other than securities may be given up by the security holders in an exchange. If security holders must make a payment in cash in addition to giving up their securities, the requirement will not be met. However, where an exchange by the holders of convertible debentures involves the elimination of accrued interest on the debentures, the elimination of interest is not considered to be a cash payment by the security holders and therefore does not violate the requirement. n23 In addition, The Staff of the Commission has considered the requirement to be met where, as part of a restructuring plan, security holders execute releases that preclude potential litigation claims against the issuer that may arise as a result of the transaction. n24

However, the general rule of no cash payments by the security holders was modified by Rule 149. This rule allows security holders to make payments in cash which are necessary to effect equitable adjustments among security holders of the same class as to dividends or interest. n25

Although security holders are limited to making cash payments for equitable adjustments, Rule 150 allows the issuer to adopt an exempt Section 3(a)(9) plan of exchange under which payments are made to the security holders in connection with an exchange of securities. n26 The payment may be one that is paid directly in cash or indirectly, such as where an issuer reduces the conversion price on convertible securities. n27

An exchange of common shares for the right to receive, at the holders' option, either cash or securities was considered

exempt where there was no intent to sell assets to repay indebtedness related to the exchange and, subsequent to the merger, the company's operations would be essentially the same in all material respects. n28 Also, an offer under which shareholders could exchange common stock for an obligation by the issuer (the new security) to make payments for it in future installments of principal and interest was considered exempt. n29

The characteristics of the security issued in the exchange need not be the same as those of the security surrendered. Therefore, a recapitalization that eliminates voting rights on common stock may qualify under Section 3(a)(9). n30

[c] Existing Security Holders Exclusively. The exchange must be with existing security holders exclusively. A public offering of the same issue of securities will destroy the exemption, because the public offering will be integrated with the exchange offer as one issue and thus involve persons who are not existing security holders. n31 The Commission will not consider securities of different classes as parts of a single issue. n32

The conversion of a security that had been issued with a delayed conversion provision is clearly a transaction with an existing security holder. However, if a security is issued with an immediate conversion privilege, it is likely to be considered to be an offering of both securities, even though the actual conversion of such a security may be within the Section 3(a)(9) exemption. n33

[d] No Commission or other Remuneration for Soliciting the Exchange. Section 3(a)(9) requires that no commission or other remuneration be paid or given directly or indirectly for soliciting the exchange. The requirement is not violated if a company's directors and officers communicate with the security holders, provided there is no additional salary or other compensation being paid and the directors' and officers' activities are only incidental to their regular duties. n34 Such communications may involve the receipt of offering circulars, the security holders' understanding of the offer, the time span during which the exchange offer is available, answers to security holders' questions, and even comments on or affirmative representations on the merits of the exchange.

Companies may also employ investor relations organizations for a fixed fee to communicate with back office personnel at brokerages and banks and with other nominee security holders concerning details and understanding about the exchange. n35 Payments to financial advisers or investor relations firms in connection with an exchange offer will not constitute the payment of a commission or remuneration for purposes of section 3(a)(9) where the services to be rendered are merely administrative, the agent does not make any recommendations and the fee is not tied to the consummation of the exchange or the number of securities exchanged. n36 But a company's financial advisers and legal counsel who are being compensated for services in connection with an exchange offer must not solicit the exchange, nor can their compensation be contingent on consummation of the exchange. n37

Where more than one class of securities is voting on a recapitalization and only one class of securities would be involved in an exchange, it is not a violation of the no solicitation requirement to solicit the security holders of the classes of securities not being exchanged, as long as none of the holders so solicited are also holders of the class of securities being exchanged. n38

A brokerage's commissions paid under an independent clearing agreement with no additional fees to be paid for the exchange transactions will not violate the prohibition against commissions for soliciting. n39 However, the requirement will not be met where a brokerage gives an opinion of fairness with respect to an exchange and would communicate with shareholders and receive a fixed fee for the exchange. n40

Investment banking firms that participate in an exchange under a standby agreement n41 do not violate the requirement as long as they do not solicit the security holders. n42 However, because Section 3(a)(9) exempts only the exchange transactions, resales of securities acquired by an investment banker pursuant to a standby agreement cannot be Salomon Bothers, 1972 SEC No-Act. LEXIS 3517 (Sept. 28, 1972) resold as part of that exemption. n43

[e] Good Faith Exchange. The Commission has implied an additional requirement under Section 3(a)(9) that the exchange be in good faith and not as part of plan to evade registration requirements. n44

[3] Resales

Because the exemption applies only to exchange transactions with an issuer, absent an available exemption, shares received in a Section 3(a)(9) transaction must be registered when they are resold. n45 A 1979 release announced that even though Rule 145(d) specifically states that it is applicable only to registered securities, the Staff will not recommend any enforcement action to the Commission if the requirements of Rule 145(d) are followed with respect to resales of securities that have been issued in a transaction covered by Rule 145 but not registered because of the availability of a Section 3(a)(9) exemption. n46

Under the safe harbor provision in Rule 145(d), n47 a seller will not be deemed to be an underwriter if the resale is in accordance with one of three alternative provisions of 145(d). n48 However, an additional problem may be presented where the securities surrendered or received in the exchange will be considered as having been issued in a transaction that did not constitute a public offering and are thus restricted securities. Also, special rules apply to resales of those securities if the securities issued in the exchange are received by an affiliate of the issuer. n49

FOOTNOTES:

(n1)Footnote 1. *See, e.g.,* Grupo TMM, S.A. de C.V., SEC No-Action Letter (June 27, 2002) (Reclassification of one series into another in order to simplify corporate structure and establish one class of voting shares).

(n2)Footnote 2. Allied-Carson Corp., 1976 SEC No-Act. LEXIS 585 (Feb. 12, 1976) . A proposal to extend the maturity date on outstanding debt securities at a higher interest rate was considered to be an offer to sell a new security, but also qualified as an exchange of securities that met the requirements for the 3(a)(9) exemption. However, the transaction had to comply with the requirements of the Trust Indenture Act of 1939.

(n3)Footnote 3. No-Action Letter, Genway Corporation, June 24, 1977.

(n4)Footnote 4. *See* the Securities Primary Law Sourcebook, Volume A,, Section C, (Matthew Bender) for the full text of Rule 145.

(n5)Footnote 5. Sec. Act Rel. No. 33-5463, 1974 SEC LEXIS 3448 (Feb. 28, 1974) .

(n6)Footnote 6. *See generally*, Federal Securities Exchange Act of 1934, Ch. 7 (Matthew Bender).

(n7)Footnote 7. *See* § 9(a)(2) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender), (which has been applied to unregistered securities) and Rules 10b-13 and 10b-18 and Regulation M under the 1934 Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

See generally Federal Securities Exchange Act of 1934, Ch. 6 (Matthew Bender).

(n8)Footnote 8. § 3(a)(9) was amended by § 306(b) of the Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2674 (1978) (effective October 1, 1979).

The amendments to Sections 3(a)(9) and 3(a)(10) by the Bankruptcy Reform Act removed the exemptions for bankruptcy securities from these Sections and made Section 1145 of the Bankruptcy Act the exclusive source of

exemption for securities, other than certificates of indebtedness, issued in a Title 11 case.

(n9)Footnote 9. NEOKA Group 1987-I, 1990 SEC No-Act. LEXIS 76 (Jan. 19, 1990) .

(n10)Footnote 10. 499 F.2d 715 (8th Cir. 1974) .

(n11)Footnote 11. *Id.* at 722 . The court found that the requirements of § 3(a)(9) were met under the circumstances presented because: only the holders of existing voting trust certificates were contacted; no new trust certificates were issued -- the old trust certificates were stamped to show the change in termination date; the voting trust was not materially changed, with the holders retaining the same equitable interests they had before the extension; and no commissions or other remuneration had been paid for soliciting the exchange.

The court also held that the voting trust, although composed of insurance company securities, did not qualify under the Exchange Act provision that exempts securities issued by an insurance company and that, therefore, the solicitations for the extension of the voting trust amounted to solicitations of proxies in violation of § 14(a) of that Act and the rules promulgated thereunder.

(n12)Footnote 12. IMCO Realty Services, Inc., 1990 SEC No-Act. LEXIS 261 (Feb.6, 1990) . The debt securities of one wholly owned subsidiary were to be exchanged for the debt securities of another wholly owned subsidiary, both guaranteed by the parent. In issuing a favorable response, the Staff of the Commission noted *inter alia* that the notes surrendered and issued in the exchange had been unconditionally guaranteed as to principal and interest by the parent and that the wholly owned subsidiaries had no economic substance or operations independent from the parent and were formed exclusively to act as financing entities.

See also Grupo TMM, S.A. de C.V., 2002 SEC No-Act. LEXIS 640 (June 27, 2002) . In *Grupo TMM*, the Commission staff agreed that interpositioning a CPO trust for ordinary participation certificates ("CPO") as a special purpose entity between the issuer of deposited securities and the holders of the related CPOs as part of a reclassification and exchange of securities to allow foreign investors to obtain economic rights in shares of the company would not change the identity of the issuer for purposes of the section 3(a)(9) exemption. The CPO Trust would not engage in any activities unrelated to this purpose, and would have no independent financial or economic activity. The same result was obtained in Pepsi-Gemex, S.A. de C.V., 2001 SEC No-Act LEXIS 608 (June 1, 2001) .

(n13)Footnote 13. *See, e.g.*, SunTrust Banks, Inc., 1999 SEC No-Act. LEXIS 635 (July 16, 1999) .

(n14)Footnote 14. *See* National Can Company, SEC No-Action Letter (September 28, 1973).

(n15)Footnote 15. American General Corp., 1980 SEC No-Act. LEXIS 3689 (September 19, 1980) . Where an indenture for convertible debentures permitted the substitution of a successor corporation by a supplemental indenture without the consent of holders, provided the successor corporation assumed all of the obligations of the original issuer, and, upon the effective date of a merger, the surviving corporation and its parent assumed primary responsibility for the payment of principal, premium, if any, and interest on the convertible debentures of the merged corporation, the subsequent conversion of the debentures into parent company stock will meet the single issuer requirement.

See also Weatherford International, Inc., 2002 SEC No-Act. LEXIS 612 (June 25, 2002) (Conversion or redemption of guaranteed debt securities for reorganized company's common shares would qualify for section 3(a)(9) exemption where the indenture under which the convertible securities are issued does not require any solicitation of consent of the holders of the convertible securities); Kerr-McGee Corporation, 2001 SEC No-Act. LEXIS 677 (July 31, 2001) (Shares to be issued on conversion of company's convertible notes are eligible for section 3(a)(9) exemption when no consent of holders was required or would be solicited); BP Amoco p.l.c., 2001 SEC No-Act. LEXIS 425 (March 27, 2001) .

(n16)Footnote 16. *See, e.g.*, Petroleum Geo-Services ASA, 1999 SEC No-Act. LEXIS 562 (June 8, 1999) .

(n17)Footnote 17. PacWest Bancorp, 1979 SEC No-Act. LEXIS 3623 (Oct. 24, 1979) .

(n18)Footnote 18. Echo Bay Mines, SEC NO-Action Letter (May 18, 1998).

(n19)Footnote 19. B.P. Amoco plc, SEC No-Action Letter (Mar. 27, 2001).

(n20)Footnote 20. Worldwide Energy Company Ltd., 1972 SEC No-Act. LEXIS 811 (Feb. 23, 1972) . A plan of reorganization and an exchange of shares due to a change of domicile received a favorable response from the Staff of the Commission. The letter of inquiry gave two grounds for an exemption from registration, i.e., exempt as not involving a public sale and exempt under Section 3(a)(9). The Staff gave no indication of whether it agreed with one or both grounds for exemption.

(n21)Footnote 21. Rule 145(a)(2) provides:

(2) *Mergers or Consolidations.* A statutory merger or consolidation or similar plan or acquisition in which securities of such corporation or other person held by such security holders will become or be exchanged for securities of any other person, unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States.

See also Sec. Act Rel. No. 33-5463, 1974 SEC LEXIS 3448 (Feb. 28, 1974) .

(n22)Footnote 22. See, e.g., Grupo TMM, S.A. de C.V., SEC No-Action Letter (June 27, 2002).

See also Nabors Industries, Inc. and Nabors Industries Ltd., SEC No-Action Letter (Apr. 30, 2002) (Holders of the new securities had the same expectations).

(n23)Footnote 23. NJB Prime Investors, 1976 SEC No-Act. LEXIS 1449 (May 14, 1976) .

(n24)Footnote 24. Seaman Furniture Company, Inc., 1989 SEC No-Act. LEXIS 1014 (Oct. 10, 1989) .

(n25)Footnote 25. Rule 149 provides the definition of "exchanged" in Section 3(a)(9) for certain transactions:

The term "exchanged" in Section 3(a)(9) shall be deemed to include the issuance of a security in consideration of the surrender, by the existing security holders of the issuer, of outstanding securities of the issuer, notwithstanding the fact that the surrender of the outstanding securities may be required by the terms of the plan of exchange to be accompanied by such payment in cash by the security holder as may be necessary to effect an equitable adjustment, in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such security holder and other security holders of the same class accepting the offer of exchange.

(n26)Footnote 26. Rule 150 provides the definition of "commission or other remuneration" in Section 3(a)(9), for certain transactions:

The term "commission or other remuneration" in section 3(a)(9) shall not include payments made by the issuer, directly or indirectly, to its security holders in connection with an exchange of securities for outstanding securities, when such payments are part of the terms of the offer of exchange.

(n27)Footnote 27. Browning Debenture Holders' Committee v. DASA Corp., 1975 U.S. Dist. LEXIS 12838 (S.D.N.Y. 1975) . The court stated that, if plaintiff's theory was correct that a reduction in the conversion price of debentures was a payment by the issuer, the payment was within the terms of Rule 150.

(n28)Footnote 28. WestMarc Communications, Inc., 1989 SEC No-Act. LEXIS 1136 (Nov.10, 1989) .

(n29)Footnote 29. Rospatch, 1981 SEC No-Act. LEXIS 4134 (Oct. 26, 1981) .

(n30)Footnote 30. Barber-Colman Co., 1980 SEC No-Act. LEXIS 3230 (May 5, 1980) . As part of a plan of recapitalization, an exchange of common stock with voting rights for common stock without voting rights and the issuance of two issues of preferred stock as a dividend were exempt under Section 3(a)(9).

(n31)Footnote 31. Sec. Act Rel. No. 33-4434, 1961 SEC LEXIS 90 (Dec. 6, 1961) addresses the integration issue as it applies to § 3(a)(11), the intrastate exemption. Sec. Act Rel. No. 4552, 1962 SEC LEXIS 166 (Nov. 6, 1962) addresses the integration issue as it applies to § 4(2), the private offering exemption. Under these exemptions, the Commission will look to whether the offerings (1) are part of a single plan of financing, (2) involve issuance of the same class of securities, (3) are made at or about the same time, (4) involve receipt of the same type of consideration, and (5) are made for the same general purpose.

Under Rule 147(b)(2), which applies to intrastate offerings, and Rule 502(a), which applies to Regulation D offerings, the Commission will consider offerings more than six months apart as not being made at or about the same time.

(n32)Footnote 32. Sec. Act Rel. No. 33-2141, 1939 SEC LEXIS 629 (Aug. 8, 1939) . The General Counsel stated in this release that, although the Commission will not consider securities of different classes as part of a single issue, this did not mean that any difference in the incidents of two blocks of securities, however trivial, rendered them separate classes and therefore separate issues for the purposes of the Act.

(n33)Footnote 33. *In re* Crowell-Collier Publishing Co., Sec. Act Rel. No. 33-3825, 1957 SEC LEXIS 316 (Aug. 12, 1957) . The issuance of a security immediately convertible into another security constituted a continuing offer of the underlying security.

(n34)Footnote 34. Chris-Craft Industries, Inc., 1972 SEC No-Act. LEXIS 4579 (Oct. 9, 1972) .

(n35)Footnote 35. *Id.*

(n36)Footnote 36. *See, e.g.*, Petroleum GeoServices ASA, SEC No-Action Letter (June 8, 1999); Carton, Inc. and Subsidiaries, SEC No-Action Letter (Sept. 30, 1991); International Controls Corp., SEC No-Action Letter (Aug. 6, 1990).

In Exxon Mobil Corp., SEC No-Action Letter (June 28, 2002), the Staff granted no-action advice for a proposed exchange offer in which Exxon Mobil intended to engage a financial adviser for a flat fee to provide the following services:

- Advising and consulting on the structure and terms of, and procedures for, the exchange offer and the preparation of various communications to the holders of securities to be exchanged;
- Being named as financial adviser in the offering circular and letter of transmittal relating to the exchange offer;
- Advising on procedures to be used in connection with conversations with holders concerning the exchange offer;
- Notifying holders of the details of the exchange offer in communications limited to answering questions and resolving any confusion as to the mechanical and procedural aspects of the exchange offer;

- Confirming the accuracy of the addresses of the holders;
- Mailing or otherwise assisting in the distribution of exchange offer materials;
- Contacting holders to determine receipt of exchange offer materials and answering any questions regarding terms within the confines of the exchange offer materials;
- Contacting holders to determine what action they plan to take;
- Contacting holders to remind them of deadlines; and
- Ensuring that all information relating to the exchange offer is forwarded to beneficial owners by nominees.

(n37)Footnote 37. Seaman Furniture Company, Inc., 1989 SEC No-Act. LEXIS 1014 (Oct.10, 1989) .

(n38)Footnote 38. *See* Time, Inc., 1979 SEC No-Act. LEXIS 2664 (April 19, 1979) , in which a recapitalization involving an exchange of one class of securities for another was to be voted upon by all classes of securities outstanding and a proxy firm's solicitation of the two classes of shares other than the one being converted was found to not violate the no solicitation requirement where the proxy firm would ascertain prior to making a recommendation whether a holder of securities of the classes not being exchanged was also a record holder of the shares being exchanged and, if so, withholding any recommendation.

(n39)Footnote 39. In Boston Futures Management Corporation, 1984 SEC No-Act. LEXIS 2756 (Nov. 21, 1984) , commodity brokerage commissions paid to a broker-dealer under an independent clearing agreement would not constitute a commission for soliciting where the commodity brokerage commissions arose out of the independent contractual relationship and no special or additional fee would be paid to the broker-dealer for its activities in connection with the transaction. The activities of the broker-dealer included having its representatives telephone those investors who had not voted within a given time period after receiving the proposal for the transaction and allowing the representatives to give an opinion on the merits of the proposal if investors asked for it.

See also Boston Futures Fund (II) and (IV), SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2407 (Sept. 14, 1987) .

(n40)Footnote 40. Dean-Witter & Co., 1974 SEC No-Act. LEXIS 997 (Dec. 23, 1974) (Where a broker-dealer would render an opinion of fairness for a proposed exchange and subsequently telephone shareholders to inquire whether they have received written materials and to answer any questions they might have, the Staff of the Commission gave an unfavorable response, despite assurances by the broker-dealer that answers would be confined to information contained in the materials.)

(n41)Footnote 41. Standby agreements are frequently entered into by issuers as a means of protecting their cash position when making a redemption call of a convertible security. A company may decide to make a redemption call when the underlying security to which the convertible security relates is selling at a price that is more attractive than the assigned redemption price and most security holders will thus be expected to exercise their conversion privilege. However, in order to guard against a drop in the market price of the underlying security during the period of the redemption, which could mean that many more shares will be redeemed at the assigned redemption price rather than converted, the issuer may enter into an agreement with one or more investment bankers. Under the terms of the agreement, the investment bank will receive a fee for redeeming shares, usually at a price somewhat in excess of the assigned redemption price. Shares redeemed by the investment bank are then converted to the underlying securities,

which are then resold by the investment bank.

(n42)Footnote 42. Squibb, 1971 SEC No-Act. LEXIS 1234 (July 23, 1971) .

(n43)Footnote 43. Salomon Bothers, 1972 SEC No-Act. LEXIS 3517 (Sept. 28, 1972) in which the Staff of the Commission acknowledged that in the past it had taken the position that standby agreements did not preclude the availability of the Section 3(a)(9) exemption, but stated that resales of securities so acquired must find a separate exemption in order to avoid the registration provisions of the Act.

(n44)Footnote 44. Sec. Act Rel. No. 33-646, 1936 SEC LEXIS 484 (Feb. 3, 1936) . The General Counsel of the Commission gave the opinion that a court making a determination as to whether an exchange was made in good faith:

[w]ould take into account various factors such as the length of time during which the securities received by the issuer were outstanding prior to their surrender in exchange, the number of holders of the securities originally outstanding, the marketability of such securities, and also the question whether the exchange is one which was dictated by financial considerations of the issuer and not primarily in order to enable one or a few security holders to distribute their holdings to the public.

(n45)Footnote 45. Sec. Act Rel. No. 33-646, 1936 SEC LEXIS 484 (Feb. 3, 1936) . This release responded affirmatively to the question whether securities received by a controlling stockholder in a § 3(a)(9) exempt transaction must be registered before being offered to the public.

(n46)Footnote 46. Sec. Act Rel. No. 33-6099, 1979 SEC LEXIS 968 (Aug. 2, 1979) . The Release took the same position with respect to resales of securities acquired in Section 3(a)(10) and Regulation A transactions, but specifically excluded resales under any other exemption.

See also PacWest Bancorp, 1979 SEC No-Act. LEXIS 3623 (Oct. 24, 1979) , in which the court found that persons who are deemed to be underwriters under Rule 145(c) may resell in accordance with the provisions of Rule 145(d). In addition, persons who are deemed affiliates of the issuer may resell their shares in accordance with the volume and transaction provisions of Rule 144.

(n47)Footnote 47. Where acquirers receive an insubstantial amount of securities in proportion to the total amount issued, resales may generally be made in reliance on Section 4(1), which exempts persons who are not issuers, underwriters, or dealers, although there will be a greater burden of proof for challenged transactions than where the requirements of a safe harbor rule are met. *See* § 4.01 *infra*.

(n48)Footnote 48. The three alternative provisions refer to various sections of Rule 144, which provides a safe harbor for the sale of restricted and control securities. *See* , Ch. 6 *infra* for a discussion of Rule 144.

(n49)Footnote 49. *Id.*

See also PacWest Bancorp , n.39 *supra*.



39 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.11

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.11 Securities Issued in Judicially or Administratively Approved Exchanges--Section 3(a)(10)

[1] In General

Section 3(a)(10) provides an exemption from the registration requirements of the Securities Act for:

[A]ny security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests... where the terms and conditions of such issuance and exchange are approved after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission, or other governmental authority expressly authorized by law to grant such approval.

Originally, the exemption for securities issued in judicially or administratively approved exchanges was used sparingly, at least in part, because of similar provisions available under federal bankruptcy law. With the enactment of the Bankruptcy Reform Act of 1978, Section 3(a)(10) was amended specifically to exclude its applicability to securities exchanged in cases under title 11 of the Bankruptcy Code. n1 However, the exemption is significant for settlements n2 and business combinations. It may also be useful for financially troubled businesses whose reorganizations or rehabilitations are undertaken under laws other than the federal bankruptcy law. Under SEC Rule 145, for example, business combinations are subject to registration unless an exemption, such as the Section 3(a)(10) exemption, applies. n3

Rule 145 deems an offer or sale to occur when security holders are asked to give their consent to certain proposed transactions and, as a result, they receive a new or different security in exchange for their existing security, on the theory that this constitutes a new investment decision. Rule 145 specifically covers

mergers, n4 consolidations, and exchanges of assets for securities. n5 The Preliminary Note to the Rule states that the exemption contained in Section 3(a)(10) is not affected by the Rule. n6 Thus, if a transaction defined by Rule 145 does

not qualify for a Section 3(a)(10) or other permitted exemption, it will be subject to the requirements of the Rule. Also, if a combination or acquisition not covered by Rule 145, such as a stock for stock acquisition, does not qualify for a Section 3(a)(10) or other exemption, it will, of course, require registration.

The Section 3(a)(10) exemption may be useful where one or more requirements of the Section 3(a)(9) exemption, which exempts voluntary exchanges between an issuer and its security holders, n7 cannot be met. Thus, unlike Section 3(a)(9), under Section 3(a)(10), there need not be a single issuer, the security holders may make payments in cash, the exchange need not be confined to existing security holders only, and the issuer may make payments to solicit security holders to accept the exchange.

In all situations, the SEC Staff has identified the following conditions which must be met before the section 3(a)(10) exemption will be available: n8

- 1) The securities must be issued in exchange for securities, claims or property interests; they may not be offered for cash; n9
- 2) A court or authorized governmental entity must approve the fairness of the terms and conditions of the offering;
- 3) The reviewing court or authorized governmental entity must (a) find, before approving the transaction, that the terms and conditions of the exchange are fair to those to whom the securities will be issued, and (b) be advised before the hearing that the issuer will rely upon the section 3(a)(10) exemption based on the court's or authorized governmental entity's approval of the transaction;
- 4) The court or authorized governmental entity must hold a hearing before approving the fairness of the terms and conditions of the transaction;
- 5) A governmental entity must be expressly authorized by law to hold the hearing, although it is not necessary that the law require the hearing;
- 6) The fairness hearing must be open to everyone to whom the securities would be issued in the proposed exchange;
- 7) Adequate notice of the hearing must be given to all persons; and
- 8) There cannot be any improper impediments to the appearance by those persons at the hearing.

Two key considerations in applying the section 3(a)(10) exemption are: (1) that the appropriate court or authority will determine whether the terms and conditions of the securities to be offered and sold are fair to investors from both a substantive and procedural point of view; and (2) that all persons to whom it is proposed that the securities be issued receive notification and have an opportunity to be heard at the hearing at which the fairness of the offering is considered. n10 The authority of a court, agency or other governmental authority to make fairness determinations in this context must be clear, and standards to be applied in making the determination must focus on the fairness on terms and conditions of the proposed offering. In *Orbital Sciences Corporation*, n11 the Commission staff sought specific assurances and the advice of Canadian counsel concerning the nature of proceedings whereby the Supreme Court of British Columbia would consider and be asked to approve the fairness of terms and conditions of a proposed offering. The inclusion of "any court" in section 3(a)(10) necessarily includes a foreign court, and the SEC Staff has examined the fairness hearing procedures to be undertaken by foreign courts in no different light other than to require that the foreign court be advised prior to the hearing that its sanctioning of a plan will constitute the basis for issuance of securities under the section 3(a)(10) exemption from registration. n12

The ingenuity of the securities bar has led to persuasive but not always successful arguments for using the exemption in non-obvious circumstances. In one case, a debtor sought to exercise warrants that it owned and to distribute pro rata to its creditors the resulting shares under the Section 3(a)(10) exemption. Although the debtor would not be the issuer of the securities, it argued that it had a contractual control relationship with the issuer and would "cause the issuance" of the securities. The Commission staff was unable to agree and, in this context, stated that Section 3(a)(10) contemplated the issuance of new securities, not a distribution of portfolio securities, for bona fide claims against the issuer. n13

Although an exchange transaction may be exempt from registration under Section 3(a)(10), it is not exempt from the civil liability and antifraud provisions of the securities laws. Also, since the transaction, not the securities themselves, is the subject of the exemption under Section 3(a)(10), future sales of the securities must also qualify for an exemption or be subject to registration.

[2] Statutory Requirements

As indicated by the legislative history and a Release by the Commission, n14 the Section 3(a)(10) exemption is based on the premise that examination and approval of the fairness of the exchange by a competent authority, after a hearing with notice to affected parties, is a substitute for the protection afforded to the investor by the information which would otherwise be made available through registration. An example is a conversion of a company from a mutual insurance company to a stock life insurance company. n15

The statutory language of the exemption provides great latitude as to the elements of the exchange: any security may be issued for securities, claims, or other property interests and may be partly in exchange or partly in cash. Most of the questions with respect to the statutory requirements of the exemption have concerned two main issues: (1) the authority of a forum to approve an exchange and (2) issues concerning the fairness hearing, including the authority of state agencies to conduct a hearing.

[a] Approval Authority. The language of the exemption is clear that courts and federal agencies have the authority to approve an exchange. The authority granted to the courts is coextensive with the inherent authority of courts to decide the issues that are properly before them. The Commission has stated that approval by a foreign court may also satisfy the statutory requirement. n16 However, the issuer must provide the Division of Corporate Finance with an opinion from counsel licensed to practice in the foreign jurisdiction that says that prior to giving its approval, the foreign court must approve the fairness of the proposed exchange to persons receiving securities in the exchange. n17 Although a court may provide a fairness hearing and give its approval to an exchange, it will not rule on the validity of the use of the exemption itself unless the issue is specifically being litigated. n18

As regards state agencies, the grant of approval authority to the agency must be explicitly provided for. n19 Approval authority will not be valid unless its regulatory purpose includes assessing the transaction specifically from the viewpoint of its fairness to investors. n20

The exemption is not available until the point that a court or other forum has given its final approval. Prior to final approval, a solicitation or other offer in connection with an exchange would violate the Securities Act, because the securities in the exchange have neither been registered nor exempted. However, if an exchange transaction requires approval by shareholders entitled to vote on the matter, this must, in most instances, be done before a court or other forum can give its final approval. n21

The statutory authority of a government entity to approve the fairness of terms and conditions must require the entity to conclude affirmatively that the exchange is fair to the security holders participating in the exchange. That is to say, the statute must require the government entity to conclude that the terms and conditions of the exchange are "in the best interests of shareholders" or "fair" to shareholders, not that the exchange is "not unfair," "not unreasonable," "not

prejudicial," or "not counter to the best interest of shareholders." n22 Also, the government entity must find the terms and conditions to be fair both proceduralkly and substantively.

[b] Fairness Hearing. The central requirement of the Section 3(a)(10) exemption is the fairness hearing, which is the functional equivalent of the full disclosure that would otherwise be provided in a prospectus and registration statement. n23 Courts are authorized to hold fairness hearings under the language of Section 3(a)(10). However, the authority of the courts to hold fairness hearings does not mean that the courts are obligated in all circumstances to do so. One court refused defendants' request for a fairness hearing under Section 3(a)(10), stating its reluctance to force unregistered securities on unwilling plaintiffs. The court found that the better remedy was rescission, which would allow plaintiffs to exercise a right that had previously been denied to them. Once the period for exercising the right had expired, defendants were then free to seek an exemption or file a registration statement, as warranted by the situation. n24

As a general matter, the fairness hearing must be open to everyone to whom securities would be issued in the proposed section 3(a)(10) exchange. The issuer must provide appropriate notice of the hearing in a timely manner, although section 3(a)(10) does not specify the information that must be contained in the required notice. The antifraud provisions of the federal securities govern disclosure. n25

The section 3(a)(10) exemption has often been used in connection with court-approved class action litigation settlements involving exchanges of securities, provided that the court approves the fairness of the terms and conditions of the exchange to those who will receive the securities. In its 1999 Staff Legal Bulletin discussing section 3(a)(10) conditions applicable generally, n26 the SEC Division of Corporate Finance identified these specific requirements for use of section 3(a)(10) in the litigation settlement context:

- (1) The court must be advised that the securities will be distributed in reliance upon the section 3(a)(10) exemption from registration based upon the court's approval of the transaction;
- (2) The court must hold a hearing open to everyone to whom the securities will be distributed;
- (3) Adequate notice must be provided to all persons to whom the securities will be distributed; and
- (4) There can be no improper impediments to the appearance by those persons at the hearing. n27

State governmental authorities and agencies must be explicitly authorized by law to hold fairness hearings. There need not be a provision under state law that a fairness hearing is mandatory; the Section 3(a)(10) requirement will be met where the state agency approving the transaction has explicit authority to hold a fairness hearing and does in fact hold a fairness hearing. n28

The requirement that the approving state agency have express authority to hold a fairness hearing is absolute. Thus, the authority to hold hearings other than fairness hearings coupled with the authority to approve the type of transaction that is the subject of an intended Section 3(a)(10) exemption will not meet this requirement. For example, a state securities commissioner's authority to hold an exemption hearing was found to be insufficient authority to hold a Section 3(a)(10) fairness hearing, despite the commissioner's additional authority to decide issues of fairness with respect to certain other securities transactions. n29

The Commission has stated that the hearing requirement implies that those who are to receive securities in the exchange be given adequate notice of the hearing and has also stated that the adequacy of various modes of notice will depend on particular facts and circumstances. n30 The protection afforded by the fairness hearing requires that the hearing be held prior to the finalization of the terms of an exchange. Thus, where a merger agreement was finalized prior to a fairness hearing, the exemption was not available. n31 Obviously, an offering will not be exempted where it is made to the general public, which could not and did not participate in the proceeding upon which the exemption was purportedly based. n32

The fairness hearing will not necessarily include a determination of the value of the securities to be issued in the exchange. In a fairness hearing for an exchange of securities as part of a settlement, the court, in *SEC v. Blinder Robinson & Co., Inc.*, n33 stated that, because the underlying business was in a developmental state, the court had made no attempt to determine the value of the securities to be issued, which had to be considered speculative. The court stated:

I have made no attempt to determine value, now or in the future, because the fairness of the offer does not depend upon it. The factors which are to be considered include: (1) the recommendations of counsel; (2) the scope of the discovery record as an indicator of the adequacy of the investigation into the facts; (3) the apparent alternatives to the settlement; (4) the nature and volume of responses from those receiving notice of the hearing; and (5) the opportunity for direct participation in the process of obtaining full disclosure. n34

A minor change in the terms of the exchange, such as where an issuer wishes to be able to increase the number of shares to be issued in the event that the market price declines prior to the exchange date, will not require that a second fairness hearing be held. n35

In 1996, Congress adopted the National Securities Market Improvements Act ("NSMIA") n36 which included an amendment to Section 18 of the Securities Act to provide that no state law, rule, regulation or order "requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply" to any "covered security" or to a security that would be a covered security upon completion of the transaction. A covered security includes any security listed (or authorized for listing) on the New York Stock Exchange or the Nasdaq National Market System ("NMS"). The Commission issued interpretive letters which stated that states were prohibited from conducting fairness hearings concerning listed companies' securities. As a result, NSMIA initially preempted states' authority to conduct fairness hearings concerning the stock of such companies. However, Congress corrected this situation in 1998 with the adoption of the Securities Litigation Standards Act of 1998 ("SLUSA") n37 which contained a technical amendment to Section 18 of the Securities Act. This amendment provides that securities issued by listed companies in reliance upon the Section 3(a)(10) exemption are not covered securities for purposes of the federal preemption provisions of NSMIA. As a result of this amendment, the fairness hearing exemption under the Section 3(a)(10) exemption has been restored for public companies' securities, and issuers may rely on fairness hearings authorized and conducted by state authorities under state Blue Sky Laws.

[3] Resales

Resales of securities received in an exchange carried out in reliance on the section 3(a)(10) exemption from registration may be made to the extent that in doing so the seller is not deemed to be an underwriter or engaged in a distribution of the securities. "Affiliates" of an issuer n38 receiving securities in an exempt transaction face the prospect of presumptive underwriter status in resales of those securities. SEC Rule 144 n39 and its restrictions on resales of securities acquired in a transaction not involving a public offering has served as the principal avenue for a seller who is an affiliate of the issuer, and for others who would rely on its safe harbor from registration requirements. Rule 144 is available for resales of section 3(a)(10) exempt securities. n40

In many instances, section 3(a)(10) will be employed in connection with reclassifications or business combinations within the scope of SEC Rule 145 under the Securities Act. n41 Rule 145 subjects these types of transactions to registration requirements under the Act. The rule provides, however, that statutory exemptions under the Act, specifically including the section 3(a)(10) exemption, are available and are not affected. n42 A Rule 145 transaction may therefore be carried out without registration in reliance upon section 3(a)(10). However, the matter of resales remains an essential consideration. Rule 145 contains specific resale provisions which largely incorporate Rule 144 requirements by reference. n43

Prior to 2007, Rule 145 imposed presumptive underwriter status on any person who resold securities received in the transaction, thus subjecting them to Rule 144 restrictions in making resales. n44 In 2007, however, the SEC amended Rule 145 to eliminate the former "presumptive underwriter" provision in Rule 145(c), except for transactions involving a shell company. n45 As a result, if the recipient seller is not an affiliate of the issuer of the section 3(a)(10) securities, and has not been an affiliate within 90 days of the date of the exempt transaction, the securities may be resold without regard to Rule 144. This is because the securities would not constitute "restricted securities" within the meaning of Rule 144(a)(3). n46 If the securities are received by affiliates of the issuer, however, those holders may rely on Rule 144 in making resales. n47

Apart from the particular circumstances of a Rule 145 transaction, based on the responses by the Staff in several No Action Letters, n48 those who receive securities in the typical Section 3(a)(10) exempt transaction may generally resell according to their status as follows:

- (1) Shares issued will not be deemed restricted if issued in exchange for shares that are not restricted. n49
- (2) Shares acquired in exchange for restricted shares continue to be restricted, n50 but holders may tack the holding period of the exchanged in satisfying the holding requirement of Rule 144(d).
- (3) Persons who become affiliates of the entity whose shares are being issued must sell the shares under Rule 144, except that the holding period is applicable only to the extent that it applied to the shares given up in the exchange.

Finally, the Commission has stated that trading on a when-issued basis before final approval of a Section 3(a)(10) exchange would violate Section 5 of the Act. n51 Even where approval has been given by the appropriate court or agency, if the exchange is subject to further approval, when-issued trading cannot commence. n52 Thus, where an exchange plan had been approved by a court, but was subject to acceptance in writing by two-thirds of each class of creditors of each corporation participating in the plan, when-issued trading would violate Section 5 of the Act. n53 However, once approval is considered complete, an appeal and, in most circumstances, a stay of an order of a court would not appear to affect when-issued trading in most circumstances. n54

FOOTNOTES:

(n1)Footnote 1. § 306(b), Pub. L. 95-598, 92 Stat. 2674 (Nov. 6, 1978) amended § 3(a)(10), effective October 1, 1979, by adding: "Except with respect to a security exchanged in a case under title 11 of the United State Code." The Securities Act of 1933 is reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

1-3 Federal Securities Act of 1933 § 3.11

For securities issued under the former Bankruptcy Act or under Section 3(a)(10) prior to its amendment, resales may be made in reliance on the safe harbor provided by Rule 148. For resale of securities under Rule 148 of the 1933 Act, reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender), and of those issued under current § 1145 of the *Bankruptcy Code*, see 8 Collier on Bankruptcy, Ch. 1145 (15th ed. Matthew Bender).

(n2)Footnote 2. See, e.g., Hanover Compressor Company, SEC No-Action Letter (Jan. 27, 2004) (Settlement of class action and derivative litigation involving issuance of "Settlement Shares," with terms and conditions of the settlement to be approved by a federal court).

See also Sprint Corporation, SEC No-Action Letter (Aug. 25, 2003) (Issuance of shares in exchange for the claim of fees payable by the company to the counsel representing plaintiffs in a shareholder derivative action).

(n3)Footnote 3. 17 C.F.R. § 230.145.

See also Ash, *Reorganizations and Other Exchanges under Section 3(a)(10) of the Securities Act of 1933*, 75 N.W. U. L. Rev. 1, 28-32 (1980).

(n4)Footnote 4. The Rule does not cover short form mergers because such mergers do not involve a vote or consent of all stockholders. See Sec. Act Rel. No. 33-5463, 1974 SEC LEXIS 3448 (Feb. 28, 1974) .

(n5)Footnote 5. Under Rule 145(a)(2) and (3), the following transactions are defined as within the Rule:

(1) *Reclassifications*. ...

(2) *Mergers or Consolidations*. A statutory merger or consolidation, or similar plan or acquisition in which securities of such corporation or other person held by such security holders will become or be exchanged for securities of any other person, unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States; or

(3) *Transfers of Assets*. A transfer of assets of such corporation or other person, to another person in consideration of the issuance of securities of such other person or any of its affiliates, if:

(i) Such plan or agreement provides for dissolution of the corporation or other person whose security holders are voting or consenting; or

(ii) Such plan or agreement provides for a pro rata or similar distribution of such securities to the security holders voting or consenting; or

(iii) The board of directors or similar representatives of such corporation or other person, adopts resolutions relative to paragraph (a)(3)(i) or (ii) of this section within one year after the taking of such vote or consent; or

(iv) The transfer of assets is a part of a preexisting plan for distribution of such securities, notwithstanding paragraph (a)(3)(i), (ii), or (iii) of this section.

(n6)Footnote 6. Rule 145, Preliminary Note states:

"Transactions for which statutory exemptions under the Act, including those contained in sections 3(a)(9), (10), and (11) and 4(2), are otherwise available are not affected by Rule 145."

(n7)Footnote 7. See § 3.10 *supra*.

(n8)Footnote 8. Rev. Staff Legal Bulletin No. 3 (Oct. 20, 1999). The Revised Staff Legal Bulletin was further revised in 2008, *see* Staff Legal Bulletin No. 3A (CF) (June 18, 2008), and is hereinafter referred to as the "June 2008 SLB."

(n9)Footnote 9. Although section 3(a)(10) will be available when options, warrants, or other convertible securities are issued in a qualifying transaction, section 3(a)(10) does not exempt the later exercise or conversion. *See* June 2008 SLB, paragraph 4(A).

(n10)Footnote 10. *See* Orbital Sciences Corp., 1995 SEC No-Act LEXIS 741 (Oct. 13, 1995) .

(n11)Footnote 11. *Orbital Sciences Corp.*, 1995 SEC No-Act LEXIS 741 , *supra*.

(n12)Footnote 12. *See, e.g.,* SanDisk Corporation, SEC No-Action Letter (Sept. 21, 2006) (Israeli court to hold a fairness hearing on the terms and conditions of a plan).

See also AngloGold Limited, SEC No-Action Letter (Jan. 15, 2004) (High Court of Ghana to conduct fairness hearing).

The use of section 3(a)(1) in connection with foreign court proceedings and approval authority is discussed further in §3.11[2][a] below.

(n13)Footnote 13. *Fox-Raff & Company, Inc.*, 1972 SEC No-Act. LEXIS 2980 (July 20, 1972) .

(n14)Footnote 14. H.R. Rep. No. 85, 73d Cong., 1st Sess. 16 (1934); Sec. Act Rel. No. 33-312, 1935 SEC LEXIS 297 (March 15, 1935) .

(n15)Footnote 15. 2001 SEC No-Act. LEXIS 590, *Phoenix Home Life Mutual Insurance Co.*, May 31, 2001 .

(n16)Footnote 16. *Hiram Walker Resources, Ltd.*, 1981 SEC No-Act. LEXIS 2855 (Jan.19, 1981) . The Commission staff's favorable response was conditioned on: (1) the foreign court (Supreme Court of Ontario, Canada) holding a hearing on the fairness of the terms and conditions of the issuance of such securities, (2) all persons to whom it was proposed to issue such securities receiving notification and having an opportunity to be heard at such hearing, (3) the court approving the fairness of the terms and conditions of the transaction described in the request for a No-Action Letter, and (4) the court being advised prior to the hearing that, if the terms and conditions of the transaction are approved, the shares to be issued will not be required to be registered under the 1933 Act by virtue of such court's approval.

See also Gilat Satellite Networks Ltd., SEC No-Action Letter, 2002 SEC No-Act LEXIS 844 (Dec.19,2002) (Israeli court fairness determination); *Bio Inc.*, SEC No-Action Letter (September. 23, 1998) (Supreme Court of Queensland, Australia); *Williams PLC*, SEC No-Action Letter (Jan. 4, 2001 (High Court of Justice in England)); *John Wood Group*, SEC No-Action Letter (Mar.1, 2001 (Court of Sessions in Scotland) and *IC/CI Bank Ltd.*, December 13, 2001 (High Courts of Bombay and Gujarat at Ahmedabad).

See also French Nationalization Law of 1982, 1982 SEC No-Act. LEXIS 2391 (May 5, 1982) . The Commission staff's favorable response in this instance shows deference to the acts of a foreign government. The request for no action was premised on three grounds: (1) the bonds to be issued by agencies of, and guaranteed by, the French government did not involve a "sale" because of the lack of any element of choice or volition on the part of those to whom the securities were to be issued, (2) the number of bonds to be issued to U.S. residents was small and no secondary market was likely to develop, and (3) the extensive quasi-judicial review by governmental bodies that deliberated about the law prior to its passage bore a strong resemblance to the proceedings contemplated by § 3(a)(10), even though the shareholders were not afforded an opportunity to appear before them. In addition, the summary of the request to the

staff stated that the situation was clearly distinguishable from those in which registration of securities issued by a foreign government agency is required because, in this case, no effort was being made to enter the U.S. capital markets for purposes of raising funds. Also, the issuance of the bonds to U.S. residents was but an incidental consequence of action taken by a foreign government for purely domestic considerations. Moreover, the issuance of bonds to limited number of U.S. residents would have at most an indirect, *de minimis* impact on U.S. investors and U.S. securities markets. In rendering its favorable reply, the staff merely stated that it did not necessarily agree that there was no "sale" within the meaning of the 1933 Act. Significantly, it did not reject the other two grounds for the exemption.

(n17)Footnote 17. June 2008 SLB, paragraph (B)(4).

(n18)Footnote 18. In *Continental Assurance Co. v. MacLeod-Stedman, Inc.*, 694 F. Supp. 449, 467 (N.D. Ill. 1988), the court held that § 3(a)(10) only requires approval of the terms and conditions of the exchange and that, if the parties required further assurances, they could request a No-Action Letter from the SEC.

(n19)Footnote 19. See Opinion of General Counsel, Sec. Act Rel. No. 33-312, 1935 SEC LEXIS 297 (March 15, 1935) :

In my opinion a State governmental authority (with the possible exception of a banking or insurance commission) must possess express authority of law to approve the fairness of the terms and conditions of the issuance and exchange of the securities in question... . The requisite express authorization of law to approve the fairness of such terms and conditions... to give effect to the words "express" and "by law," must be granted clearly and explicitly.

See also No-Action Letter, SC Acquisition Corp., July 13, 1996, where the requesting corporation was obtaining a finding of fairness by the California Commissioner of Corporations.

(n20)Footnote 20. See Peoples Mid-Illinois Corp.; Peoples Bank of Bloomington, 1971 SEC No-Act. LEXIS 1921 (Aug. 16, 1971) . Exemption was not available where approval by the Federal Reserve Board was for the purpose of a bank becoming a bank holding company. It was the staff's view that a governmental authority must be expressly authorized by law to approve the fairness of an exchange from the standpoint of investors.

See also Rhinelander Tel. Co., 1989 SEC No-Act. LEXIS 903 (Aug. 8, 1989) . Under the applicable Wisconsin statutes, the state Public Service Commission, whose approval for a proposed reorganization was necessary on two separate grounds, was authorized (1) to approve an issuance of securities where the agency found that the issuance would afford purchasers reasonable protection, and (2) could not approve a reorganization plan unless it was consistent with the public interest. The staff's unfavorable response stated that it did not view the terms "reasonable protection" and/or "consistent with the public interest" as analogous to a statutory mandate to determine the fairness of an exchange from the standpoint of shareholders.

(n21)Footnote 21. In Sec. Act Rel. No. 33-296, 1 Fed. Sec. L.Rep. (CCH) P 2245.17 (Feb. 15, 1936), the opinion of the General Counsel stated that deposit receipts issued prior to a court's confirmation of a reorganization plan under Section 77B of the Bankruptcy Act need not be registered if their legal effect was equivalent to approval or acceptance of the plan.

(n22)Footnote 22. June 2008 SLB, paragraph 4(B).

(n23)Footnote 23. Sec. Act Rel. No. 33-312, 1935 SEC LEXIS 297 (March 15, 1935) .

[T]he whole justification for the exemption afforded by section 3(a)(10) is that the examination and approval by the body in question of the fairness of the issue in question is a substitute for the protection afforded to the investor by the information which would otherwise be made available to him through

registration.

In *S.E.C. v. Blinder Robinson & Co., Inc.*, 511 F. Supp. 799, 802 (D. Colo. 1981) , the court stated:

In summary, the approach to the determination of "fairness" and approval of this settlement agreement, invoking the exemption from registration provided by Section 3(a)(10), is consistent with recognition of the purpose of the Securities Act of 1933 to protect investors by promoting full disclosure of the information believed to be necessary to the making of informed investment decisions... The fairness hearing here has been the functional equivalent of the full disclosure which would be provided in an appropriate prospectus and registration statement.

(n24)Footnote 24. *Pittsburg Terminal Corp. v. B & O Railroad Co.*, 586 F. Supp. 1297 (W.D. Pa. 1984) , *aff'd without op.*, 760 F. 2d 260 (3d Cir.) , *cert. denied*, 474 U.S. 919, 106 S. Ct. 247, 88 L. Ed. 2d 256 (1985) .

(n25)Footnote 25. See June 2008 SLB, paragraph 4(C).

(n26)Footnote 26. Rev. Staff Legal Bulletin No. 3.

(n27)Footnote 27. In all circumstances, the Staff has observed that an issuer that intends to rely on the section 3(a)(10) exemption should consider whether, as a practical matter, imposing prerequisites to appearance will prevent those persons from having a meaningful opportunity to appear at the hearing. The mere requirement to file a notice of intention to appear, however, would not be considered such an impediment. See ICICI Bank, SEC No-Action Letter (Dec. 13, 2001); Digicon, Inc., SEC No-Action Letter (Aug. 19, 1996).

(n28)Footnote 28. See Sec. Act Rel. No. 33-312, 1935 SEC LEXIS 297 (March 15, 1935) , where the opinion of the General Counsel stated:

[I]f state law expressly authorizes the approving authority to hold a hearing on the fairness of the terms and conditions of the issuance and exchange of securities, and such a hearing is in fact held, this requirement of Section 3(a)(10) is satisfied.

As discussed further below, this is particularly meaningful in the context of fairness hearings conducted under state Blue Sky Laws. Securities offered and sold in reliance on section 3(a)(10) are not "covered securities" under NSMIA, and thus an issuer may rely on a fairness hearing conducted under state securities laws to perfect an exemption under section 3(a)(10) for securities that would otherwise be NSMIA covered securities. See June 2008 SLB, paragraph (B)(3).

(n29)Footnote 29. Rice Lake Bancorp, Inc., SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep (CCH) P 76,385 (April 21, 1980). The Commissioner's additional authority to consider whether the sale or issuance of securities is or would be unfair or inequitable to purchasers in connection with the denial, suspension or revocation of a registration statement filed pursuant to the state statutes was found to be insufficient to hold a Section 3(a)(10) fairness hearing because it was applicable only to situations in which a registration statement had been filed, as opposed to situations where an exemption was being sought.

See also United Funeral System, Inc., SEC No-Action Letter [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,965 (Jan. 25, 1989).

(n30)Footnote 30. Sec. Act Rel. No. 33-312, 1935 SEC LEXIS 297 (March 15, 1935).

(n31)Footnote 31. Fidelity Financial Corporation, SEC No-Action Letter [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,840 (June 1, 1972).

(n32)Footnote 32. *S.E.C. v. Granco Products*, 236 F. Supp. 968 (S.D.N.Y.1964) .

(n33)Footnote 33. 511 F. Supp. 799 (D. Colo. 1981) . The settlement in this case specifically provided that each offeree had the opportunity to evaluate the proposal on an individual basis and that those persons who did not wish to accept the offer were not foreclosed from pursuing private claims for relief.

But see Continental Assurance Co. v. MacLeod-Stedman, Inc., 694 F. Supp. 449, 468 (N.D. Ill. 1988) . The court found sufficient evidence that the settlement was of *fair value* and was reached after fair dealing, noting the different approach to fairness in *Blinder Robinson*.

(n34)Footnote 34. 511 F. Supp. at 801 .

(n35)Footnote 35. Parsons Corp/RMP Int'l, Ltd., SEC No-Action Letter [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,006 (June 4, 1981). The staff's favorable response noted that the increase would result in the shareholders receiving more units than otherwise, the number of units representing the increase was small in relation to the amount outstanding, and the California Department of Corporations had agreed to permit the increase without the necessity of a second hearing.

(n36)Footnote 36. Pub. L. No. 104-290, 110 Stat. 3416.

(n37)Footnote 37. Pub. L. No. 105-353, 112 Stat. 3227.

(n38)Footnote 38. In this context, as in any other, an "affiliate" of an issuer is a person that directly or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, such issuer. *See, e.g.*, Securities Act Rule 144(a)(1), 17 C.F.R. §230.144(a)(1).

(n39)Footnote 39. 17 C.F.R. §230.144.

(n40)Footnote 40. *See* § 6.03[5][c] *infra* for a discussion of restricted securities issued in a Section 3(a)(10) transaction and Ch.6 *infra* for a discussion of the resale of restricted and control securities.

(n41)Footnote 41. 17 C.F.R. §230.145.

(n42)Footnote 42. *See* Preliminary Note to Rule 145, 17 C.F.R. §230.145.

(n43)Footnote 43. *See* Rule 145(d), 17 C.F.R. §230.145(d).

(n44)Footnote 44. The holding period restriction under Rule 144 was modified specifically to address resales by recipients in Rule 145 transactions. *See* Rule 144(d)(3)(viii), 17 C.F.R. §144(d)(3)(viii).

(n45)Footnote 45. Sec. Act Rel. No. 8869 (Dec. 6, 2007).

(n46)Footnote 46. June 2008 SLB, paragraph 5.

(n47)Footnote 47. *Id.*

(n48)Footnote 48. *See* Hiram Walker Resources, Ltd., SEC No-Action Letter [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,796 (Jan. 19, 1981).

(n49)Footnote 49. *But see* St. Ives Holding Company, Inc., SEC No-Action Letter [1987 Transfer Binder] Fed.

Sec. L. Rep. (CCH) P 78,465 (August 24, 1987), in which the shares received in exchange for restricted shares in a § 3(a)(10) transaction, which was followed by a public offering of additional securities, would not be deemed restricted pursuant to Rule 144(a)(3) and could be resold in the manner provided for in Rule 145(d)(1).

(n50)Footnote 50. See Kasper Instruments, Inc., SEC No-Action Letter (Feb. 26, 1976).

(n51)Footnote 51. Sec. Act Rel. No. 33-3000, 1 Fed. Sec. L. Rep. (CCH) P 2185 (June 7, 1944).

(n52)Footnote 52. *Id.* The Opinion of the Chief Counsel to the Corporate Finance Division addressed the question of when-issued trading on the over-the-counter market where the terms of the Commission's order approving a voluntary exchange plan stated that the Commission's order was not operative until the appropriate District Court entered an order enforcing the plan. The Chief Counsel stated that the terms and conditions of the issuance and exchange of a security are not approved within the meaning of section 3(a)(10) until completion of the total process of approval required in the particular case.

(n53)Footnote 53. Sec. Act Rel. No. 33-3011, 1 Fed. Sec. L. Rep. (CCH) P 2190 (August 28, 1944).

(n54)Footnote 54. Sec. Act Rel. No. 33-3343, 1 Fed. Sec. L. Rep. (CCH) P 2197 (May 24, 1949). The Opinion of General Counsel stated:



40 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.12

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.12 Intrastate Offerings--Section 3(a)(11)

[1] In General

The exemption in section 3(a)(11) of the Securities Act for securities offered and sold only to persons who are resident within a single state or territory rests on the notion that localized offers and sales of securities to finance local business are best left to localized regulation. Thus, state Blue Sky laws are presumed to be the most effective and efficient means of regulating such offerings which, by their essential characteristics, are not national in character.

As with several "securities" exemptions in section 3 of the federal Securities Act, the intrastate offering exemption is in every practical sense a *transactional* exemption. The securities involved in a qualifying section 3(a)(11) offering are exempt from Securities Act registration requirements. However, qualification for the exemption is dependent upon specific requirements applicable to the offer and sale of the securities, as well as qualifying conditions applicable to the issuer itself and the use of proceeds. Although historically the intrastate exemption appears to be well utilized, the nature and requirements of the exemption render it somewhat perilous. The adoption in 1974 of Rule 147, which provides a safe harbor for the intrastate exemption for those issuers who meet all the requirements of the Rule, alleviated some of the uncertainty with respect to such important aspects of the exemption as what constitutes an issue of securities and the period of time during which resales to nonresidents are prohibited. n1 Nevertheless, because a single sale to a non-resident of the state n2 of the offering will destroy the availability of the exemption for a particular issue, issuers and their counsel may wish to consider the availability of other exemptions. Offerings carried out under the safe harbor rules of Regulation D under the Securities Act, for example, may provide a more workable framework under a given set of circumstances.

Added to the uncertainty is the fact that the SEC staff will respond to requests for No-Action Letters under Section 3(a)(11) or Rule 147 in only the most compelling circumstances. n3 Nevertheless, the flexibility of section 3(a)(11) and Rule 147 offerings is evident in the fact that there is no maximum offering amount, and there are no sophistication or similar qualifying criteria applicable to offerees and purchasers. Although state Blue Sky laws and regulations may

impose particular qualifying conditions, and indeed, subject intrastate offerings to "merit review" procedures and requirements, there are no other federal requirements.

A preliminary note to Rule 147 states that the rule does not raise any presumption that the exemption provided by Section 3(a)(11) is not available for transactions that do not satisfy all of the provisions of the rule. n4 By its terms, the Rule applies to use of the intrastate exemption by issuers only. However, because the Rule is not the exclusive means for use of the exemption, persons in control of the issuer can avail themselves of the Section 3(a)(11) exemption for secondary offerings, provided that the exemption would be available to the issuer for a primary offering. n5

Under the Investment Company Act of 1940, the intrastate exemption is not available for securities issued by companies that are required to be registered under that Act. n6 Also, the exemption is not available for intrastate Keogh and IRA plans whose assets are commingled with assets of nonresident plans. n7

As noted above, despite the fact that section 3(a)(11) of the Securities Act exempts securities offered and sold under it from registration, section 3(a)(11) is in practice a transaction exemption, and the securities issued under the exemption are not forever exempt. Subsequent resales of securities received under the exemption must be registered unless an exemption applies. n8 As with other exemptions, Section 3(a)(11) is subject to the antifraud and civil liability provisions of the securities laws. n9 Consideration and care should therefore be given as to what disclosures should be made in order to avoid potential liability. n10

[2] Statutory/Rule 147 Requirements

Section 3(a)(11) exempts:

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.

The legislative history provides almost no guidance as to the interpretation of the statutory language. As originally enacted, the exemption was an exception to the provisions in Section 5 regarding use of the mails. n11 As amended in 1934, the legislative history made clear that the exemption was not limited to the use of the mails and that, for example, the use of an advertisement in a newspaper that is distributed in interstate commerce does not invalidate an otherwise available exemption. n12 In a 1961 release, the Commission stated "[a]s appears from the legislative history, by amendment to the Act in 1934, this exemption was removed from Section 5(c) and inserted in Section 3, relating to "Exempted Securities," in order to relieve dealers of an unintended restriction on trading activity. This amendment was not intended to detract from its essential character as a transaction exemption." n13

In the first release with respect to the exemption, n14 the Federal Trade Commission, which then had responsibility for the administration and enforcement of the Securities Act, pointed out that, in order for the exemption to be available, the securities had to be exclusively in the hands of investors resident within a single state at the time of completion of their ultimate distribution. The Commission stated that ultimate distribution would include the disposition of securities by investors in any secondary distribution that might take place pursuant to arrangements by the issuer or underwriters. The Commission also stated that an early listing of the securities on an exchange might be a further indication that further distribution of securities was contemplated prior to completion of the securities' ultimate distribution.

Three years later, the Securities and Exchange Commission issued a release n15 that emphasized the limitations of the exemption. The Release stated that the requirements of Section 3(a)(11) would be extremely difficult, if not impossible, to fulfill except with respect to issues that represent local financing by local industries carried out through local investment. n16 The Release also explained how a sale to a non-resident would destroy the exemption with respect to an

entire issue, even if the sale were rescinded: n17

[S]ince under section 3(a)(11) the exemption is applicable only if the entire issue is distributed under the circumstances specified, 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.

The single or entire "issue" concept is critical in the application of the intrastate offering exemption. It forces consideration of the prospect for "integration" of separate offerings or transactions into a single issue, such that an exemption like the intrastate offering exemption, when applied to the entire offering would destroy its applicability. Integration is a key consideration in all exempt transaction settings. Its specific application under Securities Act section 3(a)(11), however, is discussed below, as it is perhaps the most significant limiting factor in considering the availability of the exemption. Once the "single issue" element of intrastate offerings is explored, each other element of the exemption is discussed in detail.

[a] Part of an Issue. A significant limitation of the exemption is that, with respect to the same issue of securities, it cannot be combined with any other exemption that might apply for nonresidents. A single sale (or offer) to a nonresident, whether or not the sale would be exempt as an isolated transaction, would make the exemption unavailable for the entire issue. As stated by the Commission: n18

[I]t would... be immaterial that the sales might be made without use of the mails or instruments of interstate commerce, or by persons themselves exempt from registration and prospectus requirements, and might therefore, as isolated transactions, involve no violation of the Securities Act. Any such sales to non-residents, however few, and even though legal in themselves, would preclude compliance with the conditions of section 3(a)(11), and would render the exemption unavailable for that portion of the issue sold to residents through use of the mails.

In *Hillsborough Investment Corporation v. SEC*, n19 the court underscored the significance of what constitutes an issue and the taint with respect to any issue where one or more sales to nonresidents has occurred. In that case, after an issuer had been subjected to an injunction because of sales to nonresidents, the issuer made an attempt to again avail itself of the exemption through a recapitalization, by exchanging securities with resident security holders from the initial issue and selling additional shares only to residents. But the court perceived that, in reality, the newly authorized securities to be issued differed only in a small degree from the enjoined securities and that the recapitalization was an attempt at substitution for those securities, *i.e.* an attempt to cure the defects of the first offering. n20

The question of what constitutes an issue is one of fact. In one of the first decisions with respect to the exemption, *Shaw v. U.S.*, n21 the court rejected the argument that shares that were the subject of a required state permit constituted an issue of securities, stating that a provision of state law cannot be determinative of the meaning of the term "issue" under Section 3(a)(11). In a 1961 Release on the intrastate exemption, the Commission enumerated several factors, any one or more of which may be determinative of whether offerings will be integrated, *i.e.*, considered to be part of the same issue. The Commission listed the following factors: n22

- (1) are the offerings part of a single plan of financing;
- (2) do the offerings involve issuance of the same class of security;
- (3) are the offerings made at or about the same time;
- (4) is the same type of consideration to be received; and
- (5) are the offerings made for the same general purpose.

In addition, resales of securities will be considered part of the initial issue until the point that the securities have reached their ultimate distribution or have "come to rest." n23 In *Brooklyn Manhattan Transit Corp.*, n24 the Commission, after stating that the point at which a distribution is completed is a question of fact to be determined in light of all the circumstances of an offering, applied a one year standard, subject to refutation upon a showing of fact that a distribution was completed in less than a year. n25

Under Rule 147(b), for purposes of the rule only, the same or similar classes of securities will be deemed not to be part of the same issue where offers and sales made other than pursuant to the Rule take place more than six months before or more than six months after offers and sales made pursuant to the rule. n26 In deciding an interpretative issue under Rule 147(b), the Commission staff stated that a deferred fee to a non-resident placement agent would not be deemed to be part of an issue for purposes of Rule 147(b). n27 The concern of the issuer arose from the fact that the deferred fee might be viewed as dependent on the efforts of the issuer and thus a security that was being issued to a non-resident.

With respect to debt securities, the payout periods, interest rates, and time intervals between offerings appear to be important factors. In *S.E.C. v. Dunfee*, n28 the defendant sold six per cent notes payable in 20 monthly installments, followed by a period of eight months in which it sold no securities, and then sold seven per cent notes payable in 36 months. The court held that the latter notes constituted a new issue of a separate and distinct security and that the intrastate exemption was available.

[b] Offers and Sales to Residents Only. Clearly, the terms of the exemption require that offers and sales be to residents of a single state or territory. A single offer or sale to a nonresident will make the exemption unavailable as to the entire issue of securities. n29 A seasonal or temporary residence, such as the assignment of military personnel to a base, is not considered "residency" for the purpose of Section 3(a)(11) and Rule 147. n30 Under Rule 147(d)(2), an individual is deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale to him, his principal residence in the state or territory. Because the Commission has stated that mere representations of residence by offerees should not be relied on, prudence dictates that some independent verification of residence be obtained. n31

Because of the broad definition of "offer" in the Securities Act encompassing any attempt to dispose of a security for value, the strict limitation under section 3(a)(11) and Rule 147 that offers be made only to residents within a single state or territory poses a substantial risk to issuers who solicit purchasers by means of advertising in newspapers or through broadcast media and the Internet. Certainly with regard to Internet communications, the ability to control the dissemination of advertisements is severely limited, and even with newspapers or broadcast messages, the possibility exists that the advertisements will be seen or heard by persons in other states. Cross-border offers made intentionally by an issuer, without any attempt to limit their reach, violate section 3(a)(11). n32 However, the SEC staff granted a no-action request for an issuer intending to use newspaper or broadcast advertising media where the advertising and solicitation materials clearly and conspicuously stated that the offer was intended to be made only to bona fide residents of California, and that sales would be made only to California residents. n33 The same approach to controlling offers via the Internet would seem valid. Indeed, the methods by which Internet communications can be controlled so as to prevent any "offer" of securities outside a specific geographical limit is now well developed as a result of nearly uniform state Blue Sky law compliance procedures.

The one exception to the single state requirement appears to be sales to foreign investors. For example, a real estate investment trust issuing shares on a continuous basis to California residents in reliance on the intrastate exemption received a favorable response from the Commission staff to allow the trust to offer shares outside the United States to non-residents of the United States. n34 As part of its request for a No-Action Letter, the issuer stated that it would place a legend on all shares sold outside the United States to prevent resale to any resident of the United States other than residents of California. n35 The staff apparently agreed with the reasoning of the issuer that the Securities Act was not designed to protect foreign investors. It conditioned its favorable response on the issuer complying with Rule 147(e) and

(f). n36

Favorable SEC No-Action letters have also been issued in circumstances where a corporation with out of state shareholders has organized a holding company and has issued stock in connection with this transaction. In one example, a bank proposed to reorganize and create a one bank holding company by merger with the existing bank. The bank had over 275 shareholders, 20 of whom were out of state residents. The bank holding company proposed to offer stock to the resident shareholders and cash to non-resident shareholders for their shares of stock in the bank. The SEC staff agreed that the cash offering to non-resident shareholders would not effect an otherwise valid intrastate offering exemption. n37

Where an offering is made through an installment sale, the question of when the sale is completed will be critical in order to meet the purchasers' residency requirement. If the sale is considered to be completed at the time that the final payment is made and the certificate delivered, then the residency requirement cannot be met because there is no way to assure that some of the purchasers will not move during the period of the installments. n38 However, if an installment sale is structured so that it is final and complete at the time that a purchase agreement is signed, subject to cancellation and forfeiture of the security in the event of non-payment, the residency requirement may be able to be met.

Under Rule 147(d)(3), a corporation, partnership, trust, or other business organization that is organized for the specific purpose of acquiring part of an issue offered pursuant to the Rule will be deemed not to be a resident of the state or territory unless all of the beneficial owners of the organization are residents of the state or territory. n39 However, a non-resident trustee may acquire securities in an intrastate offering without destroying the availability of the Rule 147 safe harbor, where the life beneficiaries of the trust are residents of the state of the offering. n40

[c] Issuer Residence. Section 3(a)(11) requires that the issuer be resident within the state of the offer or sale and, if a corporation, that it be incorporated within the state. In addition, under Rule 147(c)(1), a limited partnership or business trust must be organized pursuant to the laws of the state. The Rule provides that a general partnership or other entity that is not formed under a specific state law must have its principal office within the state. n41 Therefore, the nonresidence of one or more general partners is not relevant to the residency requirement.

The formation of local business entities by a single multi-state business enterprise in order to meet the requirements of the exemption is invalid. In *S.E.C. v. Freeman*, n42 the court stated: "[t]he formal device of separate incorporation cannot shield what in reality is a single multiple state organization from the registration requirements of the Securities Act." In the Preliminary Notes to Rule 147, it is stated:

Finally, in view of the objectives of the rule and the purposes and policies underlying the Act, the rule shall not be available to any person with respect to any offering which, although in technical compliance with the rule, is part of a plan or scheme by such person to make interstate offers or sales of securities. In such cases registration pursuant to the Act is required.

Also, in the Release accompanying the adoption of Rule 147, the Commission stated: n43 "[A]ny plan or scheme that involves a series of offerings by affiliated organizations in various states, even if in technical compliance with the rule, may be outside the parameters of the rule and of Section 3(a)(11) if what is being financed is in effect a single business enterprise."

At least one No-Action Letter has been issued, without a discussion on the merits, where the Commission staff was apparently satisfied that a newly created local subsidiary was not part of a scheme to avoid registration for an interstate offering. In that case, although the parent had formerly transacted business within the locale without formally creating a separate subsidiary, the facts indicated that the offering would be for a local business that was significantly different from the parent's activities elsewhere. n44

Rule (c)(1) also provides that an individual who is deemed an issuer, such as a promoter issuing preincorporation certificates, will be deemed a resident if the individual's principal residence is within the state.

[d] Issuer Doing Business Within. The "doing business" requirement has presented the most questions of all the requirements for the exemption. The Commission stated in its 1961 Release on the intrastate exemption n45 that, in order to meet the doing business requirement, the issuer must be performing substantial operational activities within the state. Activities such as bookkeeping, stock record, and similar activities are clearly not sufficient to meet the requirement. n46 As an example of a business that would not meet the requirement, the Commission stated: n47

[T]he exemption would be unavailable to an offering by a company made in the State of its incorporation of undivided fractional oil and gas interests located in other States even though the company conducted other business in the State of its incorporation. While the person creating the fractional interests is technically the "issuer" as defined in section 2(4) of the Act, the purchaser of such security obtains no interest in the issuer's separate business within the State.

In the Release adopting Rule 147 in 1974, n48 the Commission stated with respect to the exemption that "not only should the business be located within the state, but the principal or predominant business must be carried on there." This Release follows the reasoning in *Chapman v. Dunn*, n49 in which the court stated that "doing business" in the context of Section 3(a)(11) means that an issuer must conduct a predominant amount of the income producing operations of a business within a state. n50 Also, as pointed out by the Iowa Supreme Court in *Midwest Management Corp. v. Stephens, et al.*, n51 the critical issue is not the location of the parties who pay a company's income but the location of the company's income producing activity.

Rule 147 contains fixed percentages of assets and revenue criteria for determining whether an issuer is "doing business within" for purposes of the Rule. Under Rule 147(c)(2), an issuer will be deemed to "doing business within" a state if with respect to:

- (1) *Revenues*: at least 80 per cent of the gross revenues of the issuer and its subsidiaries on a consolidated basis are derived from the operation of a business or property located in, or the rendering of services within, the state; n52
- (2) *Assets*: at least 80 per cent of the issuer's assets and those of its subsidiaries on a consolidated basis at the end of the most recent fiscal semi-annual period prior to the first offer of any part of the issue are located within such state;
- (3) *Use of Proceeds*: at least 80 percent of the proceeds received in the offering must be used within the state; n53 and
- (4) *Principal Office*: the issuer's principal office is located in the state.

For purposes of the 80 per cent gross revenues test, if the first offer of any part of the issue is made during the first six months of the issuer's current fiscal year, the calculation should be made according to the most recent fiscal year. If the first offer of any part of the issue is made during the last six months of the issuer's current fiscal year, the calculation should be made according to either the subsequent six month period or the twelve months ended with that period. Rule 147(c)(2) also provides that an issuer that has not had gross revenues from the operation of its business in excess of \$5,000 during its most recent twelve month period need not satisfy the revenues test. A company will not be disqualified from use of Rule 147 if more than 20% of the Company's gross revenues is interest and other payments received on a portfolio of loans made to out-of-state borrowers. n54

In the Release accompanying the adoption of Rule 147, the Commission set forth several illustrative examples to guide

in the interpretation of the economic tests in 147(c)(2). n55 From the examples, it is clear that the sale of a company's products throughout the United States will not prevent an issuer from meeting the economic tests, n56 even where it purchases the products it sells from other companies that are also outside the state. n57 Further, on site visits to out-of-state clients or where less than 80 per cent of work hours are spent at the resident home office will not prevent compliance with the Rule. n58 However, if revenues derive from the out-of-state sale of products through nonresident employees or agents, those revenues will not be considered as deriving from company operations within a state. n59

If greater than 20 per cent of assets are represented by accounts receivable of clients located in other states, the issuer may nevertheless meet the assets standard because accounts receivable arising from a business conducted in a state would generally be considered to be located at the principal office of the issuer. n60 However, other intangibles may be more difficult to characterize. In the case of a business whose purpose was to invest in commodities futures and commodities futures contracts, trading on exchanges outside the state and the fact that the proceeds from the offering were maintained in margin accounts outside the state did not invalidate the use of Rule 147. However, the Commission staff, without discussion, would have deemed the "doing business" requirement not satisfied if proceeds from the sale of commodities or futures contracts, as distinguished from the proceeds of the offering, were used to maintain margin accounts outside the state. n61

Fundamental to application of the economic tests is the determination of precisely what the business of the issuer is. Thus, where a company's business is selling undeveloped land located in other states by means of mailing brochures from its in-state office, a determination cannot be made without more information as to the relationship of the land to the company, *i.e.*, if the company owns an interest in the land, it may not meet the tests. n62 Conversely, it would appear that if the issuer is simply selling the land as a service to another separate party, it may meet the tests. Also of significance in this regard may be the nature of the involvement with another state. If the involvement is sufficiently indirect, such as an investment in a separate entity that invests in property located in another state, an issuer may still be able to meet the "doing business" requirement. n63 Where an issuer's principal function was to raise capital to fund business activities engaged in by its joint venturer and the issuer performed few if any operational activities independently and thus was dependent almost entirely on the joint venturer's efforts to produce a profit on its investment of the proceeds from the offering, the Commission staff concluded that the two entities should be treated as a single enterprise for determining the availability of Rule 147. n64

On the other hand, holding company structures may be utilized to accommodate expansion of a company's operations outside of a particular state without disqualifying the in-state subsidiary from using Rule 147. In *United Finance Co.*, n65 the SEC staff confirmed a pre-existing view that a holding company subsidiary would be considered to be doing business within a single state when all of its offices are located in the state, 80% of its revenues are derived in the state, and substantially all of the proceeds from future offerings would be used in connection with operations in the state. The particular subsidiary was part of a restructured organization involving other subsidiaries in other states, but for purposes of Rule 147 and the section 3(a)(11) intrastate offering exemption, its essential operational functions were conducted independently.

[e] Use of Proceeds. If an offering meets the criteria for the intra-state exemption, then, at least by implication, there is a requirement that the proceeds from the offering be used intrastate. In *SEC v. Truckee Showboat* n66 the court held that the Section 3(a)(11) exemption was not available where a California corporation intended to use the proceeds of an offering to acquire an out of state hotel. Also, in *SEC v. McDonald Investment Co.*, n67 where the proceeds would be invested in land development outside the state, the court found that, although the issuer would not own or control any of the operations, the successor failure of the endeavor depended on land developments outside that state that would not be subject to the jurisdiction of the court. n68

Rule 147(c)(2) addresses the use of proceeds as a "doing business within" requirement. The rule provides that at least 80 per cent of the net proceeds from sales made pursuant to the rule be intended to be and actually be used in connection with the operation of a business or property or the rendering of services within the state. Thus, where more than 20 per

cent of the proceeds from an offering would have been used in connection with services provided outside the state, the issuer could not meet the requirements of the Rule. n69 However, the maintenance of more than 20 per cent of an offering's net proceeds in investment firm margin accounts outside the state was found to meet the "doing business" requirement of the Rule. n70

Even where the use of the proceeds will be to carry out a business purpose within the issuer's state, the purchase of a business that is organized to do business and subject to the laws of another state may preclude compliance with the Rule. Thus, where an issuer would apply the funds from an offering to purchase a nonresident insurance company to reinsure policies originating in the issuer's state, the Commission staff gave an unfavorable response, noting particularly that the insurance company would not be licensed to do business in the issuer's state at the time of the offering. n71

[3] Precautionary Measures

Because of the inherent risks of the use of the intrastate exemption, particularly the fact that one sale to a nonresident will disqualify the use of the exemption for the entire issue, it is essential that precautions be taken to ensure the appropriate residence of purchasers and transferees of the purchasers. This was long recognized prior to the adoption of Rule 147, which lists the steps that must be taken for offerings made in reliance on the Rule. Rule 147(f)(1) requires that the issuer:

- (1) place a legend on the certificate that states that the securities have not been registered under the Securities Act of 1933 and set forth the limitations on resale as provided in Rule 147(e); n72
- (2) issue appropriate stop transfer instructions to the transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, make a notation in the appropriate records of the issuer; and
- (3) obtain a written representation from each purchaser as to the purchaser's residence.

Under Rule 147(f)(2), if any of the securities are presented for transfer, the issuer must follow the same precautions in (1) and (2) above with respect to the transfer. Further, with respect to any offers and sales, Rule 147(f)(3) requires that the issuer disclose the limitations on resale contained in Rule 147(e), the provisions contained in (1) and (2) of Rule 147(f)(1), and the provisions of Rule 147(f)(2).

Other precautions may be advised. For example, if the use of the exemption is challenged, the nature of the advertising for an offering may be a factor in determining the intent of the issuer. Thus, one court found that the solicitation of offerees by means of advertising in regional and national publications was inconsistent with the spirit of the claimed exemption. n73 However, an error on the part of the advertising medium, such as the omission of the phrase "for Missouri residents only" from an advertisement should not be determinative, n74 although the issuer should, of course, cure such defects that it knows about.

[4] Resales

Because the intrastate exemption is a transaction exemption, the securities issued in an intrastate offering are not themselves exempt. Unless an exemption is available, subsequent offers and sales of the securities are subject to registration. From the very first interpretative release with respect to the exemption, the limitations on resale were apparent, particularly since a resale to a nonresident could destroy the exemption with respect to an entire issue of securities. n75 In subsequent releases, the emphasis continued to focus on the effect of resales on the availability of the exemption. n76

With respect to offerings made in reliance on Rule 147, Rule 147(e) provides that, during the period of the offering and for a period of nine months from the date of the last sale by the issuer of any part of the issue, resales can only be made

to persons resident within the state. The nine month period established by the Rule has alleviated a great deal of uncertainty with respect to the exemption for both issuers and purchasers. In one case, the Commission staff took the position that foreknowledge by an issuer that a proposed merger and subsequent liquidation would mean that a small number of shares to be issued would be distributed to nonresidents did not make Rule 147 unavailable because the distribution to nonresidents would take place nine months or more after completion of the offering. n77 It is doubtful that such a result would have obtained without the certainty afforded by the nine month period under the Rule.

Even though the Rule is not exclusive for use of the Section 3(a)(11) exemption, adherence to the nine month period would appear to be prudent. However, in at least one instance, a court has upheld use of the exemption where resales occurred in less than nine months. In *Busch v. Carpenter*, n78 the district court upheld use of the intrastate exemption where a resale occurred seven months after all the shares were initially sold. The court stated:

The statute by its literal language does not make the exemption dependent on not reselling the stock... . The court is of the opinion that the seven month period from time of initial sale to the time of resale is sufficient for the offering to come to rest... The court concludes that Rule 147 provides only a safe harbor; compliance with its provisions ensures that the S.E.C. will take no action. n79 It was no doubt of some significance to the outcome of this case that there had been no allegations of fraud, and no scheme or other plan to circumvent the policies of the exemption through a straw person sale, and that the court was able to conclude on the basis of the facts presented that the defendants were neither the sellers of the stock nor in privity with them. n80

The notes following Rule 147(e) have two additional provisions:

- (1) the limitations of Rule 147(e) apply to convertible securities and, if converted, to the underlying security (for purposes of the Rule, a conversion in reliance on Section 3(a)(9) does not begin a new period); n81 and
- (2) dealers must satisfy the requirements of Rule 15c2-11 under the Securities Exchange Act of 1934 prior to publishing, or submitting for publication, any quotation for a security issued in reliance on the Rule.

In the release announcing the adoption of Rule 147, n82 it is stated that persons who acquire securities from issuers or affiliates in transactions complying with the Rule acquire unregistered securities that can only be reoffered and resold pursuant to an exemption from the registration provisions of the Act. This statement is applicable to the intrastate exemption generally.

Purchasers may rely on the provisions of Rule 144 n83 and Section 4(1) n84 for resales. In *United Virginia Bankshares, Inc.*, n85 the Staff stated that, following the satisfaction of all of the provisions of Rule 147, affiliates of the former entity who did not become affiliates of the surviving entity after a merger may resell the securities acquired in the transaction in compliance with Rule 144(c), (e), (f), and (g).

[5] Location of Underwriters and Brokers

Even though the Section 3(a)(11) exemption requires that issuers and investors be residents of the same state, there is no such requirement applicable to any underwriter or broker who may be involved in the transaction. The Commission has specifically stated that the non-residence of the underwriter or dealer is not pertinent so long as the ultimate distribution is solely to residents of the state. n86

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. § 230.147. As a "safe harbor," Rule 147 is available for use, but is not exclusive. Offers and sales of securities may be undertaken in compliance with section 3(a)(11) of the Act outside of Rule 147, but will always be subject to scrutiny for the same elements that are addressed in the Rule.

The Rules under the Securities Act of 1933 are reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

(n2)Footnote 2. The exemption applies to offerings within a single state or territory of the United States, subject to fulfillment of the statutory requirements. Throughout this section of the text, the term state should be read to mean state or territory.

(n3)Footnote 3. Sec. Act Rel. No. 33-5450, 1 Fed. Sec. L. Rep. (CCH) P 2340 at 2611-7 (Jan. 7, 1974). Sec. Act Rel. No. 33-6253, 1 Fed. Sec. L. Rep. (CCH) P 373 at 1255 (Oct. 28, 1980).

The SEC will also not generally respond to requests for No-Action Letters with respect to integration questions, *i.e.*, what constitutes a single "issue" of securities. *Id.*

(n4)Footnote 4. Rule 147, Preliminary Note 1.

(n5)Footnote 5. Sec. Act Rel. No. 33- 4434, 1 Fed.Sec. L. Rep. (CCH) P 2274 (Dec. 6, 1961); Rule 147 Preliminary Note 4.

(n6)Footnote 6. Investment Company Act of 1940 § 24(d). Sec. Act Rel. No. 33-4298, Inv. Co. Act Rel. No. 3140, 1 Fed. Sec. L. Rep. (CCH) P 2765 (Nov. 18, 1960).

(n7)Footnote 7. Sec. Act Rel. No. 33-6281, 46 FR 8446 (Jan. 15, 1981) .

(n8)Footnote 8. See § 4.11[4] *infra* for a discussion of resales.

(n9)Footnote 9. Sec. Act Rel. No. 33-5450, 1 Fed. Sec. L. Rep. (CCH) P 2340 at 2611-2 (Jan. 7, 1974).

Neither Section 3(a)(11) nor Rule 147 provides an exemption from the civil liability provisions of Section 12(2) of the Act, the antifraud provisions of the Act or of the Securities Exchange Act of 1934... the registration and periodic reporting provisions of Section 12(g) and 13 of the Exchange Act of 1934, or any applicable state laws.

See also *Leoni v. Rogers*, 719 F. Supp. 555 (E.D. Mich. 1989) , in which the court rejected the argument that a purely intrastate transaction was not governed by federal securities laws and concluded that § 3(a)(11) only exempts securities from the registration and prospectus requirements of the Securities Act and not from § 10(b) or *Rule 10b-5*; *Kelly v. West Printing Company*, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,835 (E.D.Mich. 1974), in which the court stated that the plaintiff was correct that the exemption provisions of the Securities Act could not possibly bar a § 10(b) claim under the Exchange Act, because, under the language of § 3(a), the exemption is only from the provisions of the Securities Act.

(n10)Footnote 10. In *Myer v. E.M. Adams & Co.*, 511 P. 2d 841 (Or. 1973) (en banc), the Supreme Court of Oregon rescinded a purchase of stock after defendant's representation that the stock would be "going interstate," which the purchasers understood and relied upon to mean that the stock would be subject to an interstate offering, although the defendant had meant that enough time had passed for the stock to be resold to plaintiffs.

(n11)Footnote 11. Pub. L.22, 48 Stat. 74, 77-78. H.R. Rep. No. 85, 73d Cong., 1st Sess. 7 (1933).

(n12)Footnote 12. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 409-41 (1934).

(n13)Footnote 13. Sec. Act Rel. No. 4434, 1 Fed. Sec. L. Rep. (CCH) P 2272 (Dec. 6, 1961).

(n14)Footnote 14. Sec. Act Rel. No. 33-201, 1 Fed. Sec. L. Rep. (CCH) P 2255 (July 20, 1934).

(n15)Footnote 15. Sec. Act Rel. No. 33-1459, 1 Fed. Sec. L. Rep. (CCH) P 2261 (May 29, 1937).

(n16)Footnote 16. *See also* Rule 147, Preliminary Note 3, which summarizes the local nature of the exemption.

(n17)Footnote 17. Sec. Act Rel. No. 33-1459, 1 Fed. Sec. L. Rep. (CCH) P 2261 (May 29, 1937).

(n18)Footnote 18. *Id.*

(n19)Footnote 19. *276 F. 2d 665 (1st Cir. 1960)* . The court stated: "Under the statutory scheme as construed, an entire issue must be sold only to residents or the exemption is lost, and once the exemption is lost, the use of interstate facilities in any sale, to resident or non-resident without registering the security is a violation of the Act." *Id. at 668* .

(n20)Footnote 20. *See also, SEC v. Los Angeles Trust Deed & Mortgage Exchange, 186 F. Supp. 830 (SD Cal) , aff'd, 285 F.2d 162 (9th Cir. 1960)* . The court held that an attempted separation of non-resident investor accounts by spinning them off to a subsidiary in order to claim the intrastate exemption was wholly ineffectual, because the component elements of both corporations' investment plans were not separate and distinct issues of securities.

(n21)Footnote 21. *131 F.2d 476, 480 (9th Cir. 1942)* .

(n22)Footnote 22. Sec. Act Rel. No. 33-4434, 1 Fed. Sec. L.Rep. (CCH) P 2272 (Dec. 6, 1961).

(n23)Footnote 23. *Id.*

See also Sec. Act Rel. No. 33-1459, 1 Fed. Sec. L. Rep. (CCH) P 2262 (May 29, 1937).

[S]ecurities which have actually come to rest in the hands of resident investors -- persons purchasing for investment and not with a view to further distribution or for purposes of resale -- may be resold by such persons, whether directly or through dealers or brokers, to non-residents without in any way affecting the exemption of the issuer.

Id. at 2606.

In *Busch v. Carpenter, 827 F. 2d 653 (10th Cir. 1987)* , after an issuer made a prima facie showing that its offering was consummated within a state, the court disagreed with the amicus position of the Commission that, in order to be entitled to summary judgment, the issuer should be required to disprove all the possible circumstances that might establish that its stock had not yet come to rest.

(n24)Footnote 24. *1 SEC 147, 162-63 (June 4,1935)* .

(n25)Footnote 25. *Id.* The Commission stated:

[T]he Securities Act incorporates in Section 4(1) a presumption that sales by dealers within a period of one year from the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter are a part of the distribution of the issue. That presumption which

Congress adopted should be applied here, not however, as a conclusive presumption of law, as in the third clause of Section 4(1) of the Act, but as a presumption of fact subject to refutation upon a showing of fact that distribution was completed within less than one year.

(n26)Footnote 26. Rule 147(b).

(n27)Footnote 27. GHM/Massachusetts Health Care Partners-1 L.P., SEC No-Action Letter [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,808 (May 31, 1988).

As previously stated, the Commission will accept No-Action Letter requests relating to Section 3(a)(11) and Rule 147 only in the most compelling circumstances.

(n28)Footnote 28. [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,970 (W.D. Mo. 1966).

(n29)Footnote 29. See § 3.12[2][a] *supra* for an explanation of what constitutes an entire issue.

See *SEC v. Spence & Green Chemical Co.*, 612 F.2d 896 (5th Cir. 1980) (Any part of an issue offered to a non-resident disqualifies the entire offering); *but see Busch v. Carpenter*, 827 F.2d 653 (10th Cir. 1987) (A prima facie showing that the exemption applies arises from a showing that the security was sold only to state residents).

(n30)Footnote 30. Sec. Act Rel. No. 33-4434, 1 Fed. Sec. L. Rep. (CCH) P 2274 (Dec. 6, 1961); Sec. Act Rel. No. 33-5450, 1 Fed. Sec. L. Rep. (CCH) P 2340 at 2611-6 (Jan. 7, 1974).

(n31)Footnote 31. Sec. Act Rel. No. 33-4434, 1 Fed. Sec. L. Rep. (CCH) P 2274 at 2609 (Dec. 6, 1961).

(n32)Footnote 32. See *SEC v. Spence & Green Chemical Co.*, 612 F.2d 896 (5th Cir. 1980).

(n33)Footnote 33. Master Financial, Inc. SEC No-Action Letter, 1999 SEC No-Act. LEXIS 544 (May 27, 1999).

(n34)Footnote 34. Commonwealth Equity Trust, SEC No-Action Letter [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,412 (Feb. 21, 1987).

(n35)Footnote 35. The Commission staff expressed no opinion as to whether and under what circumstances the securities sold to investors who are not United States citizens or residents may be reoffered and resold in the United States, or reoffered and resold to citizens, residents, or nationals of the United States. *Id.*

(n36)Footnote 36. Rule 147(e) deals with limitations on resale and Rule 147(f) deals with precautions against interstate offers and sales. See § 3.12[4] and § 3.12[3] *infra* respectively.

(n37)Footnote 37. No-Action Letter, West Side National Bank of San Angelo, June 11, 1980.

(n38)Footnote 38. Opportunities Investment Associates of New London, Connecticut, SEC No-Action Letter [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,738 (July 14, 1978). Where purchasers would sign subscription agreements and pay for subscriptions in monthly installments with delivery of the securities after the last payment had been made, the Commission staff was unable to agree that the purchasers would meet the residency requirement because a purchaser may no longer be a bona fide resident at the time of completion of the sale.

(n39)Footnote 39. In *SEC v. Geotek* [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,520 (N.D. Cal. 1978), the court, in refusing to grant injunctive relief against an attorney, stated that there was no authority requiring consideration of the residence of individual investors of a corporate purchaser prior to the adoption of Rule 147 in 1974 and that the SEC implicitly regarded the requirement in Rule 147 as a change or at least a clarification of previous law. The court, therefore, regarded counsel's advice in connection with forming resident corporations with non-resident

shareholders as at most a mistake of law and judgment short of intentional or negligent violation of the registration requirement of § 5 of the Act.

(n40)Footnote 40. Gold Coast Bancshares, SEC No-Action Letter [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,347 (Oct. 21, 1982).

See also Holmes v. Bartlett, Civil No. 03-1176-AS, 2004 U.S. Dist. LEXIS 10099 (D. Ore. 2004) (Although a trustee who purchases securities at the direction of beneficiaries and acts as a custodian is not a "purchaser" for the purpose of qualifying for the exemption provided by Securities Act section 3(a)(11) and Rule 147, a trustee may be deemed to be the purchaser for purposes of standing to assert claims for improper activities relating to the sale of the securities).

(n41)Footnote 41. *See* Grenader v. Spitz, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,008 (S.D.N.Y. 1975). In deciding that the issuer met the requirements of Section 3(a)(11), the court deemed the residence of a general partnership to be its principal place of business, pointing out the position under Rule 147.

See also GHM/Massachusetts Health Care Partners-1 Limited Partnership, SEC No-Action Letter [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,808 (May 31, 1988), in which the staff expressed the view that, even though a corporate general partner was a wholly-owned subsidiary of a nonresident corporation and an individual general partner was a nonresident, such persons may act as general partners under Rule 147, provided the partnership entity itself is organized in the offering state, maintains its principal office in that state, and otherwise satisfies the requirements of the rule.

(n42)Footnote 42. [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,361 at 93,243 (N.D. Ill., 1978).

(n43)Footnote 43. Sec. Act Rel. No. 33-5450, 1 Fed. Sec. L. Rep. (CCH) P 2340 at 2611-7 (Jan. 7, 1974).

(n44)Footnote 44. Levitt Corporation, SEC No-Action Letter [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,886 (Jan. 11, 1985). In its request to the staff, the issuer stated that it had been a historical accident, for business and tax reasons, that its local operations had not always been operated under a separate subsidiary and also gave assurances that it had no intention of using the proceeds from the offering outside the territory.

(n45)Footnote 45. Sec. Act Rel. No. 33-4434, 1 Fed. Sec. L. Rep. (CCH) P 2273 (Dec. 6, 1961).

(n46)Footnote 46. *Id.*

(n47)Footnote 47. *Id.*

(n48)Footnote 48. Sec. Act Rel. No. 33-5450, 1 Fed. Sec. L. Rep. (CCH) P 2340 (Jan. 7, 1974).

(n49)Footnote 49. 414 F.2d 153 (6th Cir. 1969) .

(n50)Footnote 50. *Chapman*, 414 F.2d at 159 . The court stated:

The issuer operated and staffed an office in Michigan from which he offered and sold securities. While this can be viewed as "doing business" in Michigan for some purposes, such as State taxation and judicial process, we conclude that it is not doing business within the meaning contemplated by Congress in § 3(a)(11) of the Act. *Id.*, at 157.

(n51)Footnote 51. 291 N.W. 2d 896, 910 (Iowa 1980) .

(n52)Footnote 52. The Commission does not permit this requirement to be met by rounding up to the next highest number. No-Action Letter, Berkley and Company, September 16, 1975.

1-3 Federal Securities Act of 1933 § 3.12

(n53)Footnote 53. Rule 147(c)(2) contains as part of "deemed to be doing business within" criteria, a requirement as to the use of the proceeds from the offering, which is discussed in § 3.12[2][e] *infra*.

(n54)Footnote 54. Master Financial, Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 544 (May 27, 1999).

See also Citizens Discount and Investment Corp., SEC No-Action Letter, 1990 SEC No-Act LEXIS (Sept. 26, 1990) (Issuer would qualify to use Rule 147 for the offer and sale of investment certificates provided at least 80% of the proceeds not held in reserve to pay principal and interest on investment certificates as they became due would be used to fund insurance premium finance contracts to be sold to residents in the state).

But see First Commerce of America, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1121 (Sept. 30, 1991) (Issuer would not be considered to be doing business within the State of Oregon for purposes of Rule 147 compliance when more than 20% of the proceeds to be received from a proposed offering might be used in connection with services to be performed outside the state).

(n55)Footnote 55. Sec. Act Rel. No. 33-5450, 1 Fed. Sec. L. Rep. (CCH) P 2340 at 2611-5 and 6 (Jan. 7, 1974).

(n56)Footnote 56. *Id.*, Example 1.

See also, American Computer Communications Co., Inc., SEC No-Action Letter [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,686 (July 15, 1976), where revenues were and, after a merger, would be primarily from purchasers located outside the state, but counsel for the issuer was of the opinion, and the Commission staff apparently agreed, that the revenues were sufficiently derived from operations within the state.

(n57)Footnote 57. Sec. Act Rel. No. 33-5450, n.55 *supra*, Example 2.

In Bott & Associates, SEC No-Action Letter, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,996 (Jan. 25, 1989), a wholesaler making purchases and sales both within and without the state was deemed to be "doing business within" because the sales transactions were made at the wholesaler's principal office and all activities significant to the company's business and operations were located within the state.

(n58)Footnote 58. Sec. Act Rel. No. 33-5450, n. 55 *supra*, Example 4.

(n59)Footnote 59. Capitol Securities, Inc., SEC No-Action Letter [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,516 (Oct. 2, 1987). In issuing its unfavorable response, the Commission staff noted that more than 20% of the company's consolidated revenues may come from insurance premiums on policies sold from outside the state and that more than 20% of the proceeds to be received from the offering might be used in connection with services provided outside Indiana.

In Interstate Securities Corp., SEC No-Action Letter [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,358 (Nov. 15, 1982) the Commission staff's unfavorable response was due to the fact that more than 20 per cent of the firm's revenues were derived from branch office activities outside the state, including investment transactions by out-of-state employees that were the result of decision-making authority exercised outside the state.

(n60)Footnote 60. Sec. Act Rel. No. 33-5450, n.55 *supra*, Example 5.

(n61)Footnote 61. Michael Coleman and Lawrence Grenon, SEC No-Action Letter [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,972 (Jan. 28, 1977).

(n62)Footnote 62. Sec. Act Rel. No. 33-5450, n.55 *supra*, Example 3.

(n63)Footnote 63. In California Dentists' Guild--Real Estate Equity Fund, SEC No-Action Letter [1984-85

Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,924 (March 1, 1985), where a real estate equity fund intended to invest in another real estate equity fund and the latter fund would purchase real estate located in other states, the investments were considered to be within the state for purposes of 147(c)(2) at least in part because of the indirect nature of the contact with other states.

(n64)Footnote 64. Film Festival'82, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,229 (June 25, 1982). When considered as a single enterprise, the joint venturer did not satisfy the "doing business within" requirements of Rule 147(c).

(n65)Footnote 65. SEC No-Action Letter, SEC No-Act LEXIS 774 (Sept. 24, 1999).

(n66)Footnote 66. *157 F. Supp. 824 (S.D. Cal. 1957)* .

(n67)Footnote 67. *343 F. Supp. 343 (D. Minn.1972)* .

(n68)Footnote 68. *Compare* California Dentists' Guild--Real Estate Equity Fund, SEC No-Action Letter [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,924 (March 1, 1985), in which investments were considered to meet the requirements of Rule 147(c)(2) because the fund's purchase of interests in another fund that purchased real estate outside the state was only an indirect contact with other states.

(n69)Footnote 69. Capitol Securities, Inc., SEC No-Action Letter [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,516 (Oct. 2, 1987).

(n70)Footnote 70. Michael Coleman and Lawrence Grenon, SEC No-Action Letter [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,972 (Jan. 28, 1977).

(n71)Footnote 71. Constellation Holding Company, SEC No-Action Letter [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,725 (July 19, 1978).

(n72)Footnote 72. Concerning restrictive legends, § 8-204 of the *Uniform Commercial Code* provides:

A restriction on transfer of a security imposed by the issuer, even if otherwise lawful, is ineffective against any person without actual knowledge of it unless:

(a) the security is certificated and the restriction is noted conspicuously thereon; or

(b) the security is uncertificated and a notation of the restriction is contained in the initial transaction statement sent to the person or, if his interest is transferred to him other than by registration of transfer, pledge, or release, the initial transaction statement sent to the registered owner or the registered pledgee.

In *Edina State Bank v. Mr. Steak, Inc.*, 487 F.2d 640 (10th Cir. 1973) , *cert. denied*, 419 U.S. 883, 95 S.Ct. 150, 42 L.Ed.2d 123 , the court stated that *UCC § 8-204* clearly places a duty on the issuer to note a transfer restriction conspicuously on its certificate, which it had not done. The argument by the issuer and its transfer agent that a transfer would be likely to violate federal securities law provisions against transfer of unregistered stock was without merit since the court was not deciding whether the pledgee could specifically enforce a transfer, but only whether the pledgee was entitled to damages under § 8-204.

(n73)Footnote 73. *S.E.C. v. Freeman* [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,361 at 93,243 (N.D. Ill. 1978).

(n74)Footnote 74. *SEC v. Dunfee*, [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,970 (W.D. Mo. 1966).

(n75)Footnote 75. Sec. Act Rel. No. 201, 1 Fed. Sec. L. Rep. (CCH) P 2255 (July 20, 1934). In the opinion of the Federal Trade Commission, which then had responsibility for the 1933 Act, ultimate distribution consisted in the disposition of securities in the hands of investors in any secondary distribution which might take place pursuant to arrangements by the issuer or underwriters. The Commission further stated that an early listing of the securities on an exchange might contemplate further distribution of the securities prior to completion of their ultimate distribution.

(n76)Footnote 76. Sec. Act Rel. No. 33-1459, 1 Fed. Sec. L. Rep. (CCH) P 2262 (May 29, 1937). The release stated that securities that have actually come to rest in the hands of resident investors, *i.e.*, where purchases are for investment and not with a view to further distribution or for purposes of resale, may be resold by such persons without affecting the exemption of the issuer.

See also Sec. Act Rel. No. 33-4434, 1 Fed. Sec. L. Rep. (CCH) P 2275 (Dec. 6, 1961).

(n77)Footnote 77. BSD Bancorp, Inc., SEC No-Action Letter [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,219 (May 10, 1982).

(n78)Footnote 78. SEC No-Action Letter [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,810 (D. Utah 1984).

(n79)Footnote 79. *Id.* at 90,081-90,082.

(n80)Footnote 80. *Id.*

(n81)Footnote 81. Section 3(a)(9), which details the exemption provided for voluntary exchanges with an issuer, is discussed in § 3.10[2] *supra*.

(n82)Footnote 82. Sec. Act Rel. No. 33-5450, 1 Fed. Sec. L. Rep. (CCH) P 2340 (Jan. 7, 1974).

(n83)Footnote 83. *See* Ch. 6. *infra*.

(n84)Footnote 84. *See* Ch 4.02 *supra*..

(n85)Footnote 85. SEC No-Action Letter [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,541 (Feb. 13, 1978).

(n86)Footnote 86. Sec. Act. Rel. No. 4434, 1 Fed. Sec. L. Rep. (CCH) P 2272 (Dec. 6, 1961).



41 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.13

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.13 Securities Issued in Connection with Certain Bank Holding Company Acquisitions -- Section 3(a)(12)

Section 3(a)(12) was added to the Securities Act as part of the Community Development Banking and Financial Institutions Act of 1994. n1 This act was intended to reduce the costs of forming a bank holding company and assist small banks in converting to holding companies so that they can take advantage of the flexibility available to bank holding companies. n2

The section, which provides an exemption from the registration requirements of the Securities Act, is for the sole purpose of the formation of bank holding companies. The exemption is available for an offer or sale of equity securities made in connection with the formation of a bank holding company by a bank or savings institution under the simplified procedure established under the 1994 Act, provided:

- the transaction occurs solely as part a reorganization in which the resulting holding company does not have any significant assets other than securities of the former bank and its existing subsidiaries;
- the shareholders' proportional share interests remain substantially the same;
- the shareholders' rights and interests remain substantially the same; and
- the holding company has substantially the same assets and liabilities as the bank had prior to the transaction. n3

The acquisition applies to banks under Section 3(a) of the Bank Holding Company of 1956 and savings associations under Section 10(e) of the Home Owners' Loan Act. A savings association is further defined as one under Section 3(b) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation. n4

1-3 Federal Securities Act of 1933 § 3.13

Under the limitations contained in Section 3(a)(12), the exemption does not apply to transactions where there is a transfer of corporate control or a substantial alteration in the proportional interests of shareholders. Likewise, it would not apply to a holding company formed in connection with a concurrent conversion from mutual to stock ownership. n5

The exemption applies to specified transactions, not to the securities that are issued in the transactions. Thus, absent the availability of another exemption, subsequent offerings of securities by a holding company would not be exempt from registration. n6

FOOTNOTES:

(n1)Footnote 1. Pub. Law 103-325, 108 Stat. 2160, § 320 (Act of Sept. 23, 1994).

(n2)Footnote 2. S. Rep. No. 169, 103rd Cong., 2d Sess., at 54 (1994).

(n3)Footnote 3. The full text of Section 3(a)(12) is as follows:

Any equity security issued in connection with the acquisition by a holding company of a bank under section 3(a) of the Bank Holding Company Act of 1956 or a savings association under section 10(e) of the Home Owners' Loan Act, if--

(A) the acquisition occurs solely as part of a reorganization in which security holders exchange their shares of a bank or savings association for shares of a newly formed holding company with no significant assets other than the securities of the bank or savings association and the existing subsidiaries of the bank or savings association;

(B) the security holders receive, after that reorganization, substantially the same proportional share interests in the holding company as they held in the bank or savings association, except for nominal changes in shareholders' interests and the exercise of dissenting shareholders' rights under State or Federal Law;

(C) the rights and interests of security holders in the holding company are substantially the same as those in the bank or savings association prior to the transaction, other than as may be required by law; and

(D) the holding company has substantially the same assets and liabilities, on a consolidated basis, as the bank or savings association had prior to the transaction.

For purposes of this paragraph, the term "savings association" means a savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation.

(n4)Footnote 4. *Id.*

(n5)Footnote 5. H. Rep. No. 652, 103rd Cong., 2d Sess., at 175-76 (1994).

(n6)Footnote 6. *Id.*



42 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.14

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.14 Securities Issued by Church Plans, Companies or Accounts that are Excluded from the Definition of an Investment Company

Section 3(a)(13) was added to the Securities Act as part of NSMIA. n1 The purpose of NSMIA is, generally, to reduce states' ability to impose restrictions on the offer and sale of certain securities. This exemption was adopted under Title V of NSMIA which is entitled "Reducing the Cost of Saving and Investment." n2 The specific wording of this exemption is "Any security issued by or any interest or participation in any church plan, company or account that is excluded from the definition of an investment company under Section 3(c)(14) of the Investment Company Act of 1940." n3

The section 3(a)(13) exemption was adopted as a part of certain revisions to the Investment Company Act of 1940, as amended (the "1940 Act"), the Exchange Act and the Securities Act to remove church plans from excessive regulation. Church employee plans are exempted from the definition of "investment company" under the 1940 Act, and the Exchange Act was amended to mandate disclosure to church plan participants that (i) such plans are not subject to federal or state regulatory oversight and (ii) that plan participants and beneficiaries will, therefore, not be afforded the protections concomitant with such oversight. While the legislative history concerning this exemption is somewhat sketchy, it appears that Congress felt that there was no need for a great deal of regulation of church plans.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 104-290, 110 Stat. 3416.

(n2)Footnote 2. *Id.*

(n3)Footnote 3. *Id.*



43 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.15

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.15 Security Futures Products and Standardized Options

Section 3(a)(14) of the Securities Act was added in connection with enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"). n1 CFMA addressed the regulation of security futures, which are both securities and futures contracts. A "securities futures product" is now defined in the Securities Act as a security future or an option on a security future. n2 A framework for joint regulation of these products by the SEC and the Commodity Futures Trading Commission is established under CFMA.

CFMA permits national securities exchanges registered under section 6(a) of the Exchange Act n3 and national securities associations registered under section 15A(a) to trade futures on individual securities and on narrow-based security indices. To accommodate these products, CFMA amended provisions of the Securities Act to include a security future within the definition of "security," n4 and added section 3(a)(14) n5 to exempt from all provisions of the Securities Act (with the exception of section 17 antifraud provisions) any securities futures product that is traded on a national securities exchange or a registered national securities association, and which is cleared by a clearing agency that is registered under section 17A of the Exchange Act or which is exempt from registration. CFMA also amended section 2(a)(3) of the Securities Act to ensure that a securities futures product could not be used by an issuer, affiliate of an issuer or an underwriter to circumvent the registration requirements of section 5 of the Securities Act with respect to an issuer's securities underlying the security futures product. n6

In order to provide the same exemption for exchange-traded standardized security options as the Act now provides for security futures products, in 2003 the SEC adopted Rule 238 under the Securities Act, n7 to exempt standardized options that are issued by a registered clearing agency and traded on a registered national securities exchange or registered national securities association. By the rule, the treatment of standardized options and security futures products has been harmonized, and any unintended consequences from differing treatment of these two types of derivative securities is thus avoided. Rule 238 was adopted by the SEC pursuant to its general exemption authority prescribed in sections 3(b) and (c) of the Securities Act.

FOOTNOTES:

(n1)Footnote 1. Pub. L. 106-554, 114 Stat. 2763 (2000).

(n2)Footnote 2. *See* Securities Act § 2(a)(16), 15 U.S.C. § 77b(a)(16). A coordinate definition was also added to the Exchange Act and the Commodity Exchange Act.

(n3)Footnote 3. 15 U.S.C. § 78f(a).

(n4)Footnote 4. *See* Securities Act § 2(a)(1), 15 U.S.C. § 77b(a)(1).

(n5)Footnote 5. 15 U.S.C. § 77c(a)(14).

(n6)Footnote 6. As amended, section 2(a)(3) of the Securities Act provides: "Any offer or sale of a security futures product by or on behalf of the issuer of the securities underlying the security futures product, an affiliate of the issuer, or an underwriter, shall constitute a contract for sale of, offer for sale, or offer to sell the underlying security." 15 U.S.C. § 77b(a)(3).

(n7)Footnote 7. 17 C.F.R. § 230.238.



44 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.16

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.16 Section 3(b) General Exemption Authority

As illustrated in the adoption by the SEC of Rule 238 under the Securities Act to harmonize treatment of security futures products and exchange-traded standard options on securities, the Commission has general rule-making authority under section 3(b) of the Securities Act to exempt securities when enforcement of the Act is not necessary in the public interest and investor protection is not compromised. Section 3(b) authority is most apparent as the basis for Regulation A under the Act, the conditional small issuer exemption that is now addressed through Rule 505 of Regulation D. n1 These are not exempt securities, as such, but rather are exempt from registration requirements when conditions regarding the offering are met. In this sense, Regulation A, and now Rule 505 of Regulation D, are more logically considered as transaction exemptions. They are addressed in Chapter 4, along with other transaction exemptions. However, as illustrated by Rule 238 under the Securities Act, the SEC does retain flexibility under section 3(b) to provide true securities exemptions.

Acting under the general exemption authority in section 3(b), the SEC has by rule established an exemption for shares of stock or similar securities offered to provide funds to be distributed to shareholders of the issuer of such securities in lieu of issuing fractional shares in connection with a stock dividend, stock split or certain other transactions when conditions are satisfied. n2 By another rule, an exemption under section 3(b) is established for offers and sales to certain Canadian Tax-Deferred Retirement Savings Accounts. n3 Other section 3(b) exemptions under the Securities Act include Rule 701, n4 which exempts offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation. The purposes of Rule 701 is to provide an exemption from registration requirements of the Securities Act for securities issued in compensatory circumstances. The exemption covers offers and sales of securities under a written compensatory benefit plan or other written compensation contract established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent, for the participation of their employees, directors, general partners, trustees, officers, or consultants and advisers and their family members who acquire such securities through gifts or domestic relations orders. There are special requirements for securities issued to "consultants and advisers," and other general limitations and conditions apply for the exemption.

Under section 3(b) of the Securities Act, the SEC established exemptions for "cross-border" rights offerings, exchange offers and business combinations. n5 Finally, Regulation CE, adopted under section 3(b) of the Securities Act, addresses coordinated exemptions for certain issues of securities exempt under state law. Rule 1001 under this provision n6 specifically creates an exemption for securities offered and sold in transactions exempt from qualification under *section 25102(n) of the California Corporations Code*, subject to limitations on the size of an offering and resales.

Each of the Securities Act exemptions adopted by the SEC pursuant to the authority of Section 3(b) of the Act are separately addressed in Chapter 5 of this Treatise--"Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act.

FOOTNOTES:

(n1)Footnote 1. Regulation D also includes Rule 504, an exemption for limited offerings and sales of securities not exceeding \$1 million. Rule 504 was adopted pursuant to section 3(b) exemption authority, and is also considered in detail with transaction exemptions in Chapter 4, *infra* .

(n2)Footnote 2. *See* Securities Act Rule 236, 17 C.F.R. § 230.236 ("Exemption of Shares Offered in Connection with Certain Transactions").

(n3)Footnote 3. Securities Act Rule 237, 17 C.F.R. § 230.237.

(n4)Footnote 4. 17 C.F.R. § 230.701.

(n5)Footnote 5. *See* Securities Act Rules 800 -- 802, 17 C.F.R. §§ 230.800 through 230.802.

(n6)Footnote 6. 17 C.F.R. § 230.1001.



45 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 3 Exempt Securities under Section 3 of the Securities Act

1-3 Federal Securities Act of 1933 § 3.17

AUTHOR: Robert N. Rapp, Esq. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.), and is Adjunct Professor of Law ("Law, Theory and Practice in the Financial Markets") at the Case Western Reserve University School of Law.

§ 3.17 Section 3(c) Exemption Authority

Section 3(c) of the Securities Act grants authority to the SEC to provide an exemption from registration requirements for securities issued by small business investment companies (SBICs) formed in accordance with the Small Business Investment Act of 1958. Pursuant to this authority, the SEC adopted Regulation E under the Securities Act n1 for eligible SBICs. An SBIC is a company which is either licensed as such under the Small Business Investment Company Act of 1958, or has received preliminary approval from the Small Business Administration that it may submit a license application. n2 Securities of a "business development company" may also be eligible if the company has elected to be regulated as such under the Investment Company Act of 1940. n3

Although Section 3(c) sets no dollar limit on an exemption, Regulation E permits a maximum \$5 million offering amount by qualified issuers. The aggregate offering price limit for securities offered and sold on behalf of any one person other than the issuer is \$100,000. There are particular offering procedures built around the filing of the Form 1-E Notification, which must be filed with the SEC at least ten days prior to the date on which the initial offering or sale of securities under Regulation E is to be made. The rules provide for use of an offering circular containing specified information, and include the provision for use of a preliminary offering circular which may be used during a waiting period. n4 There is an exception to the Regulation E offering circular requirements in offerings not exceeding \$100,000 which meet certain other conditions.

There are other requirements and qualifications applicable for the exemption under Regulation E. For example, the issuer in a Regulation E offering is subject to certain sales reporting requirements, and the exemption may not be available at all if certain "bad boy" criteria exists regarding persons who are to be involved in the issue and distribution of the securities. n5 Regulation E is separately discussed in detail in Section 5.07 of *this Treatise*.

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. §§230.601-610A.

(n2)Footnote 2. *See* Regulation E, Rule 602(a), 17 C.F.R. § 602(a).

(n3)Footnote 3. *Id.* A business development company is a closed-end investment company which meets the requirements of Section 2(a)(48)(A)-(B) of the Investment Company Act of 1940.

(n4)Footnote 4. *See* Regulation E, Rule 605(f), 17 C.F.R. §230.605(f).

(n5)Footnote 5. *See* Regulation E, Rule 602(b), 17 C.F.R. § 602(b).



46 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 4.syn

AUTHOR: Robert N. Rapp

§ 4.syn Synopsis to Chapter 4: Exempt Transactions Under Section 4 of the Securities Act

§ 4.01 Introduction

§ 4.02 Transactions by Persons Other Than Issuers, Underwriters, or Dealers--Section 4(1)

[1] Issuers

[2] Underwriters

[a] Section 2(a)(11) Issuers--Control

[i] Stock Ownership.

[ii] Power to Direct Management and Policies.

[iii] Officers and Directors as Controlling Persons.

[b] Purchasing From or Selling For an Issuer.

[i] Corporation Selling Its Own Shares.

[ii] Sales by Parents, Subsidiaries, and Affiliates.

[iii] Sale of Fractional Shares.

[iv] Pledges of Control Shares.

[c] "Participation In" an Underwriting.

[d] A View to Distribution

[e] Dealers Selling on Commission.

[3] Dealers

[4] An Introduction to Rule 144

§ 4.03 The Private Offering Exemption--Section 4(2)

[1] Perfecting the Section 4(2) Exemption

[a] The Offerees

[i] The Number of Offerees.

[ii] The Identity of the Offerees and Their Relationship to the Issuer.

[iii] The Sophistication of the Offerees.

[b] The Offering

[i] The Size of the Offering.

[ii] The Manner of the Offering.

[iii] Purchasers Must "Take For Investment."

[iv] The Offering Must Not be "Integrated."

[A] Interpretive Problems Regarding Integration.

[B] Numerous "Private" Sales by Issuers Prior to Registration.

[2] Section 4(2) and Rule 506 of Regulation D

§ 4.04 Private Sales by Non-Issuers: The "Section 4 (1 1/2)" Exemption and Rule 144A

[1] "Section 4 (1 1/2)"

[2] Securities Act Rule 144A

§ 4.05 Regulation D--Generally

[1] Definitions--Rule 501

[2] General Conditions--Rule 502

[a] Integration.

[b] Information Requirements.

[c] Limitations on Manner of Offering.

[d] Limitations on Resale.

[3] Notice of Sales--Rule 503

[4] Limited Offerings Not Exceeding \$1,000,000--Rule 504

[5] Limited Offerings Not Exceeding \$5,000,000--Rule 505

[6] Offerings to No More Than 35 Non-Accredited Investors--Rule 506

§ 4.06 The Dealer Exemption--Section 4(3)

§ 4.07 Broker Transactions--Section 4(4)

[1] Brokerage Transactions--Generally

[2] Sales by Controlling Persons in Brokerage Transactions

§ 4.08 Exempt Offers and Sales of Promissory Notes Secured by Certain Real Estate--Section 4(5)

§ 4.09 Exempt Offers and Sales to Accredited Investors--Section 4(6)

§ 4.10 Regulation S: Exempt Offers and Sales Made Outside the United States

Robert N. Rapp n*

FOOTNOTES:

(n1)Footnote *. This chapter was revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d ed., Matthew Bender & Co.).



47 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.01

AUTHOR: Robert N. Rapp

§ 4.01 Introduction

Section 5 of the Securities Act of 1933 n1 ("the Securities Act"), makes it unlawful to offer or sell a security through the use of the mails or instruments of interstate commerce unless a registration statement is in effect as to that security. n2

Two types of exemptions provide relief from the provisions of Section 5. In general, Section 3(a) of the Securities Act exempts from registration certain securities based on the status of the issuer, while Section 4 exempts certain transactions. In all cases, exemptions provided in the Securities Act are strictly construed against the claimant of such an exemption, and the burden of proof is on the claimant. n3

Section 4 of the Act exempts:

- (1) Transactions by any person other than the issuer, underwriter, or dealer.
- (2) Transactions by an issuer not involving any public offering.
- (3) Transactions by a dealer (including an underwriter no longer acting as a underwriter in respect of the security involved in such transaction), except in certain circumstances and subject to certain requirements;
- (4) Brokers' transactions executed on customers' orders;
- (5) The offer and sale of promissory notes by qualifying issuers and which secured by real estate where certain conditions and requirements are met; and
- (6) Transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 3(b) of Act, and certain other conditions are satisfied. n4

The vast majority of securities sales are completed under a transactional exemption rather than by registration pursuant

to Section 5. It is therefore important to understand the goals of the exemptions provided in Section 4. The Securities Act's essential structure of generally requiring registration but then carving out specific exemptions embodies a distinction between two types of securities activity: large distributions of securities, generally effected by professional investment bankers and brokers and aimed at the general public regardless of sophistication; and limited or isolated trading or transactions by issuers or individuals. Registration, with its goal of ensuring an adequate flow of accurate information to the investing public, is not deemed to be necessary for the latter. The exemptions of Section 4 thus hinge on either the "ordinary" nature of the seller (Section 4(1) and the broker and dealer exemptions of Sections 4(3) and 4(4)), or the presumably sophisticated nature of the purchaser (the private placement exemption of Section 4(2), the real estate exemption of Section 4(5) and the Section 4(6) exemption for sales to accredited investors).

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. § 77e*.

(n2)Footnote 2. Section 5(a) of the Securities Act, *15 U.S.C. § 77e(a)*, provides that:

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly--(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise ...

Section 5(c), *15 U.S.C. § 77e(c)*, provides:

It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate communication or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security ...

(n3)Footnote 3. *Gearhart & Otis, Inc.*, 42 S.E.C. 1, 4-5 (1964) , *aff'd*, 348 F.2d 798 (D.C. Cir. 1965) ; *see also SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) . Section 3 exemptions are presented in ch. 3 *supra* .

(n4)Footnote 4. The antifraud rules of Section 17(a) of the Securities Act and Section 10(b) and *Rule 10b-5* of the Exchange Act apply to all offerings regardless of whether an exemption is perfected or the securities are registered. *See § 9.06 infra* and Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, §§ 5.04 (Matthew Bender).



48 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.02

AUTHOR: Robert N. Rapp

§ 4.02 Transactions by Persons Other Than Issuers, Underwriters, or Dealers--Section 4(1)

Section 4(1) provides an exemption from the registration requirements of Section 5 "transactions by any person other than an issuer, underwriter, or dealer." n1 By thus allowing "ordinary" investors to resell their securities without registration, the Section 4(1) exemption emphasizes the distinction between *trading* by individual investors with respect to securities already issued and outstanding in the hands of the investing public, and a *distribution* of securities, which is the process by which a block of securities is dispersed and ultimately comes to rest in the hands of the investing public. n2 Since ordinary trading lacks the promotional pressure and thus the need for accurate information about the issuer that accompanies distributions of securities, there is no need to impose the registration requirements of Section 5 on individual investors. The critical consideration, however, is whether in any particular situation the elements of a distribution are in fact present, such that protection of the registration and prospectus delivery requirements of section 5 is needed. In this it is certain that the determination of whether a sale of stock constitutes a distribution is not dependent upon the number of shares involved. The sale of a small percentage of the total shares of a company that are outstanding may well constitute a distribution for purposes of section 5 depending upon characteristics of the transaction and the nature of the seller and those participating in the process. n3 "Distribution" for purposes of section 5 is generally considered to be tantamount to a "public offering." n4 But public offering is not defined in quantitative terms. Rather, the question in all circumstances is whether the offerees are in need of the protection which the Securities Act affords through registration. n5

Every offer or sale of securities involving use of the jurisdictional means is subject to the registration requirements of section 5 of the federal Securities Act unless an exemption is available. n6 A fundamental consideration in the application of federal registration requirements is that section 5 does not apply solely to initial distributions of securities. n7 Any offer and sale of securities may have the characteristics of a distribution, whether it is an initial offering or a subsequent sale by one holding securities. It is in that context that the exemption created by section 4(1) of the Act is critically important. By exempting transactions not involving an issuer, underwriter or dealer, section 4(1) is grounded in the absence of indicia of a distribution, not the least of which is the presence of an underwriter through which, or by which, a distribution is presumptively effected. Underwriter status connotes an intermediary function. That function is not limited to traditional underwriters in the public offering scenario, but is in fact a functional status that may be applied in the context of any sale of securities in which it may be said that the seller is not an investor with whom securities have come to rest, but is rather functioning in a process by which a distribution is either continuing or is

newly initiated.

A critical notion in assessing whether a distribution is present for purposes of section 5, and the section 4(1) exemption, is the concept of "secondary distribution." Secondary distributions occur when controlling persons--"affiliates" n8--sell the issuer's securities in circumstances that raise the same considerations for investor protection as if the issuer itself were engaged in the distribution of its securities. By reason of a control relationship to the issuer, controlling persons have a different status than ordinary holders in the sale of their shares. The Securities Act imposes "issuer" status on control persons for purposes of determining whether a distribution subject to section 5 registration requirements occurs, and broadens the notion of "underwriter" in connection with transactions by such control person issuers.

Proper application of the Section 4(1) exemption thus rests on the identity of the transacting party and requires careful interpretation of the definitions of "issuer," "underwriter" and "dealer." These are defined terms in Section 2 of the Securities Act, and each is considered in detail below. There is, however, an important caveat in undertaking this analysis. Even if one is not an issuer, underwriter or dealer, he or she will not be protected by section 4(1) if the sale in question is a transaction by anyone in those categories and the person's activity bearing upon the sale, or involvement in it, is significant enough to impose responsibility as a participant in what amounts to the chain of a distribution. n9

[1] Issuers

Section 2(4) broadly defines an "issuer" as "every person who issues or proposes to issue any security." n10 Thus, the term would include, among others, corporations, n11 partnerships, limited partnerships, limited liability companies, business trusts, other unincorporated associations, governments, governmental agencies, and individuals under certain circumstances. n12 In this connection, it should be noted that the definition includes a person who "*proposes* to issue any security." n13 Thus, in the event that preorganization certificates are offered for sale, the "issuer" is the person or group of promoters acting as syndicate managers. In the same manner, the "issuer" of units of a limited partnership to be formed is the proposed general partner and the "issuer" of membership interests in a limited liability company to be formed is the proposed managing member.

The remainder of Section 2(4) deals in detail with specific types of business organizations and the persons associated therewith who are "issuers" for purposes of the Securities Act. In the application of the section 4(1) exemption from registration, however, the most significant definition of "issuer" is not found in section 2(4), but rather in section 2(11), which is the definition of "underwriter" under the Securities Act. One who is an underwriter may not rely on the section 4(1) exemption, and will be subject to registration requirements under the Act unless some other exemption is available. The critical impact of the underwriter definition in section 2a(11) of the Act is discussed below.

[2] Underwriters

Section 2(a)(11) of the Securities Act (formerly Section 2(11)) defines "underwriter" as

[A]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking, but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. 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 control with the issuer. n14

The term is not confined to those who engage in underwriting as a business. Anyone who engages in the activities in the definition can be an underwriter. Thus, for example, an individual who purchases a substantial amount of securities in

an issue and then quickly sells them may be considered an underwriter, as would anyone who assists in the distribution in any way. As for the latter notion, it is important to remember that section 2(a)(11) defines underwriter to include any person who offers or sells for an issuer in connection with a distribution. As discussed in more detail below, "statutory" underwriter status is most often considered in the context of one who purchases from an issuer "with a view to distribution." However, section 2(a)(11) has a much broader scope, extending to anyone who in fact acts for an issuer in the process of a distribution of securities, or as a "link in the chain of distribution." n15 Because "issuer" is defined for purposes of section 2(a)(11) to include "any person directly or indirectly controlling or controlled by the issuer," it is at once apparent that the potential for inadvertently attaining underwriter status, and violating section 5 of the Securities Act, is meaningful.

The definition of an underwriter encompasses broker-dealers acting as firm commitment underwriters--those who purchase the security outright from the issuer or controlling person--and best efforts underwriters--those who agree to use best efforts to sell the securities but without liability for the unsold shares. n16 The definition also includes members of the underwriting syndicate or selling group. These are traditional underwriters, who perform a direct role in the distribution of securities from issuers to the investing public. In the application of Section 4(1), however, the presence a non-traditional underwriter is the primary concern. The Section 4(1) exemption excludes *statutory* underwriters as well as traditional underwriters. The determination of underwriter status depends on the actual role performed in a particular transaction. Section 2(a)(11) extends underwriter status to individuals who might otherwise be unconnected to the securities industry. Determining underwriter status for purposes of assessing the availability of the section 4(1) exemption requires analysis of the particular facts of each case. Any seller of securities may become a statutory underwriter.

A common example is when one makes a secondary distribution for the account of a person who is in a control relationship with the issuer of the securities. The one who distributes the controlling person's securities may be an "underwriter" within the Section 2(a)(11) definition regardless of occupation or lack of connection with any phase of the securities business. Moreover, a person who has no contractual arrangement with and no authorization from an issuer to distribute its securities, will be regarded as a statutory underwriter if his function is to obtain a purchaser for the securities. In *SEC v. Chinese Consolidated Benevolent Ass'n*, n17 the defendant was a volunteer who, for patriotic reasons and for no compensation solicited offers from United States citizens to buy unregistered Chinese government bonds. In holding that the defendant was an "underwriter," the court observed: "a person who solicits offers to buy securities is a seller within the statutory meaning whether he is in an ordinary legal sense acting for the issuer or the purchaser ... it was participating in a transaction with an issuer, to wit, the Chinese government." n18

Chinese Consolidated Benevolent cemented the principle that the section 4(1) exemption will not be available to those persons who have engaged in steps necessary to the distribution of the unregistered securities. Stated as a "necessary participant" test, the question is whether but for a person's participation, the sale transaction would not have taken place or, as has otherwise been stated, whether the person's acts were a "substantial factor" in the sale. n19

Many challenges in the application of section 4(1) and the scope of "underwriter" status have come in the context of Internet-based investor relations services designed to create investor awareness for public companies traded on the OTC "Bulletin Board" n20 in exchange for companies' stock or cash. In *Loursin, Inc.*, n21 for example, a company hired to place press releases and company information on its Web site, and to launch a promotional campaign for its client company, was paid with client company stock. The investor relations firm then sold the client company stock in open market transactions without compliance with section 5 of the Securities Act. The evidence was clear that the firm and its principals took shares of client companies purely as compensation, with a view to selling them on the open market. The absence of any investment intent was sufficient to impose underwriter status on the seller, and with it the violation of section 5 of the Securities Act since the shares were not covered by a registration statement. The seller's belief that the shares received as compensation were freely tradable was of no consequence. n22

In other contemporary settings, the sale of large amounts of stock received as compensation for consulting or other

services, or the exercise of options received in such circumstances followed by the sale of the option shares, also raise the question of whether the sell is a statutory underwriter without regard to the fact that bona fide consulting or other services may have been provided. In *SEC v. Universal Express, Inc.* n23 the court rejected the contention that an individual defendant was unaware that the circumstances of his acquisition and sale of millions of shares of unregistered stock as payment for consulting services constituted participation in a distribution, and that the individual had no intention of doing so. The underwriter inquiry is objective, said the court, and does no incorporate consideration of the actor's subjective understandings. n24 The court offered this further observation:

Disregard of such subjective evidence is sensible, as otherwise it would be easy enough for a Section 5 violator to claim non-underwriter exemption for massive sales of unregistered securities--defeating the purpose of the Securities Act--by swearing that he never meant to facilitate distributions of the issuer.
n25

Although evidence of subjective intent is not involved, it is also true in the critical assessment of underwriter status that determines the availability of the Section 4(1) exemption the result hinges largely on interpretations by the SEC and the courts of the specific language of Section 2(a)(11). In particular, the terms "issuer," "purchased from," "sells for," "participates in" and "with a view to ... distribution" must be properly understood in order to determine the availability of the exemption. Each is considered in more detail below.

[a] Section 2(a)(11) Issuers--Control

In order to be classified as an underwriter pursuant to Section 2(a)(11), a person must act in relation to an "issuer." As introduced above, however, section 2(a)(11) enlarges the standard definition of "issuer" contained in Section 2(a)(4) by providing that "[a]s 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." n26

No single factor determines control status and the term is not defined by the Securities Act. However, the term is defined in Rule 405 under the Securities Act as follows:

The term "control" (including the terms "controlling," "controlled by," and "under common control with") means the possession, direct or indirect, 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. n27

Control is an issue to be determined from particular facts and circumstances. An individual who is not an officer or director of a company may nevertheless be a control person as demonstrated by particular activities and the ability to control or direct the affairs of the business. n28 The notion of control-in-fact is paramount in the analysis. n29 In the assessment of underwriter status for the purpose of the section 4(1) exemption from registration requirements there are two common settings. The first involves the existence of an actual or apparent distribution of securities and the question is whether the person or persons engaged in it may claim the section 4(1) exemption. These are discreet instances of large transactions or processes by which securities are sold by persons associated in some capacity with the true issuer and acting out of the normal course of business. The earmarks of a distribution, and the concerns for investor protection that are addressed by registration under the Act, are normally apparent. The other, more common setting involves the resale of unregistered ("restricted") securities held by an individual who is or may be deemed to be an "affiliate" of the issuer, but in circumstances in which there is no purposeful undertaking to carry out a distribution of securities into the hand of the investing public. Concerns for investor protection that registration would supply are no different, but the circumstances of the transaction may be quite different, and such that the protections of registration are not necessary.

In any case, application of the basic standard for determining control requires more than a cursory inquiry into a person's influence over the issuer. This can pose a particular challenge for market intermediaries. While a broker-dealer is always under an obligation to determine the availability of an exemption before attempting to sell unregistered securities, n30 the problem becomes acute when the request to sell comes from a person whose controlling interest in the issuer is not apparent. In *Geiger v. SEC*, n31 a salesperson and trader at a brokerage firm were deemed to be underwriters in the sale of unregistered securities for what was in fact a statutory issuer of the securities. There was no evidence that these statutory underwriters actually knew the shares were controlled by a statutory issuer. The share certificate bore no restrictive legend, and the two had been assured that the shares were "free trading." Nevertheless, the D.C. Circuit Court of Appeals affirmed an administrative determination that section 4(1) did not cover the sales, and that the two intermediaries violated section 5 in effecting the sales. The problem, said the court, is that they failed to inquire sufficiently into the circumstances of the transaction. The court opined:

When a dealer is offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question ... whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then search inquiry is called for." Even if, as Kirby argues, this sale was not substantial, all the other warning signs were present. Golden Eagle was little-known and lightly traded, and Geiger was reluctant to disclose the true party in interest. If Kirby had simply insisted on knowing the identity of the seller, he would have uncovered the illegal nature of the transaction. By giving Geiger a blank check, Kirby abandoned even the pretense of due diligence. n32

In practice, "affiliate" status is most commonly the focal point in assessing the availability of the section 4(1) exemption. Affiliate status is based upon a control relationship, but is more broadly defined in Rule 405 under the Securities Act n33 as "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with" an issuer. In *SEC v. Freiberg* n34 the court explained that the affiliate inquiry is based on the totality of circumstances, including an appraisal of the influence upon management and policies of a company by the person involved. Affiliates, said the court, are most often officers, directors or majority shareholders--people who exercise control over the company's policies or finances. n35

The "affiliate" definition is carried into Rule 144 under the Securities Act, n36 where it is most prominent today. Rule 144 is the "safe harbor" provision for determining persons deemed not to be engaged in a distribution of securities, and who are not therefore underwriters. Affiliate or non-affiliate status determines the requirements under Rule 144 for the sale of "restricted securities" without registration or the availability of another exemption. Rule 144 is introduced later in this chapter, and discussed in depth in Chapter 6. Its significance is better understood first, however, by a closer examination of "control" relationships and other key elements of underwriter status for purposes of the section 4(1) exemption. The common indicia of control for purposes of underwriter status and the availability of the section 4(1) exemption are examined further below.

[i] Stock Ownership. While it is obvious that record or beneficial ownership of more than one-half of the voting securities of a company constitutes control, it is equally apparent that one (or a group) owning less than that amount may occupy the status of controlling person. n37 In this connection, Item 11(m) of Form S-1, the most generally used application form for registration, requires the registrant to list each person who owns more than 5 per cent of any class of voting securities. n38

Furthermore, this "minority control" can exist in numerous forms, including:

- Pyramiding through holding companies;
- Issuance of a larger class of nonvoting stock coupled with the issuance of a comparatively small

amount of voting stock;

- The placement of comparatively few shares in the hands of one person or one group coupled with wide distribution of the remainder;
- Proxy control through committees; and
- Control through voting trusts or protective committees in reorganization or bankruptcy proceedings.

[ii] Power to Direct Management and Policies. A test frequently used in determining the existence of control concerns the ability of the person or group in question to direct the management and policies of the issuer. As the court observed in *SEC v. Micro Moisture Controls, Inc.*, n39 "the defendants were in control because they possessed and exercised the power to direct the management and policies of Micro-Moisture... and particularly were in a position to obtain the required signatures of Micro-Moisture and its officers and directors on a registration statement." The requisite level of control is not determined by influence over day-to-day managerial functions, but rather over the company's management and policy. n40

This influence may stem from one or more of several sources. Domination of officers and members of the board of directors or executive committee is a common example. n41 Similarly, such control might arise from interlocking corporate directorships or, as indicated in Rule 405, from contractual arrangements. n42

[iii] Officers and Directors as Controlling Persons. The fact that a person is an officer or director does not in and of itself establish control. Indeed, the fact that an officer or director consistently opposed the policies of management or of those persons in mathematical control would tend to negate any indication of control status. n43 Similarly, a proxy contest or other evidence of dissatisfaction or conflict between the director or officer and management would indicate an absence of control, especially if large blocks of stock held by other persons or groups n44 have been used to outvote the officer or director.

On the other hand, certain factors tend to suggest the presence of a controlling officer or director:

- Participation in active management by the officer or director or a member of the officer or director's family;
- The necessity of the officer or director's stock, or that of the officer or director's family, to establish a quorum at annual stockholders' meetings;
- The officer or director consistently "going along" with management policies; and
- The officer or director's ownership, record or beneficial, of five percent or more of the outstanding voting securities.

Finally, the fact that an officer or director has resigned and thus has no official connection with the company does not necessarily terminate what otherwise would be a control status. The inquiry into control must focus on actual influence, and a former officer or director, whether through stockholding or some other formal or informal arrangement, such as a "consulting agreement," may be able to exert a very real influence on management policies. Control will always be determined from the particular circumstances of the case. n45

[b] Purchasing From or Selling For an Issuer.

As previously noted, the definition of "underwriter" under Section 2(11) includes broker-dealers acting as firm

commitment underwriters, who purchase the securities outright, and best efforts underwriters, who simply agree to sell the securities for the issuer but without an obligation to pay for unsold shares. A "purchase" by an underwriter under this section includes both cash transactions and acquisitions by exchange. n46 In determining whether an entity has "purchased from" an issuer, courts and the Commission look beyond the parties' terminology and consider the essence of the transaction.

In *Sweet's Steel Co.*, n47 for example, C had an option to purchase the registrant's shares but had no funds. C made an arrangement with O to provide the funds, but O, not wanting to be named as an underwriter, attempted to disguise the underwriting as a loan, some of the shares being taken as collateral. Part of the remaining shares were retained by C and O as compensation and the rest were sold to the public. In finding that the agreement between C and O was not a bona fide loan but actually an underwriting, the Commission observed: "Thus it is clear that the position of Ohstrom, Inc., and its syndicate was that of an underwriter as that term is defined in Section 2(a)(11) of the Act. ... It is our finding that Ohstrom, Inc., and members of the syndicate did purchase ... with a view to distribution. The nature of their interest is not compatible with that of a mere lender of money or a person performing a normal banking function. They were sharing the profits and risks of distribution." n48

Seeking to avoid statutory underwriter status in order to rely on the section 4(1) exemption for sales of securities, some sellers have attempted to rely on two-step or multi-stage transactions to negate the elements of section 2(a)(11). In *SEC v. M & A West, Inc.*, n49 an intermediary assisted shareholders of private companies to identify and acquire public "shell" companies as a means of placing their shares in the hands of public holders through reverse merger transactions. For his services, the intermediary received shares of stock in the former shell company, which he later sold to the public in market transactions. For these sales he claimed exemption from registration under section 4(1), on the ground that he was not a statutory underwriter because he had not purchased the shares from control persons of an issuer with a view to distribution. Given his sales of the securities within a few months after receiving them, the court concluded that there was no doubt the requisite "view" was present. The larger question, however, was whether the intermediary had in fact purchased the shares from control persons who in fact had resigned their positions in the second stage of reorganization transactions that resulted in shares being conveyed to the intermediary. The court concluded that there was no question that contracts for the intermediary's acquisition of shares were formed at a time when the shareholder groups were undoubtedly control persons. The court construed "purchased" for purposes of section 2(a)(11) underwriter status to include contracts to purchase, and thus denied application of section 4(1) in the intermediary's sales of the stock. n50

A person may be deemed to have sold securities for the issuer, for purposes of Section 2(a)(11), in a variety of contexts. Some are considered further below.

[i] Corporation Selling Its Own Shares. When a corporation proposes to sell its own securities through its officers and directors, are such officers and directors "underwriters" within the definition of this section? In *American Tung Grove Developments, Inc.*, n51 the officers spent the major portion of their time in attempts to sell the registrant's securities and received the same commission as that paid to investment bankers. Under this set of circumstances the Commission held that the officers were really acting as "underwriters" of the registrant's securities. n52 However, if the selling activities of officers and directors (or other corporate employees) may not involve special compensation and are only incidental to their ordinary functions, such selling activities do not make the sellers "underwriters." If persons are to engage in these kinds of selling activities in an offering by their company, the registrant might make appropriate disclosure in the "Underwriting" section of its prospectus in the following manner:

The Company has entered into an agreement with its president, Mr. W, whereby he will use his best efforts to sell shares of the stock offered hereby. Mr. W has the right to employ licensed securities dealers and salesmen to assist in the sale of the stock, to whom a commission of 10% for each share sold may be paid. Under no circumstances will Mr. W receive a commission in connection with the sale of such stock.

In addition, officers, directors and other employees of an issuer who fit within the safe harbor provisions of Rule 3a4-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") will not be required to register as broker-dealers. One condition of Rule 3a4-1 is that such persons not receive compensation, directly or indirectly, for their selling efforts.

[ii] Sales by Parents, Subsidiaries, and Affiliates. Suppose that the major part of Corporation A's business consists of the purchase of securities of Corporation B, its *affiliate*, *subsidiary*, or *parent*, and that Corporation A finances such purchases by sales of its own securities. Will Corporation A be regarded as an underwriter? Rule 140 under the Securities Act n53 answers this question in the affirmative: Corporation A is regarded as engaging in a distribution of Corporation B's securities. This in turn would require registration of Corporation B's securities before Corporation A could legally sell its own securities. The real purpose in such cases usually is the indirect public financing of the subsidiary, parent, or affiliate, as the case may be, by means of another corporate entity.

[iii] Sale of Fractional Shares. The declaration of a stock dividend by a corporation to its stockholders may result in fractional interests or scrip which the issuer wishes to eliminate by combining such interest into whole shares. For example, suppose that X Corporation declares a 10 percent stock dividend. S, a holder of 12 shares, is entitled to 1.2 shares of X stock. Rather than issue fractional shares to S and other similarly situated shareholders, X Corporation may want to give them the right to purchase the additional fractions necessary to make up a full share. Is X Corporation (or a transfer agent or a bank employed by X Corporation) one who "sells for" when this rounding out process is followed? Prior to the adoption of a rule on this point, the Commission had taken the position that one who acted pursuant to instructions from the shareholders in performing these purely mechanical functions was not an underwriter. In line with that position, Rule 152a under the Securities Act n54 provides that such transactions are exempt from registration under Section 4(1) of the Securities Act. The rule is applicable to stock dividends, stock splits, reverse stock splits, conversions, mergers, and similar transactions which result in fractional interests. It also applies whether such transactions are effected on behalf of the shareholders by the issuer or by a bank or other independent agent. n55

[iv] Pledges of Control Shares. Does a public sale of control shares by a pledgee, (e.g., a bank) after default by the pledgor, qualify as an exempted transaction "by any person other than an issuer, underwriter or dealer?" Or, stated conversely, must the pledgee register the pledged shares before making a public sale? The pledgee situation not only calls into play the definitions of "purchased from" and "sells for," but also raises the question of whether the putative underwriter purchased "with a view to" a distribution. n56 Translated into terms of a typical illustration, X, a controlling shareholder of C Corporation, borrows money from B Bank, pledging his unregistered C shares as collateral for the loan. X's loan is now in default and B Bank forecloses and proposes to make a public sale of X's shares. Must there be prior registration? The answer to that question will depend upon whether B Bank is regarded as an "underwriter."

It is clear that, in the absence of a bona fide pledge, the exemption contained in Section 4(1) is not applicable to a subsequent foreclosure sale by the pledgee. In other words, if the pledge is a step in the process of *distributing* the pledged securities, the sale by the pledgee requires registration. The point is that the pledgee in such a case originally takes the collateral with a view to distribution and is therefore an underwriter. n57 Suppose, however, that the pledge is a bona fide one. Does the same result follow? This question caused concern in legal and banking circles, especially in the light of certain *dicta* contained in the Second Circuit's opinion in the seminal *Guild Films* case. n58

In *Guild Films*, a controlling shareholder pledged as collateral for a loan a substantial block of securities which bore a restrictive legend. After the pledgor defaulted on the loan, the pledgee bank sold some of the securities without filing a registration statement. In holding that the bank was an underwriter and therefore not entitled to the 4(1) exemption from registration, the Second Circuit stated that even though the bank took the securities as collateral and did not deal directly with the issuer, it knew that it had been given unregistered stock and that the issuer, through the restrictive legend, had specifically instructed that the stock not be sold.

Prior to *Guild Films* the SEC had adhered to the position with respect to a bona fide pledge situation that if the loan

transaction is bona fide, in the sense that the pledgee has satisfied himself that in the absence of unforeseen circumstances the loan will be paid off and the collateral returned, the subsequent acquisition of title to the collateral by the pledgee is not considered the type of acquisition contemplated by Section 2(a)(11) since it is only incidental to the collection of indebtedness. In other words, no registration was necessary if the loan secured by the pledge was bona fide in the sense that it was expected to be paid and the transaction was not entered into with a view to distribution of the pledged securities.

The controversial part of the *Guild Films* decision, however, is the dictum added by the Second Circuit:

The exemption in 4(1) was intended to permit private sales of unregistered securities to investors who are likely to have, or are likely to obtain, such information as is ordinarily disclosed in registration statements... the good faith of banks is irrelevant to this purpose. It would be of little solace to purchasers of worthless stock to learn that the sellers had acted in "good faith." Regardless of good faith, the banks engaged in steps necessary to this public sale, and cannot be exempted. n59

Prior to the Second Circuit's opinion the view was widespread that a bona fide pledgee's foreclosure sale was entitled to the exemption contained in Section 4(1). n60 *Guild Films* obviously cast doubt on the availability of the 4(1) exemption for such a sale. n61

Guild Films, if it is confined to its facts and holding, represents nothing new or startling. Absent the controversial (and unnecessary) dictum contained in the Second Circuit's opinion, the case simply stands for the proposition that, in the absence of a bona fide pledge situation, the pledgee can make a public sale when the debt is in default only if the pledged securities have been registered. There is scant authority on the question whether registration is required in a bona fide pledge situation. n62 However, the *Guild Films* dictum requires careful consideration, for it has been widely interpreted to mean that pledges cannot, *under any circumstances*, make a public sale of control shares pledged as collateral without having effected a prior registration of those securities. Simply put, in the case of securities pledged for a loan, the pledgee should not assume that he is free to distribute without registration.

The adoption of Rule 144 modified the situation where the bona fide pledgee resells the pledged securities in a private placement. Rule 144 conditions such sales on, among other things, the availability of adequate current information with respect to the issuer of the securities. n63 The Rule 144 modification, however, includes principles of tacking and aggregation. Tacking of holding periods is permitted for bona fide pledgees, since it is considered that when they sell the securities they stand in the place of their pledgors. n64 However, securities sold by the pledgee must be aggregated with those sold by the pledgor in determining the quantitative limitations of Rule 144. n65

Accordingly, correct or not, one interpretation of the *Guild Films* dictum is still that under no circumstances may a pledgee make a public sale of collateral consisting of unregistered control securities. n66 That interpretation will continue to generate uncertainty with respect to the legality of any public sale of unregistered control shares even by a bona fide pledgee outside of the provisions of Rule 144.

[c] "Participation In" an Underwriting. The Section 2(a)(11) definition of underwriter also extends to persons that directly or indirectly participate in an underwriting without actually purchasing securities from, or selling them for, an issuer. The exact definition of "participation" becomes important, for example, in the case of finders. It is clear that the ordinary finder is not an underwriter for the reason that the finder does not make a *distribution* of the issuer's securities. In short, a finder that does no more than introduce the registrant to the investment banker is not an underwriter. n67 The fact that the finder is to receive a certain percentage of an underwriter's commission or that the finder advances the underwriter funds to enter into the underwriting contract does not necessarily make the finder an underwriter. n68 However, such compensation may make the finder a broker-dealer, requiring registration under the Exchange Act. n69 In addition, if the finder assumes part of the underwriting risk, or only furnishes funds to an underwriter and also takes a finder's fee based upon the number of shares sold, the finder will be regarded as having

"participated in" the distribution and thus will be deemed an underwriter. "The test is one of participation in the underwriting rather than of a mere interest in it." n70

[d] A View to Distribution An underwriter under Section 2(a)(11) must purchase securities *with a view to*, or sell securities *in connection with*, a distribution. In this connection, the term "distribution," as used in Section 2(a)(11) defining an "underwriter," carries the same meaning as "public offering" in Section 4(2). In short, distribution implies an offering to a substantial number of persons. A person who buys securities for investment and not for resale, is therefore not an underwriter since no distribution has occurred. n71 Similarly, no distribution is involved where a person not affiliated with the issuer or an underwriter agrees with the underwriter to purchase for investment all or a portion of an issue that remains unsold. n72 "[A] person who does no more than agree with an underwriter to take over some or all of the undistributed portion of the issue, and who purchases for investment any securities which his commitment thus obliged him to take up, does not thereby subject himself to liability as an underwriter of the securities of the issue actually distributed to the public." n73

Ascertaining the requisite "view" for assigning underwriter status is not a simple matter. It is a factual question dependent upon a number of factors. In *SEC v. iBIZ Technology Corp.*, n74 the SEC presented the following factors relevant to determining whether a person acted as an underwriter, *i.e.*, with a view to distribution:

- Whether the shares were acquired for investment purposes;
- The number of shares;
- The length of time the individual held the securities;
- Whether there was an unforeseeable change in circumstances of the holder preceding the sales; and
- Whether the individual was, directly or indirectly, participating in the distribution of securities or raising capital for the issuer. n75

In *iBIZ* an individual defendant received stock and stock options from an issuer as compensation for his consulting services. The defendant exercised his options to purchase millions of shares, which he then sold in several transactions over a one year period. Thereafter he exercised more options and sold the shares a short time later. The defendant paid for the shares he purchased upon exercise of the options with a promissory note to the issuer, which he paid for in several payments. Although the securities issued to the consultant were covered by a registration statement filed by the issuer on Form S-8, the resale of those securities by the consultant without registration was not covered. n76 The SEC alleged that the consultant violated section 5 of the Securities Act in the resales without registration, and moved for summary judgment. The defendant, on the other hand, argued that the number of shares he sold was small in comparison to the mount of shares outstanding; that the sales were isolated and spread out in time; that he controlled the timing and amount of the sales; and that he did not exercise all of this options or act under any pressure from the issuer.

Although a "close call" in the opinion of the court, viewing the facts in a light most favorable to the defendant, the court denied the SEC motion for summary judgment. The court concluded that there were disputed issues of fact as to whether the consultant had purchased his stock with a view to distribution. These issues were to be resolved by the fact finder. As to another consultant involved in the case, the court likewise concluded that there were material fact issues whether he acted as a conduit to the public in order to raise money for the issuer. That consultant had taken on certain obligations to the issuer to pay for an advertising mailer by the issuer, and he used proceeds from the sale of stock received as compensation to fulfill his obligation to pay the issuer. Here again, the court concluded that there were material issues whether the individual took the shares as just compensation and used a portion of the proceeds to fulfill his obligation to the issuer, or whether he took the shares with a view to distribution to the public.

The court's assessment in *iBIZ* illustrates that ascertaining requisite "view to a distribution" will nearly always be a question of fact. The factors identified by the SEC in the case are the historical focal points. It is the uncertainty attendant to them, however, that argued so strongly for the creation of "safe harbor" criteria dealing with each of them, which resulted in the adoption of SEC Rule 144. As the SEC observed:

Since it is difficult to ascertain the mental state of the purchaser at the time of an acquisition of securities, prior to and since the adoption of Rule 144, subsequent acts and circumstances have been considered to determine whether the purchaser took the securities "with a view to distribution" at the time of the acquisition. Emphasis has been placed on factors such as the length of time the person held the securities and whether there has been an unforeseeable change in circumstances of the holder. Experience has shown, however, that reliance upon such factors alone has led to uncertainty in the application of the registration provisions of the Act.

Thus, said the Commission, Rule 144 was adopted:

[T]o establish specific criteria for determining whether a person is not engaged in a distribution. Rule 144 creates a safe harbor from the Section 2(a)(11) definition of "underwriter." A person satisfying the applicable conditions of the Rule 144 safe harbor is deemed not to be engaged in a distribution of the securities and therefore not an underwriter of the securities for purposes of Section 2(a)(11). Therefore, such a person is deemed not to be an underwriter when determining whether a sale is eligible for the Section 4(1) exemption for "transactions by any person other than an issuer, underwriter, or dealer."

[e] Dealers Selling on Commission. Under Section 2(a)(11), "a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission" is excluded from the definition of "underwriter." Thus, although a dealer purchases at a price under the public offering price and resells to the public, he is not an underwriter unless his commission or spread exceeds the "usual and customary" dealer's commission. n77 Furthermore, although the "commission" must be received from an underwriter or dealer, that term is defined to include "commissions paid by an underwriter or dealer directly or indirectly controlling or controlled by, or under direct or indirect common control with the issuer." n78 However, the key words are "usual and customary distributors' or sellers' commission." The size of the commission is not defined in percentages. Rather, it is couched in general terms. But it specifically excludes syndicate members and "regular" underwriters even though they may receive only a "usual and customary" commission. n79

[3] Dealers

The definition of dealer leads to the conclusion that dealers can be key participants in distributions of securities. n80 Therefore, dealers are removed from the Section 4(1) exemption. However, the realities of the securities markets, i.e., countless daily transactions, and Congress' intended distinction between *trading* and *distributing* securities points to the need for the separate exemption for dealers provided in Section 4(3). n81 It is important to note that dealers are excluded from the Section 2(a)(11) definition of underwriter, as long as their commissions are not in excess of the "usual and customary" distributors' or sellers' commissions. n82

[4] An Introduction to Rule 144

Rule 144 under the Securities Act n83 creates a safe harbor for the sale of securities under the section 4(1) exemption. The SEC adopted Rule 144 in 1972 to provide a safe harbor from the definition of underwriter contained in section 2(11) of the Securities Act as applied to affiliates or controlling persons of an issuer. Compliance with Rule 144 requirements precludes any finding that the seller is a person who acquired the securities with a view to their distribution. The Rule addresses resales of "restricted securities," which are securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer, n84 and sales of control securities--those held by an affiliate of the issuing company. A person selling restricted securities, or a person selling restricted or other securities on behalf of

or for the account of an affiliate, who satisfies all of Rule 144's applicable conditions in connection with the transaction, is deemed not to be an underwriter as defined in Section 2(11), and therefore may rely on the Section 4(1) exemption for the resale of the securities.

Rule 144 is addressed in detail in Chapter 6 of this Treatise. For a complete understanding of the Section 4(1) exemption, however, it is important to understand here that the conditions of Rule 144 which assure availability of the exemption are:

- A holding period; n85
- Adequate current information about the issuer; n86
- A trading volume formula which limits the amount of securities to be sold; n87
- Manner of sale requirements; n88 and
- A notice filing requirement. n89

If a sale of securities complies with all of the applicable conditions of Rule 144:

- (1) Any affiliate or other person who sells restricted securities will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction;
- (2) Any person who sells restricted or other securities on behalf of an affiliate of the issuer will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction; and
- (3) The purchaser in such transaction will receive securities that are not restricted securities.

The purpose of Rule 144 is to provide objective criteria for determining that a person selling securities to the public has not acquired the securities from the issuer for distribution. The Rule 144 inquiry does not encompass evidence of an individual's subjective intent, but rather focuses on the objective circumstances of a sale. A holding period, for example, is one criterion established to demonstrate that the selling security holder did not acquire the securities to be sold under Rule 144 with distributive intent, and has assumed the economic risk of investment in the securities to be resold. Further resale restrictions imposed by the rule are designed to meet the concerns in a distribution that registration under Section 5 is intended address. The availability of current information, amount of sale limitations and limitations on the manner of sale to ordinary brokerage transactions with no general solicitation permitted all operate to largely eliminate the need for protection that would be afforded by registration, and negate any concern that the seller is in fact engaged in a distribution. In this context Rule 144 also makes distinction among requirements between affiliate and non-affiliate sellers. In the holding period, for example,

Compliance with Rule 144 is not the exclusive means of achieving the Section 4(1) exemption from registration. As the Rule itself provides: "Rule 144 is not an exclusive safe harbor. A person who does not meet all of the applicable conditions of Rule 144 still may claim any other available exemption under the Act for the sale of the securities." n90 At the same time, however: "The Rule 144 safe harbor is not available to any person with respect to any transaction or series of transactions that, although in technical compliance with Rule 144, is part of a plan or scheme to evade the registration requirements of the Act. n91

FOOTNOTES:

(n1)Footnote 1. Section 4(1), as renumbered by the Securities Act Amendments of 1964.

(n2)Footnote 2. See H. R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933), reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section E (Matthew Bender). See also Hicks, *The Concept of Transaction as a Restraint on Resale Limitations*, 49 Ohio State L. J., 422-24 (1988) and Campbell, *Resales of Securities Under the Securities Act of 1933*, 52 Wash & Lee L. Rev., 1333 (1995).

(n3)Footnote 3. See, e.g., *Quinn & Company, Inv. v. SEC*, 452 F.2d 943 (10th Cir. 1971), cert. denied, 406 U.S. 957 (1972) (Individual who sold 25,000 shares of stock violated section 5 even though the amount was a small percentage of the total shares outstanding).

See also *Terry T. Steen*, 53 S.E.C. 618 (1998) (Registration violation based on a sale of 300,000 shares where the issuer had in excess of 100 million shares outstanding).

(n4)Footnote 4. *Ackerberg v. Johnson*, 892 F.2d 1328, 1336 (8th Cir. 1989) .

(n5)Footnote 5. See *Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004) , in which the court observed:

Registration of securities protects "investors by promoting full disclosure of information thought necessary to informed investment decisions ..." To the purchaser of securities, the potential loss--and the need for disclosure--is the same regardless whether the securities represent one percent, five percent, or ten percent of the outstanding shares. The applicability of the § 4(1) exemption turns not on the percentage of shares involved, but "on whether the particular class of persons affected needs the protection of the Act ..." 363 F.3d at 484 [quoting *SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S.Ct. 981, 97 L.Ed. 1494 (1953)] .

(n6)Footnote 6. *Berckley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195, 212 (3d Cir. 2006) .

(n7)Footnote 7. *SEC v. Phan*, 500 F.3d 895, 902 (9th Cir. 2007) .

(n8)Footnote 8. As defined in Rule 405 under the Securities Act, 17 C.F.R. § 230.405, an affiliate is "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with" an issuer. "Control" is defined as the "possession, direct or indirect, 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." *Id.* Affiliate status encompasses officers, directors and majority or otherwise controlling shareholders--people who exercise or have the ability to exercise control in governance, policies, strategies or decisions.

There is no presumption of control. Rather, the question will always be whether there is control-in-fact. Where is it clear, for example, that an individual cannot exert any significant influence in spite of owning a significant percentage of outstanding stock, the person is unlikely to be deemed to be an affiliate. See, e.g., *SEC v. Freiberg*, No. 2:05-CV-00233PGC, [2007 Transfer Binder] *CCH Fed.Sec.L.Rep.* P 94,388 (D. Utah 2007). The uncertainty in this assessment, however, underscores the importance of Rule 144 under the Securities Act, 17 C.F.R. § 230.144, which creates a safe harbor for sales by persons who risk being held liable for failure to comply with registration requirements. The Rule 144 safe harbor is introduced later in this chapter, see § 4.02[4], *infra*.

(n9)Footnote 9. *Owen v. Kane*, 48 S.E.C. 617, 619 (1986) , *aff'd*, 842 F.2d 194 (8th Cir. 1988) .

See also *Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004) . In *Geiger* the court counseled that not everyone in the "chain of intermediaries" between a seller of securities and the ultimate buyer is sufficiently involved in the process to be deemed responsible for an unlawful distribution. However the court found that one who played a crucial role in finding the buyer, negotiating the terms, and facilitating the resale of the securities could not escape liability by

avoiding direct involvement in the final act. *See 363 F.3d at 487*.

(n10)Footnote 10. The term "issuer" is defined in Section 2(4) to mean:

[E]very person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

Section 2(a)(4) also contains narrower definitions of "issuer" as applied to particular types of securities. The definition of "issuer" may also vary depending on the context. For example, as discussed below, for purposes of defining who is an underwriter under Section 2(11), the term "issuer" includes any person in a control relationship with the issuer. *See § 4.02[2][a] infra*.

(n11)Footnote 11. A corporation that reacquires unregistered stock originally distributed pursuant to an exemption will be deemed an issuer of the stock for purposes of Section 4(1), and registration would be required, if the stock is redistributed. *SEC v. Stanwood Oil Corp.*, 516 F. Supp. 1181, [1981-1982 Transfer Binder] CCH Fed. Sec. L. Rep. P 98,202 (W.D. Pa. 1981).

Likewise, registered securities which are reacquired would have to be reregistered if redistributed in an offering requiring registration. "Registration" is not a condition, which once attained, permanently attaches to a security for the life of such security.

(n12)Footnote 12. *See* Section 2(a)(2). The Fifth Circuit held that a natural person (*e.g.*, a corporate officer) may be an issuer under Section 2(a)(4) on the basis of acts done in a representative capacity for a corporate issuer. *United States v. Rachal*, 473 F.2d 1338, 1341 (5th Cir. 1973), *cert. denied*, 412 U.S. 927 (1974).

(n13)Footnote 13. *See SEC v. Asset Management Corp.*, [1979-1980 Transfer Binder] CCH Fed. Sec. L. Rep. P 97,978 (S.D. Ind. 1979)(president/organizer of company formed to secure coal leases held to be an issuer because his activities were within the scope of one who issues or proposes to issue a security).

But see Lehman Brothers Kuhn Loeb, Inc., SEC No-Action Letter, [1982-1983 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,376 (Div. Corp. Fin.1983)(Division of Corporation Finance takes no-action position on a firm's proposal to sell common stock ex-dividend at a time when ex-dividend trading on the New York Stock Exchange had not yet commenced, in response to the firm's concern that the transactions may be deemed a new security (*e.g.*, a futures contract on the common stock) and that therefore the firm might be an "issuer" of securities under Section 2(a)(4)).

(n14)Footnote 14. 15 U.S.C. § 77b(11).

See SEC v. Poirier, 140 F.Supp. 2d 1033 (D. Ariz. 2001) (Statutory underwriters are individuals who purchase from

an issuer intending to redistribute).

(n15)Footnote 15. See *Charles F. Kirby, Admin. Proc. File No. 3-9602, Sec. Act Rel. No. 8174, 2003 SEC LEXIS 46 (Jan. 9, 2003)*.

See also *SEC v. Kern*, 425 F.3d 143 (2d Cir. 2005) ("Underwriters" include any person who is engaged in steps necessary to the distribution of securities); *Ackerberg v. Johnson*, 892 F.2d 1328, 1335-1336 (8th Cir. 1989) (Congress intended "to cover all persons who might operate as conduits for the transfer of securities to the public"); *Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009) (Individuals' involvement in a complex plan resulting in the sale of unregistered shares to the public was a "necessary and critical step" in the scheme, such that as substantial factors and participants in the distribution they were underwriters for which the section 4(1) exemption was not available).

(n16)Footnote 16. The House Committee Report confirms the scope of the definition: "The term is defined broadly enough to include not only the ordinary underwriter, who for a commission promises to see that an issue is disposed of at a certain price, but also includes as an underwriter the person who purchases an issue outright with the idea of selling that issue to the public." H.R. Rep. No. 85, 73d Cong., 1st Sess.13-14 (1933), reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section E (Matthew Bender).

But see, *Zicklin v. Breuer*, 534 F. Supp. 745, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98, 609 (S.D.N.Y. 1982), in which the court held that a bank that issued reports describing and recommending securities for customers who maintained investment advisory accounts with the bank, and that bought and sold securities for those accounts, was not an underwriter under Section 2(11). See also *Securities Industry Association v. Federal Reserve Board*, 468 U.S. 137, 104 S. Ct. 2979 (1984) where the Supreme Court allowed Bankers Trust Company to place commercial paper for several of its corporate customers (an activity quite similar to that of broker-dealers acting as underwriters), reasoning that the commercial paper placed was not a "security." The Court thus obviated the need to decide whether such activities constituted "underwriting."

(n17)Footnote 17. *120 F.2d 738 (2d Cir. 1941)*, cert. denied, *314 U.S. 618*, 62 S. Ct. 106, 86 L. Ed.497 (1941).

"The term underwriter is not limited to its common definition, but rather is a word of art. An underwriter is one who purchases stock from the issuer with an intent to resell to the public." *Quinn & Co. v. SEC*, 452 F.2d 943, 946 (10th Cir. 1971), cert. denied, *406 U.S. 957*, 92 S. Ct. 2059 (1972); *Ingenito v. Bermec Corporation*, 441 F. Supp. 525, 536 (S.D.N.Y. 1977).

(n18)Footnote 18. *120 F.2d at 740*.

(n19)Footnote 19. *SEC v. Murphy*, 626 F.2d 633, 650-51 (9th Cir. 1980).

(n20)Footnote 20. The OTC Bulletin Board (OTCBB) is an electronic quotation system in the United States that displays real-time quotes, last-sale prices, and volume information for many over-the-counter (OTC) equity securities that are not listed on a national securities exchange or traded in the Nasdaq Stock Market. The OTC Bulletin Board is accessed by broker-dealer subscribers who post buy and sell quotes.

(n21)Footnote 21. *SEC Admin. Proc. File No. 3-11310, Init. Dec. Rel. No. 250, 2004 SEC LEXIS 961 (May 11, 2004)*.

(n22)Footnote 22. But see *In re OTC Live, Inc.*, *SEC Admin. Proc. File No. 3-11309, Init. Dec. Rel. No. 261, 2004 SEC LEXIS 2244 (Sept. 30, 2004)*. In *OTC Live, Inc.* an Administrative Law Judge concluded that the Respondent firm was not a statutory underwriter in connection with an agreement that, among other things, called for the firm to feature, link to the home page of, and create an advertising button for a client company, as well as circulate the client company's information by e-mail to the Internet firm's subscribers. The Internet firm had been established by a Russian immigrant

who operated it from home, and who believed in good faith that the small amount of stock received as compensation for services could be freely sold. The Administrative Law Judge concluded that the OTC Live sites were a mere source of information, and that there was no touting or promotion of securities. Finding no "underwriter" status, she observed:

[I] cannot conclude that OTC Live and Mark Suleymanov were underwriters when they received 20,000 shares of First Capital from Genin and subsequently instructed their broker to sell them. At no time were Respondents attempting to circumvent the securities laws. Based on Genin's representations, the contract, and the advice of his broker, Suleymanov reasonably believed he was in full compliance and wanted merely to be compensated for advertising First Capital stock on OTC Live's Web site. At no time did he intend to act as a conduit for unregistered First Capital stock, nor was he providing an outlet for the stock. Because the shares were not in certificate form, there is no evidence that a restrictive legend accompanied the shares provided by Genin. 2004 SEC LEXIS 2244, at *29-30 .

(n23)Footnote 23. 475 F.Supp.2d 412 (S.D.N.Y. 2007) .

(n24)Footnote 24. *Id.*, at 432 .

(n25)Footnote 25. *Id.*, at 433 .

(n26)Footnote 26. It must not be overlooked that this expanded definition of "issuer" is only applicable "[a]s used in this paragraph [Section 2(a)(11)]." Thus, a controlling person is not an issuer for purposes of the Section 3(a)(11) or 4(2) exemptions. See § 4.02[1] *supra* for a discussion of the Section 2(a)(4) definition of "issuer."

(n27)Footnote 27. 17 C.F.R. § 230.405.

(n28)Footnote 28. *SEC v. International Chemical Development Corp.*, 469 F.2d 20 (10th Cir. 1972) .

(n29)Footnote 29. See, e.g., *Peck v. Pacifica CMA, Inc.*, No. 05-cv-00569, [2007 Transfer Binder] CCH Fed.Sec. L.Rep. P 94.349 (D. Colo. 2007). The court concluded that evidence showed two individuals to be control persons where:

[U]pon the initial purchase of the PMCA shares... the Plaintiffs both became directors and officers of PCMA. Further, Plaintiffs actively participated in the process of discovering and securing an operating company with which to reverse merge. The Plaintiffs were also active participants in gifting shares to family members in order to create a float or increase the shareholder base of PCMA. This is further evidence of the Plaintiffs' intent to attract an operating company to merge with PCMA. The Plaintiffs carried out PCMA's ultimate business plan. *Id.*

(n30)Footnote 30. See *SEC v. Ralston Purina*, 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .

(n31)Footnote 31. 363 F.3d 481 (D.C. Cir. 2004) .

(n32)Footnote 32. 363 F.3d at 485 [quoting *Wonsover v. SEC*, 205 F.3d 408, 415 (D.C.Cir. 2001)] .

As long ago as 1962, the SEC recognized the issue for intermediaries in connection with sales of securities "of relatively obscure and unseasoned companies and where all of the circumstances surrounding the proposed distribution are not known to the broker-dealer":

[In order to claim a Section 4(1) exemption,] a dealer who offers to sell, or is asked to sell a substantial amount of [unregistered] securities must take whatever steps are necessary to be sure that this

is a transaction not involving an issuer, person in a control relationship with an issuer or an underwriter. For this purpose, it is not sufficient for him merely to accept "self-serving statements of his sellers and their counsel without reasonably exploring the possibility of contrary facts."

The amount of inquiry called for necessarily varies with the circumstances of particular cases. A dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is needed.

Sec. Act Rel. No. 33-4445, CCH Fed. Sec. L. Rep. P 22,753 (1962) (citations omitted). *See also SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959). The Commission took specific exception to the holding in *U.S. v. Crosby*, 294 F.2d 928 (2d Cir. 1961). In *Crosby*, the Second Circuit found that the Section 4(1) exemption was available to dealer-defendants who claimed that they were simply conducting "business as usual" when they sold large blocks of unregistered stock in reliance on a legal opinion based on incomplete facts. The Commission found that the circumstances surrounding the transactions made violations of Section 5 of the Securities Act highly likely. After the transfer of control of the issuing company, large blocks of unregistered stock began to appear on the market, accompanied by heavy publicity from management. In such situations, the Commission stated:

[R]esponsible dealers, aware that they have the burden of proving the availability of an exemption... proceed with far more caution than was displayed in the Texas-Adams case... it was up to these dealers to make an appropriate investigation as to who their seller was, and not simply to rely upon the opinion of the seller's attorney that no control relationship existed.

Sec. Act Rel. No. 33-4445 [1962 Transfer Binder] CCH Fed. Sec. L. Rep. P 22,753 (1962); *see also* In re A. L. Williamson & Co., 15 B.N.A. Sec. Reg. & L. Rep. 1471 (SEC. 1983) (broker-dealer who traded 10,000 shares of unregistered stock of shell corporation involved in a merger violated Section 5(a) where he had reason to believe the stock came from a controlling person of the issuer).

The problem becomes particularly acute where substantial amounts of a previously little-known security appear in the trading markets within a fairly short period of time and without the benefit of registration under the Act. In such situations, it must be assumed that these securities emanate from the issuer or from persons controlling the issuer, unless some other source is known and the fact that the certificates may be registered in the names of various individuals could merely indicate that those responsible for the distribution are attempting to cover their tracks.

(n33)Footnote 33. 17 C.F.R. § 230.405.

(n34)Footnote 34. [2007 Transfer Binder] CCH Fed. Sec. L. Rep. P 94,388 (D. Utah 2007).

(n35)Footnote 35. *Id.*, P 94,388 at 92,756.

(n36)Footnote 36. 17 C.F.R. §230.144.

(n37)Footnote 37. In *Thompson Ross Securities Co.*, 6 SEC 1111, 1119 (1940), the Commission stated:

[T]he question of control is a factual question. "Control" is not synonymous with the ownership of 51 per cent of the voting stock of a corporation. Where power exists to direct the management and policies of a corporation, "control" within the meaning of Section 2(11) exists even though the persons

who possess that power do not own a majority of the corporation's voting stock.

See also In re Caplan's Petition, 246 N.Y.S.2d 913, *aff'd*, 249 N.Y.S. 2d 877 (1964) (three per cent of outstanding shares able to deliver seven of ten board members in a sale of control); *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962) (28.3% deemed "working control"); *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860 (S.D.N.Y. 1986) (under proper circumstances, a person owning no stock can be a control person).

(n38)Footnote 38. Item 11(m) of Form S-1 requires the registrant to provide the information required by Item 403 of Regulation S-K. Regulation S-K is reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume D, Section K (Matthew Bender). Item 403, requires information with respect to any person known to the registrant to be the beneficial owner of more than five percent of any class of the registrant's voting securities.

(n39)Footnote 39. 148 F. Supp. 558, 562 (S.D.N.Y. 1957), *final injunction*, 167 F. Supp. 716 (S.D.N.Y. 1958), *aff'd sub nom. SEC v. Culpepper*, 270 F.2d 241 (2d Cir.1959).

(n40)Footnote 40. As stated in *Walston & Co.*, 7 SEC 937, 950 (1940), "It cannot be accepted that Walston believed that an employee driving an automobile controls that vehicle to the exclusion of his employer or that the officers of a corporation, in the exercise of their day-to-day and detailed managerial functions, control the corporation to the exclusion of the dominating financial interest." *See also* Thompson Ross Securities, n.17 *supra*, at 1121 (purchase from husband and wife with a view to distribution, where husband "could direct policies of issuer along whatever lines he deemed desirable," was a purchase from controlling person, making the exemption under Section 4(1) unavailable for subsequent sales to the public).

If, however, a person who does not exercise the power to control allows another person (one, for example who holds only a small amount of shares) to actively manage the company, the latter person is also a controlling person. *North County Uranium & Minerals Ltd.*, 37 S.E.C. 608 (1957). Thus, "either the power to control or the actual exercise of control, even though by sufferance of another who possesses the ultimate power to control, is sufficient to make a person a controlling person." Sommer, *Who's "In Control?"* 21 Bus. Law. 559, 565 (1966)(emphasis in original).

See also, Annotation: Who is Person "Controlling or Controlled by" Issuer or Under "Direct or Indirect Control" with Issuer So As to Be Considered Issuer for Purpose of Defining Underwriters Under § 2(11) of Securities Act of 1933, 9 A.L.R. Fed. 639 (2001).

(n41)Footnote 41. *SEC v. Zimmerman*, 407 F. Supp. 623, 629 (D.D.C. 1976). *See also Wool v. Tandem Computers, Inc.*, 818 F.2d 1433 (9th Cir. 1987).

(n42)Footnote 42. *Canusa Gold Mines, Ltd.*, 2 S.E.C 548, 555 (1937) (underwriting agreement empowered underwriter to name a majority of the board of directors); *Reiter-Foster Oil Co.*, 6 S.E.C 1028, 1044 (1940) (underwriter imposed condition precedent to underwriting that control of board be turned over to the underwriter).

(n43)Footnote 43. In *United States v. Sherwood*, 175 F. Supp. 480, 483 (S.D.N.Y. 1959), although defendant was not a director, the court held with respect to this point: "The evidence does not sustain the second charge that Sherwood was at the time of the sales a 'control person.' To the contrary, although Sherwood dominated 8% of the total issued stock, he was unable to secure a representation on the board of directors, he had a falling-out with... the dominant figure in the management..."

See also Metzger v. American Food Management, Inc., 389 F. Supp. 469, 471 (W.D. Pa. 1975).

(n44)Footnote 44. As one commentator has observed: "There are innumerable instances in which a single person does not appear to have actual operating control or the power to control. Then the problem is to identify the group

which is in control and those which and those who constitute the group." Sommer, *Who's "In Control?" S.E.C.*, 21 *Bus. Law.* 559, 576 (1966). The same commentator suggests that more than mere association on the board or ability to control by random combination of votes is necessary to constitute a "group," and that acting in concert as well as whether the individuals are "associates" may be relevant. *Id.* at 578. See also *Kemmerer v. Weaver*, 445 F.2d 76 (7th Cir. 1976); *Harriman v. E.I. Du Pont Nemours & Co.*, 372 F. Supp. 101 (D. Del. 1974).

(n45)Footnote 45. See, e.g., *Peck v. Pacific CMA, Inc.*, [2007 Transfer Binder] *CCH Fed.Sec.L.Rep.* P 94,349 (D. Colo. 2007).

See also *Wheaten v. Matthews Holmquist & Associates, Inc.*, 858 F. Supp. 753, 757 (N.D. Ill. 1994); *Leiter v. Kuntz*, 655 F. Supp. 725, 728 (D. Utah 1987).

(n46)Footnote 46. See *SEC v. American International Savings and Loan Assoc.*, 199 F. Supp. 341 (D. Md. 1961) (issuance of stock in exchange for junior mortgage interest in real estate and its subsequent public sale amounted to a distribution within the meaning of "underwriter" under Section 2(a)(11)); *Hayes Mfg. Co.*, 23 S.E.C. 574, 576-77 (1946).

(n47)Footnote 47. 4 S.E.C. 589 (1939).

(n48)Footnote 48. 4 S.E.C. at 594, *supra*.

(n49)Footnote 49. *CCH Fed. Sec. L. Rep.* P 93,321, 2005 U.S. Dist. LEXIS 22452 (N.D.Cal. 2005).

(n50)Footnote 50. The intermediary also claimed that he was entitled to act in reliance on SEC Rule 144 under the Securities Act, which specifies concrete conditions under which a person will not be deemed to be engaged in a distribution, and therefore deemed not to be a statutory underwriter. The court rejected availability of Rule 144 because of its conclusion that the intermediary had in fact purchased the securities from section 2(a)(11) issuers with a view to distribution, and that Rule 144 would provide no safe harbor.

See also *SEC v. Kern*, 425 F.3d 143 (2d Cir. 2005); *Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004); *SEC v. Cavanaugh*, *CCH Fed. Sec. L. Rep.* P 92,866, 2004 U.S. Dist. LEXIS 13372 (S.D.N.Y. 2004).

(n51)Footnote 51. 8 S.E.C. 51 (1940).

(n52)Footnote 52. See also *American Gyro Co.*, 1 S.E.C. 83 (1935) (salesmen on commission); *Callahan Zinc-Lead Co.*, 5 SEC 1009 (1939) (directors acquired shares with intention to effect public distribution).

(n53)Footnote 53. 17 C.F.R. § 230.140. Rule 140 provides:

A person, the chief part of whose business consists of the purchase of the securities of one issuer, or of two or more affiliated issuers, and the sale of its own securities, including the levying of assessments on its assessable stock and the resale of such stock upon the failure of the holder thereof to pay any assessment levied thereon, to furnish the proceeds with which to acquire the securities of such issuer or affiliated issuers, is to be regarded as engaged in the distribution of the securities of such issuer or affiliated issuers within the meaning of section 2(a)(11) of the Act.

(n54)Footnote 54. 17 C.F.R. § 230.152a.

(n55)Footnote 55. Sec. Act Rel. No. 33-4470 (1962). A companion rule, Rule 236, exempts from registration shares of stock (or other securities) which are publicly offered to provide funds to be distributed to shareholders *in lieu* of issuing fractional shares, scrip certificates, or other evidences of fractional interest resulting from stock dividends,

stock splits, reverse stock splits, conversions, mergers, or similar transactions. However, the issuer must file reports with the Commission, pursuant to Section 13 or 15 (d) of the Exchange Act, and the aggregate gross proceeds from the sale of the shares must not exceed \$300,000. In addition, the issuer must furnish certain information to the Commission at least ten days prior to the offering of the shares. *Id.*

Rule 236 requires a nonrefundable filing fee at the time of filing this information.

(n56)Footnote 56. See § 4.02[2][d] *infra* for a discussion of the distribution requirement.

(n57)Footnote 57. *SEC v. Micro-Moisture Controls, Inc.*, 148 F. Supp. 558, 562 (S.D.N.Y. 1957), *aff'd sub nom. SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959) (controlling shareholders' attempted public distribution of unregistered shares after borrowing money and pledging shares as collateral, enjoined on ground that pledge and loan not bona fide).

(n58)Footnote 58. *SEC v. Guild Films Co., Inc.*, 178 F. Supp. 418 (S.D.N.Y. 1959), *aff'd*, 279 F.2d 485 (2d Cir. 1960), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819, 81 S. Ct. 52 (1960).

(n59)Footnote 59. 178 F. Supp. at 423.

(n60)Footnote 60. Although the definition of the term "underwriter," if torn from its context, is admittedly broad enough to include the pledgee who, although not in a position to compel registration, finds it necessary in the collection of his debt to utilize the usual channels of distribution, consideration of the definition from a functional point of view would without doubt lead a court to conclude that a *bona fide* pledgee in such a situation is not to be regarded as an underwriter ... The Securities Act, as proposed to Congress and as originally passed by the Senate, expressly exempted sales "by or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provision of this Securities Act, to liquidate a bona fide debt, a security pledged in good faith as collateral for such debt." H.R. 4314, 73d Cong., 1st Sess. (1963) § 12(b); S. 875, 73d Cong., 1st Sess. § 12(b) (1933).

See also Throop and Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 *Law & Contemp. Prob.* 89, 124, n.103 (1937):

On first impression, it might appear that the elimination of this section in the Act as passed is indicative of a legislative intent to require registration in the situation suggested. On the other hand, the Act, as originally introduced contained no concept of 'underwriter' comparable to that subsequently adopted by the House and retained in the Act in its final form; and the exemption which the original bill afforded to isolated transactions by non-dealers ... would in many instances not have extended to transactions of liquidation by a pledgee. ... The silence of the Conference Report [regarding the omission of the section] is indicative of the fact that the exemption provisions of the bill as reported out of the conference rendered unnecessary the retention of the earlier specific exemption of pledges' and fiduciaries' transactions." But the Second Circuit interpreted this legislative history differently, apparently regarding the elimination of this provision from the Act to require registration.

(n61)Footnote 61. *But see* In re OTC Live, Inc., et al, Admin. Proc. File No. 3-11309 (Initial Dec., Sept. 30, 2004), in which the Administrative Law Judge opined:

I find inapposite *Guild Films*, wherein the court found persuasive that the banks as pledgees were well aware of the restrictions on the stock when they accepted the stock as collateral. Accord *McClure v. First Nat'l Bank of Lubbock, Tex.*, 497 F.2d 490 (5th Cir. 1974); *SEC v. Nat'l Bankers Life Ins. Co.*, 334 F. Supp. 444 (N.D. Tex. 1971). Other cases rely on similar grounds for deeming sellers of securities underwriters. See *Geiger v. SEC*, 363 F.3d 481, 486 (D.C. Cir. 2004) (seller aware affiliate had not paid

for shares and therefore did not qualify for exemption); *United States v. Lindo*, 18 F.3d 353, 355 (6th Cir. 1994) (sellers fraudulently instructed banks to remove restrictive legends to satisfy loans); Charles F. Kirby, 79 SEC Docket 1081, 1091 (Jan. 9, 2003) (substantial block of a little-known security provided sufficient warning for the trader); Leigh, 50 S.E.C. at 195 ("customer's delivery of a large block of an obscure stock in restricted form ... provided obvious 'red flags'" for inexperienced broker dealer). The Respondents in the instant proceeding, however, were not afforded the luxury of such ample warnings.

(n62)Footnote 62. See *A.D.M. Corp. v. Thomson*, 707 F.2d 25 (1st Cir. 1983), in which the court, avoiding a decision as to whether a good faith pledgee's sale of unregistered stock at a foreclosure sale violated Section 5 of the Securities Act, enforced the sale since it did not offend public policy. In support of its holding, the court noted that the pledge had no intention of reselling the stock to the public, and in fact ended up purchasing the stock itself; the parties relied on the validity of the pledge contract; the investing public would not be damaged by the contract's enforcement or otherwise prejudiced by the lack of a registration statement; and a court should not void such a sale at the pledgor's request.

In *Skiatron Electronics & Television Corp., Sec. Act Rel. No. 33-4282*, 40 S.E.C. 236 (1960), registrant had sold shares to its licensee. The licensee immediately pledged the shares and the pledgee resold to the public. A stop order was issued suspending the effectiveness of the registration statement. But, as in the *Guild Films* case, no *bona fide* pledge was involved.

In a long list of no-action letters, the SEC staff has stated that registration is not required (i.e., Section 4(1) is available for the transaction) when a pledgee offers and sells pledged shares, otherwise restricted as to transfer, under certain conditions which generally include: notice of an auction foreclosure sale (usually pursuant to the Uniform Commercial Code); the notice states that the pledgee can be a bidder at the sale; the securities are sold only as a block to a single purchaser; the purchaser makes representations of the kind made in a Section 4(2) or Regulation D private offering; the certificate evidencing the securities bears a restrictive legend; and bidders are advised that they will be furnished information concerning the issuer, upon request. See, e.g., Capital Meat Co., Inc., SEC No-Action Letter (pub. avail. March 22, 1996); Russell Ranch, SEC No-Action Letter (pub. avail. Aug. 11, 1995); Bank of America National Trust and Savings Association, SEC No-Action Letter (pub. avail. Dec. 2, 1993); General Electric Capital Corp., SEC No-Action Letter (pub. avail. Nov. 19, 1993); One Fine Corp., SEC No-Action Letter (pub. avail. April 1, 1993); Oak Park Bank, SEC No-Action Letter (April 3, 1992); and Pittsburgh Nat'l Bank, SEC No-Action Letter (pub. avail. Feb. 6, 1990).

(n63)Footnote 63. For a thorough discussion of Rule 144, see ch.6 *infra*; see also Nimkin, *The Pledgee and Rule 144*, Rev. Secs. Reg., 925 (May 10, 1972),

(n64)Footnote 64. Rule 144 (d)(3)(iv).

(n65)Footnote 65. Rule 144 (e)(3)(ii).

(n66)Footnote 66. Thus far it has been assumed that the pledgor is in a control relationship with the issuer and thus himself an issuer for purposes of making one who takes from him with a view to distribution an underwriter. If, however, the pledgor is not in a control relationship with the issuer, neither he nor the pledgee is an underwriter, unless the collateral is stock restricted because it was purchased pursuant to a non public offering exemption under the Securities Act. See § 4.02[2] *infra*. If the pledgee, by virtue of ownership of securities, is in a control relationship with the issuer whose securities are pledged, a person selling for the pledgee would be an underwriter. Similarly, the sale by an issuer of its own stock acquired in a pledge transaction would not be exempt from registration.

In *A.D.M. Corp. v. Thomson*, 707 F.2d 25 (1st Cir. 1983), the district court held that in a *bona fide* pledge, the pledgee does not become an underwriter by making a foreclosure sale of unregistered securities. The court of appeals

stated that there was substantial support for the district court's ruling on the underwriter issue, but affirmed the case instead on other grounds.

(n67)Footnote 67. See Lipton, Broker-Dealer Regulation, § 1.04[3][b][ii][A] at 1-53-1-54 (1999 Ed.).

See also *Umpqua Mining Co.*, 3 SEC 233 (1938) ; Russell R. Miller and Company, Inc., SEC No Action Letter [1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep P 81,324 (April 15, 1997); Wesco Equity Funding, SEC No Action Letter (Aug. 10, 1985); and Davenport Management, Inc., SEC No Action Letter [1933 Transfer Binder] CCH Fed. Sec. L. Rep. P 76,643 (April 13, 1993).

(n68)Footnote 68. H.R. Rep. No. 152, 73d Cong., 1st Sess. 24 (1938).

(n69)Footnote 69. Often, an issuer will use a finder to assist in locating potential investors in the issuer's securities. As long as the finder limits itself to simply introducing investors to the issuer, it generally is not considered to be acting as either a broker, dealer, or underwriter. See Bamberger, *Sales of Businesses--When Are Business Brokers Securities Brokers?* 71 Marq. L.Rev. 309 (1988); Polanin, *The Finder's Exception From Federal Broker-Dealer Registration*, 40 Catholic U. L. Rev. 787 (1991).

See also Dominion Resources, Inc., SEC No Action Letter (March 7, 2000), in which the SEC staff rescinded a previous no action position and materially reduced the kind of activities in which persons could participate and not be required to register as broker-dealers.

(n70)Footnote 70. *Puget Sound Distillery, Inc.*, 3 S.E.C. 355 (1938) . Registrant contended that X was not an underwriter because X acted solely as a finder in bringing registrant into contact with underwriters. The record showed, however, that X was to receive from registrant \$1,500 cash plus a percentage of the proceeds to be derived from any financing X obtained from registrant. X was otherwise active in the proposed distribution of registrant's securities. Held, that X was an underwriter.

See also *Reiter-Foster Oil Corp.*, 6 SEC 1028 (1940) (outsiders who actively participated in distribution of securities held to be underwriters).

(n71)Footnote 71. One court has emphasized that § 4(1) exempts transactions, not classes, and that one who purchases for his own account is not an underwriter. *United States v. Bruce*, 488 F.2d 1224, 1230 (5th Cir. 1973) , cert. denied, 419 U.S. 825 (1975) .

See, e.g., *Seattle-First National Bank v. Carlstedt*, Fed. Sec. L. Rep. (CCH) P 91, 499 (W.D. Okla. 1984) , in which the court held that a claim that a bank which took an ordinary participation in loans used to purchase allegedly fraudulent partnership interests was an underwriter of the interests within the Securities Act was inadequate for failure to allege that the bank took any of the interests with a view to public resale or otherwise participated to any extent in distribution of the interests. The participation did not take place until two weeks after the loans had been made, and there was no allegation of direct contact between the participating bank and the borrowers until nearly two years later when the bank first attempted to collect on their obligations.

But see, e.g., *McDaniel v. Compania Minera Mar De Cortes, Sociedad Anonimo, Inc.*, 528 F. Supp. 152(D. Ariz.1981) (acquisition from the issuer and resale of stock on the same date clearly indicates that the securities were acquired with a view to distribution and that sellers were underwriters for the purposes of Section 4(1)).

The Division of Corporation Finance has taken the position that a purchaser of securities in a registered public offering ordinarily would not be considered an underwriter merely for writing exchange-traded call options or buying exchange-traded put options on securities of the same class as those that are the subject of the offering since the purchaser is not using the options for the purpose of selling the underlying securities. Sec. Act Rel. No. 33-6297, CCH

Fed. Sec. L. Rep. P 22,765 (1981). Investors generally write call options to reduce the risk of a price decline, and purchase put options with respect to securities they hold or are acquiring to protect themselves against a price decline, in the underlying securities. In addition, an investor can also be distinguished from an underwriter by the absence of an agreement with, or compensation from, the issuer which could indicate that the purchase of the underlying securities was not made with a view to distribution. The Division indicated, however, that there are situations in which the purchaser may be considered to be an underwriter: an express or implied agreement between the purchaser and the issuer or underwriter to write or buy options to facilitate the distribution; receipt by the purchaser of compensation for these activities; or a purchase by the investor of a significant portion of an offering (e.g., more than 5%) and the writing of a large number of call options or the purchase of a large number of put options in proximity to the effective date of the offering.

The Division of Corporation Finance also presented its views on whether the recommendations of an underwriter to write call options before the effective date of the registration statement constituted "gun jumping;" the Division of Market Regulation set forth its position regarding the application of Rule 101 of Regulation M under the Exchange Act (formerly Rule 10b-6) to option and option-related transactions during underwritten offerings. *Id.*

See also Schneider, Section 4(1-1/2), 49 *Ohio St. L.J.* 501 (1988) and Campbell, *Resales of Securities Under the Securities Act of 1933*, 52 *Wash & Lee L. Rev.* 1333 (1995).

The "Section 4(11/2)" exemption for private offers and sales of securities by control persons and affiliates is discussed in detail in Chapter 4.04[1], *infra*.

(n72)Footnote 72. Rule 142. This type of transaction is sometimes referred to as "old-fashioned underwriting."

(n73)Footnote 73. Op. Gen. Counsel, Sec. Act Rel. No. 33-1862, CCH Fed. Sec. L. Rep. P 1531 (1938). But this release and applicable Rule 142 are couched in language that prevents actual distributions by controlling persons and others. In addition, Rule 141 excludes from the definition of "underwriter" in Section 2(11) one who receives an ordinary seller's commission or "spread." But if more than a "usual and customary commission" is received, or if the one who receives the commission is in reality a manager "of the distribution of all or a substantial part of the particular issue" or "performs the functions normally performed by an underwriter or underwriting syndicate," that person is an underwriter within the meaning of Section 2(11). Rule 141 (c). Thus, the managing underwriter and the "purchase group" would be included within the definition of "underwriter," but the selling-group dealers would be excluded.

(n74)Footnote 74. [2008 Transfer Binder] CCH Fed.Sec.L.Rep. P 94, 783 (D. Ariz. 2008).

(n75)Footnote 75. *Id.*, P 94,783 at 95,089.

(n76)Footnote 76. The Form S-8 registration statement, most commonly used in connection with employee stock option plans is available to cover sales of securities to bona fide consultants, *see SEC v. Phan*, 500 *F.3d* 895, 902 (9th Cir. 2007), companies cannot use consultants who receive Form S-8 registered stock as conduits to the public market. *Id.* A Form S-8 registration statement does not cover resales by the recipient.

(n77)Footnote 77. Rule 141(a).

(n78)Footnote 78. Rule 141(b).

(n79)Footnote 79. Rule 141(c) provides:

The term "usual and customary distributors' or sellers' commission" in Section 2(11) shall mean a commission or remuneration, commonly known as a spread, paid to or received by any person selling either for his own account or for the account of others, which is not in excess of the amount usual and customary in the distribution and sale of issues of similar types and size, and not in excess of the amount

allowed to other persons, if any, for comparable service in the distribution of the particular issue; but such term shall not include amounts paid to any person whose function is the management of the distribution of all or a substantial part of the particular issue, or who performs the functions normally performed by an underwriter or underwriting syndicate.

(n80)Footnote 80. Section 2(12) defines "dealer" as: "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."

(n81)Footnote 81. Section 4(3) is discussed in detail in § 4.05 *infra*.

(n82)Footnote 82. *See* § 4.02[2] *supra* for a discussion of the Section 2(11) definition of "underwriter."

(n83)Footnote 83. 17 C.F.R. § 230.144.

(n84)Footnote 84. 17 C.F.R. § 230.144(a)(3).

(n85)Footnote 85. 17 C.F.R. § 230.144(d).

(n86)Footnote 86. 17 C.F.R. § 230.144(c).

(n87)Footnote 87. 17 C.F.R. § 230.144(e).

(n88)Footnote 88. 17 C.F.R. § 230.144(f) and (g).

(n89)Footnote 89. 17 C.F.R. § 230.144(h).

(n90)Footnote 90. 17 C.F.R. § 230.144 (Preliminary Note).

(n91)Footnote 91. *Id.*



49 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.03

AUTHOR: Robert N. Rapp

§ 4.03 The Private Offering Exemption--Section 4(2)

Section 4(2) of the Securities Act exempts from its registration requirements "transactions by an issuer not involving any public offering." n1 There is no limit to the amount of funds that can be raised in reliance on the exemption. The exemption permits issuers to make sales of securities to a limited number of purchasers without the burdens imposed by the registration process. n2 Literally billions of dollars of securities have been sold to institutional and individual investors. As one of the drafters of the Securities Act has observed: "The sale of an issue of securities to insurance companies or to a limited group of experienced investors was certainly not a matter of concern to the federal government. That bureaucracy, untrained in these matters as it was, could hardly equal these investors for sophistication, provided only it was their own money that they were spending." n3

The exemption soon became controversial. Grave doubts have arisen since the passage of the Securities Act as to what constitutes a "private offering" within the meaning of the exemption.

The starting point for determining whether a proposed offering is public or private has almost invariably been a 1935 opinion issued by the General Counsel of the Commission in which the scope of the exemption was interpreted. The 1935 release delineated four "principal factors" to be considered:

- 1) The number of offerees and their relationship to each other and to the issuer;
- 2) the number of units offered;
- 3) the size of the offering; and
- 4) the manner of the offering. n4

However, 20 years later the Supreme Court granted certiorari in *SEC v. Ralston Purina & Co.* n5 because of "an apparent need to define the scope of the private offering exemption." Nearly 30 years after passage of the Securities Act, the Commission, apparently discerning a need to reinterpret the scope of the exemption in light of *Ralston Purina*,

remarked: "an increasing tendency to rely upon the exemption for offerings of speculative issues to unrelated and uninformed persons prompts this statement to point out the limitations upon its availability." n6

The Commission adopted Rule 506 (and deleted its predecessor, Rule 146) in 1982. Rule 506 is a "safe harbor" for issuers, which defines with some certainty when transactions are deemed to come within the exemption and which can be used as an alternate method to perfecting the Section 4(2) exemption. The objective standards provided in Rule 506 overcome the vagueness of the judicial and Commission interpretations of the exemption. n7

In effect, the availability of the exemption turns on whether the offerees need the protection of the Securities Act. The exemption requires that all offerees have or are provided with access to the same kind of information that would be contained in a registration statement. This requirement can be fulfilled by providing disclosure of such information or by ensuring that offerees have effective access to the information. n8

[1] Perfecting the Section 4(2) Exemption

Factors to be considered in determining whether a particular offering qualifies for the private offering exemption are discussed in the 1935 Release, and interpreted in subsequent releases and judicial decisions. All of the surrounding circumstances must be considered.

Consideration of the factors detailed in the 1935 Release requires analysis of the number and identity of the offerees as well as their relationship to the issuer. In addition to the debate over the importance of the number of offerees, subsequent releases and case law make clear that the availability of the private offering exemption depends upon the basic question of whether the class of persons to whom the offering is made needs the protection of the Securities Act. Furthermore, the determination of whether the private offering exemption applies to a particular offering depends upon consideration of the characteristics of the offering, including the size of the offering, and the manner in which the offering is structured.

[a] The Offerees

[i] The Number of Offerees. In the 1935 release it was stated that "under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offer to a substantial number and presumably does not involve a public offering." n9 Perhaps this statement was an unfortunate one. In spite of the words "under ordinary circumstances" and "presumably," instances were legion where attorneys relying on the release, advised clients that *any* offering to less than 25 persons was a private one. n10 But the Commission has never taken this flat position. Indeed, the 1935 release contained the warning that: "In no sense is the question to be determined exclusively by the number of prospective offerees." n11 Moreover, in 1953, the United States Supreme Court in the *Ralston Purina* case observed that "the statute would seem to apply to a 'public offering' whether to few or to many." n12 In the 1962 Release the Commission stated that the number of offerees is not a conclusive yardstick in determining whether an offering is private. Instead, it is one factor, to be considered in conjunction with the other factors. n13

This point was brought into sharp focus in two cases decided in the Fourth and Fifth Circuits. In *Doran v. Petroleum Management Corp.*, n14 there were eight offerees, "a total that would be entirely consistent with a finding that the offering was private." n15 Nevertheless, the case was remanded, for the trial court to determine whether the offerees had access to that type of information that registration would disclose. In *Lawler v. Gilliam*, n16 the Fourth Circuit ruled that the sale of a security to a *single* financially sophisticated investor did not necessarily qualify as a private offering with Section 4(2).

It should be noted, however, that in *Ralston Purina* the Court was careful to point out that "nothing prevents the Commission in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims." n17 To sum up, although there is no magic number of offerees that spells availability or loss of the

exemption, the Commission has made it a practice not to challenge an offering to a limited number of persons, such as 20 or 25 *if the other factors are present*. In other words, the number of offerees is "relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available."

Suppose, for example, that *ABC, Inc.* sold common stock at \$20 per share in three states to a total of 15 unsophisticated persons, none of whom knew anything about *ABC, Inc.* or its financial affairs. Suppose further that the Commission took no steps to enjoin the sales, either because there was no knowledge of the offering or because it was assumed that the limited number of persons involved were sophisticated investors. Shortly thereafter the price of *ABC, Inc.* common stock declines in price to \$1.00 per share. *P*, one of the 15 purchasers, now brings an action for rescission against *ABC, Inc.*, alleging that the offering should have been registered. *P*'s chances of success in such an action may be good. n18 Moreover, this administrative practice in no way precludes a subsequent civil action under Section 12 of the Securities Act by a *purchaser* on the ground that the exemption was not available.

[ii] The Identity of the Offerees and Their Relationship to the Issuer. The identity of the offerees may weigh heavier than their number in determining the availability of the Section 4(2) exemption. It has been aptly stated that "An offering to 100 commercial banks is probably not public but an offering to 10 individuals including one old lady unversed in financial matters probably is." n19

Ralston Purina n20 does much to shift the emphasis from the number of offerees to their identity and relationship to the issuer and to each other. *Ralston Purina* had 7,000 employees and a policy of encouraging employee stock ownership. During a four-year period it sold nearly \$2,000,000 worth of its stock to over 400 employees without registration. Among the purchasers were such low salary bracket employees as foremen, stenographers, and production trainees.

An earlier pronouncement by the Ninth Circuit Court of Appeals had made it fairly clear that an offering to *all* employees (at least if the number was large) would not be entitled to the exemption: "an offering of securities to all redheaded men, to all residents of Chicago, or San Francisco, to all existing stockholders of General Motors Corporation or the American Telephone and Telegraph Company, is no less 'public,' in every realistic sense of the word, than an unrestricted offering to the world at large." n21 Thus *Ralston Purina* could hardly do less than concede that an offering to all its employees would be public. But its argument that the offering was to "key employees" only was unsuccessful:

[T]he applicability of § 4(1) [now § 4(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those shown to be able to fend for themselves is a transaction "not involving any public offering."... The exemption, as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within Section 4(1) [4(2)], e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement. n22 Absent such a showing of special circumstances, employees are just as much members of the investing "public" as any of their neighbors in the community." n23

This much is clear from the reported judicial decisions and Commission releases: The fact that an offering is restricted to a particular class of persons, e.g., stockholders n24 or employees, n25 does not prevent its having the character of a public offering.

Key phrases in the *Ralston Purina* opinion are: "access to the same kind of information that the Act would make available in the form of a registration statement" and "able to fend for themselves." n26 Certainly these words would include large institutional investors such as insurance companies, banks, and other financial institutions. Presumably they would also encompass executive personnel and true key employees who are familiar with the financial affairs of the issuer. Beyond these fairly well-defined situations, however, the area is a cloudy one. What of individual investors?

Generally speaking, if they are few in number, are financially sophisticated ("able to fend for themselves"), and have access to that type of information that would appear in a registration statement, the exemption is available.

It is now fairly clear that availability of information can consist of either disclosure of *or* effective access to the relevant information. n27 It is also clear that *all* offerees must have the information available. "Even the offeree-plaintiff's 20-20 vision with respect to the facts underlying the security would not save the exemption if any one of his fellow offerees was in a blind." n28

One may quarrel with the requirement that there be an actual showing of effective access to establish the affirmative defense of Section 4(2). Granting that the burden of proving entitlement to the exemption is on the one claiming it, it is difficult to visualize a lack of effective access where the issuer is seeking capital from one or even from a small number of offerees. As the Commission itself has stated: "[A]ccess can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables an offeree to obtain information from the issuer in order to evaluate the merits and risks of the investment ..." n29 The same "position" exists when an issuer seeks to raise funds on a one-on-one basis from one offeree or from a small number of offerees.

It is equally clear that the exemption is not available when the class of offerees is unrestricted, even though all offerees are voluntarily furnished information concerning the issuer. As the Commission has observed: "Negotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers." n30 Similarly, the "sale of stock to promoters who take the initiative in founding or organizing the business would come within the exemption. On the other hand, the transaction tends to become public when the promoters begin to bring in a diverse group of uninformed friends, neighbors and associates." n31

[iii] The Sophistication of the Offerees. The availability of the Section 4(2) exemption also depends on the ability of the persons to whom the offering is made to "fend for themselves." This seems to require that the offerees possess some amount of financial sophistication.

This requirement is illustrated in *SEC v. International Scanning Devices, Inc.*, n32 in which the court rejected a defendant's reliance on the Section 4(2) exemption. The purchasers of defendant's securities included a retired teacher and farmer, a carpenter, a maintenance supervisor and a retired comparison shopper. Most of the purchasers had no more than a high school education and none received any detailed information about the issuer. In holding the exemption unavailable, the court observed:

[A] brief review of the ISD indenture buyers' testimony is sufficient to demonstrate the paucity of "sophistication" possessed by these people.[Even] the most sophisticated of these investors ... lacked essential knowledge of many simple points, such as even a rudimentary acquaintance with the parlance of buying and selling securities. None of these individuals examined ISD's financial status before the purchase ... it is evident that each relied heavily on the apparent expertise and experience of the broker he or she dealt with to lead him or her to a sound investment. n33

However, even if all of the offerees are highly sophisticated, "[s]ophistication is not a substitute for access to the information that registration would disclose." n34 Issuers seeking to raise funds under Section 4(2) should ensure that all offerees are both sophisticated *and* have access to the relevant information or have actually been furnished with such information. In *Doran v. Petroleum Management Corp.* the court, discussing effective access to information about the issuer, stated:

[T]he investment sophistication of the offeree assumes added importance, for it is important that

[the investor] could have been expected to ask the right questions and seek out the relevant information. In sum, both the relationship between the issuer and offeree and investment sophistication are critical when the issuer or another relies on the offeree's "access" rather than the issuer's "disclosure" to come within the exemption. n35

[b] The Offering

[i] The Size of the Offering. It is obvious that the larger the offering, the more "public" it tends to become. The Commission has expressed the opinion that: "An offering of millions of dollars to non-institutional investors and non-affiliated investors or one divided, or convertible into many units would suggest that a public offering may be involved." n36 With respect to the number of units offered, if such units are offered in large denominations and are not convertible, the offering assumes a status more consonant with a private offering than if a substantial number of units are offered in small denominations, or are convertible into small denominations. n37

A special word of caution at this point is in order on convertible securities and warrants. Suppose that *ABC, Inc.* issues debentures convertible into common stock which is to be offered to the public. If these debentures are immediately convertible, there is deemed to be an offering of both the debentures and the common stock. Put another way, the issuer is regarded as making a continuing offer of the underlying securities. It follows that, unless the sales of *ABC, Inc.*'s common stock by the persons converting its debentures are exempt, both *ABC, Inc.* and the sellers are in violation of the Securities Act as having made public offerings without registration. n38 Moreover, the registration statement should cover both securities.

[ii] The Manner of the Offering. Shortly after the passage of the Securities Act, the Commission's General Counsel expressed the opinion that "transactions which are effected by direct negotiation by the issuer are much more likely to be non-public than those effected by the use of the machinery of public distribution." n39 In addition, close questions may arise where the issuer affects a private placement of its securities by utilizing the services of an investment banker. In the 1962 Release the Commission warned that the exemption may be lost where an investment banker places the securities with discretionary accounts without regard to the tests implicit in *Ralston Purina*. n40 Public advertising and general solicitation of the offering are, by definition, incompatible with a claim of a private offering.

[iii] Purchasers Must "Take For Investment." Despite the fact that the preceding requirements relating to the number of offerees, their identity, access to information, and the size, type, and manner of the offering have been met, the exemption is lost if any purchaser takes "with a view to distribution." This is so because the Securities Act defines an "underwriter" as a "person who has purchased ... with a view to, or sells for an issuer in connection with the distribution of any security." n41 Issuers therefore must take steps to ensure that purchasers take with investment intent to prevent purchasers from acting as "conduits for a wider distribution." n42 That situation arose in the seminal *Crowell-Collier* case. n43

Crowell-Collier privately placed approximately \$3,000,000 of debentures, immediately convertible into common stock, through a broker-dealer, the latter also obtaining warrants. Relying upon legal advice that the private offering exemption was available if the offering was limited to approximately 25 offerees, the debentures were sold to 27 persons, including four broker-dealers. Investment letters were obtained with respect to the debentures only, from all purchasers, stating, in effect, that they were purchasing for investment and not with a view to distribution. But at least nine of these purchasers had already induced other persons to join with them in purchasing. The following year another million dollars of debentures were disposed of in much the same manner to 22 persons, three of whom immediately resold to 15 other "investment" purchasers. The end result was that these securities reached the hands of at least 79 purchasers, many of whom converted the debentures and sold the common stock in less than one year from the date of acquisition. n44

In holding that the private offering exemption was not available, the Commission stressed certain factors: that the conversion price (\$5.00 per share) was below the then market price of the common (51/2 -61/4); that investment letters

were obtained only for the debentures; that the debentures were issued in bearer form and in small denominations; that the debentures were convertible immediately; that participation in the offering by dealers made the "investment representations" questionable. The Commission's findings were upheld by the Second Circuit. n45

Several practical lessons can be learned from *Crowell-Collier*:

First, when an "investment purchaser" is in reality one who takes with the intention of reselling and does resell the security within a short time despite the fact that he has signed an investment letter, the *issuer* of those securities may be subjected to criminal penalties under Section 17 of the Securities Act. The U.S. Supreme Court has held that Section 12(a)(2), which allows a successful plaintiff to either rescind a securities purchase or have returned to him the amount of the purchase price if he does not own the securities, applies only to registered public offerings of securities and not to non-public offerings or secondary market transactions. n46

Second the mere collection of investment letters from purchasers does not insulate the issuer from liability. "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." n47

Counsel for the issuer making a private offering should advise that two additional steps be taken:

- A restrictive legend should be made to appear on the face of the issued securities along the following lines:

These securities may not be sold, transferred, pledged or hypothecated unless they have first been registered under the Securities Act of 1933 or unless Company counsel has given an opinion that registration under said Act is not required.

- The transfer agent should be directed to place a stop-transfer order against the shares.

The foregoing precautionary measures are legal n48 and effective techniques for preventing illegal distributions. It should be emphasized, however, that none of these precautions will insulate the issuer from liability: "The additional precautions of placing a legend on the security and issuing stop-transfer orders have proved in many cases to be an effective means of preventing illegal distributions. Nevertheless, these are only precautions and are not to be regarded as a basis for exemption from registration." n49

Suppose that the holder of investment stock obtains a no-action letter from the Commission with respect to a proposed transfer. May he or she now sell the securities despite the refusal of the issuing company and the transfer agent to effect the transfer? Under common law principles, the general rule is to the effect that a corporation, acting in good faith, may refuse a transfer of securities, but it must have reasonable grounds for refusal. n50 Notice of an adverse claim to the securities sought to be transferred constitutes a reasonable ground for refusal. n51 But both at the common law and under governing provisions of the Uniform Commercial Code, adopted in all states, in the absence of an adverse claim (and under certain other conditions) the issuing company is under a duty to register the transfer. n52

With respect to investment letters, as previously pointed out, the actual intent to take for investment and not with a view to distribution is all-important. Accordingly, no matter how strongly the letter is worded, the substance of the transaction rather than the form of the letter will control. But, from the standpoint of counsel for the issuer, the primary purpose of obtaining such letters should be to impress purchasers that signing the letter is not a mere formality. Thus, a

statement that the purchaser represents that he or she is not taking with a view to distribution and that the purchaser will not sell, transfer, or otherwise dispose of the shares in the absence of an effective registration statement under the Securities Act or an opinion of company counsel that registration is not required under the Securities Act, should suffice. n53

Finally, the Commission has taken the position that it is a deceptive practice, which might activate the antifraud provisions of the securities acts, for an issuer, a control person, or any other person to sell unregistered securities in a private transaction without fully informing the purchaser as to the applicable limitations upon the resale of the securities by that purchaser. n54

[iv] The Offering Must Not be "Integrated."

The private offering exemption is available only to transactions "not involving any public offering." The exemption is therefore considered unavailable to privately offered securities if any securities comprised in the same transaction are made the subject of a public offering, or included with any other offering which in combination would disqualify the issuer from relying on the exemption. Pursuant to the principle of integration, multiple transactions are examined to determine whether they should be treated as a single, unitary transaction or offering. The concept of integrating offerings is intended to prevent an issuer from avoiding registration by structuring a transaction in two or more apparently exempt offerings (or one exempt and one nonexempt offering) when they actually should be considered a single nonexempt offering. The Securities and Exchange Commission has identified, and courts apply, five factors to determine whether a particular offering should be integrated with any other offerings:

- The different offerings are part of a single plan of financing;
- The offerings involve issuance of the same class of security;
- The offerings are made at or about the same time;
- The same type of consideration is to be received;
- The offerings are made for the same general purpose. n55

[A] Interpretive Problems Regarding Integration. Two situations may present special interpretive problems on integration: offshore offerings and voting trust certificates.

With respect to offshore offerings, generally no public offering is involved within the meaning of the term "public offering" in Section 4(2) if they are made *exclusively* abroad, even though the mails or facilities of interstate commerce are used. However, if foreign dealers or purchasers take with a view to reselling in the United States, exemption is lost. n56

In determining whether a public offering is involved in an offering addressed partly to persons in the United States and partly to persons abroad, must the number of persons addressed abroad be considered? For many years the Commission took the position that the *total* number of offerees had to be considered in determining the availability of the Section 4(2) private offering exemption, whether the offering originated in this country or in a foreign country: n57

Where a New York corporation offered securities to its existing security holders, consisting of 29 Americans and 106 English security holders, a public offering was involved. Where a Canadian corporation proposed to issue \$2,000,000 of bonds of one-half the amount in Canada or England and the offering of the other half to a group of not more than 25 in this country, who would purchase for investment, it was necessary to register. The so-called private offering in this country was a part of a

single offering, which would, as a whole, be public. n58

It appears that Commission policy on the matter has been further codified in Regulation S and may be even further revised in light of the increasingly inter-related nature of the world's securities markets. n59

Corporate codes in some states provide that all shareholders of a corporation are entitled to deposit their shares under the terms of a voting trust agreement. Accordingly, even when only a few major shareholders enter into a voting trust agreement, if the total number of shareholders is large, there is a public offering of the voting trust certificates to all shareholders. Thus, the exemption contained in Section 4(2) is not available. n60

[B] Numerous "Private" Sales by Issuers Prior to Registration. When an issuer makes a public offering and uses Form S-1 to register the securities offered, the issuer must disclose all unregistered sales of its securities within the three years preceding the public offering. n61 Unless an exemption is available for the unregistered sales, the registrant is exposed to contingent liability under Section 12, n62 and under applicable state law. That contingency must be disclosed, both in the prospectus, and in a note to the registrant's financial statements setting forth the contingent liability. n63 Where the issuer has made repeated sales of its securities to individuals, do such sales constitute private offerings or will they be "integrated"? Put another way, how many times can the issuer "go to the well" without creating a contingent liability problem?

The answer does not come easily, but, as previously indicated, if the "private" offerings are too numerous or are really part of a larger offering, integration and attendant registration violations may result. Counsel who prepares the registration statement may well encounter this problem. In that event any future course of action other than full disclosure is unthinkable. But counsel for the issuer is in somewhat of a dilemma. When the issuer does make disclosure of past sales in its filing, it may be publicly exposed to civil liability by the "private" purchasers. Moreover, if the past sales appear to constitute willful violations the Commission, as well as state regulatory agencies, may take formal action. With this in mind, it may be advisable for the issuer to make a rescission offer (in compliance with governing federal and state regulations) prior to the filing date. The following prospectus language is illustrative of such a procedure:

The 140,000 shares of Class B Common Stock which were sold by the Company were sold without compliance by the Company with the provisions of the Massachusetts Sale of Securities Act which require the filing of a notice of intention before a security may be sold. In order to eliminate any contingent liability under the Massachusetts statute on account of such sales, the Company, in April and May 1968 offered to take back the shares which were sold in nonexempt transactions and to refund the full amount paid for such shares. The Company's offer was accepted with respect to 6,200 shares of Class B Common Stock, and the Company repurchased such shares at a price of \$2.50 per share, together with interest on such amount, from the date of payment to the Company for such shares to the date of repayment therefor by the Company, at the rate of six per cent per annum. n64

However, the limitations of the rescission offer should be considered before deciding whether to make it. Suppose that the offer is accepted, and the persons to whom it is made simultaneously release the issuer from liability. Would such releases be effective in relation to federal securities laws? In all probability, the answer is no. In any event, the staff of the Commission may insist upon inclusion in the prospectus of a statement that the issuer has received from shareholders the release of any claims or causes of action arising from the fact that the issuer did not register the offering of shares.

[2] Section 4(2) and Rule 506 of Regulation D

Regulation D under the Securities Act provides for certain limited offerings which are exempt from registration and also provides a "safe harbor" for issuers seeking to rely on the Section 4(2) exemption. n65 Compliance with Rule 506 is an

alternative to attempting to satisfy the criteria of the SEC Releases and the subsequent judicial interpretations relating to a non-public offering exemption from registration. Rule 506 provides objective standards for issuers to determine with some certainty when transactions will be deemed to meet the exemption.

Rule 506 provides an exemption from registration if the terms and conditions of Rules 501 through 503 under Regulation D n66 have been satisfied, and the issuer reasonably believes that there are no more than thirty-five non accredited purchases of securities from the issuer in any offering under Rule 506. n67 There is no dollar limit on the size of an offering which may made under Rule 506. All of the requirements of Regulation D, and Rule 506 in particular, are discussed in § 4.05 below. However, Rule 506, and Regulation D generally, do not prescribe an exclusive means of carrying out a compliant offering under Section 4(2) of the Act. An issuer remains free to rely solely on Section 4(2), and to meet the burden of proving the availability of the exemption wholly outside of Rule 506 and Regulation D.

FOOTNOTES:

(n1)Footnote 1. Private offering transactions are not exempt from the anti-fraud provisions of the securities acts, and the exemption does not apply to public resale of the securities by the purchasers. *See* Sec. Act Rel. No. 33-5226, [1972 Transfer Binding] Fed. Sec. L. Rep. (CCH) P 78, 483 (1972).

See also SEC v. Cal-Am Corporation, 445 F. Supp. 1329, 1333 (C.D. Cal. 1978) .

Who is an issuer under Section 4(2)? *See SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980)* (a person organizing or sponsoring the organization of limited partnerships and who was primarily responsible for the success or failure of the venture for which the limited partnerships were formed was deemed an issuer to determine the availability of the private offering exemption). [Author's note: Many attorneys practicing in the area of securities law believe that this case is an aberration and would be decided differently if brought today. The author is under the impression that the SEC staff also shares this opinion.] *See Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage This Result, 45 Hastings L. J. 1223 (1994).*

Rule 152 provides that the phrase "transactions by an issuer not involving any public offering" shall be deemed to apply to transactions not involving any public offering at the time of those transactions although subsequently the issuer decides to make a public offering and/or files a registration statement.

(n2)Footnote 2. Section 4(2) of the Securities Act, reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section B, (Matthew Bender) has traditionally been regarded as providing an exemption from registration for bank loans, private placements with institutional investors, and promotion of business ventures by closely related persons. *See* Sec. Act. Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 2770 (1962).

(n3)Footnote 3. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 37 (1959).

(n4)Footnote 4. Sec. Act Rel. No. 33-285, Fed. Sec. L. Rep. (CCH) P 2740 (1935).

(n5)Footnote 5. *SEC v. Ralston Purina Co., 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .*

(n6)Footnote 6. Sec. Act Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 47,341.14 (1962).

Much of the controversy over the scope of the exemption revolved around the issue of whether a numerical test regarding the number of offerees controls the availability of the exemption. This issue is discussed in detail in § 4.03[1][a] *infra*.

1-4 Federal Securities Act of 1933 § 4.03

(n7)Footnote 7. Rule 506 of the Securities Act, reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section C, (Matthew Bender) is discussed in detail at § 4.03[2] *infra*.

(n8)Footnote 8. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-27 (1953) ; Sec. Act. Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 2770 (1962).

(n9)Footnote 9. Op. Gen. Counsel, Sec. Act Rel. No. 33-285, CCH Fed. Sec. L. Rep. P 2740 (Jan. 24, 1935).

(n10)Footnote 10. This reliance is understandable. For example, in 1954 a House Committee Report observed: "There is no limit to the amount which thus may be offered, provided it is not 'publicly' but 'privately' offered, which the Commission by rule of thumb construes as being no more than some 25 offerees." H.R. Rep. No. 1542, 83d Cong., 2d Sess. 19 (1954), reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section E (Matthew Bender).

Similarly, in 1957, the Commission "considered that an offering made to not more than 25 or 30 persons who take the securities for investment and not for distribution is generally a private transaction not requiring registration." Orrick, *Some Observations on the Administration of the Securities Laws*, 32 Minn. L. Rev. 25, 33 (1957).

There was a day when many lawyers thought that any offering involving less than 25 persons could safely be regarded as private. That rule of thumb is no longer sacrosanct, and the more important question now seems to be what kind of persons are involved.

Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 Va. L. Rev. 869, 871 (1959). Donahue, Regulation D; A Primer For The Practitioner, 8 Del. J. Corp. L. 495 (1984).

(n11)Footnote 11. Op. Gen. Counsel, Sec. Act Rel. No. 33-285, CCH Fed. Sec. L. Rep. P 2740 (Jan. 24, 1935).

(n12)Footnote 12. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125, 73 S. Ct. 981, 985, 97 L. Ed. 1494, 1499, (1959) .

(n13)Footnote 13. Sec. Act Rel. No. 33-4552, Fed. Sec. L. Rep. (CCH) P 2770 (1962). The word "offerees" is important, for the availability of the exemption is related to the total number of *offerees*, not the number of *actual purchasers*. See Op. Gen. Counsel, Sec. Act Rel. No. 33-285, CCH Fed. Sec. L. Rep. P 2740 (Jan. 24, 1935).

(n14)Footnote 14. 545 F.2d 893 (5th Cir. 1977) .

(n15)Footnote 15. 545 F.2d at 901 , *supra*.

(n16)Footnote 16. 569 F.2d 1283 (4th Cir.1978) . Plaintiff sued for damages under § 12(1) of the Securities Act. Defendants alleged as an affirmative defense that their transactions with plaintiff were exempt under § 4(2). The district court found no public offering, for the reason that plaintiff was experienced and able to fend for himself, and that the issuance of securities to plaintiff were isolated transactions. But the Fourth Circuit, in reversing, noted that plaintiff's "business acumen ... and his continued eagerness to invest do not supplant his lack of access to the information that a registration statement would show."

(n17)Footnote 17. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 , *supra*.

(n18)Footnote 18. Sec. Act Rel. No. 33-4552 (1962). In a suspension proceeding in 1958, the Commission had this to say:

Respondents seek to escape this conclusion by asserting that even after the *Ralston Purina* decision it was generally understood that any offering to a small group of 25 or less could safely be assumed not

to be a public offering. ... There are several reasons why we cannot accept these contentions. In the first place, the assertion that an offering to a small group is *without more* a private offering ignores the Supreme Court's statement that the Securities Act "would seem to apply to a public offering whether to few or to many." Moreover, even if we were to accept the general validity of the view that an offering to a group of about 25 persons is without more a private offering, respondents' position that registrant was free to resell its allotment of unregistered securities to a limited group of not more than 25 would if carried to its logical conclusion mean that every member of an original group of about 25 to whom unregistered securities are sold in reliance on a private offering exemption could in turn resell to a further group of approximately 25 each, without registration, ... and public distributions of securities could be readily effected without compliance with the registration, prospectus and other protective provisions of the Securities Act.

Dempsey & Co., Sec. Exch. Act Rel. No. 33-5690, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. P 76, 585 (1958). (Italics added.)

See also *SEC v. Tax Services, Inc.*, 357 F.2d 143 (4th Cir. 1966) (offering in nearly all states to a total of approximately 800 purchasers was a public offering); *Chapman v. Dunn*, 414 F.2d 153, 160 (6th Cir. 1969) (exemption unavailable where defendant sold to seventy-eight individuals and firms, knew only six of them, and record indicated that "securities were sold to anyone who had money to purchase them--housewives, physicians and businessmen"); *Henderson v. Hayden Stone, Inc.*, 461 F.2d 1069 (5th Cir. 1972); *SEC v. Continental Tobacco Co. of South Carolina*, 326 F. Supp. 588 (S.D. Fla. 1971), rev'd, 463 F.2d 137 (5th Cir. 1972) (offering to 38 persons held not public); *United States v. Custer Channel Wing Corp.*, 247 F. Supp. 481 (D. Md. 1965), aff'd, 376 F.2d 675, cert. denied, 389 U.S. 850 (1967) (initial purchasers mere conduits for wider distribution); *Barrett v. Triangle Mining Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95, 438 (S.D.N.Y. 1976).

(n19)Footnote 19. Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 Va. L. Rev. at 871 (1959).

(n20)Footnote 20. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125, supra.

(n21)Footnote 21. *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699, 701 (9th Cir. 1938).

(n22)Footnote 22. The 1935 advisory opinion of the Commission's General Counsel had also emphasized this relationship factor: "I also regard as significant the relationship between the issuer and the offerees. Thus, an offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage. This factor would be particularly important in offerings to employees, where a class of high executive officers would have a special relationship to the issuer which subordinate employees would not enjoy." Op. Gen. Counsel, Sec. Act Rel. No. 33-285, CCH Fed Sec. L. Rep. P 2740 (Jan. 24, 1935).

(n23)Footnote 23. *SEC v. Ralston Purina Co.*, 346 U.S. at 125, 73 S. Ct. at 985, 97 L. Ed. at 1499 (1953), supra. See also *In the Matter of Gilligan, Will & Co.*, Sec. Exch. Act Rel. 34-5689, CCH Fed. Sec. L. Rep. P 76,584 (1958), aff'd sub nom. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959), cert. denied, 361 U.S. 896.

See also *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971) (25 friends, educated persons and business associates of president held not to qualify under *Purina* test); *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 690 (5th Cir. 1971) ("the level of sophistication will not carry the point"); *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977) (fact that investor is sophisticated is not sufficient, since even sophisticated investors who have neither necessary disclosure nor access to relevant information cannot use their sophisticated knowledge in deciding whether to invest); *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 611 (5th Cir.1975), (discussing Section 4(2) and Rule 146), on rehearing, 521 F.2d 225 (5th Cir.1975) (discussing *in pari delicto*

defense); *Koehler v. Pulvers*, 606 F. Supp. 164 (S.D. Cal. 1985) .

(n24)Footnote 24. *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699 (9th Cir. 1938) (offering to 530 stockholders of a company involved a public offering). *But compare SEC v. Federal Compress & Warehouse Co.* (W.D. Tenn. Nov. 13, 1936) (unreported): "There was absolutely no machinery for distribution in this case, and ... intent to make a public offering of the stock. There was no advertising or prospectus issued, and no solicitation to the public, because no offer was made to it, ... the entire transaction was handled exclusively within the family group of stockholders ... to whom the offer was made exclusively." *See also S.E.C. v. La Vey*, 1 S.E.C. Jud. Dec. 369 (E.D. Wash. 1937) ; *In re Henry Friedlander*, 2 S.E.C. 531 (1937) .

(n25)Footnote 25. Shortly after the *Ralston Purina* decision the Commission adopted Form S-8 for registration of securities offered pursuant to certain types of employees' stock purchase and savings plans. Sec. Act Rel. No. 33-3480 (1953).

(n26)Footnote 26. *See also McDaniel v. Compania Minera Mar De Cortes, Sociedad Anonimo Inc.*, 528 F. Supp.152(D. Ariz.1981) (the primary focus of Section 4(2) is the nature and extent of the offerees' knowledge about the issuer). Consideration of offerees' ability to fend for themselves raises the issue of their sophistication in financial matters, discussed in § 4.03[1][a][iii] *infra*.

(n27)Footnote 27. *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 904 (5th Cir. 1977) ; *Woolf v. S. D. Cohn & Co.*, 515 F.2d 591, 612(5th Cir. 1975) , *vacated on other grounds*, 426 U.S. 944 (1976) ; *SEC v. Tax Service, Inc.*, 357 F.2d 143, 144 (4th Cir. 1966) .

Regarding the difference between disclosing and ensuring access to registration-type information, one commentator stated:

[I]t would seem wise for counsel to review the investment experience of each prospective offeree and to make sure that all offerees actually receive appropriate financial data... to the extent that financial statements, reports, or other written material is relied upon to establish "access," the writer prefers to see it actually transmitted to the several purchasers, rather than a record that it was made or kept "available" to them.

Israels, *Some Commercial Overtones of Private Placement*, 45 Va. L. Rev. 851, 860 (1959).

(n28)Footnote 28. *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 902(5th Cir. 1977) ; *Hill York Corp. v. American International Franchise, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971) ; *SEC v. Continental Tobacco Co.*, 463 F.2d 137, 158 (5th Cir. 1972) . After the decision in the *Continental Tobacco* case, especially because of certain language in the Commission's appellate brief, many securities attorneys believed the Commission's view was to preclude a private offering to individuals unless those individuals were also insiders. However, the Fifth Circuit later stated: "... the court's language in *Continental* should not be read as requiring in addition to full disclosure to all offerees a demonstration of the offerees' insider status ... We think that any such requirement would inhibit the ability of business to raise capital ..." *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 907-908 (5th Cir.1977) .

See also Fletcher, Sophisticated Investors Under the Federal Securities Laws, Duke Law Journal 1081 (1988).

(n29)Footnote 29. Sec. Act Rel. No. 33-5487, CCH Fed. Sec. L. Rep. P 2710 (Apr. 23, 1974)(adopting Rule 146). *See also Doran v. Petroleum Management Corp.*, 545 F.2d 893, 903-905 (5th Cir. 1977) . *See also Van Dyke v. Coburn Enterprises*, [1989 Transfer Binder] CCH Fed. Sec. L. Rep. P 94,404 (8th Cir. 1989)(offering to 12 offerees deemed to be a private offering; six offerees were operators of the business, the remaining six had economic bargaining power to demand the necessary information).

(n30)Footnote 30. Sec. Act Rel. No. 33-4552, Fed. Sec. L. Rep. (CCH) P 2770 (1962).

Reference is made to the so-called 'investment clubs' which have been organized under claim of an exemption from the registration provisions of the Securities Act of 1933 as well as the Investment Company Act of 1940. It should not be assumed that so long as the investment club, which is an investment company within the meaning of the latter Act, does not *obtain* more than 100 members, a public offering of its securities, namely the memberships, will not be involved. An investment company may be exempt from the provisions of the Investment Company Act if its securities are owned by not more than 100 persons *and* it is not making and does not presently propose to make a public offering of its securities. (Section 3 (c)(1).) Both elements must be considered in determining whether the exemption is available.

See also National Lithium Corp., Sec. Act Rel. No. 33-4376 [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. P 76,775 (July 6, 1961).

(n31)Footnote 31. Sec. Act Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 2774 (Nov. 6, 1962).

(n32)Footnote 32. [1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep. P 96,147 (W.D.N.Y. 1977)

(n33)Footnote 33. CCH Fed. Sec. L. Rep. P 96,147 at 92,169 , *supra*.

(n34)Footnote 34. *Doran v. Petroleum Management*, 545 F.2d 893, 902, 56 O.&G.R. 591 (5th Cir. 1977) ; *SEC v. Continental Tobacco*, 463 F.2d 137, 158 (5th Cir. 1972) ; *Hill York Corp. v. American International Franchise, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971) .

(n35)Footnote 35. *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 905 (5th Cir.1977) . *See also* *U.S. v. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir. 1967).

(n36)Footnote 36. Sec. Act. Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 2770 (1962).

(n37)Footnote 37. Op. Gen. Counsel, Sec. Act Rel. No. 33-285, CCH Fed. Sec. L. Rep. P 2740 (1935).

(n38)Footnote 38. Crowell-Collier Publishing Co., Sec. Act Rel. No. 33-3825, CCH Fed. Sec. L. Rep. P 2850.25 (1957): "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." Similarly, resales of such convertible securities or warrants by original purchasers at any time may be construed as a public offering of those securities.

See also Keller, Practising Law Institute Corporate Law and Practice Course Handbook Series--Current Issues in Private Placements: the Metaphysics of Integration of Public and Private Offerings (2000).

(n39)Footnote 39. Op. Gen. Counsel, Sec. Act Rel. No. 33-285, CCH Fed. Sec. L. Rep. P 2740 (1935).

(n40)Footnote 40. Sec. Act. Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 2770 (1962).

(n41)Footnote 41. Section 2(11), 15 U.S.C. § 77b (11) (1952).

(n42)Footnote 42. Sec. Act Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 2777 (1962).

(n43)Footnote 43. Crowell-Collier Publishing Co., Sec. Act Rel. No. 3825, CCH Fed. Sec. L. Rep. P 2850.25 (1957). *See also* In the Matter of Elliot & Co., 38 S.E.C. 381 (1958); *Gilligan, Will & Co.*, 267 F.2d 461 (2d Cir.) , *cert. denied*, 361 U.S. 896 (1959) .

(n44)Footnote 44. The facilities of the American Stock Exchange were used to dispose of some of these securities.

(n45)Footnote 45. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.) , cert. denied, 361 U.S. 896 (1959) .

(n46)Footnote 46. *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) .

(n47)Footnote 47. *Crowell-Collier Publishing Co.*, Sec. Act Rel. No. 33-3825, CCH Fed. Sec. L. Rep. P 2850.25 (1957). See also *Hazel Bishop, Inc.*, Sec. Act Rel. No. 33-4371, CCH Fed. Sec. L. Rep. P 76,772 (1961); *United States v. Custer Channel Wing Corp.*, 247 F. Supp. 481 (D. Md. 1965) , aff'd, 376 F.2d 675 (4th Cir. 1967) , cert. denied, 389 U.S. 850 ; Cf. *Stoppelman v. Owens*, Fed. Sec. L. Rep. P 91,511 (D.D.C. 1984) (exemption not violated where sophisticated and suitable investor acknowledged that he had access to information, although he did not review it); *United States v. Hill*, 298 F. Supp. 1221, 1231 (D. Conn. 1969) .

See also *Edina State Bank v. Mr. Steak, Inc.*, 487 F.2d 640 (10th Cir. 1974) , cert. denied, 419 U.S. 883 (1975) ; *DeWitt v. American Stock Transfer Co.*, 433 F. Supp. 994 (S.D.N.Y. 1977) , modified, 440 F. Supp. 1084 (S.D.N.Y. 1977) .

(n48)Footnote 48. See *Edgar v. Camera Corp. of Am.*, [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. P 91,802 (1966).

(n49)Footnote 49. Sec. Act Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 47, 341.14 (1962).

The Commission strongly recommends the use of restrictive legends on stock certificates and stop-transfer instructions to transfer agents as a means of preventing the illegal sale of privately placed securities (see Securities Act Release 5121), and the purchaser should be informed prior to being committed to purchase the securities whether such a legend will be placed on the certificate or such instructions will be issued. Sec. Act Rel. No. 33-5226, Fed. Sec. L. Rep. (CCH) P 78,483 (1972).

See also *Cameron Industries, Inc.*, Sec. Act Rel. No. 33-4159 (1959); *Silver Shield Mining & Milling Co.*, Sec. Exch. Act Rel. No. 33-6214, CCH Fed. Sec. L. Rep. P 82,615 (1960).

(n50)Footnote 50. See 12 Fletcher, *Cyclopedia Corporation* § 5527 (1957 rev.).

(n51)Footnote 51. See *Holmes v. Birtman Elec. Co.*, 18 Ill. 2d 554, 165 N. E. 2d 261 (1961) ; Note, 75 A.L.R. 2d 735 (1960).

(n52)Footnote 52. Uniform Commercial Code § 8-401. In the event of an adverse claim the company must make inquiry if written notice is received at a time and in a manner which permits the company to act on it before issuing a new certificate. The issuer may fulfill this requirement by any reasonable means, including notifying the adverse claimant by mail that the security has been presented for transfer and that the transfer will be registered, unless within thirty days either a proper restraining order issues from a court of competent jurisdiction or an indemnity bond is filed with the issuing company sufficient in amount to protect it from any loss or damages it may sustain by reason of compliance with the adverse claim. Uniform Commercial Code § 8-403. Thereafter the company must register the transfer.

See also *Kenler v. Canal National Bank*, 489 F.2d 482, 486 (1st Cir.1973) (SEC "No-Action" letter held not to constitute "opinion of counsel" required by legend on stock certificate, thus relieving transfer agent from liability to shareholder for refusal to transfer); *Gasarch v. Ormand Industries, Inc.*, 346 F. Supp. 550 (S.D.N.Y. 1972) ; *Melville v. Wantschek*, 403 F. Supp. 439 (E.D.N.Y. 1975) .

In *Kanton v. U.S. Plastics, Inc.*, 248 F. Supp. 353 (D. N.J. 1965) , the plaintiff had obtained a favorable opinion letter

and a no-action letter from the Commission, but the issuing company refused to transfer his shares on the ground that it was obliged to take reasonable steps to satisfy itself that it was not participating in a criminal act in permitting the transfer. The court found no merit in this contention and held by way of mandatory injunction that the plaintiff was entitled to have his shares transferred on the corporation's books. *See also Riskin v. National Computer Analysts, Inc.*, 308 N.Y.S.2d 985 (N.Y. Sup. Ct. 1970) , *modified*, 326 N.Y.S.2d 419 (N.Y. App. Div. 1971) .

(n53)Footnote 53. Sec. Act Rel. No. 33-1862, CCH Fed. Sec. L. Rep. P 1531 (1938). Of course, from the standpoint of the *purchaser*, it is desirable to obtain some form of an agreement on the part of the issuer to register or effect a Regulation A filing at some definite time or under certain conditions, i.e., when a certain percentage of the securities sold privately request registration.

See also KDI Corp. v. Former Shareholders of Labtron of America, 536 F.2d 1146, 1148 (6th Cir. 1976) (necessity of investment letter to preserve private offering exemption).

(n54)Footnote 54. Sec. Act Rel. No. 33-5226, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. P 78,483 (1972). Such information should include: that the securities are unregistered and must not be resold unless they are registered or an exemption is available; that resales under Rule 144 (discussed in ch.6 *infra*) can be made only in limited amounts; that if Rule 144 is not available, compliance with Regulation A or some other exemption will be required. Furthermore, the Commission observed that if there is a representation that an attempt will be made to register the securities or that a Regulation A filing will be made, the purchaser should be informed as to specific times. Similarly, if the issuer is not obligated to register or file under Regulation A, that fact should be made clear to the purchaser. The purchaser should also be informed whether the seller will furnish him with information necessary to enable him to effect sales under Rule 144. *Id.*

In *Vohs v. Dickson*, 495 F.2d 607 (5th Cir. 1974) , the court, although noting the position taken by the SEC in Sec. Act Rel. 5226, *supra*, had this to say: "Rule 10b-5 cannot be construed to require a prospective seller of securities to give his prospective buyers legal advice on technical matters arising under the federal securities law. If the buyer is aware of the material facts--*e.g.*, that the stock he is to buy was issued in an unregistered transaction--he should be as aware of the *legal consequences* of those facts as his seller." *Id.* at 625 .

See also Keller, Practicing Law Institute Corporate Law and Practice Course Handbook Series--Current Issues in Private Placements: the Metaphysics of Integration of Public and Private Offerings (2000).

(n55)Footnote 55. Sec. Act Rel. No. 33-4552, CCH Fed. Sec. L. Rep. P 47,341.14 (1962).

See also SEC v. Cavanaugh, 445 F.3d 105, 112 (2d Cir. 2006) ; JIC Drilling Companies, SEC No-Action Letter (pub. avail. Sept. 23, 1976); Thomas H. Chambers, SEC No-Action Letter (pub. avail. June 28, 1976).

In *SEC v. Ishopnomarkup.com, Inc.*, [2007 Transfer Binder] CCH Fed. Sec.L.Rep. P 94,397 (E.D.N.Y. 2007), the court concluded that three separate offerings carried out in reliance on exemptions from registration available under Regulation D of the Securities Act should be integrated. Applying the five integration factors, the court reasoned:

It is undisputed that Ishop conducted the three offerings as part of a single, continuous plan to provide financing for Ishop. Further, Defendants do not dispute that all investors bought the same class of security (common stock), at or about the same time (essentially continuously from September 1999 through July 2000), for the same type of consideration (cash). Finally, it is undisputed that the offerings were made for the same general purpose, viz. to develop a shopping mall on the internet.

But see In Verticom, Inc., SEC No-Action Letter (pub. avail. Feb. 12, 1986), the staff took the position that a private offering to a limited number of venture capital firms for the purpose of meeting the issuer's requirements for "start-up"

capital, need not be integrated with a subsequent public offering intended to finance the expansion of the issuer's business. The staff declined to base its position on Securities Act Release No. 33-4552, however, relying instead on Rule 152. Rule 152 provides that the phrase "transactions by an issuer not involving any public offering" shall be deemed to apply to transactions not involving any public offering at the time of those transactions, although subsequently the issuer decides to make a public offering and/or files a registration statement.

On Rule 152, see also Black Box Inc., SEC No-Action Letter (pub. avail. June 26, 1990), where the company was not required to integrate a private placement executed pursuant to a recapitalization agreement with the subsequent filing of a registration statement relating to an initial public offering.

See also Harcourt General, SEC No-Action Letter (pub. avail. November 5, 1993); Surgical Care Affiliates, Inc., SEC No-Action Letter (pub. avail. September 23, 1993); Quad City Holdings, SEC No-Action Letter (pub. avail. April 8, 1993); Adolph Coors Company, SEC No-Action Letter (pub. avail. December 9, 1992); and Santa Fe Pacific Corp., SEC No-Action Letter (pub. avail. September 11, 1990).

(n56)Footnote 56. "It is clear that no exemption from registration under the Securities Act is available in a situation where unregistered securities are sold to purchasers in Europe who intend to resell the securities in the United States." Morris M. Schwebel, Sec. Act Rel. No. 33-4304, Fed. Sec. L. Rep. (CCH) P 76,728 (1960).

Although "interstate commerce" is defined in Section 2(7) of the Securities Act to include "trade or commerce in securities or any transportation or communication relating thereto ... between any foreign country and any state, territory, or the District of Columbia," it is the Commission's position that the "registration requirements of Section 5 of the Act are primarily intended to protect American investors. Accordingly, the Commission has not taken any action for failure to register securities of United States corporations distributed abroad to foreign nationals." Sec. Act Rel. No. 33-4708, CCH Fed. Sec. L. Rep. Ps 1361-1363 (1964). However, the release makes two conditions:

- (1) the distribution must be made in such a manner that the securities must "come to rest" abroad; and
- (2) the offering must not be directed toward *American* nationals abroad, including servicemen.

It should also be noted that, although the foreign offering may be exempt from the Securities Act's *registration* requirements, foreign purchasers may have the protection of the antifraud provisions of the Securities Act. See, e.g., *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409 (8th Cir. 1979).

The Commission has taken a contrary position with respect to sales by United States mutual funds of their shares to foreign nationals, on the ground that "disclosure at the point of sale helps protect the United States securities markets as a whole by insuring that foreign investors will not seek redemption's because of later realization that they had been inadequately informed about their investment. Sec. Act Rel. No. 33-5068, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,828 (1970).

(n57)Footnote 57. SEC, *Instructional Manual*, p. 89. In April 1990, the Commission adopted Regulation S under the Securities Act, which essentially codified the position taken in Securities Act Release No. 33-4708 and subsequent no-action and interpretive letters. Regulation S requires that, for the exemption to be available, all purchasers must be located outside of the United States. In addition, Regulation S contains significant restrictions on reselling the securities in the United States.

(n58)Footnote 58. SEC, *Instructional Manual*, p. 89.

(n59)Footnote 59. In 1998, the Commission amended Regulation S to provide that the period during which off-shore purchasers would be restricted in selling common stock of non-reporting companies was increased to one year

from the date of purchase. One of the principal reasons for this change was to close what appeared to the Commission to be an abuse of Regulation S whereby unregistered securities were returning to the United States within periods as short as 90 days from the date of purchase. The one year holding period now mandated by Regulation S coincides with the one year holding period set forth in Rule 144(d) under the Securities Act. Securities Act Release No. 33-7505 CCH Fed. Sec. L. Rep P 86,006.

(n60)Footnote 60. *Corporation Trust Co. v. Logan*, 52 F. Supp. 999 (D. Del. 1943) (voting trust agreement constituted offer to all shareholders and, in absence of registration of voting trust certificates, certificate holders entitled to rescind).

(n61)Footnote 61. Item 15, Part II, Form S-1. The Forms issued by the SEC under the Securities Act of 1933 are reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section D (Matthew Bender).

In furnishing information with respect to its sales of unregistered securities, the registrant must provide the information set forth in Item 701 of Regulation S-K, discussed in § 7.03[3][c] *infra*, and reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume D, Section K (Matthew Bender).

(n62)Footnote 62. Section 12 is discussed in §§ 9.03 and 9.04 *infra*.

(n63)Footnote 63. An example of such a disclosure is as follows:

The Company may be contingently liable for issuing securities without compliance with the Securities Act of 1933.

Since February 1968 Griffen has made 15 acquisitions and has issued 1,037,670 shares of its Common Stock in connection with such acquisitions to 77 persons. ... The shares listed above, as well as the shares issued to stockholders of companies acquired in 1968 ... may have been sold in violation of Section 5 of the Securities Act of 1933, as amended, and if so, the Company may have a contingent liability of \$32,000,000 in the aggregate. ... Based upon the opinion of counsel for the Company, which counsel are named under 'Legal Opinions,' the Company believes that no such violation has occurred and that, accordingly, it has no such liability.

Prospectus of Prelude Corporation, File No.2-29722, pp. 4, 27, 34 (eff. Feb. 18, 1969).

(n64)Footnote 64. Prospectus of Giffen Industries, Inc., File No. 2-30297, pp. 4, 27 (eff. Feb. 6, 1969).

See Bromberg, *Curing Securities' Violations: Rescission Offers and Other Techniques*, 1 J. Corp. L. 1 (1975); Prospectus of First Banc shares of Florida, Inc., Regis. No.2-53354 (eff. June 28, 1976).

In view of the above discussion, one may quarrel with the wisdom of making a rescission offer, especially when the short one-year statute of limitations of Section 5 is applicable. In sum, it may be preferable to disclose the issuer's contingent liability and dispense with any offer of rescission. In this connection, it is extremely unlikely that the Commission will *compel* a rescission offer unless it is obvious that fraud rather than an unintentional violation occurred with respect to prior sales in violation of the Securities Act's registration provisions.

(n65)Footnote 65. Regulation D is comprised of Rules 501-508 under the Securities Act, and is discussed in § 4.05, *infra*. Certain exempt offerings under Regulation D are also discussed in Chapter 5, §§ 5.03 and 5.02.

(n66)Footnote 66. Rules 501, 502, and 503 are discussed in §§ 4.05[1], [2], and [3], respectively *infra*.

(n67)Footnote 67. If there are in fact 35 or fewer non accredited purchasers, then the issuer's reasonable belief is not relevant. Rule 506(b)(2)(i). *See* Sec. Act Rel. No. 33-6825 (1989). *See* § 4.05[5] *infra* for discussion of calculation of the number of purchasers under Rules 506 and Rule 505.

The staff of the Commission has taken the position that a Rule 506 offering may be deemed nonpublic for purposes of Section 3 (c)(1) of the Investment Company Act of 1940. Sec. Act Rel. No. 33-6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,106 (Div. Corp. Fin. 1982); *San Jose Capital Corp.*, 15 Sec. Reg. & L. Rep. (BNA) 434 (Div. Corp. Fin. 1983).



50 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.04

AUTHOR: Robert N. Rapp

§ 4.04 Private Sales by Non-Issuers: The "Section 4 (1 1/2)" Exemption and Rule 144A

[1] "Section 4 (1 1/2)"

Although there is no exemption as such provided in the Securities Act, principles underlying sections 4(1) and 4(2) of the Securities Act have been cobbled to establish a hybrid exemption for transactions by non-issuers that do not involve a public offering. The so-called "section 4 (1 1/2)" exemption addresses private resales of securities by affiliates who might otherwise be precluded from reliance on section 4(1) by reason of an affiliate/control relationship with the issuer. Non-issuers in these relationships may be deemed to be engaging in a secondary distribution of securities that is subject to section 5 registration, and additionally be deemed to be section 2(11) issuers, such that persons purchasing from them with a requisite view to distribution would be underwriters, and thus also denied the availability of section 4(1) for their own resales. As discussed earlier, section 4(2)--the "private offering" exemption in the Securities Act--as well as Regulation D, are available only to actual issuers. They do not encompass section 2(11) issuers, who are defined as such only for purposes of determining the presence of an underwriter. Holders of restricted or control securities may not, therefore, make "private" sales of their securities under section 4(2) despite structuring such sales in conformity with section 4(2) principles and limitations.

As an essentially made up provision, the section 4 (1 1/2) exemption rests on sound logic that there is no meaningful difference between issuer and non-issuer transactions that meet all of the criteria for the section 4(2) private offering exemption. Sophisticated parties are able to structure and carry out privately negotiated transactions that satisfy all criteria developed under section 4(2), but for the fact that it is an "issuer" exemption. To be sure, Rule 144 under the Securities Act was adopted to create a safe harbor for any holder of "restricted securities" to sell those securities in transactions meeting requirements of the rule, which include a significant holding period. n1 However, for sales of restricted securities that do not, or are not intended to, fit into the safe harbor of Rule 144, the combined principles underlying sections 4(1) and 4(2) provide the basis for permitting non-issuers to sell in privately negotiated transactions. Thus, relying on a claimed section 4 (1 1/2) exemption, non-issuer holders may be able to sell all their securities much sooner than would otherwise be permitted in reliance on the Rule 144 safe harbor.

In 1980 the SEC recognized the emergence of a hybrid exemption, not specifically provided for in the Securities Act, "but clearly within its intended purpose," provided that established criteria for sales under both section 4(1) and section

4(2) are satisfied. n2 Particular conditions have never been specifically identified, and over the years the SEC staff has generally declined requests to provide interpretive guidance. Nevertheless, "section 4 (1 1/2)" has by conventional wisdom been claimed as an available means to effect unregistered private secondary sales under circumstances in which the holder could not make public sales.

The key consideration in its application, however, is that recognized indicia of private placements generally be present. In *U.S. v. Lindo*, n3 the Sixth Circuit U.S. Court of Appeals rejected the availability of a claimed section 4 (1 1/2) exemption where the defendant's private placement transaction did not present such indicia. The court observed, for example, that there was no evidence of any restrictive legends being placed on reissued stock certificates, and no standard private placement contracts were used in the sales at issue. In addition, said the court, exempt private offerings are based upon buyers having access to the kind of information contained in a registration statement. In *Lindo*, numerous buyers of the stock did not have access to this type of information. Thus, the court concluded that a section 4 (1 1/2) exemption could not apply to the sales. n4

To demonstrate the indicia of a private placement for purposes of reliance on a section 4 (1 1/2) exemption it is clear that a seller must be concerned with limitations on the number of purchasers, manner of sale limitations, disclosure of information, qualifications of offerees and purchasers, and other limitations that may apply to resales. These elements of a "private" placement are no different in the context of a non-issuer sale than as applied in assessing any private transaction. The caveat in all of this, however, is that "section 4 (1 1/2)," despite its evolution as conventional wisdom, remains a theoretical exemption, the conditions of which have never been specifically articulated or explained. n5 Truly private placements between sophisticated sellers and buyers do not suggest the need for the protection of registration any more than qualifying issuer private placements carried out in conformity with long established principles. Nevertheless, reliance on "section 4 (1 1/2)" to sell securities outside of Rule 144 will always entail uncertainty. Some of that uncertainty is today ameliorated by Rule 144A under the Securities Act, which addresses private resales of securities to institutions, and is discussed below.

[2] Securities Act Rule 144A

Rule 144A under the Securities Act n6 Rule 144A does not address the broad range of section 4 (1 1/2) issues, but it does establish an exemption from section 5 of the Securities Act for sales by non-issuers (and dealers) made to a "qualified institutional buyer," and which meet other conditions. By selling in conformity with the rule non-issuers and dealers will not be deemed to be engaging in a distribution, and will not be deemed to be underwriters of the securities within the meaning of sections 2(a)(11) and 4(1) of the Securities Act.

Like Rule 144, Rule 144A is a safe harbor provision. A seller may claim availability of any other applicable exemption from the registration requirements of the Securities Act. However, availability of the safe harbor under Rule 144A is conditioned on meeting its specific requirements. Conditions to be met under Rule 144A are:

- (1) Securities must be offered and sold only to a "qualified institutional buyer" or to an offeree or purchaser that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer. Rule 144A defines "qualified institutional buyer"(QIB) to include insurance companies, registered investment companies, employee benefit plans, banks and other institutional investors meeting size or other business criteria. n7 The rule prescribes such bases and sources of information on which a purchaser may rely in making its determination that a prospective purchaser meets QIB criteria.
- (2) The seller and any person acting on its behalf must take reasonable steps to ensure that the purchaser is aware that the seller may rely on Rule 144A in making the sale.
- (3) The securities offered and sold may not be of the same class as securities listed by the issuer on a

national securities exchange or the Nasdaq Stock Market, although some provision is made for securities that are convertible into listed securities, and may not be securities of an open-end investment company, unit investment trust or a face-amount certificate company that is or is required to be registered under the Investment Company Act.

(4) If the issuer is not a reporting company under the Securities Exchange Act of 1934, prospective purchasers must have the opportunity to obtain from the issuer, seller, or any person acting on behalf of the issuer or seller, specified reasonably current business and financial information about the issuer. n8

Securities acquired in a transaction carried out in reliance on Rule 144A are deemed to be "restricted securities" within the meaning of Rule 144. n9 Thus, QIBs who take the securities become subject to Rule 144 resale limitations unless another exemption is available. In the Rule 144A transaction itself, however, there are no amount or manner of sale conditions, and Rule 144A has no seller holding period condition. Non-issuers who purchase securities from an issuer may do so fully intending ("with a view to") reselling the securities pursuant to Rule 144A. The fact that they do take with that view does not impact the availability of section 4(2) or Regulation D for the issuer, nor does it affect the availability of any exemption for a prior or subsequent holder. n10

FOOTNOTES:

(n1)Footnote 1. Rule 144, *17 C.F.R. § 230.144*, permits the public sale in ordinary transactions of limited amounts of securities owned by persons controlling, controlled by or under common control with the issuer, and by persons who have acquired restricted securities of the issuer. "Restricted securities" are generally defined as securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering. Key conditions for the operation of Rule 144 include adequate current information concerning the issuer being available to the public. A holding period is also central to the Rule, as are limitations on the amount of securities that may be sold and the manner of sales. Rule 144 is discussed in more detail in Chapter 6, *infra*. See also K&L Gates, Securities Practice Guide § 3.04[2] (2009 Edition)

(n2)Footnote 2. Securities Act Rel. No. 33-6188 (Feb. 1, 1980).

(n3)Footnote 3. *18 F.3d 353 (6th Cir. 1994)* .

(n4)Footnote 4. It is also certain that that the Section 4(1 1/2) exemption will not be available in any circumstances where an underwriter is present. As explained in *Zacharias v. SEC*, *569 F.3d 458 464 (D.D.C. 2009)* :

[A]lthough the term "4(1 1/2) exemption" adequately expresses [the relationship between § 4(1) and § 4(2)], the actual basis "for private resales of restricted securities is § 4(1)". *Ackerberg v. Johnson*, 892 F.2d 1328, 1225 n. 6 (8th Cir. 1989). Section 4(1), in turn. Exempts "transactions by any person other than an issuer, *underwriter*, or dealer." *15 U.S.C. § 77(d)(1)* (emphasis added). Thus, if an underwriter is present, the § 4(1) exemption, and by extension the 4(1 1/2) exemption, cannot apply.

(n5)Footnote 5. It is certain, however, that as in the case of an issuer claiming an exemption for a private sale under section 4(2) of the Securities Act, an affiliate claiming a section 4 (1 1/2) exemption has the burden of establishing that such sales do not constitute a disguised public distribution. *SEC v. Cavanaugh*, *1 F. Supp. 2d 337, 368-69 (S.D.N.Y. 2003)* .

(n6)Footnote 6. *17 C.F.R. § 230.144A*.

(n7)Footnote 7. See Rule 144A(a)(1), *17 C.F.R. § 230.144A(A)(1)*.

(n8)Footnote 8. Rule 144A(d)(4)(i) prescribes such information as consisting of:

[A] very brief statement of the nature of the business of the issuer and the products and services it offers; and the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available).

(n9)Footnote 9. Rule 144A, Prelim. Note 6.

(n10)Footnote 10. Rule 144A, Prelim. Note 7; *see also* Rule 144A(e).



51 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.05

AUTHOR: Robert N. Rapp

§ 4.05 Regulation D--Generally

The SEC adopted Regulation D (Rules 501-508) in 1982 to assist small business capital formation and to reduce the burdens imposed by the federal securities laws as applied to small business. Regulation D coordinates several of the various limited offering and small offering exemptions from Securities Act registration and eases the requirements for private offers and sales of securities under the Securities Act. n1 Rules 504 through 506 under Regulation D replaced the limited offering and small offering exemptions from registration contained in former Rules 146, 240, and 242. n2 Rule 504 is applicable to offerings not exceeding \$1,000,000. Rule 505 applies to offerings not exceeding \$5,000,000. Rule 506 applies to offerings without regard to the dollar amount. n3

Regulation D is also comprised of:

- Rule 501, which defines common terms used in Regulation D;
- Rule 502, which sets forth the general requirements relating to integration, information requirements, limitations on manner of offering, and limitations on resale that apply to offers and sales under Regulation D;
- Rule 503, which provides for a uniform notice of sales, Form D, for offerings under Regulation D and Section 4(6); n4
- Rule 507 which provides that no exemption under Rules 504, 505 or 506 shall be available for an issuer if such issuer, or any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminarily or permanently enjoining such person for failure to comply with Rule 503; however, the Commission, for good cause, may waive such disabilities; and
- Rule 508 which provides that a failure to comply with a term, condition or requirement of Rules 504, 505 or 506 will not result in the loss of the exemption under certain circumstances, one of which is if the failure to comply was insignificant with respect to the offering as a whole.

An issuer's reliance on the rules under Regulation D does not act as an election; the issuer may still claim the availability of any other exemption from registration. n5 Regulation D, however, is available only to the issuer and not to the issuer's affiliates or to secondary sellers of the issuer's securities. n6

The rules under Regulation D do *not* provide an exemption:

- (1) For the securities themselves, but rather only for the transaction in which the securities are offered or sold by the issuer; n7
- (2) From any provisions of the federal securities laws other than the registration provisions of Section 5; n8 and
- (3) From any applicable state law relating to the offer and sale of securities. n9

In addition, Regulation D is not available to an issuer for a transaction that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Securities Act although the issuer technically complies with the requirements of Regulation D. n10

Only offerings carried out under Rule 506 of Regulation D are exempt under Section 4 of the Securities Act. Regulation D exemptions under Rule 504 and 505 were created by the SEC pursuant to statutory authority contained in Section 3(b) of the Securities Act, which provides generally for exemptions by rulemaking for offerings in an aggregate amount up to \$5 million based on a determination that requiring registration is not necessary in the public interest and for the protection of investors. Rule 506, on the other hand, is a "safe harbor" provision with which issuers may comply to be certain of the Section 4(2) exemption. Nevertheless, the general conditions of Regulation D are applicable to all offerings made under it, and thus Regulation D as a whole is considered further below, although more particular consideration of offerings made pursuant to Rules 504 and 505 is undertaken in Chapter 5--Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act.

[1] Definitions--Rule 501

Rule 501 of Regulation D defines important terms used in Regulation D.

Accredited Investor. For purposes of Regulation D, the term "accredited investor" includes any person who comes within, or whom the issuer reasonably believes n11 comes within, certain categories of investors at the time of the sale of the issuer's securities to that person. n12 The categories include: n13

- Various institutional investors (banks, savings and loan associations, licensed brokers or dealers, insurance companies, investment companies, certain business development companies, small business investment companies, any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees if such plan has total assets in excess of 5 million dollars, n14 other employee benefit plans if the investment decision is made by a plan fiduciary which is a bank, savings and loan, insurance company or registered investment advisor or if the plan has assets in excess of 5 million dollars, or self-directed plans with investment decisions made solely by accredited investors); n15
- Any private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940; n16

1-4 Federal Securities Act of 1933 § 4.05

- Any *Internal Revenue Code* section 501(c)(3) exempt organization, corporation, Massachusetts or similar business trust or partnership with total assets in excess of 5 million dollars, not formed for the specific purpose of acquiring the securities offered; n17
- Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer; n18
- Any natural person whose individual net worth, or joint net worth with the person's spouse, at the time of the purchase exceeds \$1 million;
- Any natural person who had an individual income in each of the two most recent years in excess of \$200,000, or joint income with that person's spouse in excess of \$300,000 in each of these years and has a reasonable expectation of reaching the same income level in the current year; n19
- Any trust, with total assets in excess of \$5 million, not formed for the specific purpose of acquiring the securities offered, and whose purchases of securities are directed by a sophisticated person as described in Rule 506(b)(2)(ii) of Regulation D; and
- Any entity in which all of the equity owners are accredited investors. n20

Rule 501 also defines the following terms: "affiliate," "aggregate offering price," "business combination," "calculation of number of purchasers," "executive officer," "issuer," and "purchaser representative."

[2] General Conditions--Rule 502

Rule 502 sets forth the general conditions relating to integration, information requirements, limitations on manner of offering, and limitations on resale that apply to all exempt offers and sales effected pursuant to Rules 504, 505, and 506. n21

[a] Integration. Rule 502(a) requires integration of all sales that are part of the same Regulation D offering. The doctrine of integration prevents issuers from circumventing the Securities Act registration requirements by claiming a separate exemption for one or more parts of a transaction that comprise a single plan of financing. Accordingly, integration is a means for identifying the scope of an offering by considering the relationship between multiple transactions; it is premised on the recognition that, although the Securities Act addresses discrete offerings, not every offering is in fact a discrete transaction.

The factors listed in Rule 502 to be considered in determining whether offers and sales of securities should be integrated for purposes of a rule under Regulation D are:

- Whether the sales are part of a single plan of financing;
- whether the sales involve issuance of the same class of securities;
- whether the sales have been made at or about the same time;
- whether the same type of consideration is received; and
- whether the sales are made for the same general purpose.

These factors have also been made applicable to intrastate offerings and private offerings. n22 A safe harbor is provided

in Rule 502(a) for all offers and sales that take place at least six months before the start of, or six months after, the termination of the Regulation D offerings, if during the six month periods there are no offers or sales of securities by or for the issuer of the same or a similar class as those offered or sold under Regulation D. n23

[b] Information Requirements. An issuer that sells securities pursuant to Rule 504 or only to accredited investors pursuant to Rules 505 or 506 is not required to furnish specific information to purchasers. n24 If, however, an offering of securities pursuant to Rule 505 or 506 involves sales to non accredited investors, the issuer must furnish specified information to purchasers during the offering and before sale. n25 The specified information must be furnished a reasonable time prior to sale. n26

The issuer must also furnish the non accredited investor with a brief written description of any material written information about the offering which was previously provided by the issuer to any accredited investor but not to the non accredited investor. n27 The written information itself must be provided to the non accredited investor upon the investor's written request. n28

Finally, at a reasonable time prior to the sale of securities to any non accredited investor in a Rule 505 or Rule 506 transaction, the issuer must advise such purchaser in writing of the limitations on resale of the securities. n29

If the issuer is required to furnish specified information, and the issuer is subject to the periodic reporting requirements of the Exchange Act, the issuer must furnish prospective purchasers with the most recent annual report to shareholders, the definitive proxy statement filed in connection with that report, and the most recent annual report to the Commission on Exchange Act Form 10-K or 10-KSB upon the purchaser's request in writing. n30 Alternatively, the issuer may furnish the information contained in a registration statement on Form S-1 n31 or Form 10 or 10-KB under the Exchange Act or its annual report on Form 10-K or 10-KSB under the Exchange act, whichever is the most recently required filing, and the information contained in any subsequent reports or documents filed pursuant to the reporting requirements of the Exchange Act. n32 The issuer must also provide a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs not disclosed in the documents furnished. n33

If the issuer is required to furnish specified information but is not subject to the reporting requirements of the Exchange Act (i.e., the issuer is a non-reporting company), the level of non-financial disclosure is either (i) that required in Part II of Form 1-A in situations where the issuer is eligible to use Regulation A, or (ii) the information required in Part I of a registration statement filed under the Securities Act on the form that the issuer would be entitled to use. n34 The financial disclosure required is dependent upon the size of the offering:

- For offerings up to \$2,000,000, the issuer must furnish the information required in Item 310 of Regulation S-B, except that only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. n35
- For offerings up to \$7,500,000, the issuer must provide the financial statement information required in Form SB-2, except that if the issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. n36
- For offerings over \$7,500,000, the issuer must provide the same financial statements as would be required in a registration statement filed under the Securities Act on the form that the issuer would be entitled to use, except that if the issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. n37

A non-reporting issuer must furnish the specified information to the extent the information is material to an understanding of the issuer, its business, and securities being offered. n38

Issuers required to furnish specific information do not, however, have to provide purchasers with exhibits required to be filed with the Commission as part of a registration statement or report (other than an annual report to shareholders or parts thereof incorporated by reference in a Form 10-K or Form 10-KSB report), if the contents of the exhibits are identified and the exhibits are made available to the purchaser, upon written request before purchase. n39

[c] Limitations on Manner of Offering. Rule 502(c), applicable to all transactions under Regulation D except certain offers and sales made pursuant to Rule 504, n40 prohibits the issuer or any person acting on the issuer's behalf from offering or selling securities by any form of general solicitation or general advertising. n41

[d] Limitations on Resale. Rule 502(d), applicable to all transactions under Regulation D except certain offers and sales made pursuant to Rule 504, n42 provides that securities acquired in a transaction under Regulation D have the status of securities acquired in a transaction under Section 4(2) n43 and cannot be resold without registration or an exemption from registration.

The issuer must exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of Section 2(11). n44 Reasonable care includes, but is not limited to:

- Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;
- written disclosure to each purchaser before sale that the securities have not been registered under the Act and cannot be resold unless they are registered under the Act or unless an exemption from registration is available; and
- placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities. n45

[3] Notice of Sales--Rule 503

Rule 503 provides one uniform notice of sales, Form D, n46 for offerings pursuant to Regulation D and Section 4(6), n47 the statutory exemption for offers or sales of not more than \$5 million of securities only to accredited investors. Rule 503 and Rule 507 together obligate issuers to file under Rule 503 but do not make filing a condition of the availability of a Regulation D exemption. Instead, the failure to timely file a Form D serves as the basis for disqualifying the issuer, subject to waiver by the Commission, from future use of the Regulation D exemptions. n48 The issuer must file Form D with the Commission no later than fifteen days after the first sale of securities in an offering under Regulation D. n49

In 2008 the SEC adopted rule amendments mandating electronic filing of Form D through the Internet. n50 Revisions to the Form and to Regulation D were also adopted to simplify and restructure Form D and to update and revise its information requirements. The information required by Form D is now filed with the SEC electronically through an online filing system that is accessible from any computer with Internet access. The data filed is available on the Web site and is interactive and searchable. n51 The Form D filing is still required within 15 days of the issuer's first sale in reliance on a Regulation D exemption, However, paper filings have been eliminated. The new Form D for electronic filing generally carries over the requirements from the former Form D for basic identifying and contact information about related persons, but modifies or omits some of these types of requirements. Certain additional information about issuers is now required and, in general, information requirements are updated. The requirements carried over are

restructured to reflect the electronic character of the filing. Also, consistent with the constraints of the Regulation D safe harbor, issuers are permitted to engage in a limited amount of "free writing" as necessary to clarify responses.

[4] Limited Offerings Not Exceeding \$1,000,000--Rule 504

Rule 504 provides an exemption for offers and sales of securities by an issuer not subject to the reporting provisions of the Exchange Act that do not exceed an aggregate offering price of \$1,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of the offering and during the offering under Rule 504 in reliance on any exemption under Section 3(b) n52 or in violation of Section 5 (a). n53

Rule 504 is not available for offers and sales of securities by issuers that are investment companies, are subject to the reporting requirements of Section 13 or 15 (d) of the Exchange Act, or are development stage companies that either have no specific business plan or purpose or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company. n54 Because of a presumption that the remedial provisions of the securities laws and state regulation are sufficient protection for small offerings, no specific information disclosure requirements apply to Rule 504 offerings and there is no limit on the number of offerees and purchasers.

For purposes of Regulation D, the term "aggregate offering price" includes the sum of all cash, services, property, notes, cancellation of debt, or other consideration received by an issuer for the issuance of its securities. n55 If securities are offered for both cash and non cash consideration, the aggregate offering price is based on the price at which the securities are offered for cash. n56 If the securities are not offered for cash, the aggregate offering price is based on the value of the consideration as established by *bona fide* sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard which must be reasonable at the time made. n57

The securities purchased in a Rule 504 transaction ordinarily will be subject to limitations upon resale pursuant to Rule 502(d), as are the securities purchased in Rule 505 and 506 transactions. However, as a result of amendments to Rule 504 in April 1999, the Rule 502(d) resale limitations, as well as the 502(c) limitation on general solicitation and advertising, will not apply to offers and sales of securities made: (i) exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions; (ii) in one or more states that have no provision for registration of the securities or the public offering or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or (iii) exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to "accredited investors." In addition, an issuer in a Rule 504 transaction must satisfy applicable portions of Rules 501 through 503. n58

[5] Limited Offerings Not Exceeding \$5,000,000--Rule 505

Rule 505 of Regulation D was adopted by the SEC pursuant to authority in Section 3(b) of the Securities Act n59 for offers and sales of securities not exceeding an aggregate offering price of \$5 million. The main conditions of Rule 505 offerings are:

- The total offering price of each issue of securities may not exceed \$5 million, less the aggregate offering price for all securities sold within the twelve months before the start of the offering and during the offering under Rule 505 in reliance on any exemption under Section 3(b) or in violation of Section 5 (a). n60

1-4 Federal Securities Act of 1933 § 4.05

- The offering may not be made by means of general solicitation or general advertising.
- The issuer may sell the securities to an unlimited number of "accredited investors" and to 35 non-accredited persons. There are no requirements of "sophistication" or "wealth" for persons to whom the securities are sold.
- A company must take any necessary steps to ensure that the purchasers are acquiring securities for investment only, not for resale. The securities are thus "restricted" and investors must be informed that they may not be able to sell except pursuant to a registration statement or exemption from registration.
- The issuer is not required to file any offering materials with the Commission. Fifteen days after the first sale in the offering, the issuer must electronically file a notice of sales on Form D. The notice also contains an undertaking under the Rule for the issuer to furnish the Commission, upon its staff's request, any information given to non-accredited purchasers in connection with the offering.
- Rule 505 does not provide an exemption from state securities laws.

For purposes of calculating the number of purchasers under Rule 505 and Rule 506 discussed below, the following purchasers are excluded:

- (1) any relative, spouse, or relative of the spouse of a purchaser who has the same principal residence as the purchaser;
- (2) any trust or estate in which a purchaser and any of the persons related to the purchaser (as specified in paragraph (1) above or (3) below) collectively have more than 50 percent of the beneficial interest (excluding contingent interests);
- (3) any corporation or other organization of which a purchaser and any of the persons related to the purchaser (as specified in paragraphs (1) or (2) above) collectively are beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; and
- (4) any accredited investor. n61

An exemption from registration under Rule 505 is not available for the securities of any issuer that is subject to a disqualification under Regulation A, n62 unless the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the Rule 505 exemption be denied. n63 Securities offered pursuant to Rule 505 are "restricted" securities, and any resale must be in conformity with Rule 144 or another available exemption.

[6] Offerings to No More Than 35 Non-Accredited Investors--Rule 506

Rule 506 of Regulation D n64 is the "safe harbor" for offerings made under Section 4(2) of the Securities Act. A company using the Rule 506 exemption can raise an unlimited amount of money, and can be assured it is within the Section 4(2) exemption by satisfying the following standards:

- The company cannot use general solicitation or advertising to market the securities;
- The company may sell its securities to an unlimited number of "accredited investors" and up to 35 other purchases. Unlike Rule 505, all non-accredited investors, either alone or with a "purchaser representative," n65 must be sophisticated--that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the

prospective investment;

- Companies must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws. But companies must give non-accredited investors disclosure documents that are generally the same as those used in registered offerings. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well;
- The company must be available to answer questions by prospective purchasers;
- The company must electronically file Form D;
- Purchasers receive "restricted" securities, meaning that the securities cannot be sold without registration or in compliance with Rule 144 or an available exemption.

Rule 506 is the principal means by which "private" offerings are carried out today, as few issuers opt for reliance on Section 4(2) given its uncertainties and consequences of non-compliance outside the Rule 506 safe harbor. The utility of Rule 506 lies in its availability for offerings of unlimited amounts to an unlimited number of accredited investors. Up to 35 non-accredited investors may be involved, but consistent with a fundamental premise of the Section 4(2) exemption, for these purchasers there is a specific sophistication requirement to be met by each non-accredited purchaser either or alone or with a purchaser representative as discussed above.

FOOTNOTES:

(n1)Footnote 1. Sec. Act. Rel. No. 33-6389, [1982 Transfer Binder] CCH Fed. Sec. L. Rep. P 83,106 (1982). *17 C.F.R. §§ 230.501-508*. The Rules under the Securities Act of 1933 are reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section C (Matthew Bender).

The Commission, in conjunction with the proposal and adoption of Regulation D and in coordination with the North American Securities Administrators Association ("NASAA") has made efforts to achieve a uniform system of federal-state limited offering exemptions that facilitates capital formation consistent with the protection of investors. Regulation D is intended to be the principal element of this system. *Id.*

On March 3, 1983, the Commission issued an interpretive release setting forth responses to questions frequently received by the Division of Corporation Finance concerning the definitions, disclosure requirements, operational conditions, notice of sale requirements, and exemptions contained in Regulation D. Sec. Act Rel. No. 33-6455, CCH Fed. Sec. L. Rep. P 2380 (1983). The responses are intended to serve as guidance for any person who wishes to make an offering reliant upon the Regulation D exemptions.

(n2)Footnote 2. Rules 146, 240, and 242 and Forms 146, 240, 242 were rescinded on June 30, 1982. The Commission took the position that no registration was required for any offerings made in compliance with Rules 146, 240, or 242 that commenced before April 15, 1982, the effective date of Regulation D, and continued past June 30, 1982. Sec. Act Rel. No. 33-6389, [1981-1982 Transfer Binder] CCH Fed. Sec. L. Rep. P 83,106 (1982).

(n3)Footnote 3. Rule 506, a "safe harbor" for issuers attempting to perfect the Section 4(2) private offering exemption, is discussed in § 4.03[2] *supra*.

(n4)Footnote 4. Section 4(6) of the 1933 Act, which provides an exemption from registration for offers or sales of securities to accredited investors, is discussed in § 4.09 *infra*, and is reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section B (Matthew Bender).

(n5)Footnote 5. Preliminary Note 3, Regulation D.

(n6)Footnote 6. Preliminary Note 4, Regulation D.

For example, an underwriter for the sale of securities acquired in a firm commitment offering could not rely upon Regulation D. Sec. Act Rel. No. 33-6455, *supra*, Question 76.

(n7)Footnote 7. Preliminary Note 4, Regulation D.

(n8)Footnote 8. Preliminary Note 1, Regulation D. An issuer must therefore provide any further material information that may be necessary to make the information required under Regulation D not misleading. *Id.*

(n9)Footnote 9. Preliminary Note 2, Regulation D.

All state securities law regulators however, have adopted changes in their state laws which essentially duplicate the Regulation D exemption, including the requirement to file a Form D, in order to ease state securities law registration requirements. See Rapp, *Blue Sky Regulation*, § 5.02 (2d Ed. Matthew Bender).

After enactment of the National Securities Market Improvements Act of 1996, states are prohibited from imposing any conditions, based on merit, on offerings that are exempt from registration pursuant to Commission rules or regulations issued under Section 4(2) of the Securities Act, namely Rule 506. However, notice filing requirements substantially similar to those required by Commission rule or regulation are permitted. Also, states continue to exercise authority to determine the validity of a Rule 506 exemption as a condition to NSMIA preemption of state regulation. See R. Rapp and F. Berckmueller, "Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure," 63 *Bus. Lawyer* 809 (May 2008).

(n10)Footnote 10. Preliminary Note 6, Regulation D.

Preliminary Note 7 to Regulation D provides that offers and sales of securities to foreign persons made outside the United States that will result in the securities coming to rest abroad generally need not be registered although coincident offers and sales are made under Regulation D within the United States. Therefore:

(1) purchasers who are not U.S. citizens or U.S. residents need not be included in the calculation of the number of purchasers; and

(2) proceeds from sales to foreign purchasers need not be included in the aggregate offering price.

Preliminary Note 7, however, does not apply if the issuer relies solely on Regulation D for offers or sales to foreign persons. Sec. Act Rel. No. 33-6437, [1982-1983 Transfer Binder] CCH Fed. Sec. L. Rep. P 72,407 (1982).

(n11)Footnote 11. Since the factors that constitute reasonable belief will depend upon the facts of each case, the staff of the Commission is not in a position to express its views on, or to endorse any method for the determination of, whether an investor is accredited. Sec. Act Rel. 6455, *supra*, Part I.A.

(n12)Footnote 12. The interpretations regarding the definition of "accredited investor" in Regulation D also apply to the definition of "accredited investor" under Section 4(6), discussed in § 4.08 *infra*. *Id.*, n. 2.

(n13)Footnote 13. 17. C.F.R. § 230.501(a) (reprinted in the Securities Primary Law Sourcebook, A.A. Sommer,

Jr., General Editor, Volume A, Section C (Matthew Bender).

(n14)Footnote 14. This addition to the list of "accredited investors" was adopted in Sec. Act Rel. No. 6825, [1989 Transfer Binder] CCH Fed. Sec. L. Rep. P 84, 404 (1989).

(n15)Footnote 15. Although a trust having assets of less than \$5 million is not one of the entities defined as an accredited investor, if a bank, which, when acting in its individual or fiduciary capacity, is defined as an accredited investor, serves as trustee and makes the investment on behalf of the trust, the trust can be accredited. Sec. Act Rel. No. 33-6455, n.1 *supra*, Question 26.

See also NEMO Capital Partners L.P., SEC No-Action Letter [1987-1988 Transfer Binder] CCH Fed. Sec. L. Rep. P 78,506 (Div. Corp. Fin. April 11, 1987), in which the staff took the position that a trust having a bank as a co-trustee is an accredited investor under Rule 501(a)(1) as long as the bank acts in its fiduciary capacity on behalf of the trust, i.e., in reference to the investment decision, and the trust follows the bank's direction.

(n16)Footnote 16. *See* 15 U.S.C. § 80b-2(a)(22).

Business development companies as defined under Section 2(a)(48) of the Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(48), are included in the list of accredited investors pursuant to Section 2(15), discussed in § 4.08 *infra*.

(n17)Footnote 17. *See* 26 U.S.C. § (c)(3).

Since a state-run, nonprofit hospital falls within the substantive description of an organization within *Section 501(c)(3) of the Internal Revenue Code*, it is an accredited investor under Rule 501(a)(3) although, as a state agency, it is exempt from federal income taxation. Rule 501(a)(3) does not require the investor to have received a ruling on its tax status under Section 501(c)(3). Sec. Act Rel. No. 33-6455, n.1 *supra*, Question 4.

Also included as an accredited investor under the definition is a limited liability company if it meets the other requirements as to asset size and purpose of formation. *See* Wolf, Block, Schor and Soles-Cohen, SEC No-Action Letter (pub. avail. Dec. 11, 1996).

In computing whether the total amount of assets has exceeded \$5 million, the assets of a subsidiary may be added to those of the parent-investor if, under generally accepted accounting principles, the parent may combine its financial statements with those of its subsidiary. *Id.*, Question 5.

See also Equitable Life Assurance Society of the United States, SEC No-Action Letter (pub. avail. Feb. 1, 1986), in which the Commission staff took the position that a charitable corporation may be deemed an "accredited investor" under Rule 501(a)(3) of Regulation D even if it has not received a determination letter from the Internal Revenue Service with respect to its tax exempt status, as long as it meets all the substantive criteria of *Section 501(c)(3) of the Internal Revenue Code* and has total assets in excess of \$5 million.

(n18)Footnote 18. An executive officer of a parent of the corporate general partner of an issuer who invests in a Regulation D offering is not an accredited investor under Rule 501(a)(4) unless the executive officer of the parent can be deemed an executive officer of the subsidiary, e.g., if the executive officer performs a policy making function for the subsidiary. Sec. Act Rel. No. 33-6455, *supra*, Questions 6 and 37.

Since an investor is accredited if he or she falls into one of the enumerated categories of Rule 501(a) "at the time of the sale of securities to that person," a director of a corporate issuer who, two weeks after purchasing securities in a Regulation D offering and before completion of the offering, resigns due to sudden illness, would be an accredited investor since he or she had that status at the time of sale (unless the resignation was part of a plan to evade the

registration requirements, *see* text at n.9 *supra*). *Id.*, Question 1.

If a corporation implements an employee stock option plan for its key employees, an issuer can rely upon Regulation D for the issuance of the stock underlying the options; the offering of the stock generally will commence when the options become exercisable and will continue until the options are exercised or otherwise terminated. If the key employees are directors or officers, and they purchase securities through the exercise of their options, they will be accredited investors under § 501(a)(4). *Id.*, Question 78.

(n19)Footnote 19. In calculating individual income, a purchaser may not include the income of his or her spouse on unrealized capital appreciation. Sec. Act Rel. No. 33- 6455, *supra*, Questions 22 and 23.

In calculating the net worth of a natural person, the estimated fair market value of the investor's principal residence may be included. Sec. Act Rel. No. 33-6455, *supra*, Question 21.

Rule 501(a)(6) is inapplicable to purchases by a corporation, *Id.*, Question 20, and by the trustee of a trust, since, except where a bank is a trustee, the trust (which is not a "natural person") is deemed the purchaser, not the trustee. *Id.*, Question 29.

(n20)Footnote 20. The equity owners of a limited partnership are the limited partners, and the equity owners of a limited liability company are its members. Sec. Act Rel. 6455, *supra*, Question 25.

Thus, for example, if all but one of the shareholders of a corporate investor are accredited investors and the unaccredited shareholder is a director who purchased one share of stock to comply with a requirement that all directors be shareholders of the corporation, the corporation would not be accredited because the director, as an equity owner, is unaccredited. *Id.*, Question 24. The director cannot be accredited under Rule 501(a)(4) because he or she is a director of the investor, not the issuer.

The staff of the Commission does not consider the beneficiaries of a conventional trust to be "equity owners." The result may be different, however, in the case of certain non-conventional trusts where, as a result of powers retained by the grantors, a trust as a legal entity would be deemed not to exist. Thus, where each grantor of a revocable trust is an accredited investor and the trust may be amended or revoked at any time by the grantors, the trust can be accredited because the grantors will be deemed the equity owners of the trust's assets. Lawrence B. Rabkin, Esq., [1982-1983 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,341 (1982); Sec. Act Rel. No. 33-6455, *supra*, Question 30.

Similarly, where an Individual Retirement Account ("IRA") purchases Regulation D securities and the participant in the IRA is an accredited investor, the IRA can be accredited. *Id.*, Question 30.

A trust may also be accredited if all its beneficiaries are accredited investors in the case of a business trust, real estate investment trust, or other similar entities. Sec. Act Rel. No. 33-6455, *supra*.

In Herbert S. Wander, 15 Sec. Reg. & L. Rep. (BNA) 2252(Div. Corp. Fin. 1983), the staff of the Division of Corporation Finance took the position that a trust may be an accredited investor when the grantor is accredited, and when, due to the nature of the trust, the grantor is deemed the equity owner of the trust's assets. In the staff's opinion, where a trust is designed for a family with certain unique tax and investment goals, it has special trust characteristics that qualify it as an accredited investor.

(n21)Footnote 21. Rule 508 excuses certain "insignificant" deviations in a good faith effort to comply with the requirements of Regulation D. Under Rule 508 the failure to comply with a Regulation D requirement not designed to protect specifically the complaining person or a failure to comply that is insignificant to the offering as a whole are insignificant deviations. *See* Sec. Act. Rel. No. 33-6825, [1989 Transfer Binder] CCH Fed. Sec. L. Rep. P 84,404

(1989).

(n22)Footnote 22. See Sec. Act Rel. No. 33-4434, CCH Fed. Sec. L. Rep. PP 2270-77 (1961), and Sec. Act Rel. No. 33-4552, CCH Fed. Sec. L. Rep. Ps 2270-83 (1962). The intrastate offering exemption is discussed in § 3.12 *supra*. The private offering exemption is discussed in § 4.03 *supra*.

In Sonnenblick, Parker & Selvers, SEC No-Action Letter, (pub. avail. Jan. 1, 1986), the staff took the position that a securities offering to an issuer's officers and directors under Rule 504 must be integrated with a public offering to take place within six months of the Rule 504 offering, since both offerings were part of a single plan of financing to provide initial working capital to the issuer.

See also State Street Mortgage Company, SEC No-Action Letter, Fed. Sec. L. Rep (CCH) P 78, 415 (Div. Corp. Fin. 1987), in which the staff could not agree that a proposed offering of subordinated debentures under Section 4(6) to company officers and directors and the offering of negotiable notes to outside investors under Rule 506 of Regulation D should not be integrated. In the staff's view, the proposed offerings were a single plan for financing the Company's mortgage making activities.

In Pacific Physician's Services, Inc., SEC No-Action Letter (pub. avail 1985) the staff advised that an equity offering under Rule 505 of Regulation D to raise capital for the operation of the issuer's business need not be integrated with a Rule 504 offering of stock to employees and independent contractors made to give them a proprietary interest in the issuer and encourage them to continue their employment or service, since the offerings were not made for the same general purpose or as part of a single plan of financing.

In Laser Fax, Inc., SEC No-Action Letter [1985-86 Transfer Binder] CCH Fed. Sec. L. Rep. P 78,136 (1985) the staff stated that a proposed debenture offering under Regulation D must be integrated with a prior Regulation D offering of the issuer's common stock and with a planned public offering of common stock to be made after the debenture offering where:

- (a) the debentures were convertible into common stock of the company;
- (b) the funds to be raised from the offering of the debentures and the planned public offering of common stock were part of a single plan of financing;
- (c) the funds received from all three offerings were to be used for business operations; and
- (d) the debentures were to be offered less than six months after the termination of the first offering and the public offering of common stock was to take place less than six months after termination of the offering of debentures.

But see SEC v. Dunfee [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. P 91,970 (W.D. Mo. 1966) where the defendant sold 6% notes payable in 20 month installments, followed by a period of eight months in which it sold no securities, and then sold 7% notes payable in 36 months. The court held that the latter notes constituted a new issue and that the two offerings should not be integrated.

(n23)Footnote 23. Rule 502(a) Regulation D.

Offers and sales of securities under an employee benefit plan, which is defined in Securities Act Rule 405 as any purchase, savings, option, bonus, appreciation, profit sharing, thrift, incentive, pension, or similar plan solely for employees, directors, trustees, or officers, are permitted during the six month periods. *Id.* Thus, if an issuer commences

an offering in reliance on Rule 506 seven months after completing a Rule 504 offering, and during the seven month period the issuer only offered and sold securities under an employee benefit plan, the issuer would not be required to integrate the separate offerings. Sec. Act. Rel. No. 33-6455, *supra*, Question 53.

Transactions otherwise meeting the requirements of an exemption will not be integrated with simultaneous offerings being made outside the United States effected in a manner that would result in the securities coming to rest abroad. Note, Rule 502(a), Regulation D. *See also* Rules 901-904 (Regulation S).

In Tallgrass Technologies Corp., 18 Sec. Reg. & L. Rep. 578 (BNA) (Div. Corp. Fin. 1986), the staff took the position that securities issued under an issuer's employee stock option plan that provides that options are exercisable during exercise periods set more than six months apart, need not be integrated under Rule 502(a) with other offerings of the employer made between the exercise periods.

See also California Casualty Management Co., SEC No-Action Letter [1984-1985 Transfer Binder] CCH Fed. Sec. L. Rep P 77, 941 (Div. Corp. Fin. 1985).

(n24)Footnote 24. Note, however, that in certain cases Rule 504 investors must be advised in writing of the limitations on resale of the securities. Rule 502(b)(2)(vii), Regulation D.

(n25)Footnote 25. Rule 502(b)(2).

In offerings up to \$2 million, the offeror must furnish the same kind of information as required in Item 310 of Regulation S-B (17 C.F.R. § 239.10) except that the issuer's balance sheet must be dated within 120 days of the start of the offering and be audited. Rule 502(b)(2)(i)(B), as amended in Sec. Act Rel. No. 33-6758, [1987-1988 Transfer Binder] CCH Fed. Sec. L. Rep. P 84, 221 (1988).

An issuer may furnish prospective investors a short form offering memorandum containing a fair and adequate summary of the specified information followed by a complete disclosure document provided all required information is delivered before sale and disclosure in this manner does not obscure material information. Sec. Act. Rel. No. 33-6455, *supra*, Question 40.

An issuer making an offering in reliance on Rule 505 may change an offering originally limited to accredited investors to include sales to non accredited purchasers before completion of the offering without being precluded from relying on Rule 505 for the earlier sales to accredited investors, if the issuer furnishes the accredited investors a complete disclosure document and agrees to promptly refund their funds unless they elect to remain in the program. *Id.*, Question 41.

Regulation D does not provide for a review by the Commission staff of disclosure documents to be used in connection with a Regulation D offering or for consideration by the staff of requests for waiver of disclosure documents. Walnut Valley Special Cable TV Fund, Inc., SEC No-Action Letter [1982 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,237 (1982).

Regulation D sets forth information requirements specifically applicable to foreign private issuers eligible to use Exchange Act Form 20-F. *See* Rule 502(b)(2)(i)(C) and 502(b)(2)(ii)(D), Regulation D.

(n26)Footnote 26. Rule 502(b)(1). *See* Sec. Act Rel. No. 33-6825, [1989 Transfer Binder] CCH Fed. Sec. L. Rep. P 84,404 (1989).

Issuers should consider providing information that is furnished to non accredited investors to accredited investors as well, in view of the antifraud provisions of the federal securities laws.

(n27)Footnote 27. Rule 502(b)(2)(vii).

(n28)Footnote 28. Rule 502(b)(2)(iv).

(n29)Footnote 29. Rule 502(b)(2)(vii) and Rule 502(d). *See § 4.05[2][d] infra. See* Sec. Act Rel. No. 33-6825, [1989 Transfer Binder] CCH Fed. Sec. L. Rep. P 84, 404 (1989).

(n30)Footnote 30. Rule 502(b)(2)(ii)(A), Regulation D.

(n31)Footnote 31. Form S-11, SB-1, or SB-2, or information may be furnished where applicable. Form S-11 is used for securities of certain real estate companies and Form SB-1 is an optional form for public offerings by an issuer for an aggregate cash price not exceeding \$10,000,000. Form SB-2 is a form used to register securities to be sold for cash by "small business issuers."

The requirement to "furnish the information contained in a registration statement on Form S-1" should be construed to mean Part 1 of Form S-1. Sec. Act. Rel. No. 33-6455, *supra*, Question 50.

As part of its program of integrated disclosure under the Securities Act and Exchange Act, the Commission adopted a three-tier system of registration under the Securities Act. Form S-1 represents the third tier and is available for issuers in the Exchange Act reporting system for less than three years, such as new issuers, or for issuers for which no other form is authorized or prescribed. Sec. Act Rel. No. 33-6383, CCH Fed. Sec. L. Rep. P 956 (1982). For detailed discussion of the Commission's integrated disclosure program, including Form S-1, *see ch.7 infra*. The Forms issued by the SEC under the Securities Act are reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section D (Matthew Bender).

(n32)Footnote 32. Rule 502(b)(2)(ii)(B), Regulation D.

Although the requirement under subparagraph (B) refers to specific documents, it does not mandate delivery of the actual documents.

(n33)Footnote 33. *Id.*, Rule 502(b)(2)(ii)(C).

In determining what is the appropriate form of disclosure under Regulation D for a reporting issuer whose last registration statement was filed more than two years ago and that does not have an annual report to shareholders or related proxy statement or a Form 10-K for its most recent fiscal year (e.g., the issuer has December 31 fiscal year and the offering is being made the following February), the issuer may base its disclosure on the most recently completed fiscal year for which an annual report to security holders or Form 10-K was timely distributed or filed. The issuer should supplement the information in the report used with information contained in any reports required to be filed under the Exchange Act since the distribution or filing of that reported and briefly describe the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs not disclosed in the documents furnished. Sec. Act Rel. No. 33-6455, *supra*, Question 51.

(n34)Footnote 34. Rule 502(b)(2)(i)(A). Regulation A and Form 1-A are discussed in ch.5 *infra*.

(n35)Footnote 35. Rule 502(b)(2)(i)(B)(1). Regulation S-B, the counterpart of Regulation S-X for "small business issuers" is discussed in § 7.04[3] *infra*, and is reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume D, Section J (Matthew Bender).

(n36)Footnote 36. Rule 502(b)(2)(i)(B)(2). Form SB-2, for the registration of securities to be sold to the public for cash by "small business issuers," is discussed in § 7.04[3] *infra*.

(n37)Footnote 37. Rule 502(b)(2)(i)(B)(3). In all offerings in excess of \$2,000,000, if the issuer is a limited

partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of Federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant. Rule 502(b)(2)(i)(B)(2) and (3).

(n38)Footnote 38. Rule 502(b)(2)(i), Regulation D.

See Acorn Property Partners II Limited Partnership, SEC No-Action Letter, (pub. avail.1983), in which the staff took the position that the operating history of property being purchased by a real estate partnership and occupied by the seller under a net lease from the partnership was immaterial to offerees of partnership interests and therefore could be excluded from the partnership's offering material under Rule 502(b)(2)(i).The staff stated that since the tenant would operate the building and pay a fixed rent to the partnership regardless of the building's profitability, the operating history of the property would shed no light into the partnership's business or financial status and would be irrelevant; Peter I. Mason, Esq., SEC No-Action Letter, [1982-1983 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,405 (Div. Corp. Fin. 1983) (financial statement disclosure requirement of Rule 505 may be satisfied by furnishing an audited balance sheet as of the issuer's most recently completed fiscal year end).

(n39)Footnote 39. Rule 502(b)(2)(iii), Regulation D.

The issuer must also provide to each purchaser the opportunity to ask questions and to receive answers concerning the terms and conditions of the offering.

Among the exhibits that must be listed in the Regulation D offering material as exhibits that will be made available to purchasers on request are an opinion by counsel concerning the legality of the securities and a tax opinion if the tax consequences of the investment are material; presumably the tax consequences in an oil and gas offering will be material. Hopper, Kanouff, Smith and Peryam, CCH Fed. Sec. L. Rep. P 77,300 (Div. Corp. Fin. 1982); Sec. Act Rel. 6445, *supra*, Question 52.

See also Peter I. Mason Esq., SEC No-Action Letter [1982-1983 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,405 (Div. Corp. Fin. 1983)(in the context of promotional entities raising capital to develop oil and gas leases by selling fractional undivided interests in leases, the Rule 502(b)(2)(iii) identification of exhibits requirement is satisfied by the industry practice of providing an opinion of counsel stating that the promotional entity is duly organized and has the power to convey title to any oil and gas lease in which it has an interest).

(n40)Footnote 40. See § 4.04 [4] *infra* for discussion of Rule 504, the exemption from registration for limited offerings and sales of securities not exceeding \$1,000,000.

(n41)Footnote 41. See, e.g., Woodtrails-Seattle, Ltd., SEC No-Action Letter, (pub. avail. August 1, 1982)(although Rule 502(c) ordinarily prohibits the offer or sale of securities by general solicitation or advertising, a partnership may mail an offering statement to about 330 persons who have invested in other limited partnerships sponsored by the same general partner over the past three years without registration since each prospective offeree had a pre-existing business relationship with the general partner and the general partner believed that each prospective offeree had adequate financial and business experience to evaluate the investment). In Tax Investment Information Corp., SEC No-Action Letter, [1982-1983 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,379 (Div. Corp. Fin. 1983) the staff refused to agree that a Louisiana company formed to analyze private placement offerings and provide the issuer analyses solely to accounting and legal professionals within the state would not be engaged in activities constituting general solicitation or advertising of offerings being sold in contemplation of a Regulation D exemption, although the publisher was independent from the issuers and offerings being analyzed.

See Nancy H. Blasberg, SEC No-Action Letter, (pub. avail.1986), in which the staff took the position that publication of a guide containing information about certain privately placed and closely held preferred stocks, that would be sold to

institutional investors and investment banking firms, would not violate the prohibition against advertising in Rule 502(c) provided that the publisher was not employed by or acting as agent for any issuer mentioned in the guide, and the guide will only contain certain limited information on completed offerings.

In Webster Management Assured Return Equity Management Group Trust, SEC No- Action Letter, (pub. avail. Feb. 7, 1987), the staff refused to take a no action position with respect to the proposed sale by a broker-dealer of interests in a commingled trust to certain employee benefit plans in reliance on the Regulation D exemption. The staff noted that since the broker-dealer has no preexisting relationship with some of the plans that it proposed to solicit, and since some of the plans may not be accredited investors, the offering may be deemed a "general solicitation" for purposes of Rule 502(c), making the Regulation D exemption unavailable.

In H. B. Shaine & Co., Inc., SEC No-Action Letter (pub. avail. May 1, 1987), the staff took the position that a broker-dealer would not violate Section 502(c) in offering securities under Regulation D to investors whose sophistication and financial circumstances were determined by their responses to a questionnaire circulated by the broker-dealer to its established customers.

Although a solicitation is directed only to accredited investors, it will not necessarily be deemed in compliance with Rule 502(c). Sec. Act Rel. No. 33-6445, n.1 *supra*, Question 60. In the same release, the staff declined to express an opinion on a proposed tombstone advertisement that would announce the completion of an offering since the requesting letter did not describe the proposed use of the announcement. The staff reasoned that the announcement of the completion of one offering could be an indirect solicitation for a new offering. *Id.* Volume 3.C.

In Texas Capital Network, SEC No-Action Letter (pub. avail. February 23, 1994), the staff informed a service which matched business ventures with potential investors that its activities would not involve general solicitation or advertising pursuant to Rule 502(c), even though the service was publicized through articles prepared by business magazines and newspapers. All potential investors were required to represent that they were accredited or sophisticated investors and entrepreneurs did not receive lists of potential investors. *See also* Michigan Growth Capital Symposium, SEC No-Action Letter (pub. avail. May 4, 1995); and The Colorado Capital Alliance, Inc., SEC No-Action Letter (pub. avail. May 4, 1995). Concerning a rather unique set of circumstances, the SEC staff stated in Circle Creek Aqua Culture V, L.P., SEC No-Action Letter (pub. avail. March 26, 1993) that the issuer's previous public offering for a "blind pool," later deregistered without any sales, would constitute a "general solicitation" under Rule 502(c). The issuer had used public solicitation in connection with its aborted public offering and intended to use the services of the same broker/dealers in the proposed private offering who had worked in the previous public offering. The staff of the SEC stated in Pennsylvania Securities Commission, SEC No-Action Letter (pub. avail. January 16, 1990) that a cold mass marketing to a minimum of 200 persons summarizing a private placement memorandum under Rules 505 and 506, even though made only to broker/dealers, investment advisers, accountants and attorneys, would constitute "general solicitation" under Rule 502(c).

(n42)Footnote 42. *See* § 4.05[4] *infra* for discussion of Rule 504, the exemption from registration for limited offers and sales of securities not exceeding \$1,000,000.

(n43)Footnote 43. Section 4(2), the private offering exemption from registration, is discussed in § 4.03 *supra*.

(n44)Footnote 44. Section 2(11) is discussed in § 4.02 [2] *supra*.

In WCRS Group, SEC No-Action Letter (pub. avail. Jan. 8, 1987), the staff expressed the view that the resale restrictions of Rule 502(d) would be satisfied if holders of unregistered shares acquired under Regulation D in an exchange offer resold those shares only to non-United States citizens or non-United States residents, particularly since there was no market for the shares in the United States and no reasonable likelihood that a market will develop.

(n45)Footnote 45. Rule 502(d)(1)-(3), Regulation D.

These three steps, while sufficient in themselves to satisfy the reasonable care standards, are not exclusive, and other actions by the issuer may satisfy this provision. Rule 502(d).

(n46)Footnote 46. Copies of Form D may be obtained from the Public Reference Branch of the Commission's main office or any of the Commission's regional or branch offices. There is no filing fee.

(n47)Footnote 47. Section 4(6), the exemption from registration for offers or sales to accredited investors, is discussed in § 4.08 *supra*.

(n48)Footnote 48. See Sec. Exch. Act Rel. No. 34-6825, CCH Fed. Sec. L. Rep. P 84,404 (1989).

(n49)Footnote 49. Rule 503(a), Regulation D. Since the "first sale" in a minimum-maximum Rule 503 offering where subscription funds are held in escrow pending receipt of minimum subscriptions occurs upon receipt of the first subscription agreement and the deposit of the first funds into escrow, the issuer must file its first Form D within 15 days after the receipt of the first subscription agreement. Sec. Act Rel. No. 33-6455, *supra*, Question 82. As to an employee stock option plan, the first Form D should be filed within 15 days after the exercise of the first option. *Id.*, Question 84.

Form D may be signed on behalf of the issuer by any duly authorized person, including the issuer's attorney. *Id.*, Question 92.

(n50)Footnote 50. Sec. Act Rel. No. 33-8891 (Feb. 27, 2008), amending 17 C.F.R. § 230.503 and other rules.

(n51)Footnote 51. Mandated electronic filing of Form D became effective March 16, 2009.

(n52)Footnote 52. Section 3(b), which gives the Commission the authority to exempt from registration a securities offering with an aggregate offering price not exceeding \$5 million, is discussed in ch.5 *infra*.

In Pacific Physician Services, Inc., SEC No-Action Letter, (pub. avail. August 20, 1985), the staff took the position that a Rule 504 offering could be made during the 12 month period either preceding or following a Rule 506 offering without the offering price of securities sold pursuant to Rule 506 being aggregated to determine the amount of securities sold in the Rule 504 offering, since the Rule 506 offering was not pursuant to an exemption under Section 3(b). Rule 506 was enacted under Section 4(2).

(n53)Footnote 53. Section 5 (a) prohibits the sale of securities unless a registration statement is in effect.

If seven months before a proposed Rule 504 offering the issuer conducted a rescission offer under Rule 504 for securities sold in violation of Section 5 more than twelve months before the proposed offering, the aggregate offering price of the proposed offering should not be reduced by the amount of the rescission offer or the earlier offering in violation of Section 5. Sec. Act Rel. No. 33-6455, *supra*, Question 69. The staff of the Commission took the position that the rescission offer relates back to the offering in violation of Section 5 and, therefore, should not be deducted from the aggregate offering price for the proposed Rule 504 offering. See also the questions concerning the calculation of aggregate price under Rule 505 *infra*.

(n54)Footnote 54. Rule 504(a), Regulation D. The Division of Corporation Finance, however, has taken the position that the restriction as to investment companies should be construed to mean an investment company as that term is used in Section 3 of the Investment Company Act of 1940. Sec. Act Rel. No. 33-6455, *supra*. See Foley & Lardner, SEC No-Action Letter (pub. avail. 1982) in which the Division opined that the availability of Rule 504 to an exempt investment company under Section 3 (c) of the Investment Company Act is dependent upon whether the individual offering is deemed public or private.

Rule 504 is available to a foreign private issuer that is not subject to the reporting requirements of Section 15 (d) of

the Exchange Act and the securities of which are exempt from registration under Exchange Act Rule 12g3-2. Sec. Act Rel. No. 33-6455, *supra*, Question 62.

(n55)Footnote 55. Rule 501(c), Regulation D.

If the sole general partner of a real estate limited partnership contributes property to a program, the property need not be valued and included in the proceeds of the offering as part of the aggregate offering price if the property is contributed in exchange for a general partnership interest. Sec. Act Rel. No. 33-6455, *supra*, Question 31. If the owner of a mining or oil and gas property sells interests in the property to investors for cash and retains a royalty interest in the property, any subsequent royalty payments to the issuer need not be included in the aggregate offering price of the property interests, since the royalty payments are treated as operating expenses, not capitalized costs, for the property and are, therefore, not deemed to be part of the consideration received by the issuer for issuance of the securities. *Id.*, Question 32.

Interest payments are not deemed to be consideration for the issuance of securities and need not be included in the aggregate offering price for securities acquired by installment payments. *Id.*, Question 33.

Additional voluntary assessments that are undetermined at the time of the offering of interests in an oil and gas limited partnership and that may be called by the general partner for developmental drilling activities should not be included in the aggregate offering price of the original issuance unless they are required to be integrated with that issuance since the assessments may never be called, and if called, it is uncertain at what level they may be called. *Id.*, Question 34. Mandatory, non contingent assessments for interests in an oil and gas limited partnership for which investors are personally liable, however, must be included in the aggregate offering price. *Id.*, Question 35; Kim R. Clark, Esq., SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77, 359 (Div. Corp. Fin. 1982).

An investor's irrevocable letter of credit delivered as part of its purchase of securities must be considered part of the aggregate offering price if the letter of credit is drawn against. In planning the transaction, the full amount of the letter of credit should be included in determining the aggregate offering price. Sec. Act Rel. No. 33-6455, *supra*, Question 36.

Proceeds from sales to foreign purchasers need not be included in the aggregate offering price. Preliminary Note 7 to Regulation D.

A capital call to be made by the controlling partner of a limited partnership need not be included in the calculation of the aggregate offering price for purposes of the dollar limitation of Rule 504. United States Cellular Corporation, SEC No-Action Letter (pub. avail. June 22, 1990).

(n56)Footnote 56. Rule 501(c), Regulation D.

(n57)Footnote 57. Rule 501(c), Regulation D.

In Uptown Federal Savings & Loan Association SEC No-Action Letter (pub. avail. August 30, 1982), the Division of Corporation Finance took the position that voting trust certificates offered in exchange for the common shares of a savings and loan association resulting from a merger would not qualify for the exemption provided by Rule 504 since the post merger net worth of the resulting association was expected to exceed \$500,000 (the maximum aggregate offering price in effect at the time), although the premerger book value of the shares exchanged was less than \$500,000.

(n58)Footnote 58. Sec. Act Rel No 33-7644 [1999 Transfer Binder] CCH Fed. Sec. L. Rep. P 86,114.

(n59)Footnote 59. Section 3(b), which gives the Commission the authority to exempt from registration a securities offering with an aggregate price not exceeding \$5 million, and the particular exemptions adopted pursuant to the authority are discussed further in ch.5 *infra*.

(n60)Footnote 60. Section 5 (a) prohibits the sale of securities unless a registration statement is in effect.

If an issuer that proposes to conduct an equity offering under Rule 505 raised \$2 million from the sale of debt instruments under Rule 505 during the eight months preceding the proposed equity offering, the \$2 million must be deducted from the \$5 million ceiling so that the issuer may raise up to \$3 million in the proposed offering. Sec. Act Rel. No. 33-6455, *supra*, Question 67. If an issuer planning a Rule 505 offering conducted a Rule 506 offering ten months prior to the Rule 506 offering, the Rule 506 offering should not be counted in calculating the allowable aggregate offering price for the proposed Rule 505 offering since Rule 506 was issued under Section 4(2) rather than Section 3(b). *Id.*, Question 68. However, the offering amounts in Rule 504 and Rule 505 offerings will be aggregated since both fall under Section 3(b) of the Securities Act. See *In re Pacific Physician Services, Inc.*, 17 Sec. Reg. & L. Rep. (BNA) 1630 (1985).

The general principle on limiting the aggregate offering price set forth in Note 2 to Rule 504 is applicable to Rule 505 although it is not specifically restated in Rule 505. Note 2 to Rule 504 provides that if, as a result of one offering, an issuer exceeds the allowed aggregate offering price in a subsequent nonintegrated offering, the exemption for the first offering will not be affected. *Id.*, Question 71.

(n61)Footnote 61. Rule 501(e), Regulation D.

Relatives of purchasers who are accredited investors need not be included in the calculation of the number of purchasers in a Rule 505 or 506 offering. Sec. Act. Rel. No. 33-6455, *supra*, Question 59.

(n62)Footnote 62. So-called "bad boy" disqualifications from the use of SEC Regulation A are set out in Securities Act Rule 262, 17 C.F.R. § 230.262, and include such things as prior criminal convictions or enforcement proceedings.

An issuer that was censured as a broker pursuant to a Commission order is not prohibited from using Rule 505, since only issuers subject to the disqualifications for use of Regulation A would not be able to use Rule 505. Although one such disqualification occurs when the issuer is subject to a Commission order under Exchange Act Section 15(b), since a censure has no continuing force, the issuer would not be deemed to be subject to a Commission "order." Sec. Act Rel. No. 33-6455, *supra*, Question 66.

(n63)Footnote 63. Rule 505(b)(iii), Regulation D.

The Commission has delegated authority to the Division of Corporation Finance to grant applications for relief from the issuer disqualification provisions of Rule 505. Sec. Act Rel. No. 33-6644, [1986-1987 Transfer Binder] CCH Fed. Sec. L. Rep. P 84, 002 (1986).

(n64)Footnote 64. 17 C.F.R. § 230.506.

(n65)Footnote 65. For purposes of Rule 506, the term "purchaser representative" is defined to be any person, or any person the issuer reasonably believes, that:

(1) is not an affiliate, director, officer, or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the purchaser is:

(a) a relative of the purchaser representative by blood, marriage, or adoption and not more remote than a first cousin;

(b) a trust or estate in which the purchaser representative and any persons related to him (as specified in paragraphs (a) above or (c) below) collectively have more than 50 percent

1-4 Federal Securities Act of 1933 § 4.05

of the beneficial interest (excluding contingent interest) or of which the purchaser representative serves as trustee, executor, or in any similar capacity; or

(c) a corporation or other organization of which the purchaser representative and persons related to him (as specified in paragraphs (a) or (b) above) collectively are the beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests;

(2) has such knowledge and experience in financial and business matters that he is capable of evaluating alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment;

(3) is acknowledged by the purchaser in writing, during the course of the transaction, to be his purchaser representative in connection with evaluating the merits and risks of the prospective investment; and

(4) discloses to the purchaser in writing, a reasonable time prior to the sale of securities to that purchaser any material relationship between himself or his affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.



52 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.06

AUTHOR: Robert N. Rapp

§ 4.06 The Dealer Exemption--Section 4(3)

As previously discussed, Section 4(1) of the Securities Act exempts transactions by persons *other than* issuers, underwriters, or dealers. Specifically including dealers along with underwriters and issuers as persons ineligible to rely on section 4(1) clearly recognizes the key role that dealers play in the selling process that is a key aspect of distributions of securities. Indeed, Section 2(12) of the Securities Act defines dealer as "any person who engaged either for all or part of his time, directly, or indirectly, as agent, broker, or principal, in the business of offering, buying, selling or otherwise dealing or trading in securities issued by another person." n1 Nevertheless, in recognition of the fact that dealers engage in countless transactions every day as market participants involving securities that are not part of any distribution, and for which there is no reason to require compliance with registration and prospectus delivery requirements of section 5 of the Securities Act, section 4(3) provides a specific exemption from section 5 for transactions by dealers.

Section 4(3) is not, however, a simple exemption. Because of the key role of dealers as intermediaries in securities markets, section 4(3) prescribes its own set of *exceptions* to the exemption it creates, all of which are based on the key role that dealers play in the distribution of securities, and which are designed to assure that in that context the prospectus delivery requirements of Section 5 of the Act will be met. These exceptions operate to require all dealers to comply with section 5 prospectus delivery requirements n2 for certain periods of time for transactions in any security that is part of a public offering by an issuer or by or through an underwriter. The section 4(3) exceptions to the exemption are for:

(A) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide first offered to the public by the issuer or by or through an underwriter,

(B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days from the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and

1-4 Federal Securities Act of 1933 § 4.06

(C) transactions as to securities constituting the whole or part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter. n3

The forty day prospectus delivery period for dealers is extended to ninety days after effective date or the bona fide public offering date with respect to transactions in securities that are included in a registration statement filed by an issuer when securities of that issuer have not previously been sold pursuant to an earlier effective registration statement. n4 As exception (C) also makes clear, dealers who are part of a selling group or syndicate, and who thus are direct participants in the offering, are subject to section 5 prospectus delivery when selling any part of an allotment of the securities, without regard to time periods. n5

The construction of section 4(3) is such that in the case of registered securities, the dealer exemption will not be available to any dealer participating in the distribution so long as it has an unsold allotment or subscription. However, dealers who are merely trading and are not participants in the distribution will be subject to the provisions of Section 5 of the Securities Act only during the applicable forty or ninety day period. n6

Further complicating Section 4(3), the exceptions to the exemptions are themselves modified further by SEC Rule 174 under the Securities Act. n7 Rule 174 identifies numerous exceptions to the forty or ninety prospectus delivery requirements for dealers. Rule 174(b), for example, provides that no prospectus need be delivered under section 4(3) if the issuer is a reporting company under the Exchange Act immediately prior to the filing of a registration statement. This exception is particularly meaningful for distributions of securities in connection with corporate merger or reorganization transactions. n8 Rule 174 eliminates the statutory period with respect to delivery of a prospectus on resales of securities of an issuer which, immediately prior to the time of filing the registration statement, was subject to the reporting requirements under the Exchange Act, no matter how soon after the public offering the resale occurs. Rule 174 shortens the statutory period to 25 days with respect to the security of an issuer that is not subject to the Exchange Act reporting requirements immediately prior to the time of filing the registration statement, if, as of the offering date, the security is listed on a national securities exchange or the Nasdaq Stock Market. Rule 174 also provides relief for qualifying "shelf" registered offerings. n9 Nevertheless, Rule 174 also makes clear:

Nothing in this section shall affect the obligation to deliver a prospectus pursuant to the provisions of section 5 of the Act by a dealer who is acting as an underwriter with respect to the securities involved or who is engaged in a transaction as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter. n10

In 2005, Rule 174 was modified to accommodate newly adopted Rule 172 under the Securities Act. Rule 172 n11 Under Rule 172, a prospectus meeting the requirements of Section 10(a) will be deemed to accompany or precede the delivery of a security sold under a registration statement if such a prospectus is timely filed in EDGAR, the SEC's electronic filing system. Compliance with the Section 4(3) dealer exemption requirements for prospectus delivery may now be met by compliance with the provisions of Rule 172. n12

The construction of section 4(3) creates a dilemma for dealers in circumstances involving registration and distribution of securities by issuers with securities already issued and outstanding. Dealers may trade in the *outstanding* securities without complying with the prospectus requirements. The SEC has stated that it is unlawful for a dealer to effect transactions in unregistered securities which are about to be registered, but that dealers may ordinarily trade in other outstanding securities of the same class which are not being registered or involved in a distribution or public offering. n13 There is no guidance, however, for the dealer in distinguishing between the outstanding shares and the newly offered shares. Thus, despite the fact that certain securities in which the dealer may propose to trade are already outstanding, the dealer, in order to insure compliance with the Securities Act, should observe the prospectus requirements for the statutory period in connection with *all* transactions in securities of the class in question. n14

FOOTNOTES:

(n1)Footnote 1. The word "broker" was included in this definition to "subject brokers to the same advertising restrictions that are imposed upon dealers, so as to prevent the broker from being used as a cloak for the sale of securities." H.R. Rep. No. 85, 73d Cong., 1st Sess. 14 (1933), reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section E (Matthew Bender).

(n2)Footnote 2. Section 5(b) provides:

It shall be unlawful for any person, directly or indirectly--

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

The Securities Act is reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section B (Matthew Bender).

(n3)Footnote 3. Securities Act § 4(3)(A)-(C), 15 U.S.C. §§ 77c(3)(A)-(C).

(n4)Footnote 4. This extension of the statutory prospectus delivery period was added to section 4(3) as part of amendments in 1964 designed to address "hot issue" problems, and to make information available to investors during the course of active solicitation and trading of new issues in the aftermarket. A period of ninety days was seen as a more realistic appraisal of the time during which the distribution process continues in the case of many new issues. See S. Rep. No. 739, 88th Cong., 1st Sess. 28 (1963); see also H.R. Rep. No. 1418, 88th Cong., 1st Sess. 31 (1964), reprinted in the Securities Primary Law Sourcebook, Volume A, Section E (Matthew Bender).

See also Securities Act Rel. No. 33-4725, CCH Fed. Sec. L. Rep. P 77,127 (1964).

(n5)Footnote 5. The availability of section 4(3) thus depends upon an examination of the timing of sales in relation to a bona fide public offering date. In *UBS Asset Management (New York), Inc. v. Wood-Gundy Corp.*, 914 F. Supp. 66 (S.D.N.Y. 1966), a defendant dealer argued that section 4(3) applied to transactions in debt securities that took place more than forty days after the first date upon which the securities were offered to the public. The complaint, however, alleged that the subject securities were sold on various dates and had different maturity dates. Plaintiffs claimed that the securities were actually offered to the public on various dates in separate offerings. The court concluded that whether the sales were separate offerings, and thus subject to separate scrutiny under section 4(3), is a question of fact, and denied the defendant dealer's motion to dismiss.

For the purpose of determining a dealer's exemption under Section 4(3), a "bona fide" offer to the public may occur when the stock first appears in the "pink sheets" even though the stock may be unregistered, and thus illegally offered. *Kubik v. Goldfield*, 479 F.2d 472, 475 (3d Cir. 1973).

See also *Lustgarten v. Teller*, 304 F. Supp. 771 (E.D. Pa. 1969); *SEC v. North American Research & Development*

Corp., 280 F. Supp. 106, 125 (S.D.N.Y. 1968) , *aff'd in part, modified in part*, 424 F.2d 63 (2d Cir.1970) .

(n6)Footnote 6. See S. Rep. No. 1036, 83d Cong., 2d Sess. 14 (1954), reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section E (Matthew Bender).

(n7)Footnote 7. 17 C.F.R. § 230.174.

(n8)Footnote 8. See, e.g., Friedman, Billings, Ramsay Group, Inc., SEC No-Action Letter, 2003 SEC No-Act LEXIS 459 (Mar. 25, 2003).

To facilitate reliance on section 4(3) by allowing the Rule 174(b) exception to prospectus delivery requirements that would otherwise apply, the SEC has often granted no-action advice allowing a successor entity in such reorganization transactions to be treated as an issuer subject to Exchange Act reporting requirements for purposes of Rule 174. See, e.g., Weatherford International, Inc., SEC No-Action Letter, 2002 SEC No-Act LEXIS 612 (June 25, 2002); ConocoPhillips, SEC No-Action Letter, 2002 SEC No-Act LEXIS 688 (Aug. 23, 2002).

(n9)Footnote 9. Additionally, Rule 174 modifies or eliminates the statutory period with respect to certain other offerings. See Fed. Sec. L. Rep. (CCH) P 2862. The rules under the Securities Act are reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section C (Matthew Bender). Item 502(e) of Regulation S-K is designed to insure that dealers will be apprised of their obligations to deliver a prospectus by requiring a statement to be included in the prospectus stating the date on which the relevant 40- or 90-day period will expire.

If a post-effective amendment is filed *after* the expiration of the prospectus delivery period for the initial public offering, the statement specified in Item 502(e) of Regulation S-K is not required to be set forth in the post-amendment prospectus, since a new forty or ninety day period does not begin. However, if the post-effective amendment is filed *before* the end of the prospectus delivery period, the specified statement must be included. In such a case the period specified would begin with the effective date of the registration statement or the commencement of the public offering, whichever is later. Regulation S-K is reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume D, Section K (Matthew Bender).

(n10)Footnote 10. Rule 174(f), 17 C.F.R. § 230.174(f).

See also *SEC v. Great Lakes Equities Co.*, 1990 U.S. Dist. LEXIS 19819 (E.D. Mich. 1990) .

(n11)Footnote 11. 17 C.F.R. § 230.172.

(n12)Footnote 12. See Sec. Act Rule 174(h), 17 C.F.R. § 174(h), which provides:

Any obligation pursuant to Section 4(3) of the Act and this section to deliver a prospectus, other than pursuant to paragraph (g) of this section, may be satisfied by compliance with the provisions of Rule 172.

Paragraph (g) of Rule 174 applies to offerings of securities by a "blank check company," for which the statutory period for prospectus delivery specified in Section 4(3) will not terminate until 90 days after the date funds and securities are released from the escrow or trust account.

(n13)Footnote 13. See Sec. Act. Rel. No. 6383, [1982-1983 Transfer Binder] CCH Fed. Sec. L. Rep. P 77,328 (1982).

(n14)Footnote 14. The exemption provided by Section 4(3) is expressly limited to transactions by a dealer. In some

circumstances a broker-dealer may not qualify as a dealer within the definition contained in Section 2(12) of the Securities Act. In *Bank of America Corporation*, SEC No-Action Letter (June 11, 2009), and *J.P. Morgan Securities, Inc.*, SEC No-Action Letter (June 5, 2007), complex transactions in "baskets" of securities by customers were addressed in circumstances in which the basket of securities sold by a dealer includes securities of an affiliate. Section 2(12) of the Securities Act limits the definition of "dealer" to a person in the business of dealing or trading "securities issued by another person." When a broker-dealer offers or sells securities issued by its affiliate, those securities are not considered as being "issued by another person," and thus a broker-dealer selling those affiliate securities would not be deemed to be a dealer under Section 2(12) and the Section 4(3) exemption would not be available. In these no-action letters the SEC staff addressed the concern, confirming that the Section 4(3) dealer exemption would be available for sales of affiliate stock in order to facilitate customer transactions in particular "baskets" of stocks, and under certain conditions.



53 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.07

AUTHOR: Robert N. Rapp

§ 4.07 Broker Transactions--Section 4(4)

[1] Brokerage Transactions--Generally

Securities Act section 4(4) n1 provides an exemption from the registration requirements of section 5 of the Securities Act for "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders." Ordinary brokerage transactions in the context of a normal trading environment bear no indicia of a distribution of securities. On the other hand, particular circumstances may be such that a "brokerage" transaction is in fact part of a secondary distribution of securities in which the broker plays a facilitating role. A broker who is aware of circumstances indicating that the person for whose account securities are being sold is an underwriter with respect to the securities, or that the transaction is part of a distribution of securities of the issuer, does not effect an "ordinary" brokerage transaction and may not rely on section 4(4). n2 The greatest attention to section 4(4) of the Securities Act has been devoted to these circumstances, in which a broker, acting as agent, may in fact be a link in the chain of a distribution and thus precluded from relying on the exemption for brokers' transactions in effecting a sale.

In modern analyses and applications, the section 4(4) exemption has evolved alongside SEC Rule 144, which creates a safe harbor for sales of securities by control persons and others in circumstances that could otherwise force compliance with the registration and prospectus delivery requirements of section 5 of the Securities Act. n3 Assuring the availability of the section 4(4) exemption for brokerage transactions is an important aspect of the Rule 144 safe harbor, and doing so requires assurance that the broker effecting transactions is not deemed to be acting as or for an underwriter. Bona fide "brokers' transactions" are thus an essential element of Rule 144. Rule 144 provides that the term "brokers transactions" set out in Section 4(4) of the Act includes any transaction in which the broker:

- (a) does no more than execute customers' orders to sell securities on an agency basis;
- (b) receives no more than the customary broker's commission; and
- (c) does not solicit customers' order to buy the securities.

Rule 144 further provides that the broker must be satisfied, based on reasonable inquiry, that the person for whose

account the securities are sold is not an underwriter with respect to the securities. n4 Transactions must also conform to the manner-of-sale requirements set out in the Rule.

As a general principle involved in all section 4(4) considerations, however, a broker relying on the exemption must make whatever inquiries are necessary to determine that the transaction is not part of an unlawful distribution. Indeed, as early as 1962 the SEC offered guidance on what is required generally by brokers who rely on section 4(4):

The amount of inquiry called for necessarily varies with the circumstances of particular cases. A dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for. n5

Thus far the language and purpose of the section appear plain and simple. But, as so often happens, through interpretation the meaning of the section became vague. For example, assume that X, a controlling person, wishes to sell securities through a broker. Assuming that X complies with the quantitative and other limitations of Rule 144, is it not reasonable to assume that such a *transaction* is entitled to the Section 4(4) exemption? After all, the section does exempt "brokers' transactions." But the position was taken at an early date that the exemption applies only to the broker's part of the transaction and does not extend to the selling customer, who must find a separate exemption. n6 Consequently, what appeared to be a transaction exemption has become a "brokers' exemption," even though the broker is acting as the seller's agent. n7 In practical effect, the *ordinary seller* may rely on Section 4(1) which exempts "transactions by any person other than an issuer, underwriter, or dealer," for "seller" falls within none of these categories. n8 But the problem is intensified when a person in a control relationship with the issuer wishes to sell securities through a broker. The point is that the exemption contained in Section 4(1) may not be available to the control person for the reason that the control person is an "issuer" or an "underwriter," as defined in the last sentence of Section 2(a)(11) of the Securities Act. n9

[2] Sales by Controlling Persons in Brokerage Transactions

The registration requirements of Section 5 apply both to the distribution of a new issue and to a redistribution of outstanding securities which "takes on all the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering." n10 Thus, secondary *distributions* by controlling shareholders must be registered unless an exemption for particular sales is available to cover all aspects of the transaction. If a broker is selling for a controlling person in connection with a distribution, that broker is acting as an *underwriter* rather than as a broker. Consequently, the sales on behalf of the controlling person are not "brokers' transactions" and are not exempt under Section 4(4). If the securities are not registered, the broker will have violated section 5, and the controlling person will likewise be exposed to liability as participating in or aiding and abetting the Section 5 violation. n11 It is obvious, then, that the terms "underwriter" and "distribution" are of prime importance for the purpose of determining the availability of an exemption for sales by controlling persons.

As discussed previously, n12 the last sentence of Section 2(11) defines a controlling person as an "issuer" for the purpose of determining whether the person who sells for him is an "underwriter." The purpose of that last sentence is to require registration of secondary distributions through underwriters by controlling stockholders. n13 A common example occurs when one makes a secondary distribution of securities for the account of a person who is in a control relationship with the issuer of the securities. Accordingly, when Section 2(11) is read in conjunction with Section 4(1)("transactions by any person other than an issuer, underwriter or dealer") and Section 4(4), the following principles emerge:

- If X is in control of ABC, Inc., she is an "issuer" for the purpose of making any person who purchases from him or sells for him in connection with a public distribution of his securities an underwriter.
- If X, the controlling person, purchases her securities with a view to distribution, she herself is an "underwriter," making the exemption under Section 4(1) unavailable to her. n14

It should be stressed, however, that in the foregoing examples or in similar situations involving controlling persons, the Section 4(1) exemption is unavailable to the seller and the Section 4(4) exemption is unavailable to the broker *only if the "underwriter" takes from the "issuer" with a view to distribution*. Put another way, all underwriting involves distribution. Thus if B a broker, sells securities for X, a controlling person, and the transaction does not involve a "distribution," B is acting as a broker rather than as an underwriter, thus making the Section 4(4) exemption available to him and the Section 4(1) exemption available to X, assuming that X is also not engaged in a distribution.

Prior to the *Haupt* case, n15 the position of the Commission was to the effect that even "an *underwriter* selling for a controlling person over the exchange might conceivably be entitled to the exemption under Section 4(4) if his activities were confined strictly to the usual brokerage functions, but that as a practical matter, his activities could not be so confined in connection with a distribution of any *substantial block of securities*." n16 The Commission went on to state, however, that such an interpretation was given before it realized that "large blocks can frequently be sold without solicitations or other sales activity." (Approximately 93,000 unregistered shares had been distributed in such a manner by Ira Haupt & Co. for the Schulte interests, controlling shareholders in Park & Tilford). Accordingly, against the background of a "very different market," the pre-1946 interpretation, to some extent at least, was "overruled."

The actual holding in the *Haupt* case was that a broker making a distribution for a controlling shareholder acts as an underwriter and may not rely on the exemption in Section 4(4) for brokers' transactions. The opinion took the position that Section 4(4) was intended to distinguish between "trading" (exempt) and "distribution" (nonexempt) transactions. Much was made of this distinction; but the opinion caused confusion among brokers because of the absence of any concrete definitions of "trading" and "distribution." In short, the *Haupt* case left open the question of when a broker was acting as a broker rather than as an underwriter. Today, however, Rule 144 provides objective standards for persons other than the issuer for selling restricted and control securities without Section 5 registration. The rule establishes conditions under which persons will not be deemed to be engaged in a distribution and therefore no underwriters will be involved. n17

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77d(4).

(n2)Footnote 2. The section 4(4) exemption is not available to a registered representative acting as an agent who has reasonable grounds to believe that his or her principal is an underwriter with respect to the securities being sold. *In re Carly*, Admin. Proc. File No. 3-11626, *Init. Dec. Rel. No. 292*, 2005 SEC LEXIS 1745, *108 (July 18, 2005).

(n3)Footnote 3. Rule 144, previously introduced in § 4.02[4], is discussed in detail in ch.6 *infra*. The rules under the Securities Act are reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section C (Matthew Bender).

(n4)Footnote 4. Rule 144(g)(3), 17 C.F.R. § 230.144(g)(3).

See also Merrill Lynch, Pierce, Fenner & Smith, SEC No-Action Letter (May 30, 2001) (Where the receives an unsolicited customer order relating to securities for which it is not a market-maker, the broker's execution of the order

with an affiliated broker-dealer that is a market-maker in the security would still qualify as a broker's transaction as defined in Rule 144 notwithstanding the affiliated market-maker).

(n5)Footnote 5. "Distribution by Broker-Dealers of Unregistered Securities," Sec. Act Rel. No. 33-4445 (Feb. 2, 1962).

See also Wonsover v. SEC, 205 F.3d 408 (D.C. Cir. 2000) .

In *Wonsover*, although it was not disputed that the accounts and sales involved a statutory underwriter, the broker claimed he had made a reasonable inquiry and was ignorant of that fact at the time of the transactions. The court disagreed. The broker effected transactions in a substantial block of a little known and thinly-traded security under circumstances raising questions not only as to whether the sellers may have been intermediaries for controlling persons or statutory underwriters, but also whether they even existed. The broker's inquiry was deemed insufficient, and his petition to overturn an SEC determination that he had violated section 5 was rejected.

(n6)Footnote 6. Sec. Act. Rel. No. 33-131, CCH Fed. Sec. L. Rep. P 1551.04 (1934); Sec. Act. Rel. No. 33- 4669, CCH Fed. Sec. L. Rep. P 2920 (1964).

(n7)Footnote 7. *See Sommer, Who's "In Control?" S.E.C.*, 21 *Bus. Law*. 559 (1966); *Enstam & Kamen, Control and the Institutional Investor*, 23 *Bus. Law*. 289 (1968). *See also SEC v. American Beryllium Corp.*, 303 F. Supp. 912, 915 (S.D.N.Y. 1969) ; *Pennaluna Ltd. v. SEC*, 410 F.2d 861 (9th Cir. 1969) , *cert. denied*, 396 U.S. 1007 (1970) ; *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) , *cert. denied*, 390 U.S. 951 (1968) ; *Anderson v. Francis I. DuPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968) ; *Klapmeier v. Telecheck Int'l, Inc.*, 315 F. Supp. 1360 (D. Minn. 1970) , *rev'd on damages*, 482 F.2d 247 (8th Cir. 1973) , *SEC v. International Development Corp.*, 469 F.2d 20, 28 (10th Cir. 1972) ; *Note*, 3 *ALR Fed.* 645 (1971) . *See also Sennott v. Rodman & Renshaw*, 414 U.S. 926, 94 S. Ct. 224, 226, 38 L. Ed.2d 160, 162 (1973) ; *Ayers v. Wolfenbarger*, 491 F.2d 8, 15 (5th Cir. 1974) ; *Drier v. Tarpon Oil Company*, 522 F.2d 199 (5th Cir. 1975) .

(n8)Footnote 8. Of course, even a non-controlling person *may* become a statutory underwriter, e.g., where the securities are purchased as part of a private placement and immediately resold. *See § 4.02[2] supra*.

(n9)Footnote 9. The concept of "control" is discussed in detail in § 4.02[2][b] *supra*..

(n10)Footnote 10. *Ira Haupt & Co.*, 23 *SEC* 589, 604 (1946) . *See also* H.R. Rep. No. 85, 73d Cong., 1st Sess. 13-14 (1933).

(n11)Footnote 11. Apparently the only case where it may make a difference whether the controlling person has violated section 5 herself or has aided and abetted its violation is where unusual circumstances make it more advantageous to proceed against the controlling person alone without joining the broker-underwriter.

The aiding and abetting concept applies to securities transactions, *SEC v. North American Research and Development Corp.*, 424 F.2d 63 (2d Cir. 1970) . However, the Supreme Court held in *Central Bank v. First Interstate Bank, N.A.*, 511 U.S. 164, 114 S. Ct. 1439 (1994) , that there is no private right of action for aiding and abetting violations under Section 10 (b) of the Exchange Act.

(n12)Footnote 12. *See § 4.02[2] supra*.

(n13)Footnote 13. "It is clear from Section 4(1), read in conjunction with Section 2(11), that public distributions by controlling persons through underwriters, are intended generally to be subject to the registration and prospectus requirements of the *Act*." *Ira Haupt & Co.*, 23 *SEC* at 601 .

(n14)Footnote 14. Similarly, the exemption under Section 4(1) is not available to the original (corporate) *issuer*

and that in Section 4(4) is not available to a *dealer* making a distribution of its securities. *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269 (10th Cir. 1957) .

In one of the earliest cases imposing criminal penalties for the sale of unregistered securities by control persons, one defendant, Louis Wolfson, was sentenced to one year in prison and a \$100,000 fine. Another defendant, Elkin Gerbert, received a sentence of six months and a \$50,000 fine. *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968) , *cert. denied*, 394 U.S. 946 (1969) .

Wolfson later sued his stockbroker and other persons for failure to inform him that registration was required, but the claim was rejected on the ground that his prior conviction in a criminal proceeding stopped him from relitigating questions directly determined in that criminal prosecution. *Wolfson v. Baker*, 444 F. Supp. 1124, 1130 (M.D. Fla. 1978) . *See also* *Rachal v. Hill*, 435 F.2d 59, 62 (5th Cir. 1970) , *cert. denied*, 403 U.S. 904 (1971) ; *Shore v. Parklane Hosiery Company*, 565 F.2d 815 (2d Cir. 1977) , *aff'd*, 99 S. Ct. 645 (1979) .

(n15)Footnote 15. *Ira Haupt & Co.*, 23 SEC at 604 .

(n16)Footnote 16. 23 SEC at 605 , *supra*. (Emphasis added.)

(n17)Footnote 17. Rule 144 is discussed in detail in ch.6 *infra*.



54 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.08

AUTHOR: Robert N. Rapp

§ 4.08 Exempt Offers and Sales of Promissory Notes Secured by Certain Real Estate--Section 4(5)

As part of the Securities Acts Amendments of 1975, Congress added a new subsection (5) to Section 4. n1 Section 4(5) exempts transactions involving offers or sales of promissory notes directly secured by either a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure, or by participation interest in such a note. If these securities are originated by a state or federal supervised savings and loan association, savings bank or commercial bank, n2 they must be offered and sold subject to the following conditions:

- the minimum aggregate sales price per purchaser must not be less than \$250,000;
- the purchaser must pay cash either at the time of sale or within 60 days; and
- each purchaser shall buy for his own account only. n3

If these securities are issued by a mortgagee approved by the Secretary of the Department of Housing and Urban Development, the mortgagor must comply with the three criteria set forth in the previous paragraph and the securities must be offered or sold only to savings and loan associations, savings banks, commercial banks or similarly regulated banking institutions, or to regulated insurance companies.

As stated in the Congressional Record:

The objective of this amendment is to aid the development of a liquid secondary mortgage market in an effort to generate funds for the housing industry and other real estate needs. To accomplish this objective the amendment would exempt from the registration requirements of the Securities Act certain transactions involving mortgage related securities. The exemption is narrowly drafted and would apply only with respect to investors of very substantial resources. ... n4

FOOTNOTES:

(n1)Footnote 1. Securities Acts Amendments of 1975, § 30, 89 Stat. 169 (1975).

(n2)Footnote 2. Section 4(5)(A)(i). The Securities Act is reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section B (Matthew Bender).

Section 4(5)(A)(ii) provides that such securities may also be originated by a mortgagee approved by the Secretary of Housing and Urban Development if they are offered or sold to a savings and loan association, commercial bank, state regulated insurance company, "or the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association."

See also Institutional Securities Corporation, SEC No-Action Letter (pub. avail. June 11, 1976).

(n3)Footnote 3. Section 4(5)(C).

(n4)Footnote 4. Cong. Rec., S6188 (daily ed. April 17, 1975).



55 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.09

AUTHOR: Robert N. Rapp

§ 4.09 Exempt Offers and Sales to Accredited Investors--Section 4(6)

As Title VI of the Small Business Investment Incentive Act of 1980, Congress enacted the "Small Business Issuers' Simplification Act of 1980" that added subsection (6) to Section 4 of the Securities Act. n1 Section 4(6) is an exemption available to cover sales by issuers to "accredited persons." As discussed below, accredited persons are defined in Section 2(15) of the Securities Act, and SEC Rule 215, and generally include persons and entities which possess financial sophistication and substantial economic strength. Section 4(6) restricts the manner of sales (no advertising or public solicitation) but does not limit the number of accredited persons who may be purchasers. There is a \$5 million dollar limitation on the offering, and the issuer must file a notice of sales with the SEC on Form D

Section 2(15) of the Securities Act, defines "accredited investor" to mean:

[A] bank as defined in section 3(a)(2) whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13) of this subsection; an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser. n2

The term "accredited investor" is also defined to include any person who qualifies as an accredited investor under whatever rules and regulations the Commission may prescribe, based upon such factors as financial sophistication, net worth, knowledge, and experience in financial matters or amount of assets under management. The SEC adopted Rule 215 under the Securities Act to broaden the scope of accredited investors eligible under section 4(6). n3 The Rule 215 array of eligible accredited investors conforms to the eligibility requirements prescribed in Rule 501(a) of Regulation D under the Securities Act.

Since the rationale underlying the adoption of Section 4(6) is that sophisticated investors can "fend for themselves" when purchasing securities in a small private offering, Section 4(6) does not specify information required to be

furnished by the issuer to accredited investors. n4 However, Form D, the uniform notice-of-sales form for offerings made in reliance on Regulation D must also be filed by issuers who sell securities under Section 4(6). n5 Form D must be filed by the issuer within fifteen days after the first sale of securities is made in reliance on the exemption. n6

For the section 4(6) exemption to be available a purchaser must be an accredited investor at the time of the transaction. In *Butler v. Phlo Corporation*, n7 a defendant seller sought to avoid civil liability under section 12(a)(1) of the Securities Act on the ground that the plaintiff purchaser should be considered an accredited investor because he was previously a director and executive officer of the company. Accredited investors include persons who are directors, executive officers or general partners of the issuer. However, it was undisputed in *Butler* that the plaintiff was no longer an officer or director of the defendant issuer at the time he exercised an option to purchase 20,000 shares of the company's stock, or at the time he received those shares. Accredited investor status is not granted to former directors and officers, and thus the court ruled that no exemption under section 4(6) was available.

In practical terms, the utility of relying on section 4(6) to effect an offering solely to accredited investors is limited relative to the safe harbor provided for offerings pursuant to Rule 506 under Regulation D of the Securities Act. As illustrated in *Butler*, discussed above, there is no room for error. Offers and sales must be made solely to accredited investors, and there is no reasonable belief standard as to investor accreditation. n8 Moreover, the \$5 million limit on section 4(6) offerings may be unworkable. On the other hand, Rule 506 under Regulation D permits offering to include up to 35 non-accredited purchasers when certain conditions are met, and there is no amount limitation. Potential integration of offerings under section 4(6) versus those carried out under Rule 506 is another meaningful consideration. In *James F. Glaza*, n9 although all purchasers in a series of offerings were accredited investors, section 4(6) was not available for one of those offerings which, when integrated with the others, pushed the aggregate offering over the \$5 million limit. Section 4(6) is not a safe harbor, and established integration criteria will be applied to determine whether several offerings are in fact part of a single offering. In *Glaza*, the Administrative Law Judge concluded that although section 4(6) would not cover all of the offerings, the seller could nevertheless bring the disqualifying offering into compliance under Rule 506 of Regulation D because all investors were accredited and there was no general advertising or solicitation.

FOOTNOTES:

(n1)Footnote 1. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2294, Section 602 (Act of October 21, 1980).

(n2)Footnote 2. 15 U.S.C. § 77b(15).

(n3)Footnote 3. Rule 215, 17 C.F.R. § 230.215, was adopted in Sec. Act Rel. No. 33-9, [1981-1982 Transfer] CCH Fed. Sec. L. Rep. P 83,106 (1981). It defines the term "accredited investor" to include:

- (1) any savings and loan association or other institution specified in section 3(a)(5)(A) of the Act whether such institution is acting in its individual or fiduciary capacity;
- (2) any broker or dealer registered pursuant to section 15 of the Exchange Act;
- (3) any employee benefit plan established and maintained by a state or its political subdivisions or any agency or instrumentality of a state or its political subdivisions if such plan has total assets in excess of \$5 million;

(4) any employee benefit plan under ERISA, if the investment decision is made by a plan fiduciary, as defined under ERISA, which is a savings and loan association, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(5) any private business development company as defined in section 202(c)(22) of the Investment Advisors Act of 1940;

(6) any organization described in *section 501(a)(3) of the Internal Revenue Code of 1986*, as amended, corporation, Massachusetts or similar trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;

(7) any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(8) any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;

(9) any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(10) any trust which holds assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii); and

(11) any entity in which all of the equity owners are accredited investors.

(n4)Footnote 4. Sec. Act Rel. No. 33-6256, Fed. Sec. L. Rep. (CCH) P 82,686 (1980).

(n5)Footnote 5. Form D under the Securities Act, reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section D, (Matthew Bender), was adopted in final form in Sec. Act. Rel. 33-6389, [1981-1982 Transfer Binder] CCH Fed. Sec. L. Rep. P 83, 106 (1982). See 1933 Act rule 503, Regulation D, reprinted in the Securities Primary Law Sourcebook, A.A. Sommer, Jr., General Editor, Volume A, Section C (Matthew Bender).

(n6)Footnote 6. General Instructions, Form D.

(n7)Footnote 7. CCH Fed. Sec. L. Rep. P 91,499, 2001 U.S. Dist. LEXIS 10809 (S.D.N.Y. 2001).

(n8)Footnote 8. Rule 508 of Regulation D, 17 C.F.R. § 230.508, provides that an issuer will not lose the exemption when there is a "good faith and reasonable attempt" to comply with the accredited investor provisions of Regulation D.

See also *Faye L. Roth Revocable Trust v. UBS PaineWebber, Inc.*, 323 F.Supp.2d 1279 (S.D. Fla. 2004) .

(n9)Footnote 9. Admin. Proc. File No 3-11012, *Init. Dec. Rel. No. 293*, 2005 SEC LEXIS 1798 (July 21, 2005) .



56 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 4 Exempt Transactions Under Section 4 of the Securities Act

1-4 Federal Securities Act of 1933 § 4.10

AUTHOR: Robert N. Rapp

§ 4.10 Regulation S: Exempt Offers and Sales Made Outside the United States

Although not an exemption under section 4 of the Securities Act as such, Regulation S under the Actⁿ¹ establishes two "safe harbor" exemptions from registration for offers and sales of securities that occur outside the United States. One safe harbor in Regulation S applies to offers and sales by issuers, securities professionals involved in the distribution process pursuant to contract, their respective affiliates, and persons acting on behalf of any of them (the "issuer safe harbor"). The other (the "resale safe harbor") applies to resales by persons other than the issuer, securities professionals involved in the distribution process, their respective affiliates, and persons acting on their behalf. Regulation S operates to exempt offers and sales of securities that are deemed to be made outside the United States. An offer, sale or resale that satisfies all conditions of the applicable safe harbor in Regulation S is deemed to be outside the U.S., and thus not subject to registration requirements of section 5.

Regulation S is based on a territorial approach to section 5 of the Securities Act. In its adopting Release, the SEC observed that registration of securities is intended to protect the U.S. capital markets and investors purchasing in U.S. markets, whether U.S. or foreign nationals. Principles of comity and the reasonable expectations of participants in global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected in those jurisdictions. Thus, the SEC concluded, the territorial approach recognizes the primacy of the laws in which a market is located.ⁿ² This in turn facilitates capital formation by companies abroad, and recognizes the development of international trading markets and the significant participation by U.S. investors in foreign markets.

The availability of either safe harbor in Regulation S is subject to two principal conditions, which are themselves controlled by key definitions. First, the offer or sale of securities must take place in an "offshore transaction." An offshore transaction is one in which the offer is not made to a person in the U.S., and the purchaser is, or is reasonably believed to be, outside the U.S. at the time of the sale or is made through the facilities of an established foreign securities exchange or a "designated offshore securities market."ⁿ³ Second, to qualify under Regulation S no "directed selling efforts" may be made in the U.S. in connection with the transaction. "Directed selling efforts" means any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered under Regulation S.ⁿ⁴ Such activity includes advertising in a publication having a general circulation in the U.S. that refers to the offering of securities being made in reliance on Regulation S.ⁿ⁵

In a March 1998 Interpretive Release the SEC addressed considerations involved with Internet communications, and whether an offering of securities made on the Internet to non-U.S. investors could be considered to be an offer of the securities in the U.S., such that "directed selling efforts" in the U.S. would disqualify reliance on Regulation S. In the Release the SEC counseled that an issuer that undertakes to effect an overseas offering via the Internet will remain eligible for Regulation S provided that the Web pages contain prominent statements indicating that the offering is made only outside the U.S., and that the issuer also implements precautionary procedures reasonably designed to guard against sales to persons in the United States. n6

General conditions being satisfied, the particular safe harbors of Regulation S can be addressed. For issuers, distributors n7 and their respective affiliates and others acting on their behalf, the Regulation S safe harbor classifies securities into three categories in order to determine whether additional conditions must be met. The categories distinguish securities based upon: (1) the issuer's home jurisdiction; (2) the issuer's reporting status under the Exchange Act; and (3) the degree of "U.S. market interest" in the class of securities being offered and sold. n8 As to each category the concern, and particular requirements imposed, are based on the probability of the securities flowing back into the United States after being offered and sold abroad. In the first category, offerings by qualifying foreign issuers face no additional requirements. As to the second, category, however, offerings by issuers that are reporting companies under the Exchange Act are considered more likely to flow back to the U.S. Thus, participants in the distribution must implement offering restrictions, n9 and a "distribution compliance period" (DCP) is imposed. n10 The DCP is either a 40 day or one year period, depending on the type of security involved, during which the securities are considered "restricted securities" and may not be resold except in accordance with certain limitations and requirements. The third category of securities under these provisions encompasses everything not covered by the first two. For these securities similar additional conditions are imposed, also depending on the type of security involved.

The "resale safe harbor" under Regulation S covers resales by persons other than those eligible to utilize the issuer safe harbor. These parties must comply with the general Regulation conditions--"offshore transaction" and "no directed selling efforts" already discussed. Additionally, dealers are prohibited from knowingly selling Regulation S securities to U.S. purchasers during the applicable DCP. In circumstances in which the purchaser is also a dealer, the selling dealer must notify the purchaser that the purchaser is subject to the same resale restrictions as the seller. There are also limits on the extent of selling commissions or fees that may be paid when the offer or sale is made by certain affiliates. n11

The principal effect of 1998 amendments to Regulation S was to align resale compliance requirements with those applicable under SEC Rule 144 to stock issued by U.S. companies generally. There are, however, no manner of sale or other offeree limitations under Regulation S that are central to Rule 144 and other exemptions from registration, and Regulation S clearly defines the availability of an exemption from registration requirements for offerings effected outside the United States.

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. §§ 230.901 - 230.905, adopted in Sec. Act. Rel No. 33-6863 (Apr. 23, 1990), as amended.

(n2)Footnote 2. See Sec. Act Rel. No, 33-6863, 1990 SEC LEXIS 740, at *14 .

(n3)Footnote 3. Regulation S, Rule 902(h), 17 C.F.R. § 902(h)(i)-(ii). Note, however, that under the controlling definition, offers and sales of securities specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the armed forces serving overseas, are not deemed to be made in "offshore transactions."

(n4)Footnote 4. Regulation S, Rule 902(c)(1).

(n5)Footnote 5. Regulation S, Rule 902(c)(1). Certain types of advertising are, however, permitted. Advertisements required to be published under U.S. or foreign law, for example, are permitted provided the advertisement contains no more information than is legally required. "Tombstone" advertisements meeting strict content requirements are likewise

permitted, as are several other types of communications.

(n6)Footnote 6. *See* Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities. Solicit Securities Transactions or Advertise Investment Services Offshore, *Sec. Act. Rel. No.33-7516, 1998 SEC LEXIS 488 (March 23, 1998)* .

In *Europrospectus.com limited*, SEC No-Action Letter, 2004 SEC No-Act LEXIS 596 (Apr. 28, 2004) the SEC Staff gave no-action advice on the Internet dissemination of prospectuses for international offerings by an online database provider of information obtained from international markets. On a continual basis, the provider made available prospectuses and related documents for international offerings to subscribers. Although the prospectuses were available on the Internet to subscribers in the United States, the Staff agreed that such availability would not constitute directed selling efforts in the U.S. within the meaning of Regulation S as to any offering in light of various steps taken by the service provider. These steps included a detailed cautionary screen legend making clear that documents relate to securities that are not registered in the United States and may not be offered or sold in the United States. The database provider also entered into agreements with all subscribers restricting the users from distributing any prospectus obtained from the database to any parties outside their own respective organizations, and did not otherwise act in any manner that could be deemed inconsistent with Regulation S in the creation and dissemination of the database to subscribers. Although the SEC Staff was satisfied that in these circumstances the Internet distribution of prospectuses would not constitute directed selling efforts in the U.S., the Staff declined to express any view whether the database provider could be deemed to be a "distributor" or whether it could be considered an affiliate or as acting on behalf of entities depositing prospectuses in the database. Nor would the Staff express any view whether providing prospectuses to the database, and the availability of the database to subscribers would constitute conditioning the market in the U.S.

(n7)Footnote 7. "Distributor" in this context includes all underwriters, dealers and other persons who are participating in a distribution of securities pursuant to a contractual arrangement, such as sub-underwriters, but does not include persons participating pursuant to contract only in ancillary positions, such as fiscal agents or persons hired to perform clearing services. *Sec. Act. Rel. No. 33-6863, 1990 SEC LEXIS 740, at *18* .

(n8)Footnote 8. Regulation S, Rule 903(b), *17 C.F.R. § 230.903(b)*.

(n9)Footnote 9. "Offering restrictions" require each distributor to agree in writing that all offers and sales of securities prior to the expiration of the distribution compliance period (DCP) shall be made only in accordance with safe harbor requirements unless the securities are registered or an applicable exemption is available. Offering restrictions also require that all offering materials and documents used in connection with offers and sales of the securities prior to the end of the DCP must include statements to the effect that the securities have not been registered under the Securities Act and may not be offered and sold in the United States or to U.S. persons without registration or an available exemption.

(n10)Footnote 10. Amendments to Regulation S adopted in 1998 in an effort to curb abusive practices in connection with sales of domestic equity securities. The SEC found that Regulation S had been used as a means of perpetrating fraudulent and manipulative schemes involving thinly capitalized or "microcap" companies. With the 1998 amendments the Commission added the "distribution compliance period" (DCP) to replace the prior "restricted period" in Regulation S, and for equity securities placed offshore by domestic issuers lengthened the compliance period from 40 days to one year. *See Sec. Act. Rel. No. 33-7505, [1998 Transfer Binder] CCH Fed. Sec. L. Rep. P 86,006 (Feb. 17, 1998)*.

(n11)Footnote 11. *See* Regulation S, Rule 904 (Offshore Resales), *17 C.F.R. § 230.904*.



57 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 5.syn

AUTHOR: Robert N. Rapp

§ 5.syn Synopsis to Chapter 5: Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

§ 5.01 Small Issues Exemptions--Generally

§ 5.02 Securities Act § 3(b) -Regulation A

[1] Testing the Waters

[2] The Offering Statement

[3] SCOR Offerings under Regulation A

[4] Regulation A Procedures: Filing and Qualification

[5] Pre-Qualification Offers

[a] Preliminary Offering Circular

[b] Other Pre-Qualification Offers

[6] Manner of Offering

[7] Post-Qualification Amendments and Reporting

[8] Insignificant Deviations from Requirements

[9] Integration with other Offerings

[10] Withdrawal or Abandonment of Offerings

[11] SEC Enforcement Authority

§ 5.03 Regulation D: Rule 505 Offerings

§ 5.04 Regulation D: Rule 504 Offerings

§ 5.05 Section 3(b) Offerings -Special Considerations

[1] Angel Capital Electronic Network

[2] Revised Form D and Electronic Filing

[3] Integration of Offerings

[4] Substantial Compliance

[5] Relief from Disqualifications

[6] Intermediary Regulation

§ 5.06 Other Section 3(b) Offerings

[1] Rule 701: Compensatory Benefit Plans

[2] Securities Act Rule 236 Offerings

§ 5.07 Securities Act § 3(c): SEC Regulation E

[1] Regulation E--Generally

[2] Filing and Offering Procedures

[3] Electronic Filing

[4] SEC Enforcement Authority under Regulation E

§ 5.08 Regulation CE--Coordinated Exemption for Certain Issues of Securities Exempt under State Law

§ 5.09 The Impact of Blue Sky Laws

[1] Securities Act § 3(b) Exemptions

[2] Section 3(c) - Regulation E Offerings

Robert N. Rapp n*

FOOTNOTES:

(n1)Footnote *. This chapter has been revised and updated by Robert N. Rapp, partner in Calfee, Halter & Griswold LLP, Cleveland, Ohio. He is the author of *Blue Sky Regulation* (2d. ed., Matthew Bender & Co.)



58 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.01

AUTHOR: Robert N. Rapp

§ 5.01 Small Issues Exemptions--Generally

In chapters 3 and 4 the exemptions from registration requirements for securities and transactions contained in sections 3 and 4 of the Securities Act of 1933 are presented in detail. None of the statutory Securities Act exemptions is expressly constructed to facilitate small issues of securities, although several are sufficiently broad to encompass offerings of any size that meet applicable requirements. n1 It is only in sections 3(b) and (c) of the Act n2 that Congress specifically considered small issues. Section 3(b) empowers the SEC to issue rules and regulations exempting classes of securities if it finds that enforcement of the Securities Act with respect to such securities is not necessary in the public interest or for the protection of investors because of the small amount of securities involved or the limited character of the offering, but subject to a maximum dollar limit. Section 3(b) provides:

The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$5,000,000. n3

Section 3(c) of the Securities Act, added much later, authorizes the SEC to adopt rules and regulations providing for the exemption of securities issued by "small business investment companies" from registration requirements. The authority in section 3(c) of the Securities Act led to the adoption of Regulation E by the SEC, which permits offerings up to \$5 million by qualifying "Small Business Investment Companies" and "Business Development Companies." n4 Regulation E is not an exemption from all registration requirements. Certain filing requirements remain, and use of a disclosure document is mandated.

For small issues, section 3(b) has taken on the greatest significance as a result of the adoption of SEC Regulation D under the Securities Act, n5 which, by a series of rules, establishes certain "safe harbor" exemptions from registration adopted specifically under the authority of section 3(b). Rule 504 under Regulation D n6 provides an exemption from federal registration for limited offerings and sales of securities not exceeding \$1,000,000. Rule 505, also adopted under

the authority of section 3(b), does likewise for limited offerings up to \$5,000,000 which satisfy qualifying conditions. n7 Importantly, although these qualifying offerings are exempt from federal registration requirements, each remains subject to registration requirements under individual state Blue Sky laws if no state exemption is available. n8

Historically, Securities Act section 3(b) is most commonly linked with Regulation A under the Act. Although not an exemption from registration requirements as such, Regulation A permits an issuer to make a public offering of securities in an amount up to \$5 million with substantially less burden and procedures. Regulation A offerings share a number of characteristics with registered offerings. Use of an "offering circular" that is similar in content to a prospectus is required, for example. Also, like registered offerings, securities offered and sold under Regulation A are publicly offered, and become freely tradable in the secondary market after the offering. Principal advantages of Regulation A over full registration of securities are:

- Required financial statements are simpler, and need not be audited;
- There are no on-going Exchange Act reporting obligations after the offering unless the issuer meets certain assets and number of shareholder tests;
- Issuers may choose among three formats to prepare the offering circular, one of which is a simplified question-and-answer document; and
- Issuers may "test the waters" to determine if there is adequate interest in the securities prior to incurring the expense of filing with the SEC.

Prior to the adoption of Regulation D, short of full compliance with section 5 of the Act, small *public* offerings could be carried out only through Regulation A unless the offering was sufficiently restricted to qualify for the intrastate offering exemption provided in section 3(a)(11) of the Securities Act. Although Regulation A remains an alternative to full blown federal registration of securities for small offerings, its use has dwindled in the changed regulatory landscape brought on by the adoption of Regulation D under the Securities Act and its alternatives for small offerings that are true exemptions from federal registration requirements. Today, for example, Rule 505 under Regulation D permits offerings by an issuer of less than \$5 million in any twelve month period to an unlimited number of accredited investors plus 35 additional persons. The compliance burden under Rule 505 is considerably less than under Regulation A, as there are no formal filing and review processes. On the other hand, there are no qualifying requirements or limitations on offerees or purchasers in a Regulation A offering, and under Regulation A "testing the waters" is permitted. Under Regulation A an issuer may publish factual information about its business or proposed business before incurring legal, accounting and other costs, in order to gauge potential investor interest in a possible securities offering.

Rule 505 offerings are considered in detail elsewhere in this Treatise as part of the presentation of Regulation D generally. n9 In this chapter Rule 505 is addressed only in comparison to Regulation A, and with regard to the impact of state securities laws on the efficacy of both. In the same manner, Rule 504, which establishes an exemption from federal registration for limited offerings and sales of securities in an amount not exceeding \$1,000,000, and which was also adopted by the SEC pursuant to section 3(b) of the Securities Act, is examined in detail elsewhere as part of an analysis of Regulation D generally. n10 In this chapter it too is considered only in the context of Regulation D alternatives to a Regulation A offering, and also with specific regard to state law considerations and the factors to be considered in electing to proceed under one of those alternatives to Regulation A.

Acting under the general authority of section 3(b) of the Securities Act, the SEC has adopted other rules facilitating small issues in particular settings. Rules adopted relating to offerings by compensatory benefit plans, n11 for example, and for securities offered to provide funds for distribution to shareholders in lieu of issuing fractional shares in connection with certain corporate transactions n12 are also encompassed within the general authority of section 3(b).

Today, the practical value of small issue "exemptions" created as a result of Securities Act section 3(b) must be analyzed in the context of the full array of federal exemptions afforded in Regulation D. Rule 506 of Regulation D, for example, n13 which was not adopted under the authority of section 3(b), and which has no limitation on the amount of an offering, also permits sales to as many as 35 non-accredited investors and an unlimited number of accredited investors. For non-accredited investors there are information requirements, and there are manner of sale restrictions applicable generally in Rule 506 offerings. However, the requirements are considerably more attractive to issuers when compared to the specific disclosure document and financial statement requirements of Rule 505. Moreover, and most significantly, a compliant Rule 506 offering makes the securities involved "covered securities" under the National Securities Market Improvements Act ("NSMIA") n14 such that state regulation beyond notice filing and fee requirements is preempted. n15

Going forward the efficacy of exemptions provided under the authority of sections 3(b) and (c) of the Securities Act will also be considered in light of the general power of the SEC established by NSMIA in section 28 of the Securities Act n16 to exempt, by rulemaking, any person, security or transaction from the registration provisions of the Securities Act to the extent that such exemption is appropriate in the public interest and is consistent with the protection of investors. n17 After the enactment of section 28, the authority of the SEC to exempt transactions from registration requirements is no longer subject to the \$5 million limit specified by section 3(b) of the Act. To date, the SEC has not adopted any new rules or modified any existing provision pursuant to the authority granted in section 28 that impact any of the Securities Act section 3(b) exemptions. n18

In this chapter the elements and processes of offerings pursuant to Regulation A and other federal exemptions adopted under Securities Act section 3(b) are discussed with an emphasis on practicality. As part of that analysis Rule 505 is addressed in terms of its efficacy as the Regulation D analog to Regulation A, and with particular regard to whether either Regulation A or Rule 505 make sense today for small issues when the full scope of federal and state regulation is taken into consideration and the federal Rule 506 alternative is assessed. As for other section 3(b) exemptions, Rule 504 of Regulation D is examined in the same light.

In other particular contexts not involving capital formation section 3(b) has supported exemptions meaningful for small issuers in the context of certain corporate transactions with shareholders, and to support the distribution of securities pursuant to compensatory and benefit plans. These exemptions, set out in SEC Rules 236 n19 and 701, n20 are rooted in Securities Act section 3(b), although Rule 701 offerings are no longer strictly constrained by the \$5,000,000 offering limitation in section 3(b). Each is examined in this chapter with a view to their particular utility for small issuers.

Securities Act section 3(c) exemptions, most prominently Regulation E, applicable to Small Business Investment Companies, are examined as to focus and mechanics. Likewise, Regulation CE, n21 a coordinated exemption for certain issuers of securities specifically in the State of California is addressed to round out an understanding of complete the range of small issue exemptions that are the results of Securities Act authority granted under section 3 of the Act.

FOOTNOTES:

(n1)Footnote 1. Section 4(2) of the Act, 15 U.S.C. § 77d(2), provides an exemption from the registration provisions of the Securities Act for "transactions by an issuer not involving any public offering." This "private offering" exemption has been developed over years of interpretations by the SEC and the courts, and is available for any offering in which persons faced with an investment decision are considered able to fend for themselves, and the protection that registration under the Act would provide is not needed. The Section 4(2) exemption is discussed in Chapter 4.03, *supra*.

Section 3(a)(11) of the Securities Act provides an exemption from the registration requirements for any offer or sale of securities to residents of a single state by an issuer located in or which is incorporated in the same state and does business in that state. The "intrastate offering exemption" has certain qualification components, but is also an exemption available for any size offering. Like the section 4(2) private offering exemption, the contours of the section 3(a)(11)

exemption have been developed over the years through SEC interpretations and court decisions. However, SEC Rule 147 under the Securities Act, 17 C.F.R. § 230.147, was adopted to provide a safe harbor. The section 3(a)(11) exemption is discussed in detail in Chapter 3.12, *supra* .

(n2)Footnote 2. 15 U.S.C. § 77c(b), (c).

(n3)Footnote 3. 15 U.S.C. § 77c.

(n4)Footnote 4. The term "small business investment company" means any company that is licensed as such by the U.S. Small Business Administration under the Small Business Incentive Act of 1958. A "Business Development Company" is a form of closed-end investment company which meets definitional requirements in the Investment Company Act of 1940. Section 3(c) of the Securities Act, and Regulation E in particular, are discussed in § 5.07, *infra*.

(n5)Footnote 5. 17 C.F.R. § 230.501 -.508.

(n6)Footnote 6. 17 C.F.R. § 230.504.

(n7)Footnote 7. 17 C.F.R. § 230.505

(n8)Footnote 8. Regulation D Rule 504 offerings are fully subject to registration by "qualification" under state securities laws, and to "merit" in those states that continue to make it a part of the qualification process. Rule 505 offerings are for the most part exempt from registration under state laws by reason of the Uniform Limited Offering Exemption ("ULOE") adopted in most states, or a specific exemption analog. For an analysis of the treatment of these offerings at the state level see Rapp, *Blue Sky Regulation* §§ 8.06 -.07 (2d ed. Matthew Bender & Co.). Each is also discussed in sections 5.03 and 5.05, *infra* .

(n9)Footnote 9. See Ch 4.04, *supra* .

(n10)Footnote 10. *Id.*

(n11)Footnote 11. See Securities Act Rule 701, 17 C.F.R. § 230.701. Rule 701 is discussed in more detail in § 5.06[1], *infra*.

(n12)Footnote 12. See Securities Act Rule 236, 17 C.F.R. § 230.236. Rule 236 is discussed in more detail in § 5.06[2], *infra*.

(n13)Footnote 13. 17 C.F.R. § 230.506. Rule 506 of Regulation D was adopted under the authority of, and to provide a "safe harbor" for compliance under, Securities Act section 4(2), 15 U.S.C. § 77(d)(2), the so-called "private offering" exemption. For closer analysis of Rule 506 and its utility, see Ch [], *infra*.

(n14)Footnote 14. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (Referred to throughout this chapter as "NSMIA").

(n15)Footnote 15. See Securities Act section 18(b)(4)(D), 15 U.S.C. § 78r(b)(4)(D). The comparative advantages and disadvantages for small issues under Regulation A, and Rules 505 and 506 of Regulation D are considered further in § 5.03, *infra* .

(n16)Footnote 16. 15 U.S.C. § 77cc.

(n17)Footnote 17. Section 28 added to the Securities Act "general exemptive authority" as follows:

The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this title or of any rule or regulation issued under this title, to the extent that such

exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

Any of the exemptions adopted under section 3(b) of the Securities Act, namely Regulation A and Rules 504, 505 under Regulation D, and Rule 701 could now be adopted pursuant to Securities Act section 28 with no dollar limitation. Because the dollar limitation on SBIC offerings under section 3(c) is established by rule rather than prescribed in the statute, the general exemptive authority established in section 28 of the Securities Act has no impact. However, as to any section 3(b) exemption, the SEC is now empowered to establish dollar limitations at any level deemed to be appropriate, as well as to adopt new exemptions without any dollar limitations.

(n18)Footnote 18. In 2007 the SEC proposed to act under the authority of section 28 to create a new exemption as proposed Rule 507 under Regulation D for offers and sales of securities to "large accredited investors." The proposed definition of large accredited investor would be based on the "accredited investor" definition in Rule 502 of Regulation D, but with higher and somewhat different dollar-amount thresholds. Large accredited investors that participate in these exempt offerings would be considered "qualified purchasers" under Securities Act section 18(b)(3), thereby providing NSMIA "covered security" status and the resulting preemption of state regulation. *See* Securities Act Reel. No. 33-8828 (Revisions of Limited Offering Exemptions in Regulation D) (Aug. 3, 2007).

(n19)Footnote 19. *17 C.F.R. § 230.236.*

(n20)Footnote 20. *17 C.F.R. § 230.701.*

(n21)Footnote 21. *17 C.F.R. § 230.1001.*



59 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.02

AUTHOR: Robert N. Rapp

§ 5.02 Securities Act § 3(b) -Regulation A

In the capital formation setting, under section 3(b) the SEC adopted Regulation A and, much later, Rule 505 of Regulation D under the Securities Act. Although on its face, Regulation A creates a "conditional small issues exemption" from registration, it is in fact a mechanism for a *public* offer or sale of securities that meets the conditions. n1 In a Regulation A offering there are no limitations on the number or qualifications of offerees or purchasers. Only the aggregate dollar amount limitation applies, with the maximum amount permitted to be offered depending upon whether the offering is by an issuer (\$5,000,000) or by selling security holders (\$1,500,000). n2 Regulation A is available to U.S. and Canadian companies that are not (a) reporting companies under the Securities Exchange Act of 1934; (b) investment companies registered under the Investment Company Act of 1940; (c) development stage companies; or (d) issuers of fractional undivided interests in oil or gas rights. n3 There are also certain "bad boy" disqualifying criteria, n4 and Regulation A may not be used by so-called "blank check" companies, or-those with an unspecified business. n5

The aggregate offering price for a Regulation A offering may not exceed \$5 million. If the offering is made by or includes selling security holders, the maximum permitted by those selling security holders is \$ 1.5 million. n6 In either case, the maximum permitted is based on the offering price of all securities for all securities sold pursuant to Regulation A within 12 months before the start of and during the offering. Otherwise, Regulation A offerings are not integrated with other prior offerings, or subsequent offerings meeting certain criteria. n7 Regulation A is generally not available for an offering in which there is uncertainty involved in ascertaining the maximum dollar value of securities which may be offered under the Section 3(b) statutory limitation. In corporate spin-offs, for example, the price at which spun off securities may be resold in the market after the initial distribution by persons who may be deemed to be statutory underwriters cannot be known until such sales are actually executed. n8 The same is true for distribution of shares of a subsidiary company as a liquidating dividend. n9

Key considerations in the use of Regulation A are that there are no qualifications on offerees and purchaser, and that securities offered and sold under Regulation A may be freely traded in the aftermarket. For small business issuers, other important considerations in utilizing Regulation A are that: (1) "testing the waters," that is, soliciting interest in the offering through the use of a document is permitted prior to incurring the expense and burden of preparing and filing an offering statement; (2) required financial statements are simpler and need not be audited; and (3) there are no periodic

reporting requirements unless the issuer meets certain total assets and number of shareholder criteria. n10

[1] Testing the Waters

Perhaps the most important consideration for small issuers is that Regulation A makes specific provision for solicitation of interest ("testing the waters") to determine whether there is any interest in a contemplated securities offering. Rule 254(a) under Regulation A provides:

An issuer may publish or deliver to prospective purchasers a written document or make scripted radio or television broadcasts to determine whether there is any interest in a contemplated securities offering. Following submission of the written document or script of the broadcast to the Commission, as required by paragraph (b) of this section, oral communications with prospective investors and other broadcasts are permitted. The written documents, broadcasts and oral communications are each subject to the antifraud provisions of the federal securities laws. No solicitation or acceptance of money or any other consideration, nor any commitment, binding or otherwise, from any prospective investor is permitted. No sale may be made until qualification of the offering statement. n11

Written solicitation of interest materials submitted to the SEC and used in compliance with the testing the waters provision of Regulation A are not deemed to be a prospectus as defined in section 2(10)(a) of the Securities Act. n12 To be compliant, a written document or script of a broadcast intended for use in testing the waters must include statements, among others, that no money or other consideration may be accepted and that an indication of interest made by a prospective investor involves no obligation or commitment of any kind. n13 These written documents are subject to the antifraud provisions of the federal securities laws.

Specific content restrictions for a testing-the-waters document or script are imposed only to the extent of requiring that the document or script features no money or other consideration being solicited, and if sent in response, will not be accepted; and that no sales of the securities will be made, or any commitment to purchase accepted, until delivery of an offering circular that includes complete information about the issuer and the offering. n14 Additionally it must be stated that an indication of interest made by a prospective investor involves no obligation or commitment of any kind. n15 Content of a written document or script is limited to identifying the chief executive officer of the issuer, and briefly and in general its business and products. n16

Once an offering statement is filed, solicitations of interest may no longer be made. n17 At that point the formal Regulation A process is begun, and the preliminary offering circular becomes the basis for written pre-qualification contact with prospective investors. Additionally, no sales pursuant to a filed offering statement under Regulation A may be made until 20 calendar days after the last publication or delivery of a testing the waters document or broadcast.

Although the provision in Regulation A for testing the waters is very attractive for small business issuers, as a practical matter it may not be available. Securities offered and sold pursuant to federal Regulation A are not NSMIA "covered securities." These offerings remain subject to registration and qualification requirements under state securities laws, including merit review where applicable. The offer and sale of the securities is prohibited under state law without registration or an available exemption. The majority of states do not have an exemption or other procedure for testing the waters, and thus the federal provision is meaningless in those states that prohibit any non-exempt "offers" except in compliance with registration provisions. n18

[2] The Offering Statement

The Regulation A analog to a registration statement under the Securities Act of 1933 is Form 1-A, an "Offering Statement," filed with the SEC. The offering statement consists of three parts. Part I, a "notification," section, is essentially an information statement used to determine eligibility of the issuer to use Regulation A. Part II is the offering

circular, and Part III consists of exhibits that satisfy supplemental information requirements. n19 Parts I, II and III must be addressed by all issuers. Part II of the form, which relates to the content of the required offering circular, provides two alternate formats depending upon the nature and/or business of the issuer. Only one format needs to be followed and provided in the offering statement. General information regarding the preparation, format, and content of the Regulation A Offering Statement is contained in Securities Act Rule 252. n20 Requirements relating to the offering circular itself are contained in Rules 253 and 255. n21 As the functional equivalent of a prospectus, the offering circular in a Regulation A offering must be supplied to each purchaser.

Every Regulation A offering circular must contain the narrative and financial information prescribed by the form. The financial portions of the offering circular will not vary. n22 However, there are choices in the way a corporate issuer may present the non-financial portions of its offering circular. "Model A" of Form 1-A is available for all corporate issuers, and is a question-and-answer format that essentially adopts Form U-7, developed by the North American Securities Administrators Association (NASAA) for corporate issuers qualifying for Small Corporate Offering Registration (SCOR) under state Blue Sky laws. n23 Model A is available to all issuers utilizing Regulation A. "Model B" of Form 1-A is the original Regulation A format, and prescribes content and categories of information in much the same manner as Form S-1, the basic form of registration statement under the Securities Act. n24

[3] SCOR Offerings under Regulation A

The North American Securities Administrators Association (NASAA) adopted Form U-7 -the Small Corporate Offering Registration Form--to provide for the uniform treatment of registrations of small company offerings which are exempt from federal registration under Rule 504 of Regulation D, n25 Rule 147 of the Securities Act of 1933, n26 and Regulation A. Form U-7 -the SCOR form--is a simplified question and answer and fill-in-the-blank form of offering circular that is designed to lead an issuer through the process of creating an offering circular (or prospectus) that adequately discloses the features and risks of the offering. In addition to the form itself, the NASAA created a "Small Company Offering Registration Manual" that explains each question on the SCOR form, points out common pitfalls, and provides sample responses to certain questions. Form U-7 permits small corporate issuers to register securities by qualification under state Blue Sky laws. The utility of Form U-7 to comply with both federal Regulation A and state registration requirements is thus clear.

To be eligible for SCOR, the issuer must:

- Be a corporation or centrally managed limited liability company organized under the laws of the United States or Canada, or any state, province, or territory or possess, or the District of Columbia, and have its principal place of business in one of the foregoing;
- Not be subject to reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934;
- Not be an investment company registered or required to be registered under the Investment Company Act of 1940;
- Not be engaged in or propose to be engaged in petroleum exploration and production, mining or other extractive industries;
- Not be a development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in merger or acquisition with an unidentified company or companies or other entity or person; and
- Not be disqualified under any of several "bad boy" criteria. n27

For a SCOR offering, the offering price of the securities offered must be at least US \$1.00 per share or unit of interest, and the issuer must agree that it will not split its common stock, or declare a stock dividend for two years after the effective date of the registration if such action has the effect of lowering the price below US \$1.00. Commissions, fees or other remuneration for soliciting any prospective purchaser in connection with the offering in any state may only be paid to persons who the issuer believes, and has reason to believe, are appropriately registered or licensed in the state. n28

Financial statements for a SCOR offering must be prepared in accordance with either U.S. or Canadian generally accepted accounting principles, and must be audited unless each of the following conditions is satisfied:

- The company has not previously sold securities through an offering involving the general solicitation of prospective investors by means of advertising, mass mailing, public meetings, "cold call" telephone solicitation or any other method directed toward the public;
- The company has not been previously required under federal, state, provincial or territorial securities laws to provide audited financial statements in connection with any sale of its securities;
- The aggregate amount of all previous sales of securities by the company (exclusive of debt financing with banks and similar commercial lenders) does not exceed US \$1,000,000; and
- The amount of the current offering does not exceed US \$1,000,000. n29

The utility of SCOR and Form U-7 is limited to the extent that they are available only for corporate or limited liability company issuers. Form U-7 may not be used by partnerships, or to register securities for resale on behalf of anyone other than the corporation itself. The Model A offering circular under federal Regulation A is likewise limited to corporate issuers. Other issuers, and any issuer that chooses, use the Model B form of offering circular, which is a traditional form of prospectus. Also, although Regulation A permits an issuer to raise up to \$5 million in a 12-month period, because state SCOR registration has a \$1 million limit, Regulation A effectively is limited to this same amount when it is combined with a SCOR registration in each state. n30

[4] Regulation A Procedures: Filing and Qualification

Regulation A Offering Statements are filed with the SEC at its main office in Washington, D.C. If there is no "delaying notation" made as part of the offering statement, and the offering has not been suspended, n31 an offering statement automatically becomes qualified, without Commission action, on the 20th calendar day after its filing. n32 By including a "delaying notation" in the filing, the offering can be qualified only by order of the SEC. The prescribed form of delaying notation to be included in an offering statement reads:

"this offering statement shall only be qualified upon order of the Commission, unless a subsequent amendment is filed indicating the intention to become qualified by operation of the terms of Regulation A." n33

The delaying notation itself can only be removed by an amendment to the Offering Statement that contains the following language,

"this offering statement shall become qualified on the 20[th] day following the filing of this amendment." n34

A delaying notation provides an opportunity for SEC staff review of the offering statement, and for comments. Comments become the basis for amendments to the offering statement, and obviously lessen the possibility of a

suspension of the exemption by the SEC. n35 When the comment and amendment process is satisfactorily concluded, an order qualifying the offering by the SEC will be issued. Because Regulation A offerings are subject to regulation under state Blue Sky laws, those procedures run in tandem with the SEC qualification procedure. n36

[5] Pre-Qualification Offers

[a] Preliminary Offering Circular

In addition to allowing solicitations of interest prior to an offering statement being filed, Regulation A also permits the use of a "preliminary" offering circular to make written offers of the securities once the required offering statement is filed. n37 The preliminary offering circular is filed as part of the Offering Statement, and must contain substantially the same information required in the offering circular prescribed by SEC Form 1-A, except that certain information as to offering price, underwriting discounts and commissions or other things that are dependent on the offering price may be omitted. A prescribed legend must appear on the front cover, n38 and no sales of securities may be made until the issuer's Offering Statement has been qualified.

[b] Other Pre-Qualification Offers

In addition to the use of a preliminary offering circular, after the Form 1-A offering statement has been filed, but prior to its qualification, oral offer may be made. n39 Additionally, printed advertisements may be used (or radio and television broadcasts made) if they state from whom a preliminary offering circular or final offering circular may be obtained, and contain no more than the following information:

- The name of the issuer;
- The title of the security, amount being offered, and per unit offering price;
- The general type of the issuer's business; and
- A brief statement as to the general character and location of its property. n40

[6] Manner of Offering

Regulation A requires that either a preliminary or final offering circular must be furnished to a prospective purchaser at least 48 hours prior to the mailing of a confirmation of sale. A final offering circular must be delivered with the confirmation of sale, if it has not been delivered at an earlier time. n41 Additionally, sales by a dealer (including an underwriter no longer acting in that capacity for the security involved in the offering) that take place within 90 days after qualification of the Regulation A offering statement may be made only if the dealer delivers a copy of the current offering circular to the purchaser before or with the confirmation of sale. n42

Once a Regulation A offering statement is qualified, there are no restrictions on the use of advertising or sales material. Advertising and sales material are subject to the antifraud provisions of the federal securities laws. Although it is not a condition to the Regulation A exemption, advertising or sales material are to be filed with the SEC. n43 Here again, as with the use of "testing-the-waters" material, submitting advertising or sales material for review significantly reduces the possibility of a subsequent suspension of the offering based on inaccurate or misleading materials. Regulation A specifically empowers the SEC at any time to enter an order temporarily suspending the exemption if it has reason to believe that any sales or solicitation of interest material contains any false or misleading statement. n44

[7] Post-Qualification Amendments and Reporting

Once an offering statement is qualified, the offering circular must be revised during the course of the offering whenever

the information it contains has become inaccurate; when material developments have occurred; or when there has been a fundamental change in the information initially presented. n45 Additionally, an offering circular for a continuous offering must be updated to include updated financial statements 12 months after the date the offering statement was qualified. n46 Every revised or updated offering circular must be filed as a post-qualification amendment to the offering statement and re-qualified in accordance with the procedures established for initial qualification of the offering statement. n47

The issuer is required to file a Report of Sales on Form 2A containing the information required by that form every six months following the qualification of the offering statement by the SEC. Additionally, the issuer is required to file a final Report of Sales within 30 days after the termination, completion or final sales of securities in the offering. n48

[8] Insignificant Deviations from Requirements

A degree of flexibility is built into Regulation A with the express recognition that insignificant deviations from a term condition or requirement will not result in the loss of the exemption for any offer or sale to a particular individual or entity, provided the issuer or person relying on the exemption establishes:

- The failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity;
- The failure to comply was insignificant with respect to the offering as a whole; and
- A good faith and reasonable attempt was made to comply with all applicable, terms, conditions and requirements. n49

However, any failure to comply with the issuer qualification requirement, amount of offering limitation, offer provisions, and requirements applicable to delayed or continuous offerings are deemed to be significant. n50 Additionally, the failure to comply with any term, condition or requirement of Regulation A does not affect the exercise of SEC enforcement authority under section 20 of the Securities Act. n51

[9] Integration with other Offerings

In order to prevent loss of the Regulation A exemption by reason of combining it with such other offerings by the issuer that would together result in exceeding the \$5,000,000 amount limitation or, Regulation A n52 provides that offers and sales made in reliance on it will not be integrated with any prior offers of securities, or any subsequent offers or sales of securities that are:

- Registered under the Securities Act, except under certain circumstances in which the registration results from a change of intention by the issuer formerly relying on Regulation, in which case offers and sales will not be integrated with the registered offering if at least 30 calendar days have elapsed between the last solicitation of interest and the filing of the registration statement with the SEC; n53
- Made in reliance upon Rule 701 of Regulation D under the Securities Act, which is an exemption for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation; n54
- Made pursuant to an employee benefit plan generally;
- Made in reliance upon Regulation S under the Securities Act; n55 and

- Made more than six months after completion of the Regulation A offering. n56

[10] Withdrawal or Abandonment of Offerings

An issuer may, with consent of the SEC, withdraw an offering statement provided that none of the securities which are the subject of the offering statement have been sold, and the offering statement is not the subject of a suspension proceeding. n57 An application for withdrawal must be made, and must state the reason the offering statement is being withdrawn.

When either the originally filed offering statement or any amendment to it has been on file with the Commission for more than nine months and the offering has not commenced, the Commission may, in its discretion, proceed to have that filing declared involuntarily abandoned. Any such abandonment proceeding can only take place after the issuer and its counsel first have been notified of the Commission's intention to declare the offering abandoned, and there has been no response by way of a substantive amendment or a satisfactory explanation. n58

[11] SEC Enforcement Authority

As with any offering, Regulation A offerings are subject to general SEC enforcement authority under the federal securities laws. n59 A specific provision is contained in Regulation A, however, to provide the Commission with authority to temporarily suspend the exemption and, following prescribed procedures, to make a suspension permanent. n60 Under Regulation A, the SEC may at any time enter an order temporarily suspending the Regulation A exemption if it has reason to believe:

- The exemption is not available, or any of the terms, conditions or requirements have not been complied with;
- The offering statement, any sales or solicitation of interest material contains any false or misleading statement of a material fact;
- The offering is being made or would be made in violation of the general antifraud prohibitions in section 17 of the Securities Act;
- An event has occurred after the initial filing of the offering statement which would have rendered the exemption unavailable if it had occurred prior to the filing;
- Criminal proceedings or a civil injunction action have been initiated against certain persons associated with the issuer; or
- The issuer or any promoter, officer, director or underwriter has failed to cooperate, or has obstructed or refused to permit an investigation by the Commission in connection with any offering made or proposed to be made in reliance upon Regulation A. n61

Prompt notice to the issuer, any underwriter and any selling security is required, including the opportunity to request a hearing. If no hearing is requested, and none is ordered by the Commission, the temporary suspension becomes permanent 30 days after entry. If a hearing is requested or ordered, after that hearing the Commission may either vacate the suspension or make it permanent. n62

FOOTNOTES:

(n1)Footnote 1. For an in-depth discussion of securities offerings under Regulation A see O'Boyle, "Offerings of Securities Pursuant to Regulation A," § 3 in A.A. Sommer, Jr., gen. ed., *Securities Law Techniques* (Matthew Bender).

(n2)Footnote 2. *See* Rule 251(b), 17 C.F.R. § 230.51(b). However, in determining the maximum amount that may be offered, Rule 251 requires that the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities in reliance upon Regulation A is to be subtracted. *Id.*

Where a mixture of cash and non-cash consideration is to be received, the aggregate offering price under Regulation A is to be based on the offering price at which the securities are offered for cash. If the securities are not offered for cash, the aggregate offering price is based on the value of the consideration as is established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard. *Id.*

(n3)Footnote 3. *See* Rule 251(a), 17 C.F.R. § 230.251(a).

Although Regulation A is not available for the outright sale of fractional interests in oil or gas properties, if the offering is made by a limited partnership which will drill for oil or gas, then Regulation A is available. Once the issuer decides to use the limited partnership form of business, there is no limit to the number of wells that a specific limited partnership may drill.

(n4)Footnote 4. Although an issuer may otherwise qualify for the Regulation A, there are several circumstances under which such qualification will not be permitted. Those circumstances may involve the issuer itself or persons presently or formerly associated with the issuer or the underwriter of its securities. For example, issuers who have been sanctioned for past violations of the securities laws. Specifically, Rule 262, 17 C.F.R. § 230.262, provides that if an issuer, a predecessor or an affiliated issuer has been subject to a governmental enforcement action resulting in an injunction or criminal conviction, or has received an SEC administrative sanction within the previous five years, the issuer may not avail itself of the Regulation A exemption. This rule also applies to predecessors and affiliated issuers in order to prevent issuers who would otherwise be ineligible to use the exemption from avoiding the disability provisions. Regulation A is also not available to an issuer if any of certain specified individuals have committed specified securities law violations within five years of the filing of an offering statement. Included in this category are individuals who could have significant influence on an issuer's activities. *Id.*

Disqualifications from using Regulation A may be waived by the SEC. This process is discussed specifically in § 5.05[5], *infra* .

(n5)Footnote 5. Rule 251(a)(3), 17 C.F.R. § 230.251(a)(3) (Regulation A may not be used by a "development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company or companies").

(n6)Footnote 6. *See* Rule 251(b), 17 C.F.R. § 230.251(b).

If the market value of the securities is not determinable and the securities are offered in exchange for outstanding securities, claims, property, or services, the aggregate offering price shall be:

- If a mixture of cash and non-cash consideration is to be received, the public cash offering price of the same class of securities;
- If no public cash offering is being made, then the value of whatever is exchanged, established by bona fide sales made within a reasonable time prior to the Regulation A offering; or
- If no such sales exist, then the fair value as determined by some other accepted standard. *Id.*

(n7)Footnote 7. *See* Rule 251 (c), 17 C.F.R. § 230.251(c). Integration of Regulation A offerings with other

offerings is discussed in more detail in § 5.02 [9], *infra*.

(n8)Footnote 8. See Entron, Inc., SEC No-Action Letter, 1976 SEC No-Act. LEXIS 65 1 (Mar. 19. 1976).

(n9)Footnote 9. Strategic Automated Systems International, Inc., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 1476 (Feb 6, 1973) (Regulation A was not available because price at which the securities may be resold in the market could not be known).

(n10)Footnote 10. There are no Exchange Act reporting obligations after a Regulation A offering unless the company has more than \$10 million in total assets and more than 500 shareholders. Issuers become subject to periodic reporting requirements by reason of section 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78l (g)(1), which requires registration under the Exchange Act of securities of an issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce. However, Rule 12h-3 under the Exchange Act, 15 U.S.C. § 240.12h-3 suspends Exchange registration requirements, and thus periodic reporting requirements, for any class of equity securities held by less than 500 persons, when the total assets of the issuer have not exceeded \$10 million on the last day of each of the issuer's three most recent fiscal years See Exchange Act Rule 12h-3(b)(ii), 17 C.F.R. § 240.12h-3(b)(ii).

(n11)Footnote 11. 17 C.F.R. § 230.254(a).

(n12)Footnote 12. 15 U.S.C. § 77b(10)(a).

(n13)Footnote 13. Rule 254(b)(2), 17 C.F.R. § 230.254(b)(2).

(n14)Footnote 14. Rule 254(b)(2)(i)-(ii), 17 C.F.R. § 230.254(b)(2)(i)-(ii).

(n15)Footnote 15. *Id.*, Rule 254(b)(2)(iii).

(n16)Footnote 16. *Id.*, Rule 252(b)(2)(iv).

(n17)Footnote 17. *Id.*, Rule 252(b)(3).

(n18)Footnote 18. The impact of state Blue Sky Laws on Regulation A offerings, and the Securities Act section 3(b) exemptions in general is discussed in *section 5.09, infra*.

See also Rapp, *Blue Sky Regulation* § 4.02 (2d ed. Matthew Bender & Co.).

(n19)Footnote 19. As appropriate, the following documents are filed as exhibits to the offering statement:

- Underwriting Agreement
- Charter and by-laws
- Instruments defining the rights of security holders
- Subscription agreement
- Voting trust agreement
- Material contracts
- Material foreign patents

- Plan of acquisition, reorganization, arrangement, liquidation, or succession
- Escrow agreements
- Consents of experts and underwriters

See Securities Act Form 1-A, Part III.

(n20)Footnote 20. 17 C.F.R. § 230.252.

(n21)Footnote 21. 17 C.F.R. § § 230.253,.255.

(n22)Footnote 22. In the preparation of Regulation A offering circulars the SEC encourages the use of management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format, see Form 1-A, Part II - Offering Circular. The "safe harbor" provision relating to projections that is provided in Securities Act Rule 175, 17 C.F.R. § 230.175, is applicable. *Id.*

For helpful guidance in the preparation and presentation of forward-looking information, see AICPA, *Guide for Prospective Financial Information. A Statement of Position (SOP)* (1986).

(n23)Footnote 23. See § 5.03, *infra*.

(n24)Footnote 24. An option formerly available for corporate issuers to satisfy the Regulation A narrative disclosure requirements by furnishing the information required by Part I of former SEC Form SB-2 was eliminated in 2007 in connection with changes to the disclosure requirements of Securities Act Regulation S-B. The former "SB" Forms were eliminated, and Regulation A thus no longer provides this third option for a compliant offering circular format. See Sec. Act Rel. No. 33-8876 (Dec. 19, 2007). Changes applicable to Form 1-A became effective February 4, 2008.

(n25)Footnote 25. 17 C.F.R. § 230.504.

(n26)Footnote 26. 17 C.F.R. § 230.147. Rule 147 is the "safe harbor" provision for meeting requirements for federal exemption from registration under section 3(a)(11) of the Securities Act -the "intrastate offering" exemption. 15 U.S.C. § 77c(a)(11).

(n27)Footnote 27. See NASAA "Statement of Policy Regarding Small Company Offering Registrations" (Apr. 28, 1996), NASAA Reports (CCH), [Middle dot] 413, at 409.

SCOR, and Form U-7 are generally not be available for the securities of any company if the company or any of its officers, directors, 10 percent stockholders, promoters or any selling agents of the securities to be offered, or any officer, director or partner of such selling agent: (i) has filed a registration statement which is the subject of a currently effective registration stop order entered pursuant to any federal or state securities law within 5 years prior to the filing of the application for registration; (ii) has been convicted within five years prior to the filing of the application for registration of any felony or misdemeanor in connection with the offer, purchase or sale of any securities or any felony involving fraud or deceit, including, but not limited to, forgery, embezzlement, obtaining money under false pretenses, larceny, or conspiracy to defraud; (iii) is currently subject to any state administrative enforcement order or judgment entered by that state's securities administrator or the Securities and Exchange Commission within five years prior to the filing of the application for SCOR registration or is subject to any state's administrative enforcement order or judgment in which fraud or deceit, including but not limited to making untrue statements of material facts and omitting to state material facts, was found and the order or judgment was entered within 5 years prior to the filing of the application for

registration; (iv) is subject to any state's administrative enforcement order or judgment which prohibits, denies, or revokes the use of any exemption from registration in connection with the offer, purchase, or sale of securities; or (v) is currently subject to any order, judgment, or decree of any court of competent jurisdiction temporarily or preliminarily restricting or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction, permanently restraining or enjoining, such party from engaging in or continuing any conduct of practice in connection with the purchase or sale of any security or involving the making of any false filing with the state entered within five years prior to the filing of the application for registration.

(n28)Footnote 28. *Id.*

(n29)Footnote 29. *Id.* When audited financial statements are not required, SCOR nevertheless requires that they be "reviewed"

(n30)Footnote 30. The majority of states include specific provisions for SCOR offerings, or otherwise accommodate SCOR, in their laws or regulations. For a discussion for SCOR offerings under state securities laws generally, see Rapp, *Blue Sky Regulation § 10.04[2]* (2d. ed. Matthew Bender & Co.).

(n31)Footnote 31. The SEC may at any time enter an order temporarily suspending the Regulation A exemption based upon certain findings, see Rule 258(a), 17 C.F.R. § 230.258(a). Upon entry of an order, with notice and the opportunity for a hearing, a temporary suspension may become permanent. *Id.*, Rule 258(b)-(d). Suspension of the Regulation A exemption is discussed further in § 5.02[11], *infra* .

(n32)Footnote 32. Rule 252(g), 17 C.F.R. § 230.252(e).

(n33)Footnote 33. Rule 252(g)(2), 17 C.F.R. § 230.252(g)(2).

(n34)Footnote 34. Rule 252(g)(3), 17 C.F.R. § 230.252(g)(3).

(n35)Footnote 35. See Rule 258, 17 C.F.R. § 230.258. Specific SEC authority in regard to Regulation A offerings is discussed in § 5.02[11], *infra*.

(n36)Footnote 36. The operation and impact of state Blue Sky laws on Regulation A offerings is discussed specifically in § 5.09, *infra* .

(n37)Footnote 37. Rule 255, 17 C.F.R. § 230.255.

(n38)Footnote 38. See Rule 255(a)(1), 17 C.F.R. § 230.255(a)(1).

(n39)Footnote 39. Rule 251(d)(1)(ii)(A), 17 C.F.R. § 230.251.252(d)(1)(ii)(A).

(n40)Footnote 40. *Id.*, Rule 251(d)(1)(ii)(c).

(n41)Footnote 41. See Rule 251(d)(2)(i)(B)-(C).

(n42)Footnote 42. Rule 251(d)(2)(ii), 17 C.F.R. § 230.251(d)(2)(ii)

(n43)Footnote 43. See Rule 256, 17 C.F.R. § 230.256.

For further guidance in regard to advertising, see Sec. Act Rel. No. 33-3844, Fed. Sec. L. Rep. (CCH) 3250-3256 (1957); Sec. Act Rel. No. 33-5009, Fed. Sec. L. Rep. (CCH) [Middle dot] 1465 and [Middle dot] 77,744 (1969); Sec. Act Rel. No. 33-5092, Fed. Sec. L. Rep. (CCH) [Middle dot] 23,120A and [Middle dot] 77,915 (1970); Sec. Act Rel. No. 5101, Fed. Sec. L. Rep. (CCH) [Middle dot] 77,929 (1970); and Sec. Act Rel. No. 33-5180, Fed. Sec. L. Rep. (CCH) [Middle dot] 3056 and [Middle dot] 78,192 (1971).

These releases allow the use of newspaper advertisements and sales presentations made by the use of other literature so long as it is clearly understood that the actual offer and sale of the securities will be made only through the offering circular. Any additional offering documents or oral or written presentations should clearly state that the offering will be made only through the offering circular

(n44)Footnote 44. Rule 258(a)(2), 17 C.F.R. § 230.258(a)(2). The authority of the SEC in regard to suspension of the Regulation A exemption generally is discussed in § 5.02[11], *infra*.

(n45)Footnote 45. Rule 253(e)(1), 17 C.F.R. § 230.253(e)(1).

(n46)Footnote 46. Rule 253(e)(2), 17 C.F.R. § 230.253(e)(2).

Continuous or delayed offerings may be made under Regulation A when permitted by and carried out in accordance with Rule 415 under the Securities Act, 17 C.F.R. § 230.415 ("Delayed or Continuous Offering and Sale of Securities"), *see* Rule 251(d)(3), 17 C.F.R. § 230.252(d)(3).

(n47)Footnote 47. Rule 253(e)(3), 17 C.F.R. § 230.253(e)(3).

(n48)Footnote 48. Rule 257, 17 C.F.R. § 230.257.

(n49)Footnote 49. Rule 260(a), 17 C.F.R. § 230.260(a).

(n50)Footnote 50. *Id.*, Rule 260(a)(2).

(n51)Footnote 51. 15 U.S.C. § 77s (Injunctions and Prosecution of Offenses).

(n52)Footnote 52. Integration as applicable to section 3(b) offerings generally, is discussed further in § 5.05[2], *infra*.

(n53)Footnote 53. *See* Rule 254(d), 17 C.F.R. § 230.254(d).

(n54)Footnote 54. 17 C.F.R. § 230.701.

(n55)Footnote 55. 17 C.F.R. § 230.901-904. Regulation S exempts qualifying offers and sales of securities occurring outside the United States.

(n56)Footnote 56. Rule 251(c), 17 C.F.R. § 230.251(c).

For discussion of the general criteria used to determine whether offerings should be integrated, *see* Sec. Act Rel. No. 33-4434, Fed. Sec. L. Rep. (CCH) [Middle dot][Middle dot] 2270-2277 (1961); and Sec. Act Rel. No. 33-4552, Fed. Sec. L. Rep. (CCH) [Middle dot][Middle dot] 2770-2783 (1962). Integration of small issue offerings generally is considered further in § 5.05[2], *infra*.

(n57)Footnote 57. Rule 259(a), 17 C.F.R. § 230.259(a).

(n58)Footnote 58. Rule 259(b), 17 C.F.R. § 230.259(b).

(n59)Footnote 59. *But see SEC v. Blazon Corporation*, 609 F.2d 960 (9th Cir. 1979), in which the court concluded that use of a Regulation A offering circular which becomes false or misleading by reason of the issuer's failure to amend does not result in loss of the section 3(b) exemption from full registration under the Securities Act. Regulation A, said the court, provides the SEC with the mechanism to deal with such problems through suspension of the exemption. To allow the SEC to invalidate the exemption entirely would circumvent the suspension procedure

designed to deal with false and misleading Regulation A documents, *see* 609 F.2d at 968-69 .

(n60)Footnote 60. *See, e.g.*, Santana International, Inc., Admin. Proc. File No.3-6666, Sec. Act. Rel. No. 33-6736 (Sept. 2, 1987); Tanzeer Management Corp., Admin. Proc. File No. 3-6665, Sec. Act Rel. No. 33-6735 (Sept. 2, 1987).

(n61)Footnote 61. Rule 258(a)(1)-(7), 17 C.F.R. § 230.258(a)(1)-(7).

See, e.g., Brian V. Hanson Enterprises, Inc., Sec. Act Rel. No. 33-6668, 1986 SEC LEXIS 503 (Oct. 20, 1986) (Order permanently suspending Regulation A exemption where there were material omissions from the notification and offering circular, and the promoter and principal shareholder failed to cooperate with the inquiry regarding the offering circular); *see also* Silkaro Capital Corp., Sec. Act Rel. No. 33-6734, 1987 SEC LEXIS 3812 (Sept. 2, 1987) (Permanent suspension based on omission of material facts in offering circular concerning the identity of an additional promoter and affiliate of the issuer).

(n62)Footnote 62. *Id.*, Rule 258(b)-(c).

Under Rule 258, the SEC may at any time after notice and an opportunity for hearing, enter an order permanently suspending a Regulation A exemption for any reason on which it could have entered a temporary order. *Id.*



60 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.03

AUTHOR: Robert N. Rapp

§ 5.03 Regulation D: Rule 505 Offerings

Rule 505 under the Securities Act n1 was adopted as part of Regulation D of the Securities Act under the authority of section 3(b), and is an exemption alternative for issuers who offer and sell up to \$5,000,000 of securities in any 12 month period. n2 Unlike Regulation A, Rule 505 is a true exemption from registration requirements. There is no offering statement filing, and no SEC qualification process. n3 On the other hand, there are important restrictions. Issuers relying on Rule 505 may sell to an unlimited number of "accredited investors," but only up to 35 other persons who do not satisfy the standards used to determine accredited investor status. n4 Also unlike Regulation A, purchasers in a Rule 505 offering receive "restricted" securities, meaning they are not freely tradable and may not be sold without registration or an available exemption. n5 Moreover, the issuer in a Rule 505 offering must take reasonable care to assure that purchasers of securities in the offering are not deemed to be statutory "underwriters" as that term is defined in section 2(11) of the Securities Act n6 if there are resales of the securities. Issuers are able to demonstrate reasonable care by:

- Making a reasonable inquiry to determine that the purchaser is acquiring the securities for himself, herself, or for other persons;
- Making written disclosure to each purchaser prior to sale that the securities have not been registered under the Securities Act, and cannot be resold unless they are registered under the Act or there is an available exemption from registration; and
- Placing a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities. n7

Purchasers themselves may effect resales only in transactions and circumstances in which they would not be deemed underwriters, and therefore entitled to rely upon the exemption in section 4(1) of the Securities Act, n8 which provides that the registration requirements do not apply to transactions by any person other than an issuer, underwriter or dealer. Rule 144 under the Act n9 provides a safe harbor for resales of restricted securities, but imposes significant limitations and requirements, including up to a one year holding period. n10

Rule 505 offerings are subject to other general conditions applicable to Regulation D offerings. Thus, for example, no general solicitation or advertising is permitted. n11 General conditions in Regulation D also impose information requirements regarding sales to persons who are not accredited investors. While no offering circular, as such, is required for an offering pursuant to Rule 505, Regulation D specifically requires that the issuer must furnish non-accredited investors information that is the same kind as would be required in Part II of Regulation A -the offering circular. n12 Required financial statement information is prescribed based on the size of the offering. n13

On its face it appears that if a Rule 505 offering will include non-accredited investors there is no advantage in proceeding under it rather than Regulation A itself. In fact, there are significant advantages to proceeding under Regulation A since there is no restriction on the number of purchasers, the securities sold are freely tradable, and there may be general solicitation and advertising in the offering. There is, however, an important consideration for issuers deciding to rely on Rule 505 over Regulation A. Rule 505 has a significant advantage over Regulation A when state securities regulation is taken into account. All states have adopted some version of the NASAA Uniform Limited Offering Exemption ("ULOE"), or an equivalent, to facilitate offerings under Regulation D Rules 505 and 506. n14 In contrast to Regulation A offerings, which are fully subject to state registration and qualification requirements, compliance with ULOE conditions means that a Rule 505 offering will be exempt from those registration and qualification requirements. n15 Thus, for small business capital formation Rule 505, in conjunction with the ULOE or its equivalent does present a practical alternative to Regulation A. n16

The utility of either Regulation A or Rule 505 may be seen as significantly diminished today in comparison to offerings made pursuant Rule 506 of Regulation D. n17 Rule 506 was not adopted under the authority of Securities Act section 3(b), but rather section 4(2) of the Act, n18 which exempts "transactions by an issuer not involving any public offering" from federal registration requirements. Because it was not adopted under section 3(b) of the Act, Rule 506 provides an exemption without regard to the dollar amount of an offering. And like Rule 505, an offering under Rule 506 may be made to an unlimited number of accredited investors and up to 35 non-accredited investors. n19 The general conditions of Regulation D apply to Rule 506 offerings in the same manner as for Rule 505 offerings. A significant difference, however, is that Rule 506 includes a specific purchaser *sophistication* requirement for non-accredited investors. Under Rule 506, each purchaser who is not an accredited investor must, either alone or with a purchaser representative, have such knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment. n20 This is in addition to the information requirements applicable under Regulation D generally. n21 And Rule 506 offerings are likewise subject to the manner of offering limitations prohibiting general solicitation or advertising. n22

In addition to the unlimited amount of an offering permitted under Rule 506, the major difference between Rule 506 and offerings under either Rule 505 or Regulation D is that securities offered and sold pursuant to a valid Rule 506 exemption are "covered securities" under NSMIA. n23 As such, they are not subject to state registration or qualification requirements. n24

In the context of Securities Act section 3(b) small issue exemptions, because a Rule 506 offering is not constrained by the \$5 million section 3(b) amount limitation that is applicable to Rule 505, and because state authority to require registration or qualification of a *compliant* Rule 506 offering is preempted by NSMIA, n25 the relative utility of both Regulation A and Rule 505 is significantly diminished. Accepting the amount limitation, however, Rule 505 remains as a viable alternative for small business issuers because there is no purchaser sophistication requirement. For Regulation A the important consideration is that, subject to the amount limitation, it permits a truly "public" offering. There is no distinction between accredited and non-accredited purchasers, and no limitation on the number of purchasers. Rule 505 and Regulation A may be much less utilized than Rule 506, but each retains a specific application niche that is meaningful for small business capital formation. A further alternative adopted under Securities Act section 3(b) is considered below.

FOOTNOTES:

(n1)Footnote 1. *17 C.F.R. § 230.505.*

(n2)Footnote 2. In determining the actual amount limitation for a particular offering the aggregate offering price for all securities sold within the twelve months before the start of and during the Rule 505 offering in reliance on any other exemption under section 3(b) of the Securities Act must be subtracted. *See Rule 505(b)(2), 17 C.F.R. § 230.505(c)(2).*

(n3)Footnote 3. Companies using the Rule 505 exemption are required to file Form D -Notice of Sales--with the SEC no later than 15 days after the first sale of the securities. Specifically as to Rule 505 offerings, the Form D notice must contain an undertaking by the issuer to furnish to the Commission, upon the written request of its staff, the information furnished by the issuer any purchaser that is not an accredited investor. *See Regulation D, Rule 503(a), (c), 17 C.F.R. § 230.503(a), (c).* Form D requirements, as applicable to all offerings made pursuant to Regulation, and as amended in February 2008, are specifically discussed in § 5.05[2], *infra*. For an in-depth discussion of how to perform a Rule 505 offering *see* Loo, "The Regulation D Exemption," § 2.04 in A.A. Sommer, Jr., gen. ed., *Securities Law Techniques* (Matthew Bender).

(n4)Footnote 4. "Accredited investor" is defined in Rule 501(a) of Regulation D, *17 C.F.R. § 230.501(a)*, as:

- A bank, insurance company, registered investment company, business development company, or small business investment company;
- An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
- A charitable organization, corporation or partnership with assets exceeding \$5 million;
- A director, executive officer, or general partner of the company selling the securities;
- A business in which all the equity owners are accredited investors;
- A natural person with a net worth of at least \$1 million;
- A natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
- A trust with assets of at least \$5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person.

In determining the 35 non-accredited purchaser limitation Rule 505 incorporates the counting methodology set out in Rule 501(e) of Regulation D, *17 C.F.R. § 230.501(e)*. Under that rule, certain persons are excluded from the count, including any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser. *Id.*, *17 C.F.R. § 230.501(e)(1)(i)*.

(n5)Footnote 5. *Rule 502(d), 17 C.F.R. § 230.502(d).*

(n6)Footnote 6. *15 U.S.C. § 77b(11) (2000).*

(n7)Footnote 7. *17 C.F.R. § 230.502(d)(1)-(3).*

(n8)Footnote 8. *15 U.S.C. § 77d(1) (2000).*

(n9)Footnote 9. *17 C.F.R. § 230.144.*

(n10)Footnote 10. *Id.*, Rule 144(d). The holding period under Rule 144 is either six months or one year depending upon whether the issuer is a reporting company under sections 13 or 15(d) of the Securities Exchange Act. If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, a minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquirer or any subsequent holder of those securities.

(n11)Footnote 11. *Id.*, Rule 502(c).

Regulation D does provide, however, that publication by an issuer of a notice made in accordance with Securities Act Rule 135c, *17 C.F.R. § 230.135c*, will not be considered to be general solicitation or general advertising, *see* Rule 502(c)(2). Securities Act Rule 135c permits an issuer that is subject to reporting requirements under the Securities Exchange Act of 1934 to give notice of a proposed offering in the form of a published statement that states that securities to be offered will not be or have not been registered under the Securities Act and may not be offered or sold in the United States absent registration or an available exemption from registration, and which contains no more than the following additional information:

- The name of the issuer;
- The title, amount and basic terms of the securities offered, the amount of the offering, if any, made by selling security holders, the time of the offering and a brief statement of the manner and purpose of the offering without naming the underwriters; and
- Any statement or legend required by state or foreign law, or administrative authority.

For rights or exchange offerings certain additional information is permitted. Rule 135c(a)(3), *17 C.F.R. § 230.135c(a)(3)*. Rule 135c provides for a "notice," and although the rule references a proposed offering, it does not include any provision for solicitation of interest or a response to the notice.

(n12)Footnote 12. Rule 502(b)(2)(i)(A), *17 C.F.R. § 230.502(b)(2)(i)(A)*.

There are no requirements or restriction as to what information is given to accredited investors, although antifraud prohibitions always apply. However, Rule 502 of Regulation D does mandate that if an issuer provides information to accredited investors, it must make the same information available to non-accredited investors as well, *see* Rule 502(b)(2)(iv). The issuer must also be available to answer questions by prospective purchasers. *Id.*, Rule 502(b)(2)(v).

(n13)Footnote 13. *Id.*, Rule 502(b)(2)(i)(B).

(n14)Footnote 14. *See* NASAA Reports (CCH) [Middle dot]6201, at 6101 - 6105.

(n15)Footnote 15. The impact of state securities regulation generally on offerings made pursuant to the federal small issue exemptions is discussed in § 5.09, *infra*.

(n16)Footnote 16. However, the ULOE has its own set of conditions. For example, there is a suitability

requirement for non-accredited investors. For a discussion of the interface between Rule 505 and the ULOE at the state level, see Rapp, *Blue Sky Regulation* § 10.04[1] (2d ed. Matthew Bender & Co.).

(n17)Footnote 17. 17 C.F.R. § 230.506.

Rule 506 and all elements of Regulation D is discussed further in § 4.04 [2]-[5], *supra*.

(n18)Footnote 18. 15 U.S.C. § 77(d)(2) (2000).

(n19)Footnote 19. Rule 506(b)(2)(i), 17 C.F.R. § 230.506(b)(2)(i).

(n20)Footnote 20. Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii).

(n21)Footnote 21. See Rule 502(b), 17 C.F.R. § 230.502(b).

(n22)Footnote 22. See Rule 502(c), 17 C.F.R. § 502(c).

(n23)Footnote 23. Section 18(b)(4)(D) of the Securities Act of 1933, added by NSMIA, includes within the definition of "covered security" any security with respect to a transaction that is exempt from registration under the Securities Act pursuant to:

Commission rules or regulations issued under section 4(2), except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 4(2) that are in effect on September 1, 1996. 15 U.S.C. § 77r(b)(4)(D).

(n24)Footnote 24. See Securities Act section 18(a)(1)(A), 15 U.S.C. § 77r(a)(1)(A). However, NSMIA expressly preserved state antifraud enforcement authority. *Id.*, § 77r(c).

(n25)Footnote 25. The critical factor in assessing the scope of preemption under NSMIA is the presence of a NSMIA "covered security." While the classes of covered securities are spelled out in NSMIA, Congress made no provision for any determination as to the actual *validity* of covered security status claimed for any particular security involved in an offering. This is an important notion where, as with offerings made in reliance upon Rule 506 of SEC Regulation D, there are conditions to be met for an issuer to avail itself of the exemption. Whether covered security status for purposes of federal preemption rests on a determination of actual validity versus simple reliance on a NSMIA-recognized federal exemption is critical in assessing the permitted scope of state authority to regulate offerings. In fact, state regulators and state courts are today openly testing, if not outright challenging, the limits of NSMIA preemption based upon the actual validity of covered security status. See Robert N. Rapp & Fritz E. Berckmueller, "Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure" 63 *Bus. Lawyer* 809 (May 2008).



61 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.04

AUTHOR: Robert N. Rapp

§ 5.04 Regulation D: Rule 504 Offerings

As a further small issue exemption adopted by the SEC under the authority of section 3(b), Rule 504 of Regulation D n1 creates an exemption from federal registration requirements for offerings not exceeding \$1million. n2 There are issuer qualifications that are consistent with those applicable to Regulation A and Rule 505 offerings. To be eligible to use Rule 504 the issuer may not be a reporting company under the Securities Exchange Act of 1934, or a registered investment company, or a development stage company with no specific business plan, or if it has a business plan to engage in an unidentified merger or acquisition. n3 Subject to the \$1 million amount limitation, there are no limitations on the number of purchasers, or their qualifications. Although a compliant Rule 504 offering is exempt from federal registration requirements, they are fully subject to registration and qualification requirements under state Blue Sky laws. n4 Securities offered and sold pursuant to Rule 504 are not federal covered securities for NSMIA preemption of state authority, and the Uniform Limited Offering Exemption ("ULOE") or its equivalent adopted by states does not encompass Rule 504 offerings.

Although Rule 504 offerings must comply with registration requirements under state Blue Sky laws, and be subject to registration by "qualification" in those states providing for merit review of offerings, in some cases special provision has been made to lessen the burden on small corporate offerings. A number of states, for example have implemented the Uniform Limited Offering Registration ("ULOR") protocol, designed specifically to facilitate offerings up to \$1 million pursuant to federal Rule 504. n5 The ULOR and SCOR n6 may be referenced interchangeably, and both are based upon use of Form U-7, the SCOR registration statement.

Rule 504 mandates that offers and sale satisfy the general Regulation D terms and conditions regarding integration of offerings, manner of offering, and limitations on resale. n7 However, the role of state securities laws in regard to Rule 504 offerings is significant because the applicability of and compliance with certain state requirements eliminates the need for issuer compliance with general conditions of federal Regulation D regarding the manner of offering and limitations on resale. n8 These conditions are excused for offerings that are made:

- Exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those provisions;

- In one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filings and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure; or
- Exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to "accredited investors" as defined in Regulation D.

n9

As with all offerings conducted pursuant to Securities Act Regulation D, an issuer must file with the SEC a notice on Form D no later than 15 days after the first sale of securities. n10

Rule 504 is most commonly used by start-up companies to raise seed capital. Although it permits a "public" offering, as a practical matter the small amount involved is not likely to lead to any widespread distribution of the securities. The Securities Act section 3(b) exemptions are premised on the conclusion that enforcement of federal registration requirements is not necessary in the public interest and for protection of investors by reason of the small amount involved or the limited character of the offering. n11 Rule 504 fits well with that premise, and with the further premise that state regulation will provide necessary protection in the limited or localized context of the offering. That is clearly the import of the state registration-related alternatives for excusing manner of offering and resale limitations discussed above. It is because of that, however, that the real utility of Rule 504 as a federal safe harbor for small issues depends entirely upon the manner in which state securities regulation burdens the process. That, in turn, is a function of the extent to which those states that continue "merit review" of offerings allow the process to be cost effective for small business issuers. Fortunately, meaningful efforts have been made to minimize the burden without compromising investor protection.

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. § 230.504.

Rule 504 and all elements of Regulation D is discussed further in § 4.04 [2]-[5], *supra*. For an in-depth discussion of how to perform a Rule 504 offering see Loo, "Offerings of Securities Pursuant to Regulation A," § 2.03 in A.A. Sommer, Jr., gen. ed., *Securities Law Techniques* (Matthew Bender).

(n2)Footnote 2. The \$1 million maximum offering limitation under Rule 504 must be reduced by the aggregate offering price for all securities sold within the twelve months before the start of and during the offering in reliance on any exemption under section 3(b) of the Securities Act. Rule 504(b)(2), 17 C.F.R. § 230.504(b)(2). Integration of section 3(b) offerings generally is discussed in § 5.05[3], *infra*. Rule 504 itself is discussed in greater detail in § 5.04, *supra*.

(n3)Footnote 3. Rule 504(a)(1)-(3), 17 C.F.R. § 230.504(a)(1)-(3).

(n4)Footnote 4. For an examination of the application of state Blue Sky laws to Rule 504 offerings, see Rapp, *Blue Sky Regulation* § 10.05 (2d Ed., Matthew Bender & Co.).

(n5)Footnote 5. See, e.g., New Hampshire: N.H. Rev. Stat. § 421-B-15-a ("Uniform Limited Offering Registration").

(n6)Footnote 6. See § 5.02[3], *supra*, for a discussion of SCOR offerings in the context of Regulation A under the federal Securities Act.

(n7)Footnote 7. *See* Rule 504(b)(1), 17 C.F.R. § 230.504(b)(1).

(n8)Footnote 8. *Id.*

(n9)Footnote 9. Rule 504(b)(1)(i)-(iii).

Rule 504 offerings are excluded from the "information requirements" general condition of Securities Act Regulation D, *see* Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1) ("The issuer is not required to furnish the specified information to purchasers when it sells securities under § 230.504, or to any accredited investor"). However, compliance with state securities laws will in most cases require use of a prospectus or offering circular. And as seen here, use of a state law mandated disclosure document is a specific condition under Rule 504 if there is to be general solicitation or advertising in the offering, and if purchasers are to receive freely tradable securities rather than restricted securities.

(n10)Footnote 10. Rule 503(a), 17 C.F.R. § 230.503(a).

(n11)Footnote 11. 15 U.S.C. § 77c(b).



62 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.05

AUTHOR: Robert N. Rapp

§ 5.05 Section 3(b) Offerings -Special Considerations

[1] Angel Capital Electronic Network

Specifically designed for small companies, the Angel Capital Electronic Network ("ACE-Net") was established by the Office of Advocacy of the U.S. Small Business Administration ("SBA") as an Internet site where companies may list their Regulation A and Regulation D Rule 504/SCOR offerings. ACE-Net is a cooperative effort between the SBA, nine universities, and other non-profit organizations to provide a listing service where small companies may list their stock offerings for review by accredited investors, who are pre-qualified to have access to the site and the listings. In addition to the listing service for Regulation A and Rule 504 offerings, ACE-Net provides mentoring and educational services for small companies needing business planning and securities information. n1

[2] Revised Form D and Electronic Filing

As provided in Rule 503 of Regulation D, Form D is the notice that issuers must file with the SEC no later than 15 days after the first sale of securities in an offering made under any of the provisions of Regulation D. Form D is also used for notice filing with state securities administrators in connection with offerings under federal Rules 505 and 506. n2 In February 2008, the SEC amended Form D and its content requirements in order to: (1) obtain information regarding continuous offerings, such as the date of the first offering and the expected length of the offering; (2) clarify when amendments are required for Form D; (3) require annual amendments of Form D for continuing offerings regardless of when the initial filing was made; and (4) require the electronic filing of Form D on a new online filing system. Beginning September 15, 2008 issuers may elect to file Form D electronically, or continue to make paper filings until March 16, 2009, when they are required to make electronic filings using the revised version of the form. n3

Revised Form D includes the following additional information:

- The date of first sale of securities in the offering;
- The Central Registration Depository ("CRD") number, if applicable, for each person who has acted as a promoter of the issuer's securities within the past five years;

- Whether the offering is expected to last more than one year;
- The revenue range for the most recently completed fiscal year or the net asset value as of the most reasonably practicable date (the issuer may elect not to provide this information);
- The minimum offering amount;
- The provision of Regulation D on which the issuer is relying for the offering;
- Expenses relating to sales commissions or any amounts paid to officers, directors or promoters out of the proceeds of the offering;
- Information for multiple issuers, if applicable, if engaging in a combined offering; and
- The type of business carried on by the issuer. n4

Rule 503 and the instructions to Form D were also amended to clarify requirements for amending a previously filed Form D particularly in regard to continuing offerings. Issuers in continuing offerings must file updating amendments every year during the continuation of the offering. Amended Rule 503 further requires that an amendment to Form D must be made as soon as practicable after (1) discovery of a material mistake or error; or (2) a change in the information provided in the previously filed Form D. n5

[3] Integration of Offerings

Because each of the offerings authorized under Securities Act section 3(b) is subject to a maximum amount limitation, the extent to which separate offerings are integrated so as to be considered part of the same offering is critical in assuring the availability of the particular exemption. There are safe harbors available to avoid integration.

Offers and sales made in reliance on Regulation A will not be integrated with: (1) prior offers or sales of securities; or (2) subsequent offers or sales of securities that are:

- a) registered under the Securities Act, except as provided in Rule 254(d) regarding "testing the waters;"
- b) made in reliance on Rule 701 (which provides an exemption for certain offerings made to the issuer's employees);
- c) made pursuant to an employee benefit plan;
- d) made in reliance on Regulation S (which exempts from registration certain offerings made outside of the United States); or
- e) made more than six months after the completion of the Regulation A offering (however, deductions from the amount available under the Regulation A ceiling for the second offering may be required). n6

These specific integration criteria are "safe harbor" provisions. However, Regulation A also expressly recognizes that if an issuer offers or sells securities for which the safe harbor rules are not available, such offers and sales may still not be integrated with the Regulation A offering, depending upon the particular facts and circumstances, and the application of general integration factors articulated by the SEC that have long been in place. n7 The factors are:

- Whether the sales are part of a single plan of financing;

- Whether the sales involve issuance of the same class of securities;
- Whether the sales have been made at or about the same time;
- Whether the same type of consideration is received; and
- Whether the sales are made for the same general purpose. n8

For Rule 504 and 505 offerings under Securities Act Regulation D, there is also a non-integration safe harbor. Offers and sales that are made more than six months before the start or six months after the completion of the Regulation D offering will not be integrated with that Regulation D offering, so long as during those six month periods there are no offers or sales of securities that are of the same or a similar class as those offered under Regulation D. n9 As with Regulation A, if the issuer offers or sells securities for which the Regulation D safe harbor is not available, the determination whether separate sales of securities should be treated as part of the same offering depends on the particular facts and circumstances. In making that determination the SEC integration factors discussed above apply with equal force. n10

[4] Substantial Compliance

Regulation A and Regulation D share an identical provision providing relief from insignificant deviations from a term, condition or requirement. n11 For Regulation A, Rule 504 and Rule 505 offerings the failure to comply with a term, condition or requirement will not result in the loss of the exemption from the registration requirements of the Securities Act for any offer or sale to a particular individual or entity, provided that the issuer or person relying on the exemption establishes:

- The failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity;
- The failure to comply was insignificant with respect to the offering as a whole, recognizing, however, that the failure to comply with certain requirements shall be deemed to be significant with respect to the offering as a whole; n12 and
- A good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements.

These provisions operate to avoid the calamitous result of loss of an exemption for an entire offering by reason of a single violation, as for example, the sale in a Rule 505 offering to a person reasonably believed to be an accredited investor who in fact fails to meet the requisite net worth criterion. Reference to an insignificant deviation from a term, condition or requirement fairly implies an isolated failure in the context of a good faith undertaking to comply. It is certain that multiple failures in the same offering, however insignificant, would not support invocation of Rule 508 in defense. A key condition to relief under Rule 508 is that the failure to comply does not relate to something directly intended to protect the purchaser. Thus, for example, the offering circular requirement of Regulation A and the information requirement for non-accredited investors under Regulation D are plainly intended to protect individual purchasers, and would not qualify for relief under the insignificant deviation provisions.

[5] Relief from Disqualifications

Rule 262 of Regulation A n13 and Rule 505 of Regulation D n14 provide that neither exemption is available for the securities of an issuer that is subject to any of the disqualification provisions set out in Rule 262 of Regulation A.

Disqualifications apply to the issuer itself as well as persons presently or formerly associated with the issuer or the underwriter of its securities. The main focus of the disqualification relating to specified individuals is on whether they have committed specified securities law violations within five years of the filing of an offering statement. Included in this category are individuals who could have significant influence on an issuer's activities. As for issuers, those which have been sanctioned for past violations of the securities laws, or have been subject to a governmental enforcement action resulting in an injunction or criminal conviction within the previous five years, disqualify the issuer from using the Regulation A exemption. This rule also applies to predecessors and affiliated issuers in order to prevent issuers who would otherwise be ineligible to use the exemption from avoiding the disability provisions. n15

Although a disqualifying criterion may apply, Regulation A also provides a means for seeking relief from the disqualification. Rule 262 provides that a disqualified issuer or person can request that the SEC waive the disqualification upon a showing of good cause and without prejudice to any other action the Commission may take. n16 Rule 505 of Regulation D, which incorporates the Rule 262 disqualifying criteria by reference, likewise provides that the disqualification will not be applied if the Commission determines, upon a showing of good cause, "that it is not necessary under the circumstances that the exemption be denied. n17 "Good cause" is approached subjectively, and may include an assessment of the fairness of the penalty of disqualification in particular circumstances in which the disqualified entity, particularly one disqualified as an affiliate, is actually remote from any conduct that formed the basis of disqualification. n18

[6] Intermediary Regulation

The small issue exemptions established under Securities Act section 3(b) generally have no impact on the regulation of intermediaries that undertake those offerings with or on behalf of the issuer. Broker-dealers and agents engaged in underwriting activities, or sales generally, remain subject to licensing requirements under state Blue Sky laws.

Small business issuers may in many cases undertake to offer and sell securities directly. Most states accommodate direct issuer capital formation activities by specifically excluding issuers from the definitions of "broker" or "dealer" in their Blue Sky Laws. The 2002 Uniform Securities Act, for example, provides that the term "broker-dealer" means a person engaged in the business of effecting transactions in securities for the account of others or for the person's own account, but the term expressly does not include an issuer. n19 States without an express exclusion of issuers from the key definition incorporate one into an exemption from the broker-dealer registration requirement itself. Some others, however, impose notice requirements on issuers who engage in the offer and sale of their own securities. "Issuer agents," "finders," and other agents acting on behalf of the issuer may be subject to licensing or registration requirements at the state level. n20

The Regulation A offering process is subject to all state law provisions for licensing or registration of intermediaries that are a part of it. Because these requirements are not entirely uniform, the issuer's consideration of Rule 504 and 505 of Regulation D and Regulation A alternatives may be impacted by the extent to which state Blue Sky laws permit involvement by intermediaries not required to be licensed or registered as broker-dealers or agents. Because Rule 505 of Regulation D interfaces with the ULOE, or a ULOE analog, at the state level, a state exemption from licensing requirements for intermediaries engaged exclusively in the offer and sale of exempt securities would be significant, as there is no securities exemption in Blue Sky laws that is designed to interface with Regulation A.

FOOTNOTES:

(n1)Footnote 1. ACE-Net is available at <http://www.ace-net.org>.

(n2)Footnote 2. Although securities offered and sold in a Rule 506 compliant offering are federal covered securities under NSMIA, and for state registration and qualification requirements are thus preempted, NSMIA expressly preserved the right of state securities administrators to require notice filings, and to assess fees, *see 15 U.S.C. § 77r(c)(2)*.

(n3)Footnote 3. Securities Act Rel. No. 33-8891, "Electronic Filing and Revision of Form D" (Feb. 6, 2008).

(n4)Footnote 4. *Id.*

(n5)Footnote 5. *Id.*

(n6)Footnote 6. Rule 251(c), 17 C.F.R. § 230.251(c).

(n7)Footnote 7. *See* Securities Act Rel. No. 4552 (Nov. 6, 1962).

(n8)Footnote 8. Rule 502(a), 17 C.F.R. § 230.502(a).

The SEC staff will not issue interpretations on integration questions generally, and in connection with Regulation A offerings specifically, *see* Suburban Bankshares, Inc., SEC No-Action Letter, 1983 SEC No-Act LEXIS 2465 (June 17, 1983).

(n9)Footnote 9. Rule 502(a), 17 C.F.R. § 230.502(a).

(n10)Footnote 10. *Id.* ("Note").

(n11)Footnote 11. *See* Regulation A: Rule 260(a)(1)-(3), 17 C.F.R. § 230.260(a)(1)-(3); Regulation D: Rule 508(a), 17 C.F.R. § 230.508(a).

(n12)Footnote 12. For Regulation A offerings, the failure to comply with the eligibility rule, the amount limitation, offer restrictions, and conditions applicable to continuous or delayed offerings will not be excused, *see* Rule 260(2), 17 C.F.R. § 230.260(a)(2). Under Regulation D, the failure to comply with manner of offering limitations, and the integration provision applicable to both Rule 504 and 505 offerings is deemed to be significant, *see* Rule 508(a)(2).

(n13)Footnote 13. 17 C.F.R. § 230.262.

(n14)Footnote 14. 17 C.F.R. § 230.505(b)(2)(iii).

(n15)Footnote 15. For all disqualifications, which are applicable to Regulation A offerings and also, by incorporation, to offerings under Rule 505 of Regulation D, *see* Regulation A Rule 262(a)-(c), 17 C.F.R. § 230.262(a)-(c).

(n16)Footnote 16. *See* Donaldson, Lufkin & Jenrette Securities Corp., SEC No Action Letter, 1992 SEC No-Act LEXIS 934 (Sept. 22, 1992) (Disqualification waived where conduct related to a single, isolated underwriting, and did not involve reckless, negligent or deficient practices).

(n17)Footnote 17. Rule 505(b)(2)(iii)(C). As with Regulation A Rule 262, Rule 505 also provides that any determination made by the SEC is without prejudice to any other action by the Commission in any other proceeding or matter with respect to the issuer or any other person.

(n18)Footnote 18. *See* General Electric Company, SEC No-Action Letter, 1988 SEC No-Act LEXIS 754 (May 24, 1988) (Activities which formed the basis of disqualification occurred at an acquired company and prior to the time of the acquisition, and none of the persons directly or indirectly controlling the acquiring company were the subject of disqualifying actions).

(n19)Footnote 19. 2002 Unif. Sec. Act § 104(4)(B).

(n20)Footnote 20. *See generally* Rapp, *Blue Sky Regulation* § 10.02[3] (2d ed. Matthew Bender & Co.)



63 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.06

AUTHOR: Robert N. Rapp

§ 5.06 Other Section 3(b) Offerings

Although Regulation A and Rules 504 and 505 of Regulation D under the Securities Act are most closely identified with Securities Act section 3(b), there are two special purpose exemptions established by SEC rules that fall within the prescribed limits of section 3(b). Rule 701 under the Securities Act n1 creates an exemption from Securities Act registration requirements for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation. Rule 236 under the Securities Act n2 is an exemption available for issuers that sell securities to provide funds for distribution to shareholders in lieu of issuing fractional shares or scrip certificates in connection with a stock split, reverse stock split, conversion, merger, or like transaction. Neither of these exemptions is focused on capital formation, and they are not relevant for "small issues" in that setting. Nevertheless, both are products of section 3(b) exemption authority and are part of the complete picture of section 3(b) in operation. Each is discussed further below.

[1] Rule 701: Compensatory Benefit Plans

Rule 701 under the Securities Act creates a small offering exemption from registration requirements for issuers that are not subject to the reporting requirements of sections 13 or 15(d) of the Exchange Act that offer and sell securities under a written compensatory benefit plan or written compensation contract. The rule makes clear that its purpose is to provide an exemption from registration requirements for securities issued in compensatory circumstances. It is not available for plans or schemes designed to circumvent that purpose, such as to raise capital. n3

For purposes of the exemption, a compensatory benefit plan means any purchase, savings, option, bonus, stock appreciation, profit-sharing, thrift, incentive, deferred compensation, pension or similar plan n4 established by the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent, for the participation of employees, directors, general partners, trustees, officers, or consultants and advisers. n5 The maximum aggregate sale price or amount of securities sold in reliance on Rule 701 during any consecutive 12 month period is the greater of \$1 million or 15 percent of the total assets of the issuer, and 15 percent of the outstanding amount of the class of securities being offered. n6

Rule 701 imposes specific disclosure requirements. The issuer must deliver a copy of the compensatory benefit plan to

investors and, if the aggregate sales price or amount of securities sold during any consecutive 12 month period exceeds \$5,000,000, the following additional disclosures:

- A summary of the material terms of the plan;
- Information about the risks associated with an investment in the company; and
- Financial statements, including a balance sheet as of a date within 180 days, along with statements of income, cash flows, and stockholders' equity for two complete fiscal years and any interim period from the end of the last fiscal year to the balance sheet date. n7

Offerings made in conformity with Rule 701 will not be integrated with any other offering by the issuer. Offers and sales under Rule 701 are deemed to be part of a single, discrete offering and are not subject to integration with any other offers or sales, whether registered under the Securities Act or otherwise exempt from registration requirements. n8 However, securities issued pursuant to Rule 701 are considered "restricted securities" as defined in Rule 144 of the Securities Act. Any resales, therefore, must be registered or carried out in compliance with Rule 144 if no other exemption is available. n9

In 2007 the Securities and Exchange Commission amended Rule 701, along with Rule 12h-1 under the Securities Exchange Act of 1934, n10 with a view to expanding the ability of foreign private issuers n11 that are not U.S. reporting companies to provide stock-based compensation to their U.S. employees. n12 Those amendments are as follows:

- Effective March 4, 2008, the financial statements delivered to employee stock plan participants to satisfy Rule 701 may be prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").
- Effective December 7, 2007, compensatory stock options that meet certain criteria will no longer independently trigger reporting requirements under the Exchange Act..

Previously, stock options were viewed as a separate class of equity securities of an issuer. If there were more than 300 U.S. option holders and more than 500 worldwide, the issuer could be subjected to Exchange Act reporting requirements. The 2007 amendment to Rule 12h-1 under the Exchange Act now exempts options from triggering Exchange Act reporting requirements, provided the following conditions are met:

- The company is not already a reporting company;
- The stock options are issued under a written compensatory plan;
- Stock options are held only by employees and other individuals eligible to participate in a Rule 701 plan, and their permitted transferees;
- Stock options and, prior to exercise, the underlying shares are not transferable other than to family members, through gifts or domestic relations orders, or to an executor or guardian upon the death or disability of the holder (or to the issuer in the event of a change in control);
- The stock options and, prior to exercise, the shares issuable upon exercise are restricted as to any pledge; and
- The company agrees in the written plan (or a stock option or other agreement) to provide certain

information to option holders for as long as the issuer is relying on the exemption from reporting. n13

[2] Securities Act Rule 236 Offerings

Rule 236 n14 exempts from registration under the Securities Act, under certain conditions, shares of stock or similar security which are publicly offered to provide funds to be distributed to security holders in lieu of issuing fractional shares, scrip certificates, order forms, or other evidences of such fractional interest, in connection with a stock dividend, stock split, reverse stock split, conversion, merger or similar transaction. The conditions of the exemption are that the issuer is required to file and has filed reports with the Commission pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934, that the aggregate gross proceeds from the sale of the shares do not exceed \$300,000 and that the issuer furnish information to the Commission at least 10 days prior to the offering of the shares, as follows:

- Notice that it proposes to offer shares in reliance on Rule 236;
- The estimated number of shares to be offered;
- The aggregate market value of the shares to be offered as of the latest practicable date; and
- A brief description of the transaction in connection with which the shares are being offered. n15

The information required by Rule 236 is needed to provide public notice that an issuer is relying on the exemption.

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. § 230.701.

(n2)Footnote 2. 17 C.F.R. § 230.236.

(n3)Footnote 3. See Rule 701, Preliminary Note 5.

(n4)Footnote 4. Rule 701(c)(2), 17 C.F.R. § 230.701(c)(2).

(n5)Footnote 5. Rule 701(c)(1) sets out special requirements for sales of shares to "consultants and advisors." The critical condition is that these persons provide *bona fide* services to the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent; and those services are not in connection with the offer or sale of securities in a capital raising transaction. Similarly, the services may not directly or indirectly promote or maintain a market for the issuer's securities. See *generally*, Talbert Medical Management Corporation, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 887 (Sept. 16, 1997) (Professionals closely associated with the company in the administration and management of the company, and in providing important services, qualify as "consultants or advisers" under Rule 701(b)(1)); Princeton Medical Management Resources, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 888 (Sept. 12, 1997) (Physicians participating in the company's primary care delivery network are sufficiently closely associated with the company to qualify under Rule 701).

(n6)Footnote 6. Rule 701(d)(2), 17 C.F.R. § 230.701(d)(2).

(n7)Footnote 7. Rule 701(e), 17 C.F.R. § 230.701(e). Rule 701 does not itself require that the financial statements be audited. However, if the issuer's financial statements are audited for any other reason, then it must provided the audited financial statements for purposes of Rule 701 disclosure.

(n8)Footnote 8. Rule 701(f), 17 C.F.R. § 230.701(f).

(n9)Footnote 9. Rule 701(g), 17 C.F.R. § 230.701(g).

(n10)Footnote 10. Sec. Act Rel. No. 33-8879 (Dec. 21, 2007, eff. March 4, 2008).

Securities Exchange Act Rule 12h-1, 17 C.F.R. § 240.12h-1, was amended effective December 7, 2007, *see* Exchange Act Rel. No. 34-56887 (Dec. 3, 2007).

(n11)Footnote 11. A "foreign private issuer" for purposes of Rule 701 is defined in Rule 405 under the Securities Act as any foreign issuer other than a foreign government, but not including an issuer meeting the following conditions:

(1) More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and

(2) Any of the following:

a) The majority of the executive officers or directors are United States citizens or residents;

b) More than 50 percent of the assets of the issuer are located in the United States; or

c) The business of the issuer is administered principally in the United States.

See Securities Act Rule 405 ("Definition of Terms"), 17 C.F.R. § 230.405.

(n12)Footnote 12. Sec. Act Rel. No. 33-8879, N. 147, *supra*.

(n13)Footnote 13. Rule 12h-1(f), 17 C.F.R. § 240.12h-1(f).

(n14)Footnote 14. 17 C.F.R. § 230.236.

Provided the aggregate gross proceeds from the sale of all shares of stock offered in connection with a covered transaction and other conditions are met, Rule 236 establishes an exemption from Securities Act registration for:

Shares of stock or similar security offered to provide funds to be distributed to shareholders of the issuer of such securities in lieu of issuing fractional shares, scrip certificates or order forms, in connection with a stock dividend, stock split, reverse stock split, conversion, merger or similar transaction.

(n15)Footnote 15. Rule 236(c)(1)-(4), 17 C.F.R. § 230.236(c)(1)-(4).



64 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.07

AUTHOR: Robert N. Rapp

§ 5.07 Securities Act § 3(c): SEC Regulation E

[1] Regulation E--Generally

In section 3(c) of the Securities Act, n1 Congress authorized the SEC to adopt rules and regulations for the exemption securities offered and sold by a "small business investment company" organized under the Small Business Incentive Act of 1958. n2 The Commission responded in 1958 with the adoption of Regulation E under the Securities Act, n3 which provides an exemption from registration provisions of the Securities Act for securities issued:

by any small business investment company which is registered under the Investment Company Act of 1940, or any closed-end investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940 or has notified the Commission that it intends to elect to be regulated as a business development company pursuant to section 54 of the Investment Company Act of 1940... n4

As defined in Regulation E under the Securities Act, the term "small business investment company" means any company:

which is licensed as a small business investment company under the Small Business Investment Company Act of 1958 or which has received the preliminary approval of the Small Business Administration and has been notified by the Administration that it may submit a license application. n5

As with offerings made under exemptions adopted under section 3(b) of the Securities Act, the aggregate offering price of securities offered and sold under Regulation E is also \$5 million. This limitation, however, is prescribed by Regulation E itself rather than section 3(c) of the Securities Act, which contains no limitation.

Small Business Investment Companies ("SBICs") are financial institutions which provide equity capital and long-term debt to the small business community. n6 SBICs are licensed by the U.S. Small Business Administration ("SBA"), but are privately-managed firms. In return for pledging to finance only small businesses, SBICs qualify for long-term financing from the SBA. SBICs make only long-term loans or equity investments; therefore, the interest of the small business owner and the SBIC coincide as both want the firm to grow and prosper. Most SBICs make their profit by

owning equity in the borrower or by having an option to own equity in the small business. Securities Act section 3(c) and Regulation E, provide an avenue for SBICs in raising capital used to provide equity capital, long-term loans, debt equity investments and management assistance to qualifying small businesses. While most SBICs consider a wide variety of investment opportunities, others may elect to specialize in a certain business.

Regulation E is also available for offerings by a closed-end investment company that has elected to be regulated under the Investment Company Act of 1940 as a "Business Development Company ("BDC"). As used in Regulation E, the term "business development company" means: "Any closed-end investment company which meets the definitional requirements of section 2(a)(48)(A) and (B) of the Investment Company Act of 1940." n7 Business Development Companies operate as closed-end funds that make investments in private companies and thinly traded public companies through the use of senior debt, mezzanine financing, and equity funding. Equity capital provided by public shareholders, financial institutions, and debt capital from various sources may be used to make investments in growing small businesses and to acquire and value enhance existing shells. BDC investors can potentially enjoy the total return of capital appreciation and dividend yield offered, as well as an opportunity to participate in the growth of privately owned companies.

Regulation E requires SBICs and BDCs, when making an offering of securities pursuant to Regulation E, to notify the Commission of the offering by filing Form 1-E. n8 Filing of this form is mandatory, and must be made at least ten business days prior to the date on which the initial offering of securities is to be made. n9 The Commission staff uses the information to monitor usage of and compliance with Regulation E. The information collected on Form 1-E is publicly available, and includes information concerning:

- The issuer;
- Affiliates and principal security holders;
- Directors and officers;
- Counsel for the issuer and underwriters;
- Jurisdictions in which the securities are to be offered;
- Other unregistered securities issued or sold within one year;
- Other present or proposed offerings. n10

In operation, Regulation E parallels Regulation A in several ways. In calculating the maximum amount limitation, for example, all securities previously sold pursuant to a Regulation E offering that commenced within one year of the commencement of the proposed offering must be included. As with Regulation A, filing of an offering circular is required. The offering circular for a Small Business Investment Company is much like that used under Regulation A. Financial statements are to be included, although they need not be certified unless the issuer is otherwise required to file certified statements. Regulation E also contains requirements relating to the filing of sales materials. There are "bad boy" disqualifying criteria, and procedures for suspension of the exemption. These elements of Regulation E are discussed further below.

[2] Filing and Offering Procedures

The central elements of the Regulation E offering process are: (1) filing "notification" on Form 1-E at least 10 business days prior to the date on which the initial offering or sale of securities is to be made; n11 and (2) filing and using an Offering Circular. Upon written request, the SEC may permit a Regulation E offering to be commenced prior to the

expiration of the 10 day Form 1-E notification filing. The offering circular, prepared in accordance with either Schedule A or B of Regulation E, as appropriate, n12 must be filed with the issuer's Form 1-E notification. If the offering circular is thereafter amended, a new 10 day period for review begins, unless a shorter time is allowed.

No written offer of securities by the issuer may be made unless the offering circular is concurrently given or has previously been given to the person to whom the offer is made, or has been sent to such person under such circumstances that it would normally have been received by the person at or prior to the time of such written offer. n13 No securities may be sold unless such an offering circular is given to the person to whom the securities are sold, or is sent to such person under such circumstances that it would normally be received by that person, with or prior to any confirmation of the sale, or prior to the payment of all or any part of the purchase price of the securities, whichever first occurs. n14

Although the SEC reviews offering circulars filed under Regulation E, as with Regulation A, no approval or "effectiveness" is involved. Moreover, an offering circular filed under Regulation E may be distributed prior to expiration of the 10 day waiting period provided it is labeled as a "Preliminary Offering Circular," and that it meets specific requirements for content and contains a prescribed legend. n15 Oral offers may be made in connection with use of the Preliminary Offering Circular. However, if any changes are made in the final offering circular the revised form must be provided to all persons to whom the securities are to be sold at least 48 hours prior to mailing a confirmation of sale. In any event, an offering circular which contains all of the information required by Schedule A or B of Regulation E and which is not designated as a Preliminary Offering Circular must be furnished with or prior to delivery of a confirmation of sale to any person who has been furnished with a Preliminary Offering Circular.

Prior to sending or giving an offering circular, Regulation E also permits a limited form of advertising or communication which states from whom an offering circular may be obtained, and contains no more than the following information:

- The name of the issuer of such security;
- The title of the security, the amount being offered, and the per-unit offering price to the public; and
- The identity of the general type of business of the issuer. n16

The Regulation E offering circular requirement does not apply to an offering for which the aggregate offering price of all securities of the issuer offered or sold without the use of an offering circular does not exceed \$100,000, provided certain conditions are satisfied. n17 Those conditions require submission of Regulation E Schedule A or B information (with the exception of financial statements) along with the issuer's notification. Additionally, any advertisement must be limited solely to provide information regarding the name of the issuer; the title of the security being offered and the per unit offering price to the public; the identity of the general type of business of the issuer; and by whom orders will be filled or from whom further information may be obtained. n18

For Regulation E offerings generally, certain sales materials must be filed with the SEC at least five business days prior to being used, unless a shorter time is allowed. The specific sales materials to be filed are:

- Every advertisement, article or other communication proposed to be published in any newspaper, magazine or other periodical;
- The script of every radio or television broadcast; and
- Every letter, circular or other written communication proposed to be sent, given or otherwise communicated to more than 10 persons. n19

Reports of sales pursuant to Regulation E must be filed within 30 days after the end of each six month period following the date of the original offering circular or submission of the statement required for an offering under \$100,000. SEC Form 2-E is prescribed for this purpose. A final report of sales must be made upon completion or termination of the offering. n20

As with Regulation A, compliance with Regulation E permits unrestricted offers and sales of the securities to an unlimited number or people. Likewise, there are no resale or other post-offering restrictions on securities sold pursuant to Regulation E. In all of this, however, and as with Regulation A offerings, there is no universal interface with exemptions in state Blue Sky laws. A Regulation E offering will be subject to state registration or qualification requirements unless there is an exemption for securities issued by small business investment companies or business development companies, or the offering is eligible for another exemption. n21

[3] Electronic Filing

Currently, Securities Act Regulation S-T--General Rules and Regulations for Electronic Filings n22--requires paper filings with the SEC in connection with offerings under Regulation E. However, in order to facilitate the efficient submission of filings, and to enable the public to access them more quickly and search them more easily, in 2007 the SEC proposed to make mandatory the electronic submission of Regulation E filings by small business investment companies and business development companies through EDGAR--the Electronic Data Gathering, Analysis, and Retrieval System. n23 The EDGAR Filer Manual (Volume II) n24 has been updated to describe the EDGAR electronic submission types that filers would use for electronic submission if and when the Commission adopts the proposal. Those submission types in connection with Regulation E filings are as follows:

- 1-E: Notification under Regulation E by small business investment companies and business development companies;
- 1-E/A: Amendment to a notification under Regulation E by small business investment companies and business development companies;
- 2-E: Report of sales of securities pursuant to Rule 609 under Regulation E;
- 2-E/A: Amendment to a report of sales of securities pursuant to Rule 609 under Regulation E;
- 1-E AD: Sales material filed pursuant to Rule 607 under Regulation E;
- 1-E AD/A: Amendment to sales material filed pursuant to Rule 607 under Regulation E.

Forms 1-E AD and 1-E AD/A above are new paper submission types that were added to the EDGAR Filer Manual. n25

[4] SEC Enforcement Authority under Regulation E

Under Regulation E the SEC is authorized to temporarily suspend the exemption and, following prescribed procedures, to make a suspension permanent. n26 By this authority the SEC may at any time enter an order temporarily suspending the Regulation A exemption if it has reason to believe:

- The exemption is not available, or any of the terms, conditions or requirements have not been complied with;
- The offering statement, any sales or solicitation of interest material contains any false or misleading

statement of a material fact;

- The offering is being made or would be made in violation of the general antifraud prohibitions in section 17 of the Securities Act;
- An event has occurred after the initial filing of the offering statement which would have rendered the exemption unavailable if it had occurred prior to the filing;
- Criminal proceedings or a civil injunction action have been initiated against certain persons associated with the issuer; or
- The issuer or any promoter, officer, director or underwriter has failed to cooperate, or has obstructed or refused to permit an investigation by the Commission in connection with any offering made or proposed to be made in reliance upon Regulation E. n27

The order for a temporary suspension of the exemption becomes permanent thirty days after its entry, unless a hearing requested after the issuer is notified of the order and the reasons for it being issued. n28 Also, without issuing a temporary suspension, the Commission may at any time after notice and an opportunity for hearing permanently suspend the exemption. n29

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. § 77c(c)*.

(n2)Footnote 2. *15 U.S.C. § 661, et seq.* The Small Business Investment Act ("SBIA") was designed to improve and stimulate the flow of private equity capital and long term loan funds to small businesses for financing expansion and growth. Under the SBIA the U.S. Small Business Administration is authorized, among other things, to license and provide funding to Small Business Investment Companies. *Id.* Section 3(c) of the Securities Act provides:

The Commission may from time to time by its rules and regulations and subject to such terms and conditions as may be prescribed therein, add to the securities exempted ... any class of securities issued by a small business investment company under the Small Business Investment Act of 1958 if it finds, having regard to the purposes of that Act, that the enforcement of this Act with respect to such securities is not necessary in the public interest and for the protection of investors. *15 U.S.C. § 77c(c)*.

(n3)Footnote 3. Regulation E is comprised of Rules 601 through 610a under the Securities Act, *17 C.F.R. § 230.601 - 610a*. Regulation E is reprinted in its entirety in the Primary Law Sourcebook, Volume A, Section C of the Securities Act (Matthew Bender).

(n4)Footnote 4. Rule 602(a), *17 C.F.R. § 230.602(a)*.

(n5)Footnote 5. *Id.*

Rule 602(b)(4) makes the Regulation E exemption unavailable to an issuer if, among other things, such issuer or any of its affiliates is subject to any "order, judgment, or decree of any court of competent jurisdiction, entered within five years prior to the filing of such [Regulation E] notification, temporarily or permanently restraining or enjoining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of securities." Rule 602(c)(2) also makes the exemption unavailable to an issuer if, among other things, any investment adviser or underwriter of the securities to be issued is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer or investment adviser." Rule 602(e) provides, however, that

the disqualification shall not apply "if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." *See, e.g.*, First Southwest Co., Sec. Act Rel. No. 33-8920 (May 27, 2008); Thomas Weisel Partners, LLC, Sec. Act Rel. No. 33-8494 (Sept. 24, 2004).

(n6)Footnote 6. Rule 602(a), 17 C.F.R. § 230.602(a).

(n7)Footnote 7. 15 U.S.C. § 80a-2(a)(48). A BDC is defined in section 2(a)(48) of the Investment Company Act as a closed-end company which:

- Is organized or has its principal place of business in any state;
- Is operated for the purpose of making investments as permitted under the Act, and makes available significant managerial assistance to its portfolio companies that meet certain criteria; and
- Elects to be subject to the provisions of sections 55 through 65 of the investment Company Act. *Id.*

(n8)Footnote 8. Rule 604, 17 C.F.R. § 230.604.

(n9)Footnote 9. Rule 604a, 17 C.F.R. § 230.604a

(n10)Footnote 10. *See* Form 1-E, 17 C.F.R. § 239.200.

(n11)Footnote 11. Rule 604a, 17 C.F.R. § 604a.

(n12)Footnote 12. Schedule A of Regulation E prescribes the contents of offering circulars for Small Business Investment Companies; and Schedule B does the same for Business Development Companies, *see* Rule 610a, 17. C.F.R. § 230.610a

(n13)Footnote 13. Rule 605a(1), 17 C.F.R. § 230.605a-1.

(n14)Footnote 14. Rule 605a(2), 17 C.F.R. § 230.605a-2.

(n15)Footnote 15. Rule 605f, 17 C.F.R. § 230.605f.

(n16)Footnote 16. Rule 605b, 17 C.F.R. § 230.605b

(n17)Footnote 17. Rule 606, 17 C.F.R. § 230.606.

(n18)Footnote 18. Rule 606b, 17 C.F.R. § 230.606b.

(n19)Footnote 19. Rule 607, 17 C.F.R. § 230.607.

(n20)Footnote 20. Rule 609, 17 C.F.R. § 230.609.

(n21)Footnote 21. *See* § 5.09[2], *infra*.

(n22)Footnote 22. 17 C.F.R. § 232.

(n23)Footnote 23. *See* Sec. Act Rel. No. 33-8859 (November 1, 2007) (Rulemaking for EDGAR System; Mandatory Electronic Submission of Applications for Orders under the Investment Company Act and Filings Made Pursuant to Regulation E--proposing release).

(n24)Footnote 24. Sec. Act Rel. No. 33-8922 (May 30, 2008) (Adoption of Updated EDGAR Filer Manual).

(n25)Footnote 25. Rel. No. 33-8922, *supra*.

(n26)Footnote 26. Rule 610a-b, 17 *C.F.R.* § 230.610a-b.

(n27)Footnote 27. Rule 610(a)(1)-(7).

(n28)Footnote 28. Rule 610(b).

(n29)Footnote 29. Rule 610(c).



65 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.08

AUTHOR: Robert N. Rapp

§ 5.08 Regulation CE--Coordinated Exemption for Certain Issues of Securities Exempt under State Law

In 1996, acting pursuant to its authority to provide exemptions for small offerings under section 3(b) of the Securities Act, the SEC created a federal exemption for offerings up to \$5 million that meet the qualifications of a particular California state exemption--*Section 25102(n) of the California Corporations Code* (the "California Code"). n1 Regulation CE was created, and consists entirely of Rule 1001 under the Securities Act. n2 It exempts from the registration provisions of the federal Securities Act the offer and sale of securities that satisfy the conditions of paragraph (n) of section 25102 of the California Code and subsection (b) of Rule 1001. The Rule only addresses the California exemption. In its adopting Release, the SEC proposed to provide the same exemption for any state that enacts a transaction exemption incorporating the same standards used by California. n3 The Commission also made clear that separate consideration for a federal exemption would be given to states that adopt other similar exemptions that protect the public interest. n4 However, no other states have requested their own exemption.

Rule 1001 provides that the sum or all cash and other consideration to be received for the securities sold shall not exceed \$5,000,000, less the aggregate offering price for all other securities sold in the same offering of securities, whether pursuant to Regulation CE or another exemption from registration. All securities offered pursuant to Regulation CE are considered "restricted securities" as defined in Rule 144 under the Securities Act, and any resales of such securities must be made in compliance with the registration requirements of the Securities Act or pursuant to an available exemption.

The California exemption generally is limited to issuers that are California corporations or other forms of business entities organized under California law, including partnerships and trusts. Sales of securities made pursuant to Section 25102(n) must be made only to qualified purchasers or other persons the issuer believes, after reasonable inquiry, to be qualified purchasers. n5 A corporation, partnership, or other organization specifically formed for the purpose of acquiring the securities offered by the issuer in reliance upon the exemption may be a qualified purchaser if each of the equity owners of such entity is a qualified purchaser. Qualified purchasers include the following:

- any person so designated in Section 260.102.13 of the California Code of regulations;
- a bank, savings and loan association, trust company, insurance company, investment company

1-5 Federal Securities Act of 1933 § 5.08

registered under the Investment Company Act of 1940, certain pension or profit sharing trusts, an institutional investor or governmental agency or instrumentality designated by the California Corporation Commission, any corporation without standing securities registered under Section 12 of the Exchange Act or any wholly owned subsidiary thereof or any other person designated by rule of the California Corporation Commission;

- a pension or profit-sharing trust of the issuer, a self-employed individual retirement plan or an individual retirement account if the investment decisions made on behalf of the trust, plan or account are made solely by persons who are qualified purchasers;

- a not-for-profit organization under *section 501(c)(3) of the Internal Revenue Code*, a corporation, a Massachusetts or similar business trust or a partnership, with total assets in excess of \$5 million; and

- with respect to the offer and sale of one class of voting common stock of an issuer or a preferred stock of an issuer entitling the holder thereof to at least the same voting rights as the issuer's one class of voting common stock, provided that the issuer has only one class voting common stock outstanding upon consummation of the offer and sale, an actual person who either individually or jointly with the person's spouse, (1) has a minimum net worth of \$250,000 and had, during the immediately preceding tax year, gross income in excess of \$100,000 and reasonably expects gross income in excess of \$100,000 during the current tax year or (2) has a minimum net worth of \$500,000, which net worth is determined exclusive of home, home furnishings, and automobiles.

Each such natural person by reason of his or her business or financial experience or the business or financial experience of his or her professional adviser, who is unaffiliated with and who is not compensated, directly or indirectly, by the issuer of any affiliate or selling agent of the issuer, can be reasonably assumed to have the capacity to protect his or her own interests in connection with this transaction. The amount of investment of each natural person in such investment shall not exceed 10 percent of the net worth of such person.

Each person in a Rule 1001 California transaction must represent that he or she is purchasing for the purchaser's own account and not with a view to or for sale in connection with a distribution of this security. n6 The issuer must provide to each natural person purchaser, at least five business days before securities are sold to or a commitment to purchase is accepted from such purchaser, a written offering disclosure statement which satisfies the requirements of Regulation D under the federal Securities Act. n7 The issuer is allowed to make a general announcement of its proposed offering under Rule 25102(n) by publishing a written document which provides "tombstone" type information. This announcement *must* contain the following information:

- the name of the issuer;
- the full title of the security to be issued;
- the anticipated suitability standards for prospective purchasers;
- a statement that no money order or other consideration is being solicited or will be accepted, an indication of interest made by a prospective purchaser involves no obligation or commitment of any kind, and, if the issuer is required to deliver a disclosure statement to prospective purchasers, that no sales will be made or commitment to purchase accepted until five business days after delivery of such disclosure statement; and
- an address where a purchaser can obtain more information about the issuer. n8

The following information *may* be included in such an announcement:

- a brief description of the issuer's business;
- the geographic location of the issuer and its business; and
- the price of the security to be issued or, if the price is not known, the method of its determination or the probable price range as specified by the issuer and the aggregate offering price. n9

Section 25102(n) prohibits the issuer from making telephone solicitations until the issuer has determined that the prospective purchaser is a qualified purchaser. n10 The issuer is also required to file a notice of a Section 25102(n) transaction concurrent with the publication of a general announcement of a proposed offering or at the time of the initial offer of the securities, whichever occurs first, accompanied by the filing fee, and within ten business days following the close or abandonment of the offering, but in no case more than 210 days from the date of filing the first notice. n11

FOOTNOTES:

(n1)Footnote 1. Sec. Act Rel. No. 33-7285, Fed. Sec. L. Rep. (CCH) [Middle dot] 85,803 (May 1, 1996)

(n2)Footnote 2. *17 C.F.R. § 230.1001.*

(n3)Footnote 3. Sec. Act Rel. No. 33-7285, Fed. Sec. L. Rep. (CCH) [Middle dot] 85,803 (May 1, 1996).

(n4)Footnote 4. *Id.*

(n5)Footnote 5. *Cal. Corp. Code § 25102(n)(2).*

(n6)Footnote 6. *Cal. Corp. Code § 25102(n)(3).*

(n7)Footnote 7. *Cal.Corp. Code § 25102(n)(4).*

(n8)Footnote 8. *Cal. Corp. Code § 25102(n)(5)(A).*

(n9)Footnote 9. *Cal. Corp. Code § 25102(n)(5)(B).*

(n10)Footnote 10. *Cal. Corp. Code § 25102(n)(6).*

(n11)Footnote 11. *Cal. Corp. Code § 25102(n)(7).*



66 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 5 Small Issue Exemptions under Sections 3(b) and 3(c) of the Securities Act

1-5 Federal Securities Act of 1933 § 5.09

AUTHOR: Robert N. Rapp

§ 5.09 The Impact of Blue Sky Laws

The dual system of federal and state securities regulation means that unless state regulation has been preempted, offerings made in reliance on a federal exemption must also qualify as exempt from registration requirements under state Blue Sky laws. To interface smoothly with federal Regulation D, states adopted, in one form or another, a coordinate exemption. In most states that coordinate exemption is the Uniform Limited Offering Exemption ("ULOE") developed by the North American Securities Administrators Association ("NASAA"). n1 After NSMIA, a Rule 506 offering is a federal "covered security" for which state registration and qualification requirements are preempted. n2 However, with the ULOE in place, offerings made in compliance with Rule 505 of federal Regulation D will also be exempt under Blue Sky laws, provided ULOE requirements applicable to non-accredited investors are met. n3

[1] Securities Act § 3(b) Exemptions

Regulation A does *not* interface with state law exemptions under the ULOE or otherwise. Thus, for example, in states making no provision for "testing the waters" by solicitations of interest, use of that procedure specifically authorized under Regulation A will violate the applicable Blue Sky law unless some exemption is available to cover what, by definition, will be defined as an offer to sell. In the 2002 Uniform Securities Act, for example, "offer to sell" is defined to include "every attempt or offer to dispose of, or solicitation of an offer to purchase a security or interest in a security for value." n4 Only a handful of state securities laws allow testing the waters. The states that do are not entirely uniform, and in some instances impose conditions that differ in some respects from those imposed under Regulation A. n5

Because there is no coordinate state law exemption for Regulation A offerings, and because securities offered under Regulation A are not federal covered securities for purposes of NSMIA preemption, these offerings will be subject to state registration requirements. At the state level it is, therefore, more desirable to rely on Rule 505 of Regulation D, which does coordinate with the ULOE. n6 The ultimate determination, however, may rest on the fact that Regulation A imposes no restriction on purchasers, and expressly permits testing the waters, which is meaningful in those states that also permit the process. The ability to engage in general solicitation and advertising, which is not permitted under Rule 505 of Regulation D, is another important consideration in determining the choice of action.

Also, the ULOE has its own set of conditions. For example, while non-accredited investors are not required to meet a sophistication standard, there is a *suitability* requirement imposed on the issuer if the non-accredited investor lacks sufficient knowledge and experience. n7 The interface of Rule 505 and state law ULOE provisions also means that qualified offerings must meet the information requirements of Rule 502(b) for sales to non-accredited investors. For offerings by small issuers that are not subject to the reporting requirements of the Exchange Act, this means supplying to non-accredited investors the non-financial information equivalent to that which would be contained in Part II of Form 1-A of Regulation A. n8 Thus, while each small issue must be considered individually in terms of proceeding under Regulation A or Rule 505 of Regulation D under the federal Securities Act, it is certain that state Blue Sky laws will play an important role in evaluating the alternatives.

Regulation D Rule 504 offerings remain fully subject to state regulation. Neither the ULOE, nor state analogs for the most part, n9 encompass Rule 504 offerings. As discussed earlier, however, states have made accommodations to ease the compliance burden on small business issuers through SCOR and other alternatives.

Outside the capital formation setting state securities laws impact Securities Act section 3(b) exemptions by reason of non-uniformity. State exemptions applicable to compensatory benefit plans are not uniform, and issuers relying on the federal exemption from registration provided by Securities Act Rule 701 n10 face considerable uncertainty. The original (1956) Uniform Securities Act, on which the majority of state securities laws are based, includes no exemption relating to compensatory benefit plans, and states have thus approached exemptions independently and non-uniformly. Only the 2002 Uniform Securities Act, adopted in several states and under consideration in others, currently contains an exemption that may be applied consistently with federal Rule 701. n11

Although particular state securities laws may complicate the small issue offerings established under federal Securities Act section 3(b), it is also important to recognize that many states have their own small or limited offering exemptions that provide workable alternatives for small business issuers, particularly those seeking to raise seed capital. n12 There are conditions, and any such exemption is applicable only as to offers and sales of securities in that state. However, in many cases they present a better practical alternative to an offering exempt under federal law but nevertheless subject to state registration and qualification, as is the case absolutely with offerings pursuant to Rule 504 of Regulation D and pursuant to Regulation A.

The impact of state regulation of public offerings made in accordance with either federal Regulation A or pursuant to Rule 504 of Regulation D has been addressed by state level initiatives for coordinated procedures to streamline the process for registration of securities. Perhaps most notable among these initiatives is the "CR--SCOR--Mid-Atlantic Review" Program that is available to companies seeking to raise capital in Delaware, the District of Columbia, Maryland, New Jersey, Pennsylvania, Virginia, and West Virginia. The program, which includes a "Small Business Offering Mid-Atlantic Regional Review Protocol," provides an issuer with much greater efficiencies in completing the registration process. Each participating state has agreed to apply certain standards when reviewing registration applications. In particular, the Protocol adopts Form U-7 as the accepted form of registration statement for small business offerings, and also incorporates the NASAA Small Company Offering Registrations (SCOR) Issuer's Manual. n13 A lead jurisdiction is designated to coordinate the registration with each participating state, and the issuer deals only with the lead examiner. There is also an agreed time-line for the review process. Programs for coordinated review on a regional basis have been established in other areas of the country as a means of facilitating the registration and offering process in a manner that particularly benefits small business issuers who rely on either Regulation A or Rule 504 of Regulation D. n14

[2] Section 3(c) - Regulation E Offerings

Securities offered and sold under Regulation D are not federal covered securities under NSMIA. States do not exempt offerings by Small Business Investment Companies (SBICs) or Business Development Companies (BDCs) made under federal Regulation E from registration requirements. A number of states do provide an exemption for securities of local

economic development or venture capital enterprises. n15 Such individual state exemptions may be useful alternatives, although they are for the most part limited to particular state sponsors and conditioned as to purpose. Absent some other exemption, as, for example, relying on an available accredited investor exemption, Regulation E offerings must comply with state registration requirements. For that reason, as a practical matter, Regulation E offerings are often made only to accredited investors. However, an alternative may be available through a state registration by "coordination."

Registration by coordination is generally available only in regard to an offering for which a "registration statement" has been filed under the Securities Act of 1933. n16 However, two states--Maryland and Montana--have expressly incorporated Regulation E into their provisions for registration by coordination. n17 Outside of these two states, and in the absence of a available state law exemption, Regulation E offerings must be registered and, where applicable, subjected to merit review.

FOOTNOTES:

(n1)Footnote 1. See CCH NASAA Reports [Middle dot]6201, at 6101.

States that have not adopted the ULOE include specific transaction exemptions for offers and sales of securities made in conformity Regulation D Rule 505 or 506, although the latter is no longer necessary. See, e.g., *Ohio Rev. Code §§ 1707.03(W), (X)*. The 2002 Uniform Securities Act, adopted in several states and under active consideration in others, includes a blanket exemption for all federal covered securities but no ULOE analog for federal Rule 505 offerings, see 2002 Unif. Sec. Act § § 201-202. State adopting the 2002 Uniform Act have by rule provided for a continuing coordinated limited offering exemption, either in the form of the ULOE or otherwise, see, e.g., S.C. Sec. Comm'r Rule 13-204 ("Regulation D Offerings").

(n2)Footnote 2. But see Rapp & Berckmueller, *supra*, at 815-827.

(n3)Footnote 3. The ULOE does not impose any qualification requirements on accredited investors beyond the accreditation criteria. Non-accredited investors, however, must meet either a suitability or a sophistication standard. For a discussion of these standards, and the ULOE or its equivalents in general, see Rapp, *Blue Sky Regulation § 8.06[2]* (2d ed. Matthew Bender & Co.)

(n4)Footnote 4. 2002 Unif. Sec. Act § 102(26).

(n5)Footnote 5. In Illinois, for example, one condition to testing the waters is that the solicitor *intends* to register the security, see *14 Ill. Admin. Code § 130.212*, in contrast to Regulation A Rule 254(a), which speaks of a "contemplated" securities offering.

In the states providing for testing the waters, conditions typically focus on the type of issuer involved, the absence of disqualifying criteria, the proper qualification of agents making the solicitation, minimum information requirements, and the manner of making solicitations, see, e.g., *Ariz. Admin. Code § R14-2-141*. Some form of advance filing with the administrator is required, and a uniform form (SOI) is in most case used for this purpose.

(n6)Footnote 6. An additional consideration in weighing advantages and disadvantages between Regulation A and Rule 505 offerings is that Rule 508 of Regulation D, *17 C.F.R. § 230.508*, provides that a Rule 505 exemption will not be lost if there is a good faith insignificant deviation or failure to comply with a particular requirement. Under Rule 508 the burden is on the issuer to show that the failure to comply did not pertain to a term, condition or requirement intended to protect a particular individual or entity, and that the failure to comply was insignificant in relation to the offering taken as a whole. See also § 5.05[3] ("Substantial Compliance"), *supra*.

(n7)Footnote 7. In Massachusetts, for example, in all sales to non-accredited investor made in reliance upon that state's ULOE, the issuer must be satisfied, or the issuer and any person acting on behalf of the issuer shall have grounds to believe, after making reasonable inquiry, that purchaser suitability requirements relating to financial profile or

knowledge and experience in financial and business matters (either alone or with a purchaser representative) are met. *See 950 Code Mass. Regs. § 14.402(B0(13)).*

(n8)Footnote 8. *See* Reg. D, Rule 502(b), 17 C.F.R. § 230.502(b).

(n9)Footnote 9. *But see* Okla. Sec. Commission Admin. Rule § 660:11-11-43 (Coordinated limited offering exemption includes offers and sales made under Rule 504 of Regulation D provided certain additional state requirements are met).

(n10)Footnote 10. *See* § 5.06[1], *supra*.

(n11)Footnote 11. *See* 2002 Unif. Sec. Act § 202(21).

(n12)Footnote 12. These include various "private" offering exemptions or procedures that were in place prior to federal Regulation D and the ULOE. Several states simply exempt "small" offerings, usually up to \$500,000, when certain conditions are met, *see, e.g.,* Kentucky: *Ky. Rev. Stat. § 292.410(i)*. As reflected in the 2002 Uniform Securities Act, all states make some meaningful provision for facilitation of small business capital formation either through outright exemptions or limited offering procedures. The 2002 Uniform Act itself provides an exemption for sales to no more than 25 non-institutional purchasers during and 12 consecutive months when certain conditions are satisfied, *see* 2002 Unif. Sec. Act § 202(14). State specific alternatives are discussed further in Rapp, *Blue Sky Regulation*, *supra*. § § 8.06 and 10.04, and summarized as to each state in the *State Guides* that are a part of that Treatise.

(n13)Footnote 13. SCOR Offerings under Regulation A are discussed in § 5.02[3], *supra*.

(n14)Footnote 14. In addition to the Mid-Atlantic program, regional review programs are available in the New England, Midwest and Western regions.

(n15)Footnote 15. *See generally* Rapp, *Blue Sky Regulation* § 8.04[3] (2d ed. Matthew Bender & Co.).

(n16)Footnote 16. *See, e.g.,* 2002 Unif. Sec. Act § 303 ("A security for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offering may be registered by coordination under this section").

(n17)Footnote 17. In Maryland, registration by coordination is available for:

Any security for which the documents required by any regulation adopted by the Securities and Exchange Commission under § 3(b) or § 3(c) of the Securities Act of 1933 have been filed with the Commission in connection with the same offering may be registered by coordination... . *Md. Corp. & Associations. Code Ann. § 11-503*

See also Montana Code Ann. § 30-10-204.



67 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 6.syn

§ 6.syn Synopsis to Chapter 6: Restricted and Control Securities under the Federal Securities Laws

Scope

§ 6.01 Introduction

§ 6.02 Why it Matters that Securities Are Restricted or Control Securities: Limitations on Disposition

[1] General Availability of the Resale Exemption

[2] Limitations on Availability of Resale Exemption for Public Sales of Restricted Securities

[a] Legal Limitations.

[b] Other Limitations on Public Sales of Restricted Securities.

[3] Limitations on Availability of Resale Exemption for Public Sales of Control Securities

[4] Limitations on Availability of Resale Exemption for Public Sales of Unrestricted Securities by Non-affiliates

[a] Underwriters' Compensation Securities.

[b] Holders of Substantial Amounts of Securities.

[c] Underwriters as Result of Rule 145(d) Reorganizations or Similar Transactions.

[d] Resale of Certain Securities Acquired Overseas.

§ 6.03 Definition of Restricted Securities

[1] Rule 144 Definition

[2] Scope of Rule 144 Definition

[a] Securities.

[b] Method of Acquisition.

[3] Sources of Restricted Securities

[a] Status of Securities Acquired from the Issuer.

[i] In a Public Offering.

[ii] In a Private Offering.

[b] Status of Securities Acquired from an Affiliate.

[c] Status of Securities Acquired from Another Holder.

[d] Special Categories of Securities.

[i] Underwriters' Compensation and Similar Securities.

[ii] Securities Acquired Through Employee Benefit Plans.

[iii] Section 3(a)(10) Securities.

[iv] Section 3(a)(9) Securities.

[v] Section 3(a)(11) Securities.

[vi] Securities Acquired as Stock Dividends or in Stock Splits.

[vii] Securities Acquired as Spin-Offs or Liquidating Distributions.

[viii] Rule 145 Securities.

[ix] Securities Acquired Overseas.

[x] Securities Acquired by "Underwriters" in Bankruptcy Code Section 1145 Transactions.

[xi] Securities Acquired Pursuant to Regulation CE

[xii] Securities Offered in Rule 801 or 802 Transactions.

[4] Duration of Restricted Status

§ 6.04 Definition of Control Securities

[1] Rule 144 Definition of an Affiliate

[2] Controlling Persons of the Issuer

[3] Other Types of Affiliates

[a] Persons Controlled by the Issuer.

[b] Persons under Common Control with the Issuer.

[c] Persons Otherwise Deemed Affiliates.

[4] Duration of Control Securities Status

§ 6.05 Public Resales of Restricted Securities and Control Securities under Rule 144

[1] Nature of Rule 144

[a] Approach of Rule 144.

[b] Construction of Rule 144.

[c] Nonexclusivity of Rule 144.

[d] Amendments to Rule 144.

[2] Availability of Rule 144

[a] Resale of Restricted Securities.

[b] Sales of Control Securities.

[c] Limitations on Availability for Sales of Restricted Securities and Control Securities.

[i] Sales of Securities Subject to Registration Rights.

[ii] Sales of Restricted Securities to be Followed by Purchases of Unrestricted Securities.

[iii] Short Sales Against the Box.

[iv] Listed Call and Put Options.

[v] Sales by Broker-Dealers.

[vi] Sales by Subsidiaries of the Issuer.

[d] Sales of Unrestricted Securities by Non-affiliates.

[3] Adequate Current Public Information Requirement--Rule 144(c)

[a] Basis for Conditions of Rule 144(c).

[b] Requirements for Reporting Issuers.

[i] Ninety-Day Waiting Period.

[ii] Adequate Current Filings.

[c] Requirements for Non-reporting Issuers.

[i] Adequate Current Information.

[ii] Public Availability of Information.

[d] Exemption from Provisions of Rule 144(c).

[4] Holding Period Requirement--Rule 144(d)

[a] Basis for Condition of Rule 144(d).

[b] Commencement of Holding Period.

[i] Beneficial Ownership.

[ii] Full Payment of Purchase Price.

[c] Tacking Provisions.

[i] Securities Acquired as Stock Dividends, in Stock Splits or in Recapitalizations.

[ii] Securities Acquired in Conversions.

[iii] Securities Acquired through Contingent Payment Provisions.

[iv] Pledged Securities.

[v] Securities Acquired as Gifts.

[vi] Securities Acquired by Trusts.

[vii] Securities Acquired by Estates.

[viii] Securities Acquired upon Reclassifications, Mergers and Sales of Assets.

[ix] Securities Acquired in Divorce Settlements.

[x] Securities Acquired from Closely Related Persons.

[xi] Securities Acquired in Spin-offs or Liquidating Distributions.

[xii] Cashless Exercise of Options and Warrants

[xiii] Section 3(a)(10) Securities.

[xiv] Other Securities Subject to Tacking Provisions.

[5] Volume Limitation Requirement--Rule 144(e)

[a] Basis for Conditions of Rule 144(e).

[b] Amount of Limitations-Equity Securities.

[c] Amount of Limitations -- Debt Securities.

[d] Aggregation Provisions.

[i] Aggregation through Definition of "Person".

[ii] Pledged Securities.

[iii] Securities Acquired as Gifts.

[iv] Securities Acquired by Trusts.

[v] Securities Acquired by Estates.

[vi] Securities Sold by Persons Acting in Concert.

[vii] Securities Acquired in Divorce Settlements.

[viii] Securities Acquired from Closely Related Persons.

[ix] Securities Acquired in Spin-offs or Liquidating Distributions.

[e] Exemptions from Provisions of Rule 144(e).

[6] Manner of Sale Requirement--Rule 144(f)

[a] Basis for Conditions of Rule 144(f).

[b] Brokers' Transactions.

[c] Transactions with a Market Maker.

[d] Exemptions from Provisions of Rule 144(f).

[7] Notice of Proposed Sale Requirement--Rule 144(h)

[8] Unavailability to Securities of Issuers with No or Nominal Operations and No or Nominal Non-Cash Assets

[9] Procedures for Sales under Rule 144

[a] Responsibilities of Sellers.

[b] Responsibilities of Sellers' Brokers.

[c] Responsibilities of Issuers.

[d] Responsibilities of Transfer Agents.

[10] Effects of Compliance with Rule 144

§ 6.06 Public Resales of Restricted Securities and "Control Securities" Outside Rule 144

[1] Availability of Resale Exemption

[2] Availability of Other Exemptions

§ 6.07 Private Resales of Restricted Securities and Control Securities to Qualified Institutional Buyers under Rule 144A

[1] Nature and Philosophy of Rule 144A

[2] Conditions of the Rule 144A Exemption

[a] Reasonable Belief Buyer is a QIB

[i] Definition of QIB.

[ii] Basis for Reasonable Belief.

[b] Notice to Buyer of Reliance on Rule 144A.

[c] Eligible Securities; Fungibility Prohibition.

[i] Not of the Same Class.

[ii] Not Convertible or Exchangeable for Same Class.

[iii] When Issued.

[iv] Not Issued by an Investment Company.

[d] Information Requirement.

[i] How Right May be Ensured.

[ii] What Information Must be Available.

[3] Rule 144A Trading Markets

§ 6.08 Private Resales of Restricted Securities and Control Securities Outside Rule 144A

[1] Section 4(11/2) Phenomenon

[a] Availability of Exemption.

[b] Effects of Use of Exemption.

[2] Non-4(11/2) Resales

§ 6.09 Resales Overseas



68 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 Scope

Scope

This chapter was revised and updated by Sara Hanks, a partner in Clifford Chance US LLP, New York and Washington D.C.. Ms. Hanks is a graduate of the School of Jurisprudence of Oxford University, a Solicitor of the Supreme Court of England and Wales, and is admitted to the New York and D.C. Bars.



69 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933

SUMMARY OF THIS CHAPTER

Whether a security is a "restricted" or a "control" security is important because such securities cannot be freely resold. Restrictions on the resale of securities mainly arise where the security holder is in a control relationship with the issuer (in which case the securities are termed "control securities"); where the holder acquired the securities in a manner that involved or resulted in limitations on the availability of the Section 4(1) exemption from registration that is available for most resales (in which case the securities are termed "restricted securities"); or where both of these circumstances exist.

Holders of restricted securities and control securities who generally do not qualify for the Section 4(1) resale exemption from registration may rely on Rule 144 to effect a sale of those securities publicly. They may also resell those securities privately. *See § 6.01 infra.*

Section 4(1) exempts from the Securities Act's registration and prospectus delivery requirements all transactions by any person other than an issuer, underwriter or dealer. This is the exemption from registration relied upon (whether they realize it or not) by most persons reselling securities in the secondary market. Most ordinary investors are not underwriters, but in certain circumstances their status or activities result in their being treated as underwriters, with the result that they cannot rely on Section 4(1) for resale of their securities and therefore must register the transaction or seek another exemption. Sales of restricted securities or control securities in public offerings are generally deemed to involve an underwriter and therefore are not exempt under Section 4(1). There are even a few limitations on the availability of the Section 4(1) resale exemption for public sales of unrestricted securities by non-affiliates. *See § 6.02 infra.*

The term "restricted securities" is defined in Rule 144(a)(3) to include all securities acquired from the issuer or an affiliate of the issuer in a transaction or series of transactions not involving any public offering. All securities acquired from the issuer in a private offering are restricted. However, whether securities acquired from an affiliate in a private offering are restricted may depend on whether those securities were acquired in a "sale" or in a transaction not involving a sale. In the former case, the securities are restricted. In the latter case, the securities are restricted in the hands of the holder only if they were restricted in the hands of the affiliate. Securities acquired from a holder other than an issuer are restricted only if they were restricted in the hands of the transferor. Certain unregistered securities are not easily characterized as privately or publicly offered. *See § 6.03 infra.*

While not "restricted," "control securities" are also subject to certain limitations, including the non-availability of the Section 4(1) resale exemption. Securities obtained from a person other than an issuer or affiliate can become subject to limitations if sold to a person to whom restrictions apply (e.g. an officer or director). *See § 6.04 infra*.

Rule 144 provides that resales of restricted and control securities by the issuer and affiliates of the issuer will not be deemed a "distribution" if certain specified conditions are met. While Rule 144 is not the exclusive lawful method of effecting sales of restricted and control securities, for some transactions (such as the public resale of control securities) other methods may not be available. Those relying on the resale exemption under Section 4(1) for public resales in the absence of compliance with Rule 144 must meet a substantial burden of proof to sustain that exemption. Rule 144 is also available for resales of those few categories of unrestricted securities that are not freely tradeable by non-affiliates. Rule 144 imposes different conditions on resales depending whether the seller is an affiliate or non-affiliate of the issuer.

Rule 144(c) requires that there be adequate current information available about the issuer. This requirement is satisfied if the issuer is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act for at least ninety days prior to the time of the proposed sale and has filed all reports required to be filed during the preceding twelve months. If the issuer is a non-reporting issuer, it may meet the adequate current information requirement by voluntarily filing reports or by making publicly available the information specified in clauses (1) through (14) and (16) of Rule 15c-2-11(a)(4) under the Exchange Act.

Rule 144(d) imposes a six month holding period for restricted securities when the issuer is a reporting company under the Exchange Act and one year holding period when the issuer is not a reporting company under the Exchange Act and does not make public information specified under Rule 15c-2-11(a)(4) under the Exchange Act. This time period generally commences on the day the securities are acquired from the issuer or an affiliate of the issuer. Where restricted securities are purchased the holding period will not commence until the purchaser becomes the beneficial owner and the entire purchase price is paid. In transactions not involving a purchase, the time when economic risk commences must be determined from the nature of the transaction. In general, holders of restricted securities may "tack" the period for which they held the securities to the period for which the securities were held by a previous holder unaffiliated to the issuer. Under certain circumstances, securities may even be deemed to have been acquired by a non-affiliate as of a date when the securities were actually held by an affiliate. In addition, under certain circumstances, the holder of restricted securities may tack on to the applicable holding period the period during which securities that were economically equivalent to the restricted securities proposed to be sold were held.

Rule 144(e) imposes volume limitations for sales by affiliates. The amount of securities to be sold pursuant to Rule 144 together with the amount of the securities already sold during the three month period preceding the date of the proposed sale must be limited to the greater of one percent of the outstanding securities of the class being sold or the average weekly trading volume for the class during the four week period preceding the date of the proposed sale.

Rule 144(f) requires that sales of securities by affiliates under Rule 144 be made either in brokers' transactions, in transactions directly with a market maker, or in certain riskless principal transactions. Except in the case of riskless principal transactions, the seller is precluded from soliciting or arranging for the solicitation of orders to buy the securities proposed to be sold and from making any payments respecting the proposed sale to anyone other than the broker executing the order to sell the securities. *See § 6.05[6] infra*. Under Rule 144(h), prior to any sale of restricted or control securities under Rule 144 above a specified threshold, a notice on Form 144 must be filed in connection with sales by affiliates with the Commission and with the principal exchange on which the securities proposed to be sold are admitted to trading.

If the seller is unfamiliar with the rule's requirements and does not have counsel, an experienced broker can assist in compliance with the rule. Although compliance with Rule 144 is the seller's primary responsibility, it is also the issuer's

responsibility to guard against unauthorized sales of restricted securities by obtaining investment representations from the purchaser, placing legends on the stock certificates, and placing stop transfer instructions with its transfer agent. *See § 6.05[9] infra.*

In theory, public sales of restricted securities may take place outside Rule 144 in reliance on the resale exemption under Section 4(1) and exemptions under Sections 3(a)(10) and 3(a)(11), and Regulation A. The Commission has warned that those selling outside Rule 144 in reliance on the resale exemption will have a heavy burden of proving the availability of the exemption. *See § 6.06 infra.*

Rule 144A provides an exemption from registration for resales of restricted securities made in accordance with its conditions. Any holder of restricted securities other than the issuer may resell securities to a "qualified institutional buyer" as defined in Rule 144A. Such a resale will be deemed not part of a distribution and the seller, whether an ordinary investor or dealer, will be deemed not an underwriter. *See § 6.07 infra.*

Outside Rule 144A, restricted and control securities may be resold privately in transactions not amounting to "distributions" and thus entitled to the resale exemption. An exemption for private resales is more readily available when the prospective purchasers are a limited number of sophisticated investors who have access to information about the issuer. Industry practice has established so-called "Rule 4(11/2)" for private resales. *See § 6.08 infra.*

Restricted and control securities may also be resold outside the United States in reliance on Regulation S. Restricted securities of U.S. issuers resold in this manner remain restricted. *See § 6.09 infra.*



70 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.01

§ 6.01 Introduction

The Securities Act of 1933 and the Securities Exchange Act of 1934 generally permit members of the investing public to resell their securities in reasonable amounts in ordinary trading transactions without registering the offering of those securities under the Securities Act. Most such sales rely on the exemption from registration provided by Section 4(1) of the Securities Act. n1 Accordingly, most publicly held outstanding securities are freely tradeable in the marketplace.

Certain resales of outstanding securities, however, may not be made routinely in reliance upon the exemption from registration contained in Section 4(1) (the "resale exemption"). n2 Most of those resales fall into two categories. n3 The first includes all resales of the large number of presently outstanding restricted securities. n4 The second category includes all resales of any outstanding securities, restricted or unrestricted, by a person who is in a control relationship with the issuer of those securities. n5

In the case of restricted securities, the limitations on resale derive generally from the manner in which the securities were acquired (and typically result in their value being substantially less than that of unrestricted securities of the same class and issuer). n6 In the case of securities held by a person in a control relationship with the issuer, known as "control securities," the limitations on resale result only from the relationship between the existing security holder and the issuer and exist only as long as the securities are held by that controlling security holder. n7 Certain securities are subject to restrictions on resale on both counts because they are restricted securities held by a controlling person. As a matter of the federal securities laws, the difference, an important one as will be seen, between restricted securities and control securities, on the one hand, and all other outstanding securities, so-called "free-trading securities," on the other hand, is that restricted securities and control securities are not freely tradeable. n8

With limited exceptions, resales of restricted securities and control securities, at least outside Rule 144, are not routine trading transactions. Accordingly, the Section 4(1) resale exemption is frequently unavailable for their public resale. n9

The general unavailability of the resale exemption for the public resale of restricted securities and control securities, however, does not mean that the large number of outstanding restricted securities n10 and the unknown, but presumably lesser, number of control securities n11 cannot be lawfully resold under the federal securities laws. Their resale is simply made more difficult by being subject to special conditions. The difficulty is substantially mitigated by the broad availability of the Rule 144 exemption for certain public resales of securities that were previously not considered freely tradeable under Section 4(1). n12

Alternatively, such securities may be easily sold privately in reliance on Rule 144A. n13 Where Rule 144 or Rule 144A is not available, it may still be possible to resell restricted or control securities privately (through so-called "Section 4(1/2)" transactions, for example) or publicly, although the conditions for such resales are more limited and less certain. n14

FOOTNOTES:

(n1)Footnote 1. *See generally* § 6.02 *infra*.

(n2)Footnote 2. Section 4(1) is also discussed in § 4.01 *supra*. *See also* § 6.02[1] *infra*. Section 4(1) of the 1933 Act is reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

(n3)Footnote 3. The third, if less common, circumstance under which securities are often restricted occurs when the parties anticipate that securities will not be resold publicly. Often these securities are restricted through buy-back arrangements or with a restriction that they can be sold only to others active in the business. A fourth circumstance occurs when securities can only be held by licensed professionals, and holding by others is prohibited by law, for example doctors in a medical professional corporation. A fifth instance is found where regulatory restrictions place a limitation on the amount of securities which can be held prior to triggering a requirement for regulatory filings, as is sometimes the case with early stage insurance companies and banks.

(n4)Footnote 4. According to the NASDAQ Stock Market, the value of new private placements of unregistered stock or Rule 144A transactions reached \$162 billion in 2006, surpassing the \$154 billion raised in initial and secondary public offerings. Secondary private transactions for unregistered securities in U.S. private companies increased to \$3 billion (approximately up 140 PERCENT) according to a 2007 NYPPEX Private Markets report. *See Business & Finance Week*, Expanded Reporting Section, pg. 267, July 14, 2008.

(n5)Footnote 5. Rule 144(a)(1) labels such a person an "affiliate"; regarding such definition, *see* § 6.04[1] *infra*. 1933 Act Rule 144 is reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

(n6)Footnote 6. John H. Butala, Jr., *Estate Planning for Securities Burdened with Securities Law Restrictions*, 1981 U. Miami L. Center 15 Inst. on Est. Plan. P 900, P 903, at 9-13 (1981) and tax cases cited therein. *See also* *Rev. Rul. 77-287, 1977-2 C.B. 319* (there is no general valuation formula; lists factors to be considered); *Investment Co. Act Rel. No. 5847, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 72,135 (1970)* (value of restricted securities in investment company portfolio to be determined in good faith judgment by company's board).

(n7)Footnote 7. *But see* the exception described in § 6.04[4] *infra* .

(n8)Footnote 8. *But see* § 6.02[4] *infra* for exceptions to the freely tradeable nature of unrestricted securities held by other than a controlling person of the issuer.

(n9)Footnote 9. For an extensive analysis of this difference, *see* § 6.02[1], [2] and [3] *infra*.

(n10)Footnote 10. Regarding the number of outstanding restricted securities, *see* § 6.01 n.4 *supra*.

(n11)Footnote 11. The number of control securities is whatever the aggregate amount of securities held by all affiliates of all issuers happens to be at a particular time. The author has located no pertinent statistics.

(n12)Footnote 12. For an extensive analysis of Rule 144, *see* § 6.05 *infra*.

(n13)Footnote 13. *See* § 6.07 *infra*.

(n14)Footnote 14. *See* §§ 6.06, 6.08, and 6.09 *infra* .



71 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.02

§ 6.02 Why it Matters that Securities Are Restricted or Control Securities: Limitations on Disposition

Both the antifraud provisions of the Securities Act and the Exchange Actⁿ¹ and, unless an exemption applies, the registration and prospectus delivery requirements of the Securities Actⁿ² apply to all sales of all securities, including all resales of outstanding securities of a restricted or an unrestricted nature, provided that some means of interstate commerce is involved.ⁿ³ Every investor proposing to sell any securities of whatever nature must therefore make such disclosures as are required to not fall foul of the antifraud provisions of both Acts or risk liability thereunder.ⁿ⁴ In the case of any offering of restricted securities, the required disclosures must therefore include both a statement that the securities are restricted within the meaning of Rule 144(a)(3) and information regarding the consequent limitations on their public resale under the Securities Act. As to compliance with the antifraud provisions of the Securities Act and the Exchange Act, the sale of restricted securities is otherwise no different than the sale of unrestricted securities, although these provisions may impact the sale of restricted and unrestricted securities differently (increasing the disclosure obligations of a controlling person, for example).

In addition to complying with the antifraud provisions of the federal securities laws, every investor proposing to sell any securities of whatever nature in the United States must also either sell them pursuant to an effective registration statement or in proper reliance on an available exemption from the registration requirements of Section 5 of the Securities Act.ⁿ⁵ Unless the investor has a "control" relationship with the issuer of these securities, it will normally be unable to insist on the registration of those securities, except where registration rights were contracted for as a part of an earlier private offering by the issuer.ⁿ⁶ Accordingly, most members of the investing public desiring to lawfully sell securities must rely on a statutory exemption from the registration requirements of the Securities Act. The exemption customarily relied on for most resales of outstanding securities is that contained in the Section 4(1) resale exemption.ⁿ⁷ Since the availability of the resale exemption frequently determines whether particular securities may legitimately be publicly sold in the United States, the extent to which Section 4(1) is less available for proposed resale of restricted securities than for a proposed resale of unrestricted securities is a particularly significant limitation.

[1] General Availability of the Resale Exemption

Section 4(1) exempts from the Securities Act's registration and prospectus delivery requirements all "transactions by any person other than an issuer, underwriter, or dealer."ⁿ⁸ Those terms are defined in Sections 2(4),ⁿ⁹ 2(11),ⁿ¹⁰ and 2(12)ⁿ¹¹ of the Securities Act, respectively. As becomes obvious from reviewing those definitions, the resale exemption is designed to allow ordinary holders of outstanding securities who are not acting for the issuer or for a

controlling person of the issuer and who are not involved in the securities industry to sell their securities without concern for the registration provisions of the Securities Act. The ordinary investor, in other words, being neither the issuer of the securities to be sold nor a dealer as that term is defined in the Securities Act, n12 is permitted to sell securities without concern for the Securities Act's registration requirements, provided that neither the selling investor n13 nor any other participant in the transaction is an underwriter within the meaning of Section 2(11) of the Securities Act. Section 2(11) provides in pertinent part that an underwriter is:

[A]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has participation in the direct or indirect underwriting of any such undertaking ... 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. n14

The result of this definition, as discussed more fully below, is that the Section 4(1) resale exemption is available for all private resales of outstanding securities by any person other than the issuer or a dealer, but for only some public resales of some outstanding securities by some investors, including those amounting to routine trading transactions.

Upon close scrutiny of the language of Section 2(11), it becomes clear that only where the transaction itself amounts to or is a part of a "distribution of any security" may the investor be found to be an underwriter. Since a distribution requires a public offering, n15 it is simply not possible for the selling investor, its agent, or any other participant in the sale to be a statutory underwriter where the transaction as a matter of all the relevant factors is itself a private rather than a public offering and does not constitute, together with certain other sales, a public offering. n16 Accordingly, the resale exemption is available for *all* private resales of any outstanding securities by any investor. It is available to the investor even if a broker is used to effect the private sale; n17 the selling investor is an affiliate of the issuer of the securities; n18 or the securities involved are restricted securities. n19 Thus, private resales of restricted securities are always entitled to the resale exemption. n20

A public resale of outstanding securities will often, but not always, involve a "distribution" within the meaning of Section 2(11), which generally means that an underwriter is involved and the transaction cannot rely on the resale exemption. The term "distribution," though crucial to the issue of whether a selling investor or any broker or other person involved in the transaction is a statutory underwriter rendering the resale exemption unavailable, is not defined in the Securities Act, although various differing definitions have been endorsed for differing circumstances. n21 The courts and the Commission appear to view particular cases in light of the purposes of the resale exemption. There is no question that the resale exemption's primary purpose is to permit routine trading transactions. n22 It is also clear, however, that the resale exemption was not intended to permit large secondary distributions by affiliates of the issuer or others that would be substantially equivalent to a primary distribution from the perspective of the purchasing members of the investing public. n23 Neither was it intended to provide a way around the registration requirements for an issuer by allowing the immediate resale of securities privately placed by the issuer with affiliates or others committed or likely to resell them to members of the investing public. The vehicle Congress relied upon to separate permissible trading transactions from secondary distributions and two-step primary distributions was the concept of the "statutory underwriter," that is, underwriter as defined in Section 2(11). It follows that the courts and the Commission are likely to interpret the critical term "distribution" and the other key phrases contained in the definition of underwriter with this legislative intent in mind.

A public resale of outstanding securities will constitute or be a part of such a secondary or two-step primary distribution rather than an exempt resale transaction only if an underwriter is involved. Either the selling investor or any broker or other participant in the transaction could conceivably be a statutory underwriter and cause the loss of the resale exemption. If the selling investor is an affiliate of the issuer and uses a broker to effect a public resale, then the broker would be a statutory underwriter. n24 Accordingly, the resale exemption is ordinarily unavailable for the public resale

of "control securities" through a brokers' transaction.

If the selling investor is not an affiliate of the issuer, the resale exemption is lost only if it or someone it uses to effect the sale falls within the category of a statutory underwriter. An ordinary investor or its agent may become a statutory underwriter in one of the following ways:

- by purchasing from the issuer or controlling person, albeit through others, with a view to distribution, rather than with investment intent; n25
- by offering or selling securities "for the issuer" or a controlling person in connection with a distribution, whether or not pursuant to an actual agreement; n26 or
- by simply participating in a distribution involving the issuer or a controlling person. n27

While an investor's intent at the time of the purchase is in theory determinative of whether he falls within the category of an underwriter, it has proved an unworkable standard. In reality, the best evidence of investment intent is the absence of any sale or attempted sale of the securities in question for a substantial period of time. Of course, the longer the period of time during which the investor holds the securities, the more persuasive is the evidence that the investor is not a statutory underwriter.

It is, of course, ultimately a question of fact whether a particular seller is a statutory underwriter. The availability of the exemption, however, must be proved by the investor seeking to rely on it, n28 a tough burden particularly in the context of an enforcement proceeding brought by the Commission. In light of the risk of enforcement by the Commission or of a suit by a purchaser and the severity of the remedies available in either case, n29 the resale exemption should not be relied upon casually for other than ordinary trading transactions in the absence of a no-action letter from the staff of the Commission.

Given the purposes of the resale exemption, which are to allow private resales and ordinary trading transactions, but not to permit secondary or two-step distributions without registration, it is not surprising that the resale exemption, as interpreted by the courts and the Commission, is broadly available for the resale of unrestricted securities by non-affiliates of the issuer. In general, only in the case of an attempted sale of a substantial amount of securities held for less than the holding period specified by Rule 144(d) or in a few other limited circumstances is the Commission likely to deem or presume that a non-affiliate holder of unrestricted securities is an underwriter and therefore unable to rely on Section 4(1) for the public resale of those securities. It is also not surprising that an investor holding restricted securities is generally regarded by the Commission as an underwriter and therefore unable to rely on Section 4(1) except pursuant to Rule 144 when it makes a public resale of those securities, at least until the securities become freely tradeable under Rule 144. n30 As discussed below, the resale exemption is normally also unavailable for the public resale of control securities because of the involvement of a statutory underwriter, whether the affiliate itself or the broker acting for the affiliate. n31

If the resale exemption is not available to an investor for the sale of outstanding securities because it falls within the category of an underwriter, that investor may not lawfully resell its securities unless the transaction is registered under the Securities Act or some other exemption from registration is available. Often the staff will permit such a holder of unrestricted securities to sell limited amounts of securities immediately in compliance with certain of the conditions of Rule 144. n32

A second effect of a proposed seller of securities being an underwriter is that any broker used for the sale will be unable to rely on either Section 4(3) n33 or 4(4) n34 of the Securities Act to exempt its part of the transaction. n35 In light of the rather substantial penalties for a broker that sells securities in violation of Section 5, n36 a seller who is, or even may be regarded by the staff as, an underwriter may encounter difficulty finding a reputable broker willing to publicly

sell his securities.

[2] Limitations on Availability of Resale Exemption for Public Sales of Restricted Securities

As a matter of the federal securities laws, the sole, but critical, n37 difference between restricted securities n38 and unrestricted securities is that unrestricted securities may be freely traded by ordinary investors in reliance on the resale exemption, n39 whereas restricted securities are not freely tradeable. The non-availability of the Section 4(1) exemption for the public resale of restricted securities is the source of that difference. This non-availability derives from the application of a broader interpretation of the term "underwriter" when restricted securities rather than unrestricted securities are involved. In short, dealings in restricted securities are treated differently from ordinary trading transactions for securities regulation purposes. n40 That difference in treatment is based upon both the purpose of the Securities Act, which is to protect investors through disclosure in the form of a registration statement and the resulting periodic reports, n41 and the purposes of the resale exemption. n42

An ordinary investor may resell securities in reliance upon Section 4(1) of the Securities Act provided that neither that investor nor any broker involved in the transaction is an underwriter within the meaning of Section 2(11) of the Securities Act. n43 Since an investor cannot become an underwriter unless it is involved in a distribution, a private sale even of restricted securities by any investor may lawfully be made in reliance upon the resale exemption. n44 It is, therefore, only in the context of a proposed public sale that the holder of restricted securities is in a different position from a counterpart holder of unrestricted securities.

[a] Legal Limitations. By definition, restricted securities were acquired, directly or indirectly in a series of transactions, from the issuer or an affiliate of the issuer without a public offering. n45 In fact, no current information about the issuer may be available. n46 A significant aspect of a lawful private offering is that the purchasers are likely to have been not ordinary investors, but rather sophisticated investors who had no need for the protection afforded by a registration statement and who did not purchase "with a view" to distribution. n47 If substantial public resales of the restricted securities were to occur pursuant to the resale exemption soon after the private offering, then the result would be the same as an unregistered primary distribution by the issuer or secondary distribution by an affiliate, though in two steps, pursuant to the Section 4(2) and 4(1) exemptions, respectively. Because of the very real risk that the registration provisions of the Securities Act would be frequently circumvented by this two-step distribution, virtually every public resale of any restricted securities, at least for a material period of time following the relevant private offering, n48 is regarded separately as a distribution in itself n49 or, together with the initial private offering and perhaps other resales, as a part of "the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public." n50 Accordingly, only private resales of restricted securities are clearly not distributions for at least six months or a year following the private placement. n51

Since most public resales of restricted securities appear to involve a distribution within the meaning of Section 2(11), n52 the investor may rely on the resale exemption for such a sale only if it can establish that:

- the original purchase was with investment and not distributive intent;
- the resale is other than a sale for the issuer or for a controlling person; and
- the resale does not amount to a participation in a two-step distribution. n53

As discussed above, if the investor is an affiliate of the issuer, the public resale will usually involve an underwriter and the resale exemption will be therefore unavailable regardless of the restricted or unrestricted character of the securities. n54

Unlike a routine resale of unrestricted securities by an ordinary investor, an attempted public resale of restricted

securities is itself strong evidence that the non-affiliate investor is a statutory underwriter. The attempted sale is generally regarded as a strong contradiction of an investment intent, n55 making it virtually impossible for an investor to argue that he or she did not take with a view to a distribution. Even if the investor could convince the Commission of original non-distributive intent, the Commission may still view the investor as an underwriter. At the time it adopted Rule 144, the Commission made clear that in its view "it is insufficient to conclude that a person is not an underwriter solely because he did not purchase securities from an issuer with a view to a distribution" n56 Rather, the Commission indicated that the presence of a distribution is, in the case of restricted securities, synonymous with underwriter status. n57 In other words, despite the express language of Section 2(11), the Commission apparently believes that all resales prior to the expiration of the holding period n58 are deemed to be "for the issuer" or the "controlling person" and therefore render the selling investor a statutory underwriter unable to rely on the resale exemption. In light of that view and the refusal of the staff of the Commission to issue no-action letters regarding the availability of the Section 4(1) exemption outside Rule 144 for securities acquired since April 15, 1972, n59 it is extremely difficult for any holder of restricted securities to resell them publicly in reliance upon the resale exemption outside the rule a year (or six months, depending on the nature of the issuer) of the private placement without risking a violation of the registration requirements of the Securities Act. n60

The public resale of outstanding securities is usually possible only with the assistance of a broker. As explained above, the broker will violate the Securities Act unless its part of the transaction is exempt from the registration requirements. Typically, the broker relies on the dealer's exemption contained in Section 4(3) or the exemption for brokers' transactions contained in Section 4(4) of the Securities Act. Neither of those exemptions is available to the broker if the selling investor is an underwriter. n61 Accordingly, because, as discussed above, any investor attempting to publicly sell restricted securities is also most certainly an underwriter at least in the Commission's view, reputable brokers are likely to refuse to effect the transaction except where all of the conditions for a resale under Rule 144 can and will be satisfied.

In 1962, the Commission issued a release providing detailed guidance as to the expected standards of conduct for broker-dealers. Under the Commission's guidelines, broker-dealers involved in the sale of large quantities of securities must ensure that they are not participating in an illegal distribution. The broker-dealer must take affirmative steps to verify the identity of the seller and any claimed registration exemptions, and cannot rely on the statements of the seller or seller's counsel. The thoroughness of the investigation expected of a broker-dealer increases with the quantity of securities involved in the sale. Failure to conduct a sufficient investigation may lead to liability under the anti-fraud provisions of the securities laws if as a result the broker-dealer makes recommendations without adequate basis or fails to disclose material information. n62

[b] Other Limitations on Public Sales of Restricted Securities. An investor seeking to publicly resell restricted securities that believes that it falls outside the category of a statutory underwriter and is therefore entitled to rely on the resale exemption or that wishes to risk a possible violation of the Securities Act may find that the resale will be difficult to complete because of limitations from sources other than the possible unavailability of the Section 4(1) resale exemption.

All restricted securities were acquired from the issuer of those securities or from an affiliate of the issuer in a private offering that was exempt from registration under the Securities Act by reason of one of the private offering exemptions. n63 Normally those securities, if certificated, will bear a legend indicating that they may not be transferred in the absence of registration or an available exemption from registration. In addition, stop transfer instructions will generally have been issued to the transfer agent. These precautions against resale will exist where explicitly required by regulation for reliance upon a particular exemption. They are also typically utilized by an issuer selling securities in reliance upon the statutory "private placement" exemption contained in Section 4(2) of the Securities Act to ensure the viability of that exemption. The reason is that while neither the legend nor the stop transfer instructions are necessary for the perfection of that exemption, n64 (and may well be ignored by issuers in smaller offerings), they assist in preventing resales to non-qualifying investors that could at least in theory cause the loss of the exemption for the earlier offering and subject

the issuer to liability for a violation of the Securities Act. n65 As a result, the transfer agent will not effect the transfer of the restricted securities without direction from the issuer. The issuer is not likely either to direct the removal of the legends or the stop transfer instructions or to authorize the transfer of the securities until expiration of the holding period without an opinion of its or other counsel n66 experienced in securities law that either Section 4(1) or some other exemption from the registration requirements of the Securities Act is available for the proposed resale and that all of the requirements of that exemption have been or will be complied with by the selling parties. n67

[3] Limitations on Availability of Resale Exemption for Public Sales of Control Securities

Section 4(1) exempts from the registration and prospectus delivery requirements of the Securities Act any transactions by a person "other than an issuer, underwriter, or dealer." n68 As discussed above in connection with the resale of securities other than "control securities," n69 the availability of the resale exemption depends upon the lack of involvement of anyone who falls within the category of a statutory underwriter. If none of the selling security holder, the participating broker, or any other person involved in the transaction is an underwriter, the seller may rely on the resale exemption; and the broker, despite being a dealer, may rely on either the dealer exemption or the exemption for brokers' transactions contained in Sections 4(3) and 4(4) of the Securities Act, respectively, without depriving the seller of the resale exemption. n70

The resale exemption contains no language regarding an affiliate or a control person. Yet the exemption (except pursuant to Rule 144) is almost never available for the public resale of "control securities" because the transaction ordinarily involves an underwriter within the meaning of the Securities Act. Section 2(11) defines an underwriter to include a person "who sells for an issuer in connection with" a distribution. n71 A public resale of securities by an affiliate normally involves a distribution except when made in compliance with Rule 144. n72 Section 2(11) goes on to specify that for purposes of defining an underwriter only, the term "issuer" shall include "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." n73 In other words, an affiliate of the issuer is, as a result of that language, an issuer for purposes of determining whether another person is an underwriter. When an affiliate attempts to effect a public sale of securities, he will generally engage a broker. The broker, because the affiliate is an issuer under Section 2(11), will be selling "for an issuer" in connection with a distribution and therefore become an underwriter. Since an underwriter, i.e., the broker, is involved in the transaction, the transaction falls outside the resale exemption, rendering that exemption unavailable to the affiliate. n74 Accordingly, regardless of whether the affiliate is itself an underwriter for purposes of Section 2(11), it may almost never publicly sell "control securities" in reliance upon Section 4(1) of the Securities Act except pursuant to Rule 144. n75

The primary effect of that result on the affiliate of the issuer is that the affiliate may not lawfully resell any securities of the issuer publicly without causing a registration statement to be filed and to become effective or finding another available exemption. Another effect of that result is that even a holder of securities who either believes that he is not an affiliate of the issuer or desires to risk possible liability for a violation of the registration requirements of the Securities Act will find it virtually impossible to complete the contemplated sale of securities.

Unlike restricted securities, control securities usually contain no legend and are generally not subject to stop transfer instructions. While technically the issuer has no securities law obligation or reasons to prevent their resale it does have a general interest in not participating in a violation of any of the securities laws and needs insiders to disclose accurate information about their holdings in order to make accurate disclosure itself. The affiliate then will often not encounter any difficulty from the issuer's transfer agent although many reputable brokers will be alert to the problems posed by control securities.

[4] Limitations on Availability of Resale Exemption for Public Sales of Unrestricted Securities by Non-affiliates

While a non-affiliate holder of unrestricted securities generally may sell those securities freely in reliance upon Section 4(1) of the Securities Act, there are a few exceptions to this rule.

[a] Underwriters' Compensation Securities. As discussed further below, n76 underwriters' compensation securities, at least those acquired in a registered public offering, are regarded by the staff of the Commission as unrestricted securities, because of their acquisition in a transaction involving a registered public offering. Unlike most other unrestricted securities, including even such atypical categories of unrestricted securities as those acquired through employee benefit plans, n77 underwriters' compensation securities are not freely tradeable. The holders of these securities are literally underwriters and, as such, are in the staff's view forever excluded from relying upon any Section 4 exemption. As a result, underwriters' compensation securities, at least until 1975, could not be sold unless they were registered by the issuer. n78 Since 1975, however, the staff has allowed the resale of certain underwriters' compensation securities in conformity with most of the requirements of Rule 144, even though the rule is technically not applicable to unrestricted securities. n79

[b] Holders of Substantial Amounts of Securities. As mentioned above, Section 4(1) was intended to exempt routine trading transactions, but not secondary distributions, from the registration requirements of the Securities Act. To protect investors from the market effect of resales of substantial amounts of unrestricted securities by non-affiliates, the staff of the Commission developed the informal "presumptive underwriter doctrine" to prevent resales by purchasers of large blocks of securities in reliance upon the resale exemption. Under this doctrine the staff would presume a person:

to be an underwriter, within the meaning of section 2(11) of the Securities Act, if such person purchases or acquires a significant percentage of the securities offered pursuant to a registered distribution, except that such purchaser is not deemed to be an underwriter if he resells such securities in limited quantities. n80

The result was that a recipient of securities who on the basis of such traditional standards as motivation and relationship to the issuer would be considered a member of the general investing public would be presumed an underwriter solely by virtue of having acquired a relatively large amount of securities in a public offering. n81 This presumption, of course, was subject to rebuttal. n82 The doctrine has been applied to both registered securities and securities offered in reliance upon one of the public offering exemptions from the registration requirements of the Securities Act. n83 Although the percentage of outstanding securities of the issuer that needed to be offered to trigger the presumption of underwriter status was initially 10 percent of the amount offered, n84 the staff's no-action letters establish that it later regarded the doctrine to be applicable whenever the amount of securities offered exceeded the volume limitations contained in Rule 144(e), n85 which at the time was essentially a 1 percent test. n86

The presumptive underwriter doctrine was obviously inconsistent with the express statutory language of Section 2(11). It was never officially adopted by the Commission or considered by any court. It appears to have been applied in practice by the staff frequently, but haphazardly. n87 For some time the doctrine was regarded as largely obsolete and, as a result of the 1983 amendment to Rule 144 that added Rule 144(k), n88 there is little question that it is dead. n89 In 2007 the Commission finally eliminated the presumptive underwriter provision of Rule 145, except for transactions involving a shell company. n90

Once Rule 144(k) was adopted, even restricted securities could be sold freely by a non-affiliate two years after the securities were last held by the issuer or an affiliate pursuant (the 2007 amendments shortened this period) and a non-affiliate seller of unrestricted securities should be in no worse a position. Thus, a non-affiliate purchaser of a substantial amount of unrestricted securities may establish that it did not purchase them with a view to distribution n91 by holding them for the applicable holding period and thus be entitled to rely on the resale exemption. n92

[c] Underwriters as Result of Rule 145(d) n93 Reorganizations or Similar Transactions.

Where the surviving party to a business combination uses securities as all or part of the consideration for the business

deal, security holders in the acquired company could be deemed to be underwriters if they publicly offered the securities acquired in such a transaction. Rule 145(a) specifies that an "offer" or "sale" will be deemed to occur with exchanges of securities in connection with certain reclassifications, mergers, consolidations and transfers of assets that are submitted for the vote or consent of the security holders of a corporation. Accordingly, the "sale" must be registered unless an exemption is available.

Under Rule 145(c), or the presumptive underwriter provision, any party to any transaction of the type set forth in Rule 145(a) (other than the issuer) or an affiliate of such party who publicly offers the securities acquired in such transaction is an "underwriter", but only where any party to a Rule 145(a) transaction is a shell company, other than a business combination related shell company. n94

Any party to a transaction of the type set forth in Rule 145(a) involving a shell company, other than the issuer, may resell the securities acquired in the transaction only in compliance with the resale restrictions of Rule 145(d), which follow the requirements of Rule 144. n95 If a person has expressly acknowledged or agreed in writing to be subject to, and bound by, the previous provisions of Rule 145 with respect to securities acquired in a transaction, such persons will presumably remain bound by those terms. A holder currently subject to such restrictions may wish to seek a waiver or modification of such writing to reflect the amendments to Rule 145.

[d] Resale of Certain Securities Acquired Overseas. Securities of U.S. issuers sold overseas in reliance on Regulation S are restricted. n96 Generally, securities of non-U.S. issuers acquired overseas in reliance on Regulation S, at least once any applicable distribution compliance period has expired, are unrestricted. n97 This does not automatically mean, however, that securities acquired overseas can be resold back into the United States at the end of the distribution compliance period in reliance on the resale exemption. n98 The statutory definition of underwriter includes one who has purchased from an issuer (including affiliates) "with a view to ... distribution." n99 Thus, a person that purchases securities overseas with the intention of selling them back into the U.S. public markets at the end of any applicable distribution compliance period may be deemed to be an underwriter and thus unable to rely on the resale exemption. Although it may be difficult to prove that a public resale in these circumstances amounted to a public offering or distribution, such transactions should be examined carefully.

FOOTNOTES:

(n1)Footnote 1. *See generally* Ch. 9 *infra*, and Federal Securities Exchange Act of 1934, Ch. 5 (Matthew Bender).

(n2)Footnote 2. *See* Sections 5 and 10 of the 1933 Act, discussed in § 7.02 *infra*, and reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

(n3)Footnote 3. *See* Section 2(7), discussed in § 4.03 *supra*. In addition to federal regulation of interstate security sales, individual states often place restrictions on securities offered privately within the state. *See, e.g.*, Uniform Securities Act of 1956 § 402(b)(9), which imposes registration and filing requirements on securities offered to more than ten people during a twelve-month period, and which has been adopted in whole or in part by several states.

(n4)Footnote 4. Section 12(a)(2) of the Act provides the purchaser of securities in a public transaction with an express remedy against the seller amounting to rescission of the transaction. Section 12(a)(2) is discussed in § 9.04 *infra*. In addition, the purchaser in both public and private transactions has an implied private right of action against the seller for a violation of Section 10(b) of the Exchange Act of 1934, *Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). Finally, the seller risks enforcement action by the Commission.

(n5)Footnote 5. *See* Ch. 7 *infra*.

(n6)Footnote 6. Frequently, the purchasers of securities from the issuer in a private placement under Section 4(2) of the Act or one of the related rules (*see* § 4.02 *supra*) will require the issuer to register the privately placed securities upon the request of a specified percentage of the holders within a particular time frame. In other cases, the purchasers of privately placed securities will be satisfied with "piggy-back" registration rights. In the latter case, the holders of the privately placed securities will be able to cause their securities to be registered only if the issuer happens to be preparing a registration statement in connection with an unrelated offering. In light of the difficulty of lawfully selling restricted securities other than through a restricted offering or pursuant to Rule 144 or Rule 144A, *see* § 6.06 and § 6.08 *infra*, investors should consider registration rights if they do not wish to risk the need to hold restricted securities for the § applicable holding period.

(n7)Footnote 7. Section 4(2), which exempts non-public transactions from registration, is available to the issuer only, and not for resale. Section 4(1) is also discussed in § 4.01 *supra*.

(n8)Footnote 8. Section 4(1). With respect to resales generally, *see* R. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 *Wash. & Lee L. Rev.* 1333 (1995).

(n9)Footnote 9. Section 2(4), discussed in § 4.02[1] *supra*, defines the term "issuer" as a "person who issues or proposes to issue any security." The definition is straightforward. It clearly means a corporation and includes other persons such as promoters, for example, involved in the issuance of securities. It does not include, however, ordinary investors.

(n10)Footnote 10. *See* the text accompanying n.28 *infra*.

(n11)Footnote 11. The Section 2(12) definition of a dealer is discussed in § 4.02[3], and § 4.05 *supra*.

(n12)Footnote 12. The term "dealer" includes persons who act as agents for investors in buying and selling transactions, as well as persons who buy and sell for their own accounts. In other words, persons who function as brokers in a selling or purchasing transaction fall within the definition of dealer for purposes of Section 4(1) of the Act.

(n13)Footnote 13. The term "investor" will be used throughout this chapter to refer to a holder of outstanding securities who is not a dealer within the meaning of Section 2(12).

(n14)Footnote 14. Section 2(11) is discussed further in § 4.02[2] *supra*.

(n15)Footnote 15. *See* § 4.02 *supra*.

(n16)Footnote 16. *See* § 4.03 *supra* regarding the meaning of the term "public offering."

(n17)Footnote 17. *Value Line Income Funds, Inc. v. Marcus*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,523, at P 94,972 (S.D.N.Y. 1965).

(n18)Footnote 18. *Id.*

(n19)Footnote 19. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959); *Value Line Income Fund, Inc. v. Marcus*, n.31 *supra*, at P 94,972.

(n20)Footnote 20. For a discussion of the various methods of resale under Section 4(1), *see* §§ 6.05- 6.09 *infra*.

(n21)Footnote 21. *See* § 4.02 *supra*. One court has equated the term "distribution" with "public offering," at least in the context of an attempted sale of restricted securities. *Gilligan, Will & Co. v. SEC*, n.23 *supra*. In a case before the Commission involving a series of sales of unrestricted securities by affiliates of the issuer, the Commission found that a

distribution is "the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public." *In the Matter of Ira Haupt & Co.*, 23 S.E.C. 589, 597, [1945 -1947 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 75,690 at P 77,559 (1946), citing *Oklahoma-Texas Trust*, 2 S.E.C. 764, 769 (1937), *aff'd*, 100 F.2d 888 (10th Cir. 1939). More recently the Commission has indirectly defined a distribution at least in the context of attempted resales of restricted securities and of "control securities" by deeming no distribution to exist if all of the conditions contained in Rule 144 or Rule 144A are satisfied. *See generally* §§ 6.05 and 6.07 *infra* for a discussion of those conditions. In the context of "pump and dump" schemes, Judge Easterbrook held that a plan to "move securities from the issuer to the public, where they would trade freely" is a plan to engage in distribution. *SEC v. McNamee*, 481 F.3d 451, 455 (7th Cir. 2007).

(n22)Footnote 22. *In the Matter of Ira Haupt & Co.*, n.35 *supra*, at 602; H.R. Rep. No. 85, 73d Cong., 1st Sess., 13-14 (1933).

(n23)Footnote 23. *Id.*

(n24)Footnote 24. *See* discussion in § 6.02[2] *infra*.

(n25)Footnote 25. *See* text accompanying n.21 *supra*.

(n26)Footnote 26. *Id.*; *see also SEC v. Chinese Consolidated Benevolent Ass'n.*, 120 F.2d 738, 740 (2d Cir. 1941), *cert. denied*, 314 U.S. 618 (1941).

(n27)Footnote 27. *See* text accompanying n.21 *supra*; *see also SEC v. Chinese Consolidated Benevolent Assn.*, n.26 *supra*, at 741.

(n28)Footnote 28. *SEC v. Continental Tobacco Company of South Carolina*, 463 F.2d 137, 156 (5th Cir. 1972); *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953).

(n29)Footnote 29. *See* n.15 *supra* and Chs. 9-11 *infra*.

(n30)Footnote 30. *See* "Resales of Restricted Securities under Revised Rules 144 and 145 and Section 4(1/2)". Davidson, Gordon K. Practising Law Institute Corporate Law and Practice Handbook Series PLI Order No. 13990, New York City, April 10-11, 2008. Private Placements.

(n31)Footnote 31. *See* § 6.02[3] *infra*.

(n32)Footnote 32. *See* Rule 144 and discussion in § 6.05[2][d] *infra*.

(n33)Footnote 33. Section 4(3) is discussed in § 4.05 *supra*.

(n34)Footnote 34. A broker's transaction is limited to a transaction where the broker, among other things, "after reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter" Rule 144(g)(3), discussed in § 6.05[6][b] *infra*. *See also In the Matter of Ira Haupt & Co.*, n.35 *supra*, at 598.

(n35)Footnote 35. Unlike the presence of an underwriter, the presence of a broker does not render the resale exemption unavailable to the selling investor despite the reference to dealers contained in Section 4(1). Ruder, *Federal Restrictions on the Sale of Securities*, 67 Nw. U. L. Rev. 1, 36-37 (Supp. 1972). The broker, however, will violate Section 5 of the Act unless it relies on some other available exemption. Normally, the broker will look to the exemption for brokers' transaction contained Section 4(4) of the Act for the broker's part of the transaction. Section 4(4) of the Act is discussed § 4.04 *supra*.

Another option sometimes available for the broker is the dealer's exemption contained in Section 4(3), discussed in §

4.03 *supra*. In that regard, see *Resale by Institutional Investors of Debt Securities Acquired in Private Placements*, 34 *Bus. Law.* 1927, 1945-46 (1979).

(n36)Footnote 36. In addition to the possible liabilities as described in n.415 *supra* and in Chapters 9-11 *infra*, the Commission may see fit to revoke the broker's registration as a broker-dealer or suspend it from membership in Financial Industry Regulatory Authority ("FINRA"). See Section 15(b)(4)(D) (which permits the Commission to impose a sanction upon a broker-dealer who has willfully violated the Securities Act) and Section 15A(g)(2) (which permits a national securities association upon direction by the Commission to deny membership or association with a member to any broker-dealer subject to a statutory disqualification); see, e.g., *In the Matter of Ira Haupt & Co.*, n.34 *supra*.

(n37)Footnote 37. The difference is critical primarily because of the difference in value. See § 6.01, n.6 and accompanying text *supra*.

(n38)Footnote 38. See § 6.03 *infra* for the definition of the term "restricted securities" and an extended analysis thereof.

(n39)Footnote 39. See § 6.02[1] *supra*; but see § 6.02[4] *infra*, for the limited exceptions to that general rule.

(n40)Footnote 40. Alan J. Bowton, *Public Resales of Restricted Securities in Reliance upon Section 4(1) of the Securities Act*, in *Sales and Resales of Restricted Securities* 1979, at 385, 388 (PLI Corporate L. & Practice Course Handbook Series No. 314, 1979).

(n41)Footnote 41. Preamble of the Securities Act; see also the message of President Franklin D. Roosevelt, S. Rep. No. 47, 73d Cong., 1st Sess., 6-7 (1933) and H.R. Rep. No. 85, 73d Cong., 1st Sess., 1-2 (1933).

(n42)Footnote 42. See § 6.02[1] *supra*.

(n43)Footnote 43. See § 6.02[1] *supra*.

(n44)Footnote 44. See § 6.02[1][a] *supra*.

(n45)Footnote 45. Rule 144(a)(3), discussed in § 6.03[1] *infra*.

(N46)Footnote 46. Current information would not be available unless voluntarily made so by the issuer or unless required by Section 13 or 15(d) of the Exchange Act. The Section 13 reporting of information requirements are triggered by the registration of securities under the Securities Act or the Exchange Act. Those reporting requirements are not triggered by a private offering of securities.

(n47)Footnote 47. Prior to 1990, such purchasers were generally required to show that they were purchasing with "investment intent" and not with a view to resale. Since the adoption of Rule 144A in 1990, however, and in view of Rule 144A's objective of increasing secondary market liquidity for restricted securities, it is not necessary that investors in private placements not purchase with a view to resale. It is merely necessary that they not take with a view to *public* resale, or "distribution." See the discussion of Rule 144A at § 6.07.

(n48)Footnote 48. See § 6.05[4] *infra*.

(n49)Footnote 49. *Gilligan, Will & Co. v. SEC*, n.19 *supra*, at 466-67.

(n50)Footnote 50. *In re Ira Haupt & Co.*, n.34 *supra*, at 590, Fed. Sec. L. Rep. (CCH) at P 77,5597.

(n51)Footnote 51. See § 6.05[4] *infra* and discussion of "Section 4(11/2)", § 6.08 *infra*.

(n52)Footnote 52. See text accompanying nn.35 *supra*.

(n53)Footnote 53. *SEC v. Ralston Purina*, 346 U.S. 119, n. 28 *supra*.

(n54)Footnote 54. See n.31 and accompanying text *supra*; § 6.04[1] *infra*.

(n55)Footnote 55. *PLI, Sales and Resales of Restricted Securities*, n.40 *supra*, at 392. *But see* n.61 *supra*. Since the adoption of Rule 144A, the phrase "investment intent" should generally be replaced with "non-distributive intent."

(n56)Footnote 56. Preliminary note to Rule 144.

(n57)Footnote 57. *Id.*

(n58)Footnote 58. Rule 144(d).

(n59)Footnote 59. Sec. Act Rel. No. 33-6253, 1 Fed. Sec. L. Rep. (CCH) P 134A at P 1017-6 (1980).

(n60)Footnote 60. *But see* § 6.06 *infra*.

(n61)Footnote 61. See ns.21-27 and accompanying text *supra*.

(n62)Footnote 62. Securities Act Release No. 4445, Fed. Sec. L. Rep. (CCH) P 76,820 (February 2, 1962).

(n63)Footnote 63. See § 4.02 *supra*.

(n64)Footnote 64. C. Schneider, *Developments in Definition of a "Security"--1983/ 84 Update*, 17 Rev. Sec. Reg. 851, at 880 (1984).

(n65)Footnote 65. Ruder, *Federal Restrictions on the Sale of Securities*, n.35 *supra*, at 45.

(n66)Footnote 66. There have been recent cases where attorneys were sanctioned for inappropriately issuing Rule 144 "clean" letters. In *Packetport*, the attorney issued an opinion letter to the transfer agent stating that the transferor was a non-affiliate and had held the securities for two years. In response, the transfer agent removed the restrictive legends from the shares. The attorney knew that this information was false. The SEC charged the attorney and his accomplices with fraud and registration violations. See *SEC v. Packetport.com, Inc.*, Civ. No. 3:05-CV-1747 (D. Conn. 2005).

(n67)Footnote 67. In this regard the Commission is of little help. The staff takes the position that the placement and removal of restrictive legends on securities is completely within the discretion of the issuer, that the Commission has no authority to require the imposition or removal of those legends, and that the staff will take no view respecting any right or duty of removal. See, e.g., *Buck-Man Electronics Inc.*, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3170, (March 4, 1981). *But see* *Limited Stores, Inc.*, SEC No-Action Letter 1983 SEC No-Act. LEXIS 3070 (December 7, 1983), in which the Division suggests that the removal of legends after three years (the holding period mandated by then Rule 144(k)) seems appropriate because of then applicable Rule 144(k).

(n68)Footnote 68. Section 4(1), discussed in § 4.02 *supra*.

(n69)Footnote 69. See § 6.02[1] *supra*.

(n70)Footnote 70. See ns. 24-27 and accompanying text *supra*.

(n71)Footnote 71. See text accompanying n.21 *supra*.

(n72)Footnote 72. The Commission's view was originally that Rule 144 provided the exclusive method for publicly selling "control securities" under the Section 4(1) resale exemption. That position is dependent upon the view that every public resale of securities by an affiliate outside of Rule 144 constitutes a distribution within the meaning of Section

2(11) of the Act. Sec. Act Rel. No. 33-5306, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,000 (1972); Sec. Act Rel. No. 33-5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78, 487 (1972). In 1979, the Commission declared that Rule 144 was non-exclusive, with the addition of then Rule 144(j). Sec. Act Rel. No. 33-6032 (1979). If one were able to determine (in the case, for example, of the sale of an insignificant amount of securities) that no distribution were involved, then it is possible that the sale of unrestricted securities by an affiliate might be able to rely on the resale exemption. *See* § 6.06 *infra*.

See § 6.05 *infra* for detailed discussion of Rule 144.

(n73)Footnote 73. Section 2(11), discussed in § 4.06 *supra* in connection with controlling persons.

(n74)Footnote 74. *United States v. Wolfson*, 405 F.2d 779, 782 (2d Cir. 1968) , *cert. denied*, 394 U.S. 946 (1969)

(n75)Footnote 75. *Id.*

(n76)Footnote 76. *See* § 6.03[3][d][i] *infra*.

(n77)Footnote 77. *See, e.g.*, Allied Technology, Inc. SEC No-Action Letter, 1980 SEC No-Act. LEXIS 2909 (March 3, 1980), allowing resales of such securities by non-affiliates in reliance upon Section 4(1).

(n78)Footnote 78. D. Goldwasser, A Guide to Rule 144 at 125-27 (2d ed. 1978).

(n79)Footnote 79. The Division of Corporation Finance now generally allows holders of underwriters' compensation securities acquired in a public offering who are not affiliates of the issuer to resell those securities to members of the public in compliance with all of the requirements of Rule 144 (other than the filing of Form 144), provided certain other conditions are satisfied. Those other conditions are that the securities were originally registered as part of the public offering and that at least six months has elapsed from the date of the last sale of any of the securities offered under the registration statement pursuant to which the underwriters' compensation securities were issued. Sec. Act Rel. No. 33-6099, 1 Fed. Sec. L. Rep. (CCH) P 2705H (1979), at Section II(A), Question 10 n.8; Communications Properties, Inc., SEC No-Action Letter 1978 SEC No-Act. LEXIS 1000 (April 13, 1978), Paulson Investment Company, Inc., SEC No-Action Letter 1997 SEC No-Act. LEXIS 994 (November 10, 1997). This policy exception to the Division's previous rule that underwriters' compensation securities could never be resold pursuant to the exemption contained in Rule 144 has been extended to underwriters' compensation shares issued in connection with a Regulation A offering, Florafax International, Inc., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2209 (February 12, 1979), but not to such securities inadvertently not included in the original registration statement, Dicomed Corp., SEC No-Action Letter 1981 SEC No-Act. LEXIS 4086 (October 5, 1981). It has also been extended to permit the resale of stock acquired upon exercise of warrants issued as underwriters' compensation, provided that the stock so acquired has been held for a full two years from the date of exercise of the warrants. American Growth Fund Sponsors, Inc., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 2720 (May 26, 1981). It has been extended to allow a broker-dealer liquidating in bankruptcy to sell securities acquired by an underwriter in connection with registered offerings but which admittedly were not underwriter's compensation. Drexel Burnham Lambert Inc., SEC No-Action Letter 1990 SEC No-Act. LEXIS 989 (July 25, 1990).

See § 6.03[3][d] *infra* for a discussion of underwriters' compensation securities acquired in a private offering.

(n80)Footnote 80. R. Ahrenholz and W. Van Valkenberg, *The Presumptive Underwriter Doctrine: Statutory Underwriter Status for Investors Purchasing a Specified Portion of a registered Offering*, 1973 Utah L. Rev. 773, 775-776.

(n81)Footnote 81. Charles Nathan, *Presumptive Underwriters*, 8 Rev. Sec. Reg. 881, 883 (1975).

(n82)Footnote 82. R. Jennings & H. Marsh, *Securities Regulation* 355 (5th ed. 1982).

(n83)Footnote 83. Nathan, n.81 *supra*, at 884-86.

(n84)Footnote 84. Ahrenholz and Van Valkenberg, n.78 *supra*, at 774.

(n85)Footnote 85. *See, e.g.,* Daylin, Inc., SEC No-Action Letter 1976 SEC No-Act. LEXIS 2205 (October 13, 1976) [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,787; Amco Energy Corp., SEC No-Action Letter 1977 SEC No-Act. LEXIS 1079 (April 15, 1977).

(n86)Footnote 86. *See* Rule 144(e) and the analysis in § 6.05[5] *infra*.

(n87)Footnote 87. An analysis of the vast number of no-action letters relating to proposed resales of Section 3(a)(10) securities (prior to the adoption of Staff Legal Bulletin No. 3 in 1997 (revised in 1997)) indicates that the staff, whenever given the opportunity, would almost always apply the presumptive underwriter doctrine to prevent any resales of those securities in excess of the Rule 144(e) volume limits. *See generally* Barbara A. Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 Nw. U.L. Rev. 1, 82-85 (1980).

For additional evidence of the staff's approach to unrestricted securities that were publicly offered without registration, see American Pacific State Bank, SEC No-Action Letter 1981 SEC No-Act. LEXIS 4357 (December 7, 1981), in which resales of unrestricted Section 3(a)(10) securities were limited to the amount specified in Rule 144(e); Ascot Petroleum Corp., SEC No-Action Letter 1981 SEC No-Act. LEXIS 4398 (December 17, 1981), in which resales of unrestricted Section 3(a)(10) securities by persons receiving more than one percent of the issued and outstanding shares were permitted only in accordance with all of the conditions of Rule 144 except the holding period and filing of notice requirements; and Bell Canada, SEC No-Action Letter 1982 SEC No-Act. LEXIS 2636 (August 2, 1982), one of several letters in which the staff allowed public resales of unrestricted Section 3(a)(10) securities presumably in unlimited amounts in reliance upon Section 4(1) only because of the presence of the following three conditions:

- the transaction was governed by Rule 145 though also eligible for Section 3(a)(10);
- the securities were registered under Section 12 of the Exchange Act; and
- the issuer was subject to the reporting requirements of Section 13 of the Exchange Act.

It is obvious that a crucial factor related to the application of the presumptive underwriter doctrine by the staff has been the availability of prospectus-like information about the issuer. Where such information was available, which was always the case if the securities were registered under Section 5 of the Securities Act, see Section 15(d) of the Exchange Act, resales were more likely to be permitted subject to one or more of the conditions contained in Rule 144, exclusive of the holding period and filing of notice requirements.

(n88)Footnote 88. *See* former Rule 144(k), which is discussed in § 6.05[4] *infra*.

(n89)Footnote 89. Barron, *Control and Restricted Securities-- The SEC Staff Finally Abandons the 'Presumptive Underwriter Doctrine*, 15 Sec. Reg. L.J. 296 (1987).

(n90)Footnote 90. *See* Release No. 33-8869, December 6, 2007. pg. 2647,2657.

(n91)Footnote 91. *See* n.75 *supra*.

(n92)Footnote 92. Other means by which the prospective reseller may establish that he or she is not involved in a distribution are discussed in §§ 6.05- 6.09 *infra*.

(n93)Footnote 93. The Commission has proposed elimination of this provision (which embodies the presumptive underwriter concept) and the resale provisions of Rule 145(c) and (d). Sec. Act Rel. No. 33-7391 [current decisions] Fed. Sec. L. Rep. (CCH) P 85,908 (1997).

(n94)Footnote 94. Rule 145(c), prior to the 2007 amendments to Rule 144, defined any party to any transaction of the type set forth in Rule 145(a) (other than the issuer) or an affiliate of such party who publicly offers the securities acquired in such transaction as an "underwriter" (and did not limit the designation to transactions involving shell companies). Prior to the amendments, such a "presumptive underwriter" would be required to comply with Rule 145(d) in connection with resales of the acquired securities even if the person, following the transaction, were no longer an affiliate of the combined entity and even if such person received registered securities in the business combination. The 2007 amendments, in short, eliminated the presumptive underwriter provision of Rule 145(c), except with respect to transactions involving a shell company.

(n95)Footnote 95. Prior to 2007, the Commission had taken the position that Rule 145(d) applied to securities acquired pursuant to exempt exchanges under Section 3(a)(10). The adopting release, *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)*, stated that the Commission intends to address the treatment of parties to a transaction and their affiliates that have acquired securities in a transaction exempt from registration pursuant to Section 3(a)(10) of the Securities Act in a revised Staff Legal Bulletin No. 3. *See § 6.03[3][d][iii] infra*

(n96)Footnote 96. Sec. Act Rel. No. 33-7505 (1998); *see also* Chapter 4, *supra*.

(n97)Footnote 97. Sec. Act Rel. No. 33-6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,524 (1990), at n.110. *See § 6.03[3][d][ix] infra*.

(n98)Footnote 98. The purpose of the distribution compliance period in Regulation S is to ensure that during the offering period and in the subsequent aftermarket trading that takes place offshore, the persons complying with the Rule 903 safe harbor (issuers, distributors and their affiliates) are not engaged in an unregistered, non-exempt distribution of securities into the U.S. capital markets. In connection with the 2007 amendments to Rule 144, the Commission amended Regulation S to conform the distribution compliance period in Rule 903(b)(3)(iii) for Category 3 reporting issuers to the amendments to the Rule 144 holding period. Accordingly, U.S. reporting issuers will be subject to a distribution compliance period of six months under Regulation S (as opposed to the previous one-year distribution compliance period).

(n99)Footnote 99. *See* n.21 *supra* and accompanying text.



72 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.03

§ 6.03 Definition of Restricted Securities

The term "restricted securities" cannot be found in the text of the Securities Act or indeed in any of the federal securities laws. Over the years, the term was applied by securities lawyers and other members of the securities industry to all securities that were not freely tradeable because of restrictions resulting from the Securities Act. As time went on and more specificity became desirable, the term was used more narrowly to refer to only that category of restricted securities commonly referred to as "letter" securities or privately placed securities, as opposed to the other category of restricted securities commonly called "control securities." In 1972, the Securities and Exchange Commission promulgated Rule 144, which codified that narrower usage by expressly defining restricted securities to include only privately placed securities n1, although that definition has been expanded by subsequent amendments to Rule 144.

[1] Rule 144 Definition

Paragraph (a)(3) of Rule 144 presently defines the term "restricted securities" to include:

- securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;
- securities acquired from the issuer that are subject to the resale limitations of Rule 502(d) under Regulation D or Rule 701(c) under the Securities Act;
- securities that are acquired in a transaction or chain of transactions meeting the requirements of Rule 144A;
- securities acquired from the issuer in a transaction subject to the conditions of Regulation CE (Rule 1001);
- equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of Rule 901 or 903 under Regulation S; n2
- securities acquired in a transaction made under Rule 801 under the Securities Act to the same extent and proportion that the securities held by the security holder of the class with respect to which the rights

offering was made were, as of the record date for the rights offering, "restricted securities" within the meaning of this paragraph (a)(3);

- securities acquired in a transaction made under Rule 802 under the Securities Act to the same extent and proportion that the securities that were tendered or exchanged in the exchange offer or business combination were "restricted securities" within the meaning of this paragraph (a)(3);

- securities acquired from the issuer in a transaction subject to an exemption under section 4(6) of the Securities Act.

Securities that fall outside the rule's definition are normally *unrestricted* securities for purposes of the federal securities laws, regardless of any limitations on their disposition imposed by agreement, by any state statute, or otherwise. n3 In other words, the lawful resale of unrestricted securities under the Securities Act is not limited as a result of the manner of their acquisition, n4 though their resale may be restricted because they are held by a controlling person of the issuer n5 or because of other circumstances. n6

[2] Scope of Rule 144 Definition

The definition of the term restricted securities contained in Rule 144(a)(3) is the standard by which all securities are classified as either restricted securities or unrestricted securities with the consequent effects on their resalability without registration under the Securities Act. Although the definition is relatively precise as compared with past usage of the term, certain aspects require some clarification to ensure the proper identification of all restricted securities.

[a] Securities. Any outstanding security of whatever nature, for example, stock, debenture, or investment contract, may be a restricted security, provided, of course, that the so-called security is in fact a security within the meaning of Section 2(1) of the Securities Act. n7 The form of a security is never determinative of whether that security is a restricted security.

Certain securities, apparently either because of their intrinsic nature or because of the protection that results from regulation other than through the securities laws, n8 are completely exempt from the Securities Act's registration requirements by one of Sections 3(a)(2) through 3(a)(8), regardless of the nature of the transactions in which they are involved. n9 These so-called exempt securities, therefore, are regulated only by the antifraud provisions of the securities acts. Since neither the initial sale nor any resale of exempt securities is subject to the registration requirements, they are generally freely tradeable. The manner of any offering is not relevant to the application of the Securities Act's registration requirements, and the concept of restricted or unrestricted as applied to an exempt security is generally without meaning. n10 Exempt securities, therefore, are outside the scope of this chapter.

[b] Method of Acquisition. A security takes on its restricted or unrestricted character primarily as a result of the private or public manner of its acquisition by a person other than the issuer. The actual method of acquisition, n11 whether by purchase, gift, bequest or pledge, is unimportant. Any outstanding security, no matter how acquired, generally will be restricted if it was acquired from either the issuer or an affiliate of the issuer in a transaction or chain of transactions not involving any public offering. n12

[3] Sources of Restricted Securities

There are only two sources of all restricted securities: the issuer of those securities n13 or an affiliate of the issuer. n14 In either case, the securities must have been acquired in a transaction or series of transactions not involving any public offering. n15 While no other person can create a restricted security from an unrestricted security, whatever the manner of the transaction, any person can render a restricted security unrestricted by transferring it in a transaction involving a public offering or, generally only in the case of foreign securities, outside the United States. n16 Otherwise, the security remains restricted whether held by a single holder or transferred any number of times in transactions not involving a

public offering. n17

[a] Status of Securities Acquired from the Issuer.

If the holder of particular securities acquired them directly from the issuer in a private offering, the securities became restricted as a result of that transaction, are restricted in the holder's hands, and will remain restricted until transferred publicly. n18 An issuer may create restricted securities by privately offering authorized but previously unissued securities, in a typical capital-raising transaction. An issuer may also create restricted securities by purchasing any of its outstanding securities, restricted or unrestricted, in a private or public transaction and by privately reoffering them. Their restricted character is determined by the non-public nature of the offering by the issuer. Other circumstances are simply not relevant to that classification. n19

Since the existence of a public offering is in most cases the basis for separating restricted securities from unrestricted securities, the meaning of the term "public offering" is crucial. Although Section 4(2) of the Securities Act exempts from its registration and prospectus delivery requirements "transactions by an issuer not involving any public offering," n20 the Securities Act contains no definition of the term "public offering." n21 At least for purposes of determining the availability of the so-called private placement exemption from registration contained in Section 4(2), the term has been interpreted by numerous courts, n22 and less directly by the Commission, in connection with the promulgation of various rules under Section 4(2) and related sections of the Securities Act. n23 Ultimately, the determination of whether a particular transaction was a public offering must be made after considering such factors as the number of persons to whom the securities were offered and sold, the amount of securities acquired, the manner of sale, the adequacy of the then available information about the issuer and the needs of the offerees at that time for the protection afforded by the registration requirements of the Securities Act. n24

While many transactions must be individually examined and measured in light of the existing judicial and administrative standards for public offering, two types of sale transactions are clearly public offerings for purposes of the definition of restricted securities. The first is the rather obvious case of an offering of securities by or through a securities broker in an open market transaction. n25 The second involves an offering that is registered under the Securities Act. Since registration of the securities can be accomplished by the issuer only by complying with the rather costly and otherwise burdensome procedures required by the Securities Act and since private offerings may take place in the absence of registration, n26 securities offerings are registered only if there is to be a public offering, and the securities sold under the registration statement are unrestricted. n27 In addition, a public offering probably occurs whenever securities are offered or distributed to all the holders of a class of securities which is required to be registered under the Exchange Act, even if Securities Act registration of the securities is not required either because no sale or offer to sell is involved n28 or because the transaction is explicitly exempted from the registration requirement. n29

[i] In a Public Offering. Public offerings are generally registered under the Securities Act because they cannot meet the specific requirements of any of the rather specialized exemptions available for those offerings. Certain public transactions, however, may take place without registration if all of the requirements of an applicable exemption can be satisfied. Where one of these exemptions is relied upon, the resulting unregistered securities are in *most* cases unrestricted. n30

The Securities Act, together with certain related rules, provides several possible transaction exemptions for an issuer proposing to sell securities in a public offering. If the aggregate offering price of the securities to be offered does not exceed \$5,000,000, the issuer may be able to rely on the exemption for certain small offerings contained in Regulation A promulgated by the Commission under Section 3(b) of the Securities Act. Most states require that the securities from such an offering be legended, even though the Commission does not require it, although certain intra-state legending exemptions are available n31. If the offering will be made only to residents of a single state by an issuer that is also a resident of and doing business primarily in that state, the issuer may be able to meet the requirements of the intrastate offering exemption contained in Section 3(a)(11) of the Securities Act or in the related Rule 147. n32 Securities sold

pursuant to 3(a)(11) are restricted from transfer outside the applicable state for nine months. In addition, securities sold in such transactions, unless registered under the state laws, must rely on a state exemption from securities registration which almost invariably contains a requirement that the security be registered, and the states will look to Rule 144 as a means for lifting the restriction. The remaining two alternatives available to the issuer are contained in Sections 3(a)(10) n33 and 3(a)(9) n34 of the Securities Act and are limited to certain qualifying transactions that involve exchanges of securities.

Pursuant to Rule 701 of the Securities Act, an issuer who is not yet subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act may offer and sell limited amounts of its securities pursuant to certain compensatory benefit plans and written compensation agreements. Although the Rule 701 exemption is available for public as well as private qualifying offerings, the rule expressly provides that all securities issued pursuant to it are restricted. n35

Rules 801 and 802 under the Securities Act provide exemptions from registration for rights offerings and exchange offers made by non-U.S. issuers where a limited number of shareholders of the subject class of securities are located in the United States. The restricted status of the securities offered depends on the status of the subject securities. n36

The Bankruptcy Code provides an exemption from registration for reorganizations pursuant to Section 1145. Since such transactions are public offerings, persons acquiring securities thereby (other than those persons deemed "underwriters" by the Bankruptcy Code) acquire unrestricted securities. n37

[ii] In a Private Offering. Since 1933 the traditional private placement by the issuer has been exempted from registration by Section 4(2) of the Securities Act, which exempts all "transactions by an issuer not involving any public offering." n38 The scope of this so-called private placement exemption turns on the meaning of the term "public offering," which, as stated above, is a factual determination for the issuer (and counsel) after consideration of the relevant factors. n39 Securities offered in this way are restricted.

A holder of securities offered in this way will generally be aware of their restricted nature because of actual knowledge that the issuer relied on Section 4(2). Normally there is no question that the issuer relied on the Section 4(2) exemption. Usually, but not always, the issuer will place a conspicuous legend on the face of the privately offered securities in an attempt to assure the availability of the exemption and consequently avoid possible liability under Section 12(1) for violating Section 5 of the Securities Act. Typically, this restrictive legend would state that the securities were not registered under the Securities Act and that they may not be resold or otherwise transferred in the absence of registration or compliance with the requirements of an available exemption from registration. Often the issuer will indicate in the legend that any transfer of the securities will require an opinion of its or other counsel respecting the availability of a claimed exemption from registration. Finally, the issuer will commonly give stop transfer instructions to the transfer agent, a fact that can be easily discovered by contacting the transfer agent before attempting a sale.

In addition, at least the first holder of privately placed securities will probably be expressly informed by the issuer that the securities are restricted and that they may be resold only in certain limited circumstances. n40 Since the failure of the issuer to so inform the purchasers of privately placed securities constitutes a material omission in violation of the antifraud provisions of the Securities Acts, n41 it is unlikely that the issuer will fail to make this disclosure. Where the previous reliance on the private offering exemption by the issuer is suspected but not obvious, however, the holder of the suspect securities (or counsel) must confirm the use of Section 4(2) or another exemption through appropriate investigation.

Five other private offering exemptions from registration are available to the issuer. First, Section 4(6) of the Securities Act provides an exemption for up to \$5,000,000 of securities privately offered only to institutional investors and certain other wealthy investors. n42 As in the case of reliance on Section 4(2), an issuer relying on Section 4(6) will normally include a legend on the certificates, issue stop transfer instructions to the transfer agent, and inform the purchasers of the restricted nature of the securities and the consequent limitations on the resale of those securities under the Securities

Act. The 2007 amendments codified the Commission's position that securities acquired under Section 4(6) are restricted. n43

In addition to the statutory exemptions under Sections 4(2) and 4(6), the issuer may sell unregistered securities privately in reliance upon one of the three exemptions contained in Regulation D, promulgated by the Commission under both Sections 4(2) and 3(b) of the Securities Act. n44 Although Rules 504 and 505 provide exemptions pursuant to Section 3(b) of the Securities Act and only Rule 506 provides an exemption under Section 4(2), n45 the resulting securities are normally restricted securities. n46 Regulation D expressly requires that the purchaser be informed of the restricted status of the securities and the resulting limitations on their resale and that the certificates contain a legend to that effect. n47 Accordingly, the restricted nature of Regulation D securities is almost never in doubt. n48

As a result of the Rule 701 exemption adopted by the Commission in 1988 pursuant to Section 3(b) of the Securities Act, n49 an issuer who is not yet subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act may offer and sell limited amounts n50 of its securities pursuant to certain compensatory benefit plans and written compensation agreements. n51 Although the Rule 701 exemption is available for public as well as private qualifying offerings, n52 the rule expressly provides that all securities issued pursuant to it are restricted. n53 Securities issued pursuant to Rule 701 maybe resold as freely unrestricted securities ninety days following the issuer's becoming subject to the reporting requirements of the Exchange Act. n54 Again, since recipients of Rule 701 securities must be provided with a copy of the underlying plan or arrangement, the restricted nature of their securities should be clear to them. n55

In some cases the investor is perfectly well aware that securities acquired privately from the issuer are restricted, but does not desire restricted securities. Through arrangements with existing stockholders the investor acquires shares that are unrestricted or are eligible for sale under Rule 144 and the existing shareholder is issued new shares by the issuer. The Commission disapproves of these "gypsy swaps" and holds that the new investor has acquired restricted securities with a holding period commencing at the time it acquired the shares from the existing stockholder. According to the SEC staff, a "public resale of the shares acquired from the stockholder without regard to the conditions of Rule 144 would raise serious issues under Section 5 of the Securities Act for all parties to the transaction." n56

[b] Status of Securities Acquired from an Affiliate. If the holder of securities acquired them directly from an affiliate of the issuer in a private transaction, the securities are not always restricted, despite the literal language of the Rule 144(a)(3) definition. Unlike the case where the securities were acquired from the issuer, n57 the restricted or unrestricted status of the securities acquired from the affiliate may sometimes depend upon whether that private acquisition was through a sale or through a transaction not involving a sale under the Securities Act.

In the light of the importance of the sale versus the nonsale nature of the transaction in determining the character of securities acquired privately from an affiliate, the scope of the term "sale" is crucial. Section 2(3) of the Securities Act broadly defines "sale" to mean "every ... disposition ... for *value*"; n58 and the courts, usually in the context of determining the applicability of the registration requirements of the Securities Act, have construed that definition broadly. For example, a pledge of securities as collateral for the repayment of a loan has been determined to be a sale. n59 Only where no value is given is it clear that the transfer involves no sale for purposes of the Securities Act generally.

If particular securities were acquired from an affiliate in a private transaction n60 involving a sale, then the securities are always, in accordance with the language of Rule 144(a)(3), restricted securities. As in the case of securities acquired from the issuer, the securities sold by the affiliate to the holder in a private transaction are now restricted in the holder's hands even if they were unrestricted in the affiliate's hands because they had been acquired by that affiliate in a public offering. n61

Where, however, the securities were acquired from an affiliate in certain transactions not involving a sale, they are restricted securities in the hands of the holder only if they were restricted securities in the hands of the affiliate, as

would be the case if the affiliate acquired them from the issuer in a transaction, or series of transactions, not involving a public offering. The securities will not become restricted securities, however, despite the express language of Rule 144(a)(3), if they were unrestricted in the hands of the affiliate (because they were purchased by the affiliate in a transaction involving a public offering) and then transferred in a private transaction not involving a sale. n62 The reason that the Commission has taken this position presumably is one of equity. If restricted securities were to become restricted as a result of a gift of them by an affiliate, the donee would be in a worse position than their donor. Instead, the donee is deemed to stand in the shoes of the donor. n63 Although the donee-holder would have unrestricted securities, it would be treated, nevertheless, as an affiliate for purposes of resale, at least until the donor ceased to be an affiliate and could freely trade the securities if it still owned them. n64

In sum, an affiliate creates restricted securities by *selling* any securities in a private transaction. In a non-sale disposition, the affiliate simply passes on the existing restrictions of restricted securities or control securities, n65 as the case may be, and does not cause unrestricted securities to become restricted by privately transferring them in a non-sale transaction. Non-sale transactions for purposes of determining the restricted or unrestricted character of securities acquired from an affiliate would include gifts n66 and bequests n67 and presumably certain distributions. n68

As is always the case, any transfer of securities by an affiliate in a public transaction of any nature (sale or non-sale) would not result in restricted securities. n69

An affiliate proposing to sell securities in a public offering may rely on one of four possible exemptions from registration, provided all of the requirements for perfection of one of these exemption can be satisfied. The affiliate may rely on Regulation A for an offering of up to \$5,000,000 (for selling security holders), n70 on the intrastate offering exemption contained in Section 3(a)(11) (but not on Rule 147), n71 on the exchange exemption contained in Section 3(a)(10), or on Rule 144. n72 The resale exemption contained in Section 4(1) outside Rule 144 is normally not available for a public offering by an affiliate because the transaction would ordinarily involve an underwriter within the meaning of the Securities Act. n73

[c] Status of Securities Acquired from Another Holder. If the holder of securities acquired them from a person other than the issuer or an affiliate of the issuer in a transaction not involving a public offering, they are restricted if, and only if, they were restricted in the hands of the transferor. The chain of transactions n74 would have to be examined until the transferor was the issuer or an affiliate of the issuer. If, when the securities were first acquired from the issuer or an affiliate of the issuer, they were restricted securities in the hands of the transferee and if the chain of transactions from that first holder to the present holder of the securities involved no public resale, then the securities are restricted. n75 Otherwise, they are unrestricted securities and may be traded freely in the marketplace.

[d] Special Categories of Securities.

The dichotomy between public offering and private offering exemptions from registration is generally determinative of the unrestricted or restricted status of the securities so offered. There are, however, several significant categories of securities that cannot be so easily labeled under that dichotomy. Since these securities have proved troublesome both to the Commission and to securities lawyers, they warrant special mention.

[i] Underwriters' Compensation and Similar Securities. Frequently, the underwriters of an issuer's first public offering are given the opportunity to purchase an equity interest in the issuer at a price well below the public offering price as partial compensation for their services. Although these underwriters' compensation securities, or so-called "cheap" securities, were arguably offered privately to the underwriters, the staff of the Commission views them as securities acquired in a transaction or chain of transactions *involving* a public offering and therefore as unrestricted securities. n76 Notwithstanding this position, however, the staff has permitted resale of such securities pursuant to Rule 144. Otherwise, sale of such securities would be even more difficult than for restricted securities. n77 If the securities were issued as compensation for arranging a private offering, on the other hand, then they would not have been acquired

in connection with a public offering and would therefore be restricted securities as defined by Rule 144(a)(3). n78

Similarly, an issuer will often issue securities, usually contemporaneously with its public offering, to various other persons who rendered services in connection with that public offering. Any securities so issued to finders or financial consultants are normally viewed by the staff as unrestricted securities on the ground that they were issued in connection with the related public offering. n79 Securities acquired by lawyers and accountants for their services in connection with a public offering, however, are usually, but not always, regarded by the staff as privately placed by the issuer and therefore restricted. n80

[ii] Securities Acquired Through Employee Benefit Plans. Securities are frequently sold or distributed to employees by employee benefit plans that are established by the employer. n81 These employee stock option, stock purchase, stock bonus and various other benefit plans vary widely in form, n82 but all are designed to provide employees with some equity interest in the employer. Commonly, the plan, which may be an affiliate of the employer, n83 will acquire the securities of the employer directly from the employer in a private transaction and subsequently distribute them to the beneficiaries of the plan. Alternatively, the plan may purchase the securities to be distributed in the marketplace. In either case, the distribution of those securities to a number of employees will usually constitute a "public offering" within the meaning of the Securities Act and the Rule 144(a)(3) definition of restricted securities. n84 Accordingly, under the literal analysis set forth above, n85 the securities acquired from the plan would usually be unrestricted securities because they were acquired in a public offering, regardless of whether the plan was an affiliate for, or merely an agent for, the issuer of those securities.

The Division of Corporation Finance of the Commission, however, has taken a different approach toward securities of an employer acquired by the participants of an employee benefit plan. In the case where these securities were registered, they are of course deemed unrestricted in the hands of the participants. n86 Frequently, the securities distributed pursuant to an employee benefit plan were not registered because no sale was involved, n87 because a transaction exemption was available, n88 or because the staff of the Division took a no-action position regarding the need for registration, presumably on the ground that since the employees never make any investment decision regarding their participation in the plan, they would not benefit in any way from registration of the plan or of the underlying securities. n89 Prior to 1976, the Commission took the position that, despite the literal language of Rule 144(a)(3), all unregistered securities of the issuer distributed pursuant to a stock bonus or other employee benefit plan were restricted securities in the hands of the participants regardless of the public or private nature of the particular offering. n90

In 1976, the Commission reversed that rigid position and adopted a limited policy exception to its earlier rule. n91 That exception is now incorporated in Securities Act Releases Nos. 6188 n92 and 6281 n93 and reflected in literally dozens of no-action letters involving a wide variety of employee benefit plans. n94 Under this policy exception, securities of the employer issued under most employee benefit and similar plans will not be treated by the Commission as restricted securities and may be freely traded if, and only if, the following three conditions are satisfied:

- the issuer of the securities is subject to the periodic reporting requirements of Section 13 or 15(d) of the Exchange Act; n95
- the stock being distributed under the plan is actively traded in the open market; and
- the number of shares being distributed under the plan is relatively small in relation to the number of shares of that class issued and outstanding. n96

If any one of the three conditions is not strictly satisfied, then the securities issued by the plan fall outside the Commission's exception and, according to the staff, are restricted securities in the hands of the participants. n97 For example, where the issuer's reporting obligations pursuant to Section 15(d) of the Exchange Act were suspended, the staff took the position that the unregistered securities distributed pursuant to a stock bonus or option plan were restricted

securities. n98 Similarly, where the number of securities expected to be issued to certain employees during 1983 would exceed one percent of the total number of those securities outstanding in March of 1982, the Division found that the amount to be distributed was not "relatively small" within the meaning of the third condition above and that the securities, therefore, should be treated as restricted securities. n99

Although the staff has elaborated on only a few occasions on the "actively traded" requirement, presumably it would require evidence of regular trading of a number of shares large enough to ensure that resales of the securities distributed pursuant to the plan would have no measurable effect on the trading market. n100 Accordingly, securities acquired from employee benefit plans should not be treated as unrestricted securities in the absence of a favorable interpretive letter from the staff where the number of securities distributed in any one year may have exceeded one percent of the outstanding securities of the same class, or where the volume of shares traded on an exchange or over the counter is not clearly substantial, or indeed where the plan, the issuer, or the participants are in any other way different from the cases clearly falling within the Commission's policy exception. In addition, it must be kept in mind that securities issued pursuant to an employee benefit plan to an affiliate of the issuer will be "control securities" regardless of whether they are restricted or unrestricted under the above analysis. n101

[iii] Section 3(a)(10) Securities. Section 3(a)(10) of the Securities Act provides an exemption from registration for securities that are issued in exchange for outstanding securities, claims (including legal fees) or other property, or partly in such exchange, provided that a court or authorized governmental authority has approved the transaction on the basis of a suitable fairness hearing. n102 Typically, this exchange exemption is relied upon for securities issued in court approved settlements of litigation n103 and for securities issued in reorganizations found to be fair by authorized state securities commissions n104 or by courts with proper jurisdiction. n105 As noted above, it is an exemption available to both the issuer of the securities being exchanged and to affiliates of the issuer, n106 the two sources of restricted securities. Since the availability of the Section 3(a)(10) exchange exemption is not limited by the amount of securities issued, the number of recipients of the Section 3(a)(10) securities, or the manner of offering, it is generally regarded as an exemption available for public offerings. Accordingly, the securities issued in proper reliance upon the Section 3(a)(10) exemption from registration would normally be unrestricted securities because they were acquired in a public offering.

The staff now views even securities issued in exchange for restricted securities pursuant to Section 3(a)(10) as being unrestricted, reversing its earlier position that securities issued in a Section 3(a)(10) exchange for restricted securities were restricted themselves. n107 Now persons who were affiliates of an acquired company but are not affiliates of the issuer after a transaction can resell the securities received in the exchange in the manner permitted by Rule 145(d)(1) without regard to the holding period required by Rule 144(d). n108 Persons who are or become affiliates of the issuer after the transaction may resell the securities of the issuer only in accordance with the provisions of Rule 144 other than the holding period requirement of Rule 144(d). n109 Non-affiliates of the issuer and the acquired company, including those who relinquished restricted securities, are free to resell the unrestricted securities received in the exchange without regard to the limitations of Rules 144 or 145(c) and (d). n110 The St. Ives Holding Co., Inc. letter also covers Section 3(a)(10) business reorganizations involving foreign issuers; the same interpretations apply where Section 3(a)(10) exempts the issuance of unregistered securities in settlement of litigation. n111 Any party to a Section 3(a)(10) involving a shell company, other than the issuer, must resell the securities acquired in the transaction only in compliance with the resale restrictions of Rule 145(d), which follow the requirements of Rule 144. n112

[iv] Section 3(a)(9) Securities. Section 3(a)(9) provides an exemption from registration for issuers in the case of certain recapitalizations. n113 Although the number of outstanding securities that were issued in reliance upon Section 3(a)(9) is relatively small because of the fairly limited scope of the exemption, n114 it cannot be ignored because certain Section 3(a)(9) securities are restricted securities in the view of the staff of the Commission. In contrast to the situation under 3(a)(10) exchanges discussed above, perhaps because of the nature of judicial review involved in such transactions, securities exchanged by the issuer without registration in reliance upon Section 3(a)(9) of the Securities Act are considered restricted securities if they were issued in exchange for restricted securities and unrestricted if issued

in exchange for unrestricted securities. n115 Again, the staff has taken the position that the securities are restricted if the exchange transaction was "private" rather than public in nature. n116

[v] Section 3(a)(11) Securities. The Section 3(a)(11) intrastate offering exemption from registration under the Securities Act is available for sales of securities by the issuer of those securities or by an affiliate of the issuer where the transaction is in every respect intrastate in nature. n117 Like the exchange exemptions contained in Sections 3(a)(10) and 3(a)(9) of the Securities Act, the intrastate offering exemption is available regardless of the amount of securities offered, the number of offerees involved, or the manner of the offering. Accordingly, Section 3(a)(11) is available for all intrastate offerings, including public offerings; and the securities once issued are therefore normally regarded as unrestricted securities. n118 Once again, the staff of the Commission has taken the position that while most securities sold in reliance upon the Section 3(a)(11) (or the related Rule 147) intrastate offering exemption are unrestricted as to resale, those issued in a "private" Section 3(a)(11) or Rule 147 transaction are restricted securities within the meaning of Rule 144(a)(3). n119

[vi] Securities Acquired as Stock Dividends or in Stock Splits. Normally, securities of the issuer distributed by it to its own shareholders as stock dividends or as a result of a stock split are not registered under the Securities Act because no sale is involved. n120 As set forth above, under the literal analysis of the Rule 144(a)(3) definition of restricted securities, those securities would be restricted in the hands of the recipient shareholders only if the distribution did not involve a public offering within the meaning of the rule. n121 Once again, the approach of the staff of the Commission is different. In the staff's view, the public or private nature of the transaction is not the deciding factor. Instead, the staff deems unregistered securities distributed as stock dividends or as a result of a stock split as restricted if they were distributed in respect of restricted securities. n122 Otherwise, they are regarded as unrestricted securities. n123 As is always the case, any of these securities distributed to an affiliate of the issuer will be "control securities" regardless of their restricted or unrestricted character. n124

One effect of this approach is that frequently some of the securities distributed as a stock dividend will be restricted securities in the hands of the recipients while others of the same issue will be unrestricted securities. n125 In fact, any particular shareholder may receive some restricted securities and some unrestricted securities in the same distribution because he received them in respect of both types of securities. Though perhaps illogical in light of the Rule 144(a)(3) definition of restricted securities, these effects also exist in the case of those Section 3(a)(9) securities that are issued in a public offering, but are deemed restricted by the staff of the Commission on the ground that they were issued in exchange for restricted securities. n126

As noted above, the Division of Corporation Finance has taken a more flexible approach as to securities acquired through certain employee benefit programs. n127 As a result, those securities are often deemed unrestricted and therefore freely tradeable by most employee participants who receive them. n128 The staff also appears to be moving in a similar direction as to certain securities acquired in spin-offs or liquidating distributions. n129 Given these trends and the effects of the staff's approach to securities acquired as stock dividends or in stock splits, a shift by the staff to a more literal analysis of the Rule 144(a)(3) definition of restricted securities would not be startling. Meanwhile, securities received in respect of restricted securities in a public offering should not be regarded as unrestricted and freely tradeable in the absence of a favorable interpretive letter.

[vii] Securities Acquired as Spin-Offs or Liquidating Distributions. A spin-off is a free distribution of the securities of an issuer other than the distributing entity to the distributing entity's own security holders. As in the case of an ordinary stock dividend, the securities, albeit those of a different issuer, are received in respect of the outstanding securities of the distributing entity. A liquidating distribution is similar to a spin-off, except that the distribution is incident to the liquidation and dissolution of the distributing entity. n130 In effect, then the security holders of that liquidating entity receive the securities of a different issuer in exchange for their securities of the liquidating entity that become valueless as a result of the liquidation. Frequently, the liquidation is the final step in a reorganization that involved the sale of all of the assets of the distributing entity in exchange for the securities that are thereafter distributed

as a liquidating dividend.

In the case of both a spin-off and a liquidating distribution, the securities that are distributed by the distributing entity may have been either restricted securities or unrestricted securities in the hands of that distributing entity. In the case of either transaction, the distribution may or may not constitute a public offering within the meaning of the Rule 144(a)(3) definition of restricted securities. Finally, the distributing entity may be unrelated to the issuer of the securities distributed (as is often the case where an investment company is divesting itself of some or all of the securities in its portfolio), or the distributing entity may be an affiliate, or even the parent, of the issuer of the securities distributed. In 1997, the staff of the Commission issued a Staff Legal Bulletin outlining the circumstances in which spin-off transactions are not required to be registered under the Securities Act. n131 Based on a "no-sale" theory, and taking into account the policy concern that adequate information be available about the issuer of the spun-off securities, the staff's position is that a subsidiary does not have to register a spin-off if the following conditions are met:

- the parent shareholders do not provide consideration for the spun-off shares;
- the spin-off is pro rata to the parent shareholders;
- the parent provides adequate information about the spin-off and the subsidiary to its shareholders and to the trading markets;
- the parent has a valid business purpose for the spin-off; and
- if the parent spins off "restricted securities," it has held those securities for at least two years. n132 Presumably the two year requirement would now be one year or six months pursuant to the 2007 amendments to Rule 144.

By issuing the Bulletin, the staff hoped to decrease the considerable number of no-action letters it received on the subject of spin-offs. n133

Securities that are acquired in a registered spin-off or liquidating distribution, like all securities acquired in any other registered offering, are unrestricted securities in the hands of the distributees regardless of whether they were distributed in respect of restricted securities or whether the distributing entity was an affiliate of the issuer of those securities. n134

In the case of unregistered spin-offs or liquidating distributions, however, the restricted or unrestricted character of the securities in the hands of the distributees was, until issuance of Staff Legal Bulletin No. 4, less clear. If the literal analysis of the Rule 144(a)(3) definition of restricted securities were applied, the securities acquired in a spin-off or liquidating distribution would be restricted securities in the hands of the distributees only if the distribution were a private rather than a public transaction, and either the securities were restricted securities in the hands of the distributing entity or the distributing entity were an affiliate of the issuer. n135 The Bulletin states that it is the view of the Division of Corporation Finance that securities received by shareholders in a spin-off that meets the conditions set out in the Bulletin are generally not restricted securities. n136 Sales by the spun-off company's affiliates, however, would be subject to Rule 144(d), absent registration or another appropriate exemption. n137 The staff states that in rare situations, a large shareholder so controls the parent that the shareholder essentially decides whether to do the spin-off, in which case the staff would view the spin-off as a privately negotiated transaction, with that shareholder getting restricted securities (and other shareholders receiving unrestricted securities). n138

It would seem from these statements that the staff has returned to a more literal interpretation of the Rule 144(a)(3) definition. Previously, the staff had regarded all such securities as restricted securities, n139 then later viewed securities acquired in a spin-off or liquidating distribution as restricted securities in the hands of the distributees whenever they had been restricted securities in the hands of the distributing entity prior to the distribution. n140 This was the case even

where the transaction appeared more public than private in nature. n141 A later view of the staff appeared to depend first upon whether the distributing entity was an affiliate of the issuer of the distributed securities at the time of the transaction. In the case of the non-affiliate distributing entity, the public or private nature of the spin-off or liquidating distribution was neither the determining nor even a relevant factor in determining the securities' character. The securities so acquired were viewed as restricted securities in the hands of the distributees if they had been such in the hands of the non-affiliate distributing entity. n142

The staff's current position is consistent both with the express language of Rule 144(a)(3) and the stated purpose of Rule 144 "to prohibit the creation of public markets in securities of issuers concerning which adequate current information is not available to the public." n143 It is unlikely, despite the wording of Rule 144(a)(3), that the staff will extend its position to any public spin-offs or liquidating distributions of restricted securities that fail to conform to the disclosure requirements mentioned above because such distributions do create a public market without ensuring the availability of adequate public information. The securities acquired in such nonconforming transactions, therefore, should continue to be viewed as restricted securities with all of the accompanying restrictions on their trade ability in the marketplace.

[viii] Rule 145 Securities. Rule 145 provides that certain business combinations, such as mergers, consolidations and acquisitions of assets, are subject to the registration requirements of the Securities Act. n144 Rule 145(a) specifies that an "offer" or "sale" will be deemed to occur with exchanges of securities in connection with certain reclassifications, mergers, consolidations and transfers of assets that are submitted for the vote or consent of the security holders of a corporation. Accordingly, the "sale" must be registered unless an exemption is available. Under Rule 145(c), or the presumptive underwriter provision, any party to any transaction of the type set forth in Rule 145(a) (other than the issuer) or an affiliate of such party who publicly offers the securities acquired in that transaction is an "underwriter" if any party to a Rule 145(a) transaction is a shell company, other than a business combination related shell company. n145

[ix] Securities Acquired Overseas. In 1990, the Commission promulgated Regulation S, which provides that offers and sales of securities made outside the United States are not subject to the registration requirements of the Securities Act. n146 The release adopting Regulation S stated that securities sold overseas in reliance on Regulation S were not "restricted securities." n147 It would be logical to suppose that securities acquired overseas otherwise than in reliance on Regulation S were similarly not restricted, although the Regulation S adopting release makes no reference to such transactions. n148

After the adoption of Regulation S, however, there were reports of its misuse for offerings by U.S. companies which purported to be made overseas in reliance on the Regulation, but where the securities so offered were intended to be sold back into the United States in an unregistered public offering. n149 In view of these perceived abuses, in 1995, the Commission issued a Concept Release expressing concerns about such practices, n150 and in 1998 adopted Rule 905, which stated that equity securities offered overseas by U.S. companies were restricted securities and would remain restricted notwithstanding any resales overseas. n151 Such securities are permitted to be resold under Rule 144.

[x] Securities Acquired by "Underwriters" in Bankruptcy Code Section 1145 Transactions. *Section 1145(c) of the Bankruptcy Code* provides that transactions that take place pursuant to Section 1145(a) are public offerings, and thus, securities issued pursuant to that section are unrestricted, so long as the sellers are not deemed "underwriters" by that section. n152 Underwriters for that purpose include those offering to sell securities received under the plan or offering to buy such securities with a view to distribution. Such underwriters may resell their securities in "ordinary trading transactions" so long as there are no concerted selling efforts of recipients of the securities pursuant to the reorganization, no use of offering documents other than that used for the reorganization and special compensation to brokers. n153

[xi] Securities Acquired Pursuant to Regulation CE Under Regulation CE (Rule 1001), offers and sales of securities that satisfy the conditions of California Corporations Code paragraph (n), Sec. 25102 shall be exempt from Section 5 of the Securities Act, provided that the sum of all cash and other consideration to be received shall not exceed

\$5,000,000, less the aggregate offering price for all other securities sold in the same offering, whether pursuant to this or another exemption. n154 Securities issued under this rule are "restricted securities" as defined by paragraph (a)(3) of Rule 144 and accordingly resales of such securities must be made in compliance with the Securities Act registration requirements or an exemption therefrom. n155

[xii] Securities Offered in Rule 801 or 802 Transactions. In 1999, the Commission adopted new rules to make it easier for non-U.S. companies to make rights offerings into the United States and for persons (U.S. or non-U.S.) to extend into the United States tender offers and exchange offers for securities of non-U.S. companies that are made primarily outside the United States. n156 The rules exempt exchange offers and tender offers from registration under the Securities Act (and provide other regulatory relief) when 10% or less of the subject class of securities is owned by U.S. holders, and other procedural requirements are met. New securities issued in rights offerings under Rule 801 are unrestricted if the subject securities were unrestricted, and restricted only if the subject securities were restricted. The same principles apply in exchange offers under Rule 802.

[4] Duration of Restricted Status

Particular securities are unrestricted in any of the following four situations:

- where the security holder acquired those securities in a public offering, whether registered under the Securities Act n157 or exempt from n158 or not subject to the Securities Act's registration requirements; n159
- where the security holder's transferor (provided that the transferor was not then an affiliate of the issuer) acquired those securities in a public offering; n160
- where a previous security holder acquired those securities in a public offering; or
- where the securities are of a non-U.S. issuer and were acquired by the security holder or a previous security holder outside the United States in a transaction complying with Regulation S. n161

Thus, involvement of securities in a public offering, n162 at any time after they were last held by the issuer or an affiliate of the issuer normally renders them unrestricted. n163 It is important to realize that while registered securities are normally unrestricted securities, unregistered securities are not restricted securities if they meet the above tests.

As mentioned above, once restricted securities have been created, they remain restricted throughout any number of sales, donations or other transfer until they are transferred in a public offering n164 or overseas n165 or the expiration of the applicable holding period since the securities were last held by the issuer or any affiliate of the issuer. n166 At that point, they become essentially unrestricted securities and may therefore be freely traded under the resale exemption contained in Section 4(1) of the Securities Act. n167

FOOTNOTES:

(n1)Footnote 1. See Sec. Act Rel. No. 33-5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,487 (1972).

(n2)Footnote 2. Rule 144(a)(3) of the 1933 Act, reprinted in the Analysis of Key SEC No-Action Letters. Haft, Robert and Michele Hudson. § 7:4. (Thomson Reuters/West 2008).

(n3)Footnote 3. Certain securities, frequently those of private or close corporations, are subject to various share

transfer restrictions imposed through shareholders' agreements or otherwise. These restrictions on resale are governed by the applicable state corporation law. The sale of securities is also, of course, normally subject to the relevant state securities law or laws and to the Uniform Commercial Code, Article 8, in the form adopted by the relevant state or states. All of these limitations, although matters of concern for counsel representing the potential seller of securities, are outside the scope of this chapter.

(n4)Footnote 4. For discussion of such limitations, see § 6.02[2] *supra*.

(n5)Footnote 5. For discussion of the limitations on the resale of securities by affiliates, see § 6.02[3] *supra*.

(n6)Footnote 6. See § 6.02[4] *supra*, and see n3.

(n7)Footnote 7. Section 2(1) of the 1933 Act, reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender), is discussed in § 2.01 *supra*. It is not always easy to determine whether a particular interest falls within that definition of a security. In that regard, see generally Schneider, *The Elusive Definition of a Security*, 14 Rev. Sec. Reg. 981 (1981), and its updates; Schneider *Developments in Defining a "Security"*, 16 Rev. Sec. Reg. 985 (1983); Schneider, *Definition of a "Security"--1983/ 84 Update*, 17 Rev. Sec. Reg. 851 (1984); and Schneider, *The Elusive Definition "Security"-- 1990 Update*, 24 Rev. Sec. Reg. 13 (1991) for summaries of the elusiveness of the definition of the terms under the Act. See also M. Steinberg & W. Kaulbach, *The Supreme Court and the Definition of a Security*, 40 Vand. L. Rev. 489 (1987).

(n8)Footnote 8. See Allen E. Throop & Chester T. Lane, *Some Problems of Exemption under the Securities Act of 1933*, 4 Law & Contemp. Prob. 89 (1937).

(n9)Footnote 9. Sections 3(a)(2) through 3(a)(8) are discussed in §§ 3.03- 3.09 *supra* .

(n10)Footnote 10. *But see* Consolidated Freightways, Inc., SEC No-Action Letter 1982 SEC No-Act. LEXIS 3110 (November 27, 1982), in which the staff states that Section 3(a)(6) securities "are not 'restricted securities' within the meaning of Rule 144(a)(3)."

(n11)Footnote 11. In perhaps only one instance has it been argued that a transfer fell short of being an acquisition for purposes of Rule 144(a)(3). In the no-action letter Equimark Corp., SEC No-Action Letter 1988 SEC No-Act. LEXIS 279 (February 16, 1988), counsel argued that the distribution of unrestricted securities by a partnership that was an affiliate of the issuer to its individual partners was not an acquisition and that therefore the securities should remain unrestricted in the hands of those distributee partners. While the staff concurred in counsel's conclusion, it did not address the acquisition analysis, and its concurrence could well be based on the non-sale nature of the transaction. Regarding no-action letters generally, see n.17 *infra*.

(n12)Footnote 12. *But see* § 6.03[3][a] and § 6.03[3][d] *infra* for certain exceptions.

(n13)Footnote 13. The term "issuer" is precisely defined by Section 2(4) and is discussed in § 4.01[1] *supra*.

(n14)Footnote 14. See § 6.03[3][d][ix] *infra* with regard to the definition of the term "affiliate."

(n15)Footnote 15. See § 6.03[3][a][i] *infra* with regard to the meaning of the term "public offering." If the securities were acquired from the issuer in a Rule 504 or 701 transaction, see § 6.03[3][a][ii] *infra*, they are restricted even though a prior distribution of the same securities by the issuer could have been public rather than private.

(n16)Footnote 16. See § 6.03[3][d][ix] *infra* for a discussion of transactions outside the United States pursuant to Regulation S.

(n17)Footnote 17. See, e.g., Analysis & Technology, Inc., SEC No-Action Letter 1979 SEC No-Act. LEXIS 2208 (February 12, 1979). This letter is an interpretive letter issued by the staff of the Division of Corporate Finance of the

Commission. "An interpretive letter is one in which the staff provides an interpretation of a specific statute, rule or regulation in the context of an actual fact situation." Sec. Act Rel. No. 33-6253, Fed. Sec. L. Rep. (CCH) P 134A (1980). Similarly, no-action letter is one in which a member of the staff "indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated. In some instances, the staff will state in response to a no-action request that it is unable to assure the writer that it will not recommend" such enforcement action if the transaction occurs as described. *Id.* Since December 1, 1970, these interpretive and no-action letters have been made available to the public and are widely regarded, particularly in the aggregate, as some evidence of the views of the Commission's staff on the subject of the inquiries involved. The Division has indicated that "[m]embers of the public are entitled to rely on no-action and interpretive letters as representing the views of the Division. Such letters, however, set forth staff positions only and do not constitute an official expression of the Commission's views." *Id.* All of the letters cited in this chapter are available through LexisNexis, and the cites within this chapter to each letter cite to the relevant electronic database where the letter can be located.

(n18)Footnote 18. With respect to the status of restricted securities sold overseas, see § 6.09 *infra*.

(n19)Footnote 19. *But see* § 6.03[3][a][i] *infra* for limited exceptions.

(n20)Footnote 20. Section 4(2) is discussed in § 4.03 *supra*.

(n21)Footnote 21. By contrast, Section 1145(c) of the federal Bankruptcy Code specifically states that securities received pursuant to court-approved reorganization plans in bankruptcy proceedings are deemed to be received in a public offering. Accordingly, they are unrestricted and outside the scope of this chapter. *See, e.g.*, Northeast Utilities, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 264 (February 11, 1991); Zenith Laboratories, Inc., SEC No-Action Letters 1990 SEC No-Act. LEXIS 37 (January 12, 1990); Cyclops Industries, Inc., SEC No-Action Letter 1988 SEC No-Act. LEXIS 626 (June 2, 1988).

(n22)Footnote 22. *See, e.g.*, *SEC v. Ralston Purina Co.*, n.28 *supra*.

(n23)Footnote 23. *See, e.g.*, Regulation D, discussed in § 4.04 *supra* and Rule 144A, discussed in § 6.07 *infra*.

(n24)Footnote 24. *See generally* C. Schneider, *The Statutory Law of Private Placements*, 14 Rev. Sec. Reg. 869 (1981).

(n25)Footnote 25. *See, e.g.*, Rio Grande Industries, Inc., 1989 SEC No-Act. LEXIS 490 (April 5, 1989).

(n26)Footnote 26. *See* Ch. 4 *supra*.

(n27)Footnote 27. *See, e.g.*, Hechinger Co., SEC No-Action Letter 1990 SEC No-Act. LEXIS 771 (May 8, 1990) (merger shares acquired in registered offering are not restricted); Nathan Golden, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,409 (1987). In fact, registered securities are unrestricted even if they were acquired in exchange for restricted securities. Vitro, Sociedad Anonima, SEC No-Action Letter 1991 SEC No-Act. LEXIS 1278 (November 19, 1991); Kaneb Services, Inc., SEC No-Action Letter 1981 SEC No-Act. LEXIS 3195 (March 9, 1981). *But see* R. B. Jones Corp., SEC No-Action 1974 SEC No-Act. LEXIS 2209 (May 27, 1974) in which the staff of the Commission deemed the shares issued in connection with the acquisition of a privately held company restricted despite their inclusion in a registration statement prepared for other purposes; Kaiser Industries Corp., SEC No-Action Letter 1977 SEC No-Act. LEXIS 2138 (August 25, 1977), in which the staff deemed shares included in a registration statement to be restricted securities even though an integral part of a public offering, because the cover page stated that those shares were being purchased by a particular individual and were not being publicly offered.

(n28)Footnote 28. *See* § 6.03[3][b] *infra*.

(n29)Footnote 29. See §§ 6.03[3][a][i] and [b] *infra*.

(n30)Footnote 30. But see § 6.03[3][d] *infra*.

(n31)Footnote 31. Regulation A is discussed in Ch. 5 *supra*.

(n32)Footnote 32. Section 3(a)(11) and Rule 147 are discussed in § 3.12 *supra*.

For information regarding the scope of the intrastate offering exemption, see J. Hicks, Exempted Securities Transactions Under the Securities Act of 1933, § 4.01 through § 4.09 (1933).

(n33)Footnote 33. Section 3(a)(10) is discussed in § 3.11 *supra*. For information regarding the scope of the exchange exemption contained in that section, see Loo & Soderbeck, *The "Fairness Hearing" Exemption*, 18 Rev. Sec. & Comm. Reg. 73 (1985); Kreutz & Margiotta, *Section 3(a)(10) of the Securities Act of 1933, A Practical Alternative to the Private Offering Exemption in Mergers and Acquisitions*, 635 PLI Corp. 505 (1989); Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 Nw. U. L. Rev. 1 (1980). See also Staff Legal Bulletin No. 4 (CF), September 16, 1997.

(n34)Footnote 34. Section 3(a)(9) is discussed in § 3.10 *supra*. For information regarding the more limited scope of that exemption, see Campbell, *Mergers, Acquisitions and Recapitalizations Under Section 3(a)(9) of the Securities Act of 1933*, 61 Va. L. Rev. 1957 (1975). See also Note, *Distress Contingent Convertible Bonds*, 104 Harv. L. Rev. 1857, 1871 n.77 (1991); *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. Rev. 5452 n.135 (1990).

(n35)Footnote 35. See Rule 701 and see 6.03[3][a][ii] *infra*.

(n36)Footnote 36. See Rules 801 and 802 and see § 6.03[3][d](xi) *infra*.

(n37)Footnote 37. See, e.g., I.C.H. Corporation, SEC No-Action Letter 1997 SEC No-Act. LEXIS 528 (April 14, 1997).

(n38)Footnote 38. Section 4(2) is discussed in § 4.02 *supra*.

(n39)Footnote 39. See § 6.03[2] *supra*.

(n40)Footnote 40. It is important to note that restrictions on resale of privately placed securities may be imposed both by applicable securities laws and by the terms of the offering. Since privately placed securities are restricted, they may not be freely resold and must be sold pursuant to a registration statement or in accordance with exemptions such as Rule 144, see § 6.02 *supra*, or Rule 144A, see § 6.07 *infra*. They could also be resold outside the United States in reliance on Regulation S, see § 6.09 *infra*, or resold in reliance on the "exemption" under so-called "Section 4(11/2)," see § 6.08[1] *infra*. The terms of the offering, however, may restrict resale to only certain of these options. The permitted resale options should be clearly indicated to investors.

(n41)Footnote 41. Sec. Act Rel. No. 33-5226, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,483, at P 81,037 (1972).

(n42)Footnote 42. Section 4(6) is discussed in § 4.06 *supra*.

(n43)Footnote 43. See § 6.03[1] *supra*.

(n44)Footnote 44. See Regulation D, discussed in § 4.04 *supra*. Regulation D's Rules 504, 505 and 506 replaced former Rules 240, 242 and 146, respectively. Rules 240, 242 and 146 were repealed effective June 30, 1982. Sec. Act Rel. No. 33-6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,106 (1982).

(n45)Footnote 45. Section 3(b) provides an exemption for securities placed in offerings not exceeding \$5,000,000 and encompasses public offerings. An offering under Rule 504 or 505, therefore, may or may not involve a public offering depending upon all the facts and circumstances of the case. *San Jose Capital Corp.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,391 (1983).

(n46)Footnote 46. Despite the fact that securities sold publicly in reliance on Section 3(b) might otherwise be unrestricted securities (*see* discussion of status of securities sold in reliance on Regulation A at § 5.02[6] *supra*), both Regulation D and Rule 144 deem such securities to be restricted. Rule 502(d), discussed in § 4.04 *supra*. *See also* Rule 144(a)(3).

But see Rule 504(b)(1), discussed in § 4.04 *supra*, for a very limited exception. Rule 504(b)(1) provides that intrastate offerings complying with its requirements and made in accordance with state securities laws may be made publicly without implicating restrictions on transfer under federal securities law, but nearly all states impose their own resale restrictions.

(n47)Footnote 47. Rule 502(d), discussed in § 4.04 *supra*.

(n48)Footnote 48. *See* NASAA Guidelines for Cover Legends, October 2, 2004.

(n49)Footnote 49. Sec. Act Rel. No. 33-6768, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,231 (1988).

(n50)Footnote 50. While the maximum amount of securities that may be offered annually under Rule 701 depends upon the total assets and the number of outstanding securities of the same class of the issuer (essentially 15% tests), it may in no event exceed \$5,000,000 worth of securities. Rule 701(b)(5).

(n51)Footnote 51. Rule 701(a) and (b). *See also* Jackson, Tufts, Cole & Black, SEC No-Action Letter 1988 SEC No-Act. LEXIS 757 (May 25, 1988).

(n52)Footnote 52. Sec. Act Rel. No. 33-6768, n.45 *supra*, at 89,064.

(n53)Footnote 53. Rule 701(g)(1). Securities Act Rule 701(g)(3) outlines the resale limitations for securities issued under Rule 701. The limitations for resales by non-affiliates includes references to paragraphs (e) and (h) of Rule 144, which under the 2007 amendments to Rule 144 are no longer apply to resales by non-affiliates. Accordingly, the resale restrictions of securities acquired pursuant to employee benefit plans under Rule 701 of the Securities Act have been conformed to the 2007 amendments to Rule 144 by removing references to Rule 144(e) and (h) from Rule 701.

(n54)Footnote 54. Rule 701(g)(3).

(n55)Footnote 55. Rule 701(b)(3).

(n56)Footnote 56. Current issues and Rulemaking Projects, SEC Division of Corporation Finance, November 14, 2000, at 56. Where the issuer controls the shareholder who purportedly transfers unrestricted shares in return for restricted shares, the recipient is acquiring shares from an affiliate in a non=public transaction and, therefore, is acquiring restricted shares. *See, e.g.* In the Matter of Energy & Enginge Technology Corporation, Securities Release No. 8311 (October 23, 2003).

(n57)Footnote 57. *See* § 6.03[3] *supra*.

(n58)Footnote 58. Emphasis added. Section 2(3) is also discussed in § 2.02 *supra*.

(n59)Footnote 59. *Rubin v. United States*, 449 U.S. 424 (1981); *SEC v. Guild Films Co., Inc.*, 279 F.2d 485 (2d Cir. 1960), *cert. denied sub nom. Santa Monica Bank v. SEC*, 364 U.S. 819 (1960).

(n60)Footnote 60. As discussed in § 6.02[3] above, an affiliate may not generally rely on the Section 4(1) resale exemption for public resales because the transaction will be deemed to be part of a distribution and the affiliate will thus be an underwriter.

(n61)Footnote 61. Rule 144(a)(3); Sec. Act Rel. No. 33-6099, 1 Fed. Sec. L. Rep. (CCH) P 2705H (1979) at Section II(A), Question 9.

(n62)Footnote 62. *Id.*

(n63)Footnote 63. *Id.*

(n64)Footnote 64. *Id.* at Section II(b), Question 12.

(n65)Footnote 65. See § 6.02 *supra* and § 6.04 *infra* for the meaning of "control securities" and the restrictions on their resale.

(n66)Footnote 66. Rite Aid Corporation, SEC No-Action Letter 1997 SEC No-Act. LEXIS 949 (October 20, 1997).

(n67)Footnote 67. Sec. Act Rel. No. 33-6099, n.61 *supra*, at Section II(a), Question 9(b), in which the Commission indicates that such a transfer is simply not a transaction at all.

(n68)Footnote 68. Equimark Corp., n.11 *supra*. For further analysis of other special cases of apparently non-sale transactions by affiliates, see § 6.03[3][d] *infra*.

(n69)Footnote 69. *But see* § 6.03[3][d] *infra* for certain exceptions.

(n70)Footnote 70. Rule 254(a)(1)(i).

(n71)Footnote 71. The "safe harbor" provided by Rule 147 is available only to the issuer. See Rule 147(a).

(n72)Footnote 72. See § 6.05[2][b] *supra*.

(n73)Footnote 73. See § 6.02[3] *supra*.

(n74)Footnote 74. See "chain of transactions" language of Rule 144(a)(3). It must be noted that such "chain of transactions" language does not cover securities acquired in a Rule 701 transaction, discussed in § 6.03[1] *supra* and § 6.03[3][a][i] *infra*, an apparent oversight that does allow the conclusion, however, that a holder who acquires those securities from the original transferee even in a private transaction holds unrestricted securities. The more logical view is that Rule 701 securities were intended to be and should be treated like Rule 504 securities.

(n75)Footnote 75. Arguably a resale overseas, as well as a public resale, results in the securities becoming restricted. *But see* § 6.09 *infra*.

(n76)Footnote 76. See, e.g., Kleinberg, Bensley, Kaplan & Wolff, SEC No-Action Letter 1972 SEC No-Act. LEXIS 1474 (April 12, 1972).

(n77)Footnote 77. See § 6.02[4][a] *supra*.

(n78)Footnote 78. MetPath, Inc., SEC No-Action Letter 1975 SEC No-Act. LEXIS 1607 (August 6, 1975).

(n79)Footnote 79. Sec. Act Rel. No. 6099, n.56 *supra* at Section II(A), Question 10.

(n80)Footnote 80. John C. Shaw, SEC No-Action Letter 1988 SEC No-Act. LEXIS 1376 (October 12, 1988). See

Newbery Energy Corporation, SEC No-Action Letter 1975 SEC No-Act. LEXIS 1840 (August 29, 1975); *but see* Hosposable Products, Inc., SEC No-Action Letter 1977 SEC No-Act. LEXIS 397 (February 24, 1977) (shares received by attorney who drafted registration statement treated like underwriter's compensation shares).

(n81)Footnote 81. *See* § 6.03[3][a][ii] *supra*, for a discussion of offerings to employees pursuant to Rule 701.

(n82)Footnote 82. *See generally* D. Goldwasser, § 6.02, n.78, *supra*, 141-143.

(n83)Footnote 83. As an affiliate, the plan may sell securities to the participants in reliance on Rule 144. Sec. Act Rel. No. 33-6281, Fed. Sec. L. Rep. (CCH) P 1052 (1981), at Section IIIA *infra*.

(n84)Footnote 84. *SEC v. Ralston Purina Co.*, n.28 *supra*.

(n85)Footnote 85. *See* § 6.03[2] *supra*.

(n86)Footnote 86. *See, e.g.*, Itel Corp., SEC No-Action Letter 1980 SEC No-Act. LEXIS 3808 (October 15, 1980); *see also* Sec. Act Rel. 33-6188, 1 Fed. Sec. L. Rep. (CCH)P 1051 (1980), at Section VI(A).

(n87)Footnote 87. *See, e.g.*, Peninsular & Oriental Steam Navigation Company, SEC No-Action Letter 2004 SEC No-Act. LEXIS 724 (August 30, 2004); Peoples Bancorporation, SEC No-Action Letter 1983 SEC No-Act. LEXIS 2266 (April 25, 1983).

(n88)Footnote 88. *See* Sec. Act Rel. No. 33-6188, n.86 *supra*, at Section IV (describing available exemptions).

(n89)Footnote 89. *See, e.g., id.*, at Section III(B)(2).

(n90)Footnote 90. Sec. Act Rel. No. 33-5243, [Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,701 (1972). It appears that the Commission took and continues to take the same position with respect to all unrestricted securities of issuers other than the employer that are distributed by the employer pursuant to an employee stock plan. Catalyst Stock Plan I, Ltd., SEC No-Action Letter 1983 SEC No-Act. LEXIS 1765 (February 14, 1983).

(n91)Footnote 91. Sec. Act Rel. No. 33-5750, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,766 (1976).

(n92)Footnote 92. 1 Fed. Sec. L. Rep. (CCH) P 1051 (1980) at Section VI(B).

(n93)Footnote 93. 1 Fed. Sec. L. Rep. (CCH) P 1052 (1981) at Section III(B)

(n94)Footnote 94. *See, e.g.*, Norfolk Southern Corporation, SEC No-Action Letter 1992 SEC No-Act. LEXIS 1058 (November 20, 1992); Westinghouse Electric Corp., SEC No-Action Letter 1991 SEC No-Act. LEXIS 1067 (September 12, 1991) (one-time free stock bonus to all employees of a division); Intelligent Electronics, Inc., SEC No-Action Letter 1991 SEC No-Act. LEXIS 1024 (August 20, 1991) (bonus shares distributed in relatively broad class of employees); Total Assets Protection, Inc., SEC No-Action Letter 1990 SEC No-Act. LEXIS 612 (March 30, 1990) (one-time free stock bonus to all non-management employees); UJB Financial Corp., SEC No-Action Letter 1990 SEC No-Act. LEXIS 118 (January 30, 1990) (long-term performance stock plan); Pioneer Hi-Bred International Corp., SEC No-Action Letter 1983 SEC No-Act. LEXIS 1881 (February 24, 1983) (involving a typical plan). Based on the policy exception, securities were also deemed unrestricted where the plan participants were entitled to elect cash in lieu of some or all of the securities available to them, Alexander & Baldwin, Inc., SEC No-Action Letter 1983 SEC No-Act. LEXIS 2186 (April 11, 1983); and where the "plan" was in fact a series of door prize programs rather than a traditional employee benefit plan, Coca-Cola Company, SEC No-Action Letter 1983 SEC No-Act. LEXIS 1612 (January 7, 1983). However, the policy exception was not applicable to the securities of issuers other than the employer even though distributed as part of an employee benefit plan, *see* Catalyst Stock Plan I, Ltd., n.90 *supra*.

(n95)Footnote 95. Or, although the issuer is not subject to the periodic reporting requirements of the Exchange Act, it submits to the Commission information as required under Section 12(f)(1)(A) of the Exchange Act. *See* B.A.T. Industries p.l.c., SEC No-Action Letter 1992 SEC No-Act. LEXIS 671 (May 20, 1992).

(n96)Footnote 96. Sec. Act Rel. No. 33-6281, n.83 *supra*, at Section III(B). The number of securities distributed pursuant to the plan and available for resale during a fiscal year generally must not exceed 1% of the total of the number of shares outstanding. *See, e.g.,* Norfolk Southern Corp., SEC No-Action Letter 1992 SEC No-Act. LEXIS 1058 (November 20, 1992). The exception also appears to apply to securities issued to foreign participants of employee benefit plans, Tandy Corporation, SEC No-Action Letter 1981 SEC No-Act. LEXIS 3809 (July 24, 1981), though perhaps with additional requirements to accord with the requirements of foreign law. *See* [E.I. Du Pont de Nemours & Co., SEC No-Action Letter (letter available September 25, 1982),] where the securities were deemed unrestricted based on the usual three requirements and the further condition that the shares be held by the plan participants for at least two years as required by the applicable local law. The exception also applies to securities issued to non-employee directors. Pacific Telesis Group, SEC No-Action Letter 1992 SEC No-Act. LEXIS 766 (June 30, 1992).

(n97)Footnote 97. Hach Co. Employee Stock Ownership Plan, SEC No-Action Letter (January 21, 1983); Lamb Technicon Corp., SEC No-Action Letter 1982 SEC No-Act. LEXIS 2608 (July 8, 1982).

(n98)Footnote 98. Marline Oil Corporation, SEC No-Action Letter 1979 SEC No-Act. LEXIS 2011 (January 4, 1979); *see also* Sulpetro Limited, SEC No-Action Letter 1982 SEC No-Act. LEXIS 2609 (July 8, 1982).

(n99)Footnote 99. Braniff International Corp., SEC No-Action Letter 1982 SEC No-Act. LEXIS 2434 (May 31, 1982); Intergraph Corporation, SEC No-Action Letter 2002 SEC No-Act. LEXIS 583 (May 15, 2002).

(n100)Footnote 100. Aristek Communities, Inc., SEC No-Action Letter 1983 SEC No-Act. LEXIS 2878 (October 1, 1983) (average monthly trading of 1.7% of outstanding was enough). *See also* two instances where average monthly trading volume of less than 1% of the outstanding shares was enough, Rose's Stores, Inc., SEC No-Action Letter 1983 SEC No-Act. LEXIS 1617 (January 7, 1983 (0.5%)) and American Agronomics Corp., SEC No-Action Letter 1981 SEC No-Act. LEXIS 2810 (January 12, 1981) (0.8%).

(n101)Footnote 101. *See generally* § 6.04 *infra*.

(n102)Footnote 102. Section 3(a)(10) is discussed in § 3.11 *supra*. The conditions for availability of Section 3(a)(10) and the consequent status of the securities so issued are now codified in the Commission's Staff Legal Bulletin No. 3 (CF), July 25, 1997, as revised by Revised Staff Legal Bulletin No. 3 (CF), October 20, 1999.

(n103)Footnote 103. *See, e.g.,* Sprint Corporation, SEC No-Action Letter 2003 SEC No-Act. LEXIS 681 (August 25, 2003); Carolco Pictures, Inc., SEC No-Action Letter 1991 SEC No-Act. LEXIS 89 (January 23, 1991); *see also* Ash, n.33 *supra*, at 37-40.

(n104)Footnote 104. *See, e.g.,* Microlog Corp., SEC No-Action Letter 1990 SEC No-Act. LEXIS 1263 (November 23, 1990); *see also* Ash, n.33 *supra*, at 37-40.

(n105)Footnote 105. *See, e.g.,* Hong Kong and Shanghai Banking Corp., Ltd., SEC No-Action Letter 1991 SEC No-Act. LEXIS 93 (January 23, 1991); International Mahogany Corp., SEC No-Action Letter 1990 SEC No-Act. LEXIS 1223 (October 25, 1990). In Staff Legal Bulletin No. 3 as originally released, the SEC Staff expressed the view that the National Securities Markets Improvements Act of 1996 precluded reliance on a fairness hearing conducted under states securities law as the basis for a claim of exemption pursuant to Section 3(a)(10) for any security that was a "covered security" (i.e., as to which state jurisdiction was pre-exempted by federal law) prior to the hearing. Revised Staff Legal Bulletin No. 3 provides that since the Securities Litigation Uniform Standards Act of 1998 adds Section 3(a)(10) securities to the definition of "covered securities," an issuer may now rely on a fairness hearing conducted under state securities law.

(n106)Footnote 106. *See* §§ 6.03[3][d][viii] *supra*.

(n107)Footnote 107. St. Ives Holding Co., Inc., SEC No-Action Letter 1987 SEC No-Act. LEXIS 2250 (July 22, 1987).

(n108)Footnote 108. *Id.* at 77,540.

(n109)Footnote 109. 1st United Bancorp, SEC No-Action Letter 1993 SEC No-Act. LEXIS 928 (August 20, 1993).

(n110)Footnote 110. *See, e.g.*, EIG Mutual Holding Company, SEC No-Action Letter 2006 SEC No-Act. LEXIS 652 (October 25, 2006); EquiServe Trust Company, N.A., SEC No-Action Letter 2000 SEC No-Act. LEXIS 121 (February 2, 2000).

(n111)Footnote 111. *See, e.g.*, Transocean inc. SEC No-Action Letter 2007 SEC No-Act. LEXIS 596 (September 26, 2007); SanDisk Corporation SEC No-Action Letter 2006 SEC No-Act. LEXIS 621 (September 21, 2006); Ashanti Goldfields Company Limited, SEC No-Action Letter 2002 SEC No-Act. LEXIS 609 (June 19, 2002).

(n112)Footnote 112. *See* §§ 6.03[3][a] and [b] *supra*.

(n113)Footnote 113. Section 3(a)(9) of the 1933 Act, reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender), is discussed in § 3.10 *supra*.

(n114)Footnote 114. *See* Ash, n.33 *supra*, at 33-34 (1980).

(n115)Footnote 115. Mr. Coffee, Inc., SEC No-Action Letter 1991 SEC No-Act. LEXIS 766 (June 6, 1991).

(n116)Footnote 116. *See* Auto Finance Group, Inc., SEC No-Action Letter 1991 SEC No-Act. LEXIS 1313 (December 3, 1991); Terminal Data Corp., SEC No-Action Letter 1990 SEC No-Act. LEXIS 1260 (November 19, 1990); Delta Drilling Company, SEC No-Action Letter 1982 SEC No-Act. LEXIS 2373 (April 29, 1982).

(n117)Footnote 117. *See* § 6.03[3] *supra*.

(n118)Footnote 118. John F. Davis, SEC No-Action Letter 1983, SEC No-Act. LEXIS 1693 (January 18, 1973).

(n119)Footnote 119. Electronic Data Systems Corporation, SEC No-Action Letter 1975 SEC No-Act. LEXIS 918 (May 14, 1975).

(n120)Footnote 120. *See* § 6.03[3][d] *supra*.

(n121)Footnote 121. *See* § 6.03[3] *supra*.

(n122)Footnote 122. Turner Broadcasting System, Inc., SEC No-Action Letter 1987 SEC No-Act. LEXIS 1480 (January 5, 1987); Associated Communications Corporation, SEC No-Action Letter 1983 SEC No-Act. LEXIS 2710 (August 18, 1983); Teleflex Incorporated, SEC No-Action Letter 1972 SEC No-Act. LEXIS 2149 (May 31, 1972); Mini Mart Corporation, SEC No-Action Letter 1972 SEC No-Act. LEXIS 2450 (June 29, 1972).

(n123)Footnote 123. Associated Communications Corporation, n.118 *supra*; Teleflex Incorporated, n.118 *supra*; Mini Mart Corporation, n.118 *supra*.

(n124)Footnote 124. *See generally* § 6.02 *supra*.

(n125)Footnote 125. This effect is significant given the difference in actual value between restricted securities and unrestricted securities of the same class of the same issuer. *See* § 6.01, n.5 and accompanying text *supra*.

(n126)Footnote 126. *See* § 6.03[4][d] *supra*.

(n127)Footnote 127. *See* § 6.03[3][d][ii] *supra*.

(n128)Footnote 128. *See* § 6.02 *supra*.

(n129)Footnote 129. *See* § 6.03[3][d][vii] *infra*

(n130)Footnote 130. The distribution is of course a liquidating distribution when the securities being distributed are the only assets of the liquidating entity.

(n131)Footnote 131. Staff Legal Bulletin No. 4 (CF), September 16, 1997.

(n132)Footnote 132. *Id.* The Bulletin discusses each of these conditions in detail.

(n133)Footnote 133. For a transaction in which the staff took a no-action position on spin-offs of U.S. domestic affiliates of the distributing entity without registration, see PepsiCo, Inc., SEC No-Action Letter 1997 SEC No-Act. LEXIS 873 (September 15, 1997).

With respect to no-action positions on spin-offs of affiliates involving non-U.S. distributing entities, see AB Electrolux, SEC No-Action Letter 1997 SEC No-Act. LEXIS 569 (April 28, 1997).

See also Chugai Pharmaceutical Co., Ltd., SEC No-Action Letter 2002 SEC No-Act. LEXIS 456, (April 30, 2002), which covers the spin-off of a U.S. subsidiary by a non-U.S. parent, a situation not covered by the Bulletin, but granting no-action relief on essentially the same grounds as set forth in the Bulletin.

(n134)Footnote 134. Midwestern Financial Corporation; First Golden Bancorporation, SEC No-Action Letter 1973 SEC No-Act. LEXIS 2946 (June 25, 1973).

(n135)Footnote 135. *See* § 6.03[3][b] and § 6.03[4] *supra* .

(n136)Footnote 136. *See* Staff Legal Bulletin No. 4, n.127 *supra*.

(n137)Footnote 137. *Id.*

(n138)Footnote 138. *Id.*

(n139)Footnote 139. Goldwasser, § 6.02, n.78 *supra* , at 151-153.

(n140)Footnote 140. *See, e.g.*, Virginia Real Estate Investment Trust, SEC No-Action Letter 1979 SEC No-Act. LEXIS 2858 (May 29, 1979).

(n141)Footnote 141. 20th Century Corp., SEC No-Action Letter 1977 SEC No-Act. LEXIS 2631 (November 7, 1977), involving a distribution to approximately 33 shareholders. Where the distributed securities had been unrestricted securities in the hands of the distributing entity, the staff reversed its earlier position and regarded them as unrestricted securities in the hands of the distributees. Kaiser Industries Corp., SEC No-Action Letter 1977 SEC No-Act. LEXIS 95 (January 21, 1977).

(n142)Footnote 142. Huntington Bancshares, Inc., SEC No-Action Letter 1980 SEC No-Act. LEXIS 3691 (September 21, 1980).

(n143)Footnote 143. *See* Preliminary Note to Rule 144.

(n144)Footnote 144. *See* § 6.02[4][c] *supra*.

(n145)Footnote 145. Rule 145(c), prior to the 2007 amendments to Rule 144, defined any party to any transaction of the type set forth in Rule 145(a) (other than the issuer) or an affiliate of such party who publicly offers the securities acquired in such transaction as an "underwriter" (and did not limit the designation to transactions involving shell companies). Prior to the amendments, such a "presumptive underwriter" would be required to comply with Rule 145(d) in connection with resales of the acquired securities even if the person, following the transaction, were no longer an affiliate of the combined entity and even if such person received registered securities in the business combination. The 2007 amendments, in short, eliminated the presumptive underwriter provision of Rule 145(c), except with respect to transactions involving a shell company.

(n146)Footnote 146. Sec. Act Rel. No. 33-6863 [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,524 (April 24,1990).

(n147)Footnote 147. At least once any "distribution compliance period" (imposed on certain types of offerings to limit the chances of unregistered distributions in the United States) had expired. *Id.*, at n.112. *See, however*, § 6.02[4][d] *supra* .

(n148)Footnote 148. *But see* International Income Property, SEC No-Action Letter 1980 SEC No-Act. LEXIS 4064 (December 12, 1980) in which the staff permitted reliance on Rule 144 to resell securities acquired overseas.

(n149)Footnote 149. *See* Hanks, *Direct Regulation S Offerings and the SEC's "Problematic Practices" Release*, Stanford J.L. Bus & Fin. Vol. 2 No. 2, 303, at n.2 (1996).

(n150)Footnote 150. Sec. Act Rel. No. 33-7190, 1 Fed Sec. L. Rep. (CCH) P 3059 (1995).

(n151)Footnote 151. Sec. Act Rel. No. 7505 (1998).

(n152)Footnote 152. For an example of a situation where the Staff declined to agree that Section 1145(a) was available, see XO Communications, Inc. (publicly available June 1, 2004).

(n153)Footnote 153. I.C.H. Corporation, SEC No-Action Letter 1997 SEC No-Act. LEXIS 528 (April 14, 1997).

(n154)Footnote 154. *See* 17 CFR 230.1001 (Regulation CE)

(n155)Footnote 155. *Id.*

(n156)Footnote 156. Sec. Act Rel. No. 33-7759 (1999).

(n157)Footnote 157. In certain circumstances securities held by "innocent persons" who purchased such securities in an unregistered chain of transactions which constituted an unrestricted public offering made in ignorance of, with disregard for, or under a misinterpretation of the Securities Act's registration requirements have been permitted to be resold pursuant to Rule 144 in compliance with Rule 144's requirements other than the holding period and the filing of notice requirement, despite the fact that they are not technically restricted securities. The availability of Rule 144 protects such persons from being deemed to be involved themselves in an unregistered public offering. *See, e.g.*, Fluid Power Pump Company, SEC No-Action Letter 1976 SEC No-Act. LEXIS 2667 (December 16, 1976); Hadron Inc., SEC No-Action Letter 1981 SEC No-Act. LEXIS 3836 (available July 31, 1981).

(n158)Footnote 158. *See* § 6.03[3][a] *supra* for a list of the possible public offering exemptions from registration under the Act.

(n159)Footnote 159. Regulation S under the Act provides that offers and sales made outside the United States are not subject to (as opposed to exempt from) the Act's registration provisions. *See* discussion of status of Regulation S

securities in § 6.03[3][ix] *supra* .

(n160)Footnote 160. If the security holder's transferor was an affiliate, then the securities could nevertheless be restricted again at least in the hands of a purchaser from the security holder. *See* § 6.03[3][b] *supra* for further explanation.

(n161)Footnote 161. *See* § 6.03[3][d][ix] *infra* for discussion of securities acquired overseas.

(n162)Footnote 162. *See* § 6.05[2][d] *supra* with respect to the implications of a public offering being registered.

(n163)Footnote 163. *But see* §§ 6.03[3][d] *supra*.

(n164)Footnote 164. *See* n.17 and accompanying text *supra*.

(n165)Footnote 165. *See* n.16 and accompanying text *supra*.

(n166)Footnote 166. *See* discussion in § 6.05[4] *infra*.

(n167)Footnote 167. In fact such securities remain by definition restricted securities in the hands of the seller but may be sold freely under Rule 144's safe harbor within Section 4(1). *See* Republic Resources Corporation, SEC No-Action Letter 1988 SEC No-Act. LEXIS 188 (February 15, 1988) and analysis in §§ 6.02[1] *supra* and 6.05[8] *infra* .



73 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.04

§ 6.04 Definition of Control Securities

The second of the two major categories of resales limited by the general unavailability of the Section 4(1) resale exemption (the first being restricted securities) includes, if an underwriter is involved, any resale of any outstanding securities by a person who at the time of the resale is in a control relationship with the issuer of the securities. n1 These securities, commonly referred to over the years as "control securities," are restricted as to their public resale only for as long as they are held by a person who is in a control relationship with, or in the terminology of Rule 144, is an affiliate of the issuer. n2

The Securities Act contains no definition of the term "control securities," nor indeed any reference whatever to this category of securities. Unlike the case of restricted securities, n3 the limitations on the resale of control securities derive from nothing other than the affiliate status of the holder. Simply put, control securities are securities that are owned by an affiliate of the issuer. To determine then whether securities that are proposed to be sold are control securities, it is necessary only to ascertain the affiliate or non-affiliate status of the holder.

[1] Rule 144 Definition of an Affiliate

Paragraph (a)(1) of Rule 144 defines the term "affiliate" of an issuer to mean "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." Three categories of persons n4 are, under this definition, affiliates of the issuer:

- persons who *control* the issuer,
- persons who are *controlled by* the issuer, and
- persons who are *under common control with* the issuer.

It is, therefore, the concept of control that is determinative of affiliate status.

[2] Controlling Persons of the Issuer

While the concept of control runs throughout the federal securities laws, n5 neither the Securities Act nor the Exchange Act contains a statutory definition of control. Rule 405, however, relating to registration under the Securities Act

specifies that:

[t]he term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, 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 (emphasis added).

As that definition makes clear, each of those persons who either actually controls or has the power to control the policies of the issuer is a controlling person and therefore an affiliate of the issuer. When Rule 144 was adopted, the Commission considered, n6 but did not adopt, more objective standards for determining control status. Control status remains therefore, a question of fact and indeed a question of fact that must be resolved in most cases by either counsel for the proposed seller or counsel for the issuer. n7

Because there is no mathematical or other objective test, the determination of control status is often difficult or uncertain. As a practical matter, the staff of the Commission appears rather consistently to presume that persons who fall within certain categories are affiliates. Those categories include, in addition to persons able to cause the issuer to file a registration statement, n8 the following persons:

- executive officers and directors of the issuer, n9 including those who perform the functions of such persons; n10
- persons who own more than 10 percent of the voting securities of the issuer; n11
- close family relatives of any of the above persons; n12 and
- creditors of the issuer who have control by reason of negative covenants in the relevant underlying loan agreements. n13

The presumption of affiliate status is rebuttable by any of those persons, but the burden of proving that the person does not, even in conjunction with others, control or possess the power to control the issuer is substantial. n14 The staff, on the other hand, has not suggested categories of persons who will be presumed not to be affiliates.

The term controlling person not only refers to an individual person, but also includes each of the members of a controlling group. n15 Again, the concept of a control group has never been defined. Paragraph (a)(2) of Rule 144, however, does define the term "person" when used with reference to a person whose securities are to be sold to include, in addition to the actual person, all of the following persons:

- relatives and spouses sharing the same home (a relative or spouse sharing the same home with an affiliate is always an affiliate and the affiliate status of a relative of a control person is rebuttable only when that relative does not share a residence with the control person); n16
- trusts or estates in which the person and those in paragraph (1) above together have a 10 percent or more beneficial interest or of which one of those persons is a fiduciary; n17 and
- any corporation or other organization in which the person and any relative or spouse sharing the same home own at least 10 percent of an equity interest. n18

Though the staff does not limit the pool of possible affiliates to the persons specified in Rule 144(a)(2), n19 the staff assumes that at least those persons are affiliates. n20 In addition, in certain cases, each different from the next and therefore of little general precedential value, the staff has also assumed that certain persons outside of the Rule

144(a)(2) categories are affiliates of the issuer. n21 Accordingly, the issue of whether a person is, alone or as a member of a controlling group, a controlling person and therefore an affiliate of the issuer must be resolved on a case-by-case basis by appropriate counsel with limited guidance.

[3] Other Types of Affiliates

As the Rule 144(a)(1) definition makes clear, a controlling person of the issuer is only one of the possible types of affiliates, though the most common type. In addition, a person may be an affiliate because that person is controlled by the issuer or is under common control with the issuer or even for reasons outside of the rule's definition. n22

[a] Persons Controlled by the Issuer. The most obvious example of a person who is an affiliate because it is controlled by the issuer is a subsidiary of a corporate issuer. n23 Other common examples of these types of affiliates of an issuer include an employee benefit plan n24 and corporations of which the issuer is a creditor empowered to exercise control through the lending instruments. n25 Again, these represent only the more common examples of such affiliates.

[b] Persons under Common Control with the Issuer. The definition of affiliate contained in Rule 144(a)(1), clearly includes persons under common control with the issuer. The history of the common control concept makes sense because the idea, presumably, was to prevent a controlling person from accomplishing a prohibited action through an affiliated entity such as a sister corporation. In the context of defining control securities, however, it may be too broad. If one of the controlling persons of the issuer, such as a director, happens to also be a director of a second corporation, the two corporations could be viewed as affiliates of each other even if neither corporation owns any significant amount of the securities of the other or the two corporations are in no other respect related. It is doubtful that the staff would assume the two corporations to be affiliates of each other without more for purposes of imposing the sale restrictions on "control securities," n26 but the possibility of an expansive approach should be kept in mind by counsel faced with opining as to these circumstances.

The application of the "under common control" test for rendering a person an affiliate of the issuer is particularly troublesome in the case of trusts and estates that are related to an issuer through an affiliate of that issuer. Where the trust or estate owns an amount of voting securities of the issuer sufficient to constitute control, it is obviously an affiliate of the issuer because it is a controlling person in its own right. n27 Where, however, the only relationship between the trust or estate and the issuer is that the trustee or executor is an affiliate of the issuer, the affiliate status of the trust or estate is less certain. Arguably, the relationship is simply too remote and the trust or estate would be found to have inadequate control over the issuer through its fiduciary.

The staff's view, however, at least as yet is unclear. The status of the fiduciary will not be automatically attributed to the trust or estate or to the respective beneficiaries. n28 In fact, the staff will not view a trust or estate as an affiliate of the issuer where the only basis is that a person who is an affiliate of the issuer is the trustee or executor or a beneficiary of that trust or estate. n29 Apparently, though, it will view the trust or estate as an affiliate of the issuer if a person who is an affiliate of the issuer is both the fiduciary *and* a beneficiary of the trust or estate. n30 Certainly, however, in that case the issue of affiliate status for the trust or estate will be affected by the extent of that affiliate's interest in that estate or trust and perhaps by the amount of securities of the issuer held by the estate or trust. If the trust or estate owns no securities that might be rendered "control securities" by virtue of its affiliate status, the question of its affiliate status is irrelevant in the context of this chapter.

[c] Persons Otherwise Deemed Affiliates. In light of the history of the controlling person concept n31 and the express definition of the term "affiliate" contained in Rule 144(a)(1) for the purpose of defining "control securities" and of subjecting all affiliates to Rule 144, it would be logical to conclude that any holder of securities who is not a controlling person of, a person controlled by, or a person under common control with the issuer of those securities is not an affiliate of the issuer. However, as mentioned above, a security holder who receives previously unrestricted securities from an affiliate of the issuer in a private nonsale transaction does not acquire restricted securities despite the literal wording of the Rule 144(a)(3) definition. n32 Instead, the security holder is deemed to stand in the shoes of the

transferor, not in a worse, but also not in a better position. The security holder holds, therefore, unrestricted rather than restricted securities. But the security holder, like the affiliate transferor, is viewed as a holder of "control securities."

[4] Duration of Control Securities Status

Securities become "control securities" immediately upon their acquisition by an affiliate of the issuer of those securities or upon their holder becoming an affiliate of the issuer even if those securities were previously free trading. Once in that category with the consequent limitations on their resale, "control securities" remain such until they are sold to a non-affiliate of the issuer or until their affiliate holder loses his affiliate status. n33 As mentioned above, however, if a non-affiliate acquires "control securities" in a private *nonsale* transaction, those securities continue to be viewed as "control securities" (as opposed to restricted securities) in the hands of the recipient until the transferor is no longer an affiliate or until they are disposed of by the non-affiliate recipient. If the nonsale transaction is a bequest or spin-off or liquidating distribution and the transferor by reason of the transferring event is no longer an affiliate of the issuer, the securities lose their "control securities" status just as if they had been sold. In the case of a private gift of securities by an affiliate, however, they may continue to have the limitations as to resale that attach to "control securities," while the donor remains an affiliate. Whether or not the limitations continue depends on the relationship of the donee to the donor. If the donee is deemed to be a "separate person" from the donor pursuant to Rule 144(a)(2), then the donee may sell the securities freely after the applicable holding period. Otherwise, the donee may resell the securities only as if it were an affiliate until such time as the transferor is no longer an affiliate of the issuer. n34

FOOTNOTES:

(n1)Footnote 1. *See* § 6.02[1] *supra*.

(n2)Footnote 2. *See* § 6.04[4] *supra*.

(n3)Footnote 3. In the case of restricted securities, the limitations on their resale derive from the private manner of the acquisition from the issuer or an affiliate of the issuer and continue until the restricted taint is removed. *See* §§ 6.03[3] and [4] *supra*.

(n4)Footnote 4. Section 2(2) of the 1933 Act, and reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender), defines the term "person" as:

an individual, a corporation, a partnership, an association, a joint stock company, a trust, any unincorporated organization, or a government or political subdivision thereof.

See Rule 144(a)(2) of the 1933 Act reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

(n5)Footnote 5. *See* A. Sommer, *Who's "In Control?"*, 21 *Bus. Law.* 559, 559-62 (1966); *see, e.g.*, SEC v. Tuchinsky [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96, 917 at 93,805 (S.D. Fla. 1992).

(n6)Footnote 6. Sec. Act Rel. No. 33-5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,487 (1972); D. Goldwasser, *A Guide to Rule 144*, at 91-92 (2d ed. 1978).

(n7)Footnote 7. The staff has repeatedly stated that it no longer makes determinations of affiliate status. Sec. Act Rel. No. 33-6253, 1 Fed. Sec. L. Rep. (CCH) P 134A (1980). Its position is that affiliate status is a factual question best resolved by the parties involved in the transaction and their counsel. *See, e.g.*, Hoedeman and Christy, P.A., SEC No-Action Letter 1991 SEC No-Act. LEXIS 1165 (October 10, 1991); Gulf Energy Corporation, SEC No-Action Letter 1981 SEC No-Act. LEXIS 4156 (October 30, 1981).

(n8)Footnote 8. C. Israels, SEC Problems of Controlling Stockholders and in Underwritings 21 (1962), *quoting* Commissioner Manuel F. Cohen.

(n9)Footnote 9. *See, e.g.*, Servo Systems, Inc., SEC No-Action Letter 1977 SEC No-Act. LEXIS 1172 (April 27, 1977); *see generally* Sommer, n.6 *supra*, at 573. Some guidance regarding at least directors and officers who have been nominees for the position of director is provided by the issuer's proxy statements since the control status of such persons must be indicated. Item 6(b), Exchange Act of 1934 Schedule 14A.

(n10)Footnote 10. Section 16 of the Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender), provides a practical guideline for determining which persons other than directors are control persons. If a person under the regulations and case law interpreting that section is required to make regular filings of his stock ownership under Exchange Act of 1934 Section 16(a), then that person would probably also be a control person for purposes of determining the availability of Securities Act Section 4(1) and Rule 144.

(n11)Footnote 11. *See, e.g.*, Del Electronics Corp., SEC No-Action Letter 1980 SEC No-Act. LEXIS 3473 (July 21, 1980) (holder of 13.43% of outstanding shares presumed affiliate).

(n12)Footnote 12. *See, e.g.*, Jesse M. Brill, Esq., SEC No-Action Letter 1979 SEC No-Act. LEXIS 3489 (September 24, 1979), in which the staff viewed all family members of an affiliate living in the same household as affiliates; Radiation Technology, Inc., SEC No-Action Letters 1973 SEC No-Act. LEXIS 1092 (December 26, 1973).

(n13)Footnote 13. Sommer, n.5 *supra*, at 573; D. Goldwasser, n.6 *supra*, at 92; *but see* Mangel Stores Corp., SEC No-Action Letter 1975 SEC No-Act. LEXIS 2429 (December 5, 1975).

(n14)Footnote 14. D. Goldwasser, n.6 *supra*, at 94-95.

(n15)Footnote 15. *See, e.g.*, Carnation Co., SEC No-Action Letter 1980 SEC No-Act. LEXIS 2742 (February 3, 1980); Comtech Laboratories, Inc., [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,231 (1973).

(n16)Footnote 16. *See* Carolina Securities Corp., [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,373, SEC No-Action Letter 1979 SEC No-Act. LEXIS 3766 (November 23, 1979).

(n17)Footnote 17. *But see* text accompanying ns.28-31 *infra*.

(n18)Footnote 18. Rule 144(a)(2); it should be noted that while this paragraph is primarily for the purpose of the rule's aggregation requirements, *see* § 6.05[5][c][i] *infra*, it is also relevant to the definition of control.

(n19)Footnote 19. *See, e.g.*, the interpretive letters listed in D. Goldwasser, n.6 *supra*, at 97-99.

(n20)Footnote 20. *Id.* at 100.

(n21)Footnote 21. *Id.* at 97-99.

(n22)Footnote 22. *See* § 6.04[3][c] *infra* for discussion of persons otherwise deemed affiliates.

(n23)Footnote 23. A subsidiary of the issuer, however, may not rely on Rule 144 for the sale of the securities of the issuer that it owns. Sec. Act Rel. No. 33-6099, [Transfer Binder] Fed. Sec. L. Rep. P 2705H (1979), at Section II(H), Question 83.

(n24)Footnote 24. Winkelman Stores, Inc., [Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,771 (1972); *see generally* § 6.03[3][d][ii] *supra*.

(n25)Footnote 25. D. Goldwasser, n.6 *supra*, at 101.

(n26)Footnote 26. See Kaiser Industries Corp., SEC No-Action Letter 1977 SEC No-Act. LEXIS 95 (January 21, 1977) for an example of a fact situation involving related corporations that caused the Division of Corporation Finance to conclude that one was the affiliate of the other through their common control.

(n27)Footnote 27. Rule 144(a)(2)(ii); Butala, P§ 6.01 n. 6 *supra* at 9-5.

(n28)Footnote 28. *Id.*

(n29)Footnote 29. Sec. Act Rel. No. 33-6099, n.24 *supra*, at Section II(A), Question 9(c); Wells Fargo Bank, N.A., SEC No-Action Letter 1975 SEC No-Act. LEXIS 1998 (September 29, 1975).

(n30)Footnote 30. Jesse M. Brill, Esq., n.12 *supra*.

(n31)Footnote 31. See *generally* Sommer, n.5 *supra*.

(n32)Footnote 32. See § 6.03[3][b] *supra*.

(n33)Footnote 33. Sec. Act Rel. No.33-6099, n.24 *supra*, at Section II(B), Question 11: *see also* Rule 144(a)(1) and (b) and D. Goldwasser, n.6 *supra*, at 104-05.

(n34)Footnote 34. Rule 144(a)(3); Sec. Act Rel. No. 33-6099, n.23 *supra*, at Section 11(A), Question 9. The donee holder of securities privately acquired from an affiliate may resell those securities freely three (now one) years after the securities were acquired from the affiliate as long as the donee is not itself an affiliate. See Rule 144 and discussion in § 6.05[8] *infra*. See P. Michael Coleman and The Coleman Charitable Foundation, Inc., SEC No-Action Letter 1994 SEC No-Act. LEXIS 860 (December 29, 1994); R.E. Turner and The Turner Foundation, Inc., SEC No-Action Letter 1993 SEC No-Act. LEXIS 489 (March 19, 1993); The Gap, Inc., SEC No-Action Letter 1992 SEC No-Act. LEXIS 928 (September 16, 1992); The Moores Foundation, SEC No-Action Letter 1991 SEC No-Act. LEXIS 991 (August 14, 1991).



74 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.05

§ 6.05 Public Resales of Restricted Securities and Control Securities under Rule 144

The Commission, after a lengthy period of study and consideration of several variations of proposed rules, n1 promulgated Rule 144 in 1972. n2 The Commission's purpose was to clarify for the benefit of investors and members of the securities industry and their counsel when and under what circumstances a holder of restricted securities or control securities may lawfully resell those securities in reliance upon the resale exemption contained in Section 4(1) of the Securities Act. n3 As a result of the adoption of Rule 144, a more objective and more certain exemption from the Securities Act's registration requirements became and remains available to allow the public resale of both restricted securities and control securities whenever all of the specific requirements pertaining to the potential seller can be satisfied. As a practical matter, the rule frequently provides the only reasonably available exemption for the public resale of these two categories of securities, restricted and control securities, that are not otherwise publicly tradeable under the Securities Act.

[1] Nature of Rule 144

During the several years prior to the adoption of Rule 144, considerable confusion had developed regarding the resale of the two common categories of restricted securities: those securities that had been privately placed by the issuer, then known as "letter securities," and those securities that had been acquired by a person in a control relationship with the issuer, known as "control securities." The rule was expressly made applicable to resales of these two types of securities only, n4 thereby formally setting them apart from all other outstanding securities.

In addition, Rule 144 codified the distinction between these two categories of securities. First, it formally defined restricted securities to include only those outstanding securities that had been privately offered and sold and had never been the subject of a public distribution. n5 Second, it confirmed that the term "control securities" includes only that category of outstanding securities, whether restricted or unrestricted under the Rule 144(a)(3) definition, that are owned by an affiliate of the issuer. Rule 144 then went on to formally define that critical person, the "affiliate." n6 In effect, much of the rule's accomplishments amounted to substantial clarification of, but no real change in, the then existing law regarding the two categories of outstanding securities whose resale had been restricted under the Securities Act. In its approach to the actual resale of both restricted securities and control securities, however, the rule represented a radical departure from the subjective standards preceding its adoption.

[a] Approach of Rule 144. The Section 4(1) resale exemption n7 is available for resales by investors, n8 whether or not a broker is involved, n9 only if neither the investor nor any participating broker is an underwriter as that term is

defined in Section 2(11) of the Securities Act. n10 At the time of Rule 144's adoption, a non-affiliate investor wishing to publicly resell restricted securities could rely upon the resale exemption only if he or she could establish that:

- the original purchase was not "with a view to" a distribution of those securities; and
- he or she was not selling for the issuer or an affiliate of the issuer in connection with a distribution or otherwise participating in that distribution. n11

Despite the other aspects of the Section 2(11) definition, the focus had been on the factual issue of intent. n12 As a result, the proposed seller of restricted securities could rarely be certain of the availability of the resale exemption until he or she had owned those securities for a substantial, but indefinite, period of time. n13 If the proposed seller was an affiliate of the issuer, the participating broker would be a statutory underwriter because it would be selling for a control person of the issuer in connection with a distribution. n14 Accordingly, the resale exemption could be relied upon by an affiliate of the issuer only if no distribution were involved, that is, only for private resales of securities. n15

Rule 144 introduced an entirely new objective set of standards for the public resale of both restricted and control securities. Conceptually, its approach is definitional. Focusing perhaps more on the disclosure purposes of the securities laws and less on the statutory language of Section 2(11), the Commission defined the term "distribution" to exclude those resales of restricted securities and those resales of any securities by affiliates that are completed in compliance with the applicable requirements of the rule. n16 Under the current incarnation of Rule 144, for all resales of restricted securities, no distribution is involved: n17

If reselling equity securities:

Resales by affiliates of the issuer:

- if selling securities of a reporting company, a minimum of a six months has elapsed between the acquisition of the securities from the issuer or an affiliate of the issuer; n18
- if selling securities of a non-reporting company, a minimum of one year has elapsed between the acquisition of the securities from the issuer or an affiliate of the issuer; n19
- adequate current public information is available about the issuer; n20
- the amount of securities to be sold during any three month period is less than basically the greater of one percent of the total number of shares outstanding or the average weekly trading volume in those securities over a four week period; n21
- the sales effected are in brokers' transactions, with a market maker or in riskless principal transactions; n22
- a notice of the proposed sale is timely filed; n23 and
- the person filing the notice has a bona fide intention to sell the securities referred to in the notice within a reasonable period of time. n24

Resales by non-affiliates of the issuer:

- if selling securities of a reporting company, a minimum of a six months has elapsed between the acquisition of the securities from the issuer or an affiliate of the issuer; n25

- if selling securities of a non-reporting company, a minimum of one year has elapsed between the acquisition of the securities from the issuer or an affiliate of the issuer, n26 and
- adequate current public information is available about the issuer between the dates six months and one year after the acquisition of the securities from the issuer or an affiliate of the issuer. n27

If reselling debt securities:

Resales by affiliates of the issuer:

- all of the above requirements for resales by affiliates of equity securities apply except that there are no manner of sale requirements regarding resales of debt securities by affiliates; n28 and
- in addition to the above volume limitations pertaining to resales of equity securities by affiliates, there is an additional volume limitation imposed on resales of debt securities such that 10 percent of the principal amount of the tranche attributable to the securities sold, if the amount sold during any three month period is less than the greater of one percent of the total shares outstanding or the average weekly trading volume in those securities over a four week period. n29

Resales by non-affiliates of the issuer:

- all of the same requirements above for resales by non-affiliates of equity securities apply.

As to resales of unrestricted securities by affiliates, or control securities, no distribution is involved provided all of the same conditions, other than the holding period requirements set forth above, n30 are satisfied. Resales that comply with all of the applicable Rule 144 requirements are simply deemed not to involve a distribution. In the absence of a distribution, neither the selling investor nor any broker selling for an affiliate (or a market maker who purchases from an affiliate or purchases restricted securities from a non-affiliate or securities sold in riskless principal transactions) or a non-affiliate selling restricted securities can be an underwriter under the Securities Act. n31 Where no underwriter is involved, the transaction may be completed in reliance upon the resale exemption. In effect, through its definitional approach, the rule provides a safe harbor for the resale of both restricted securities and control securities under Section 4(1) of the Securities Act. n32

[b] Construction of Rule 144. The adoption of Rule 144 by the Commission was initially on an experimental basis. n33 While the Commission selected the above-described approach to the statutory underwriter concept in an effort to achieve the certainty of more objective standards, n34 it also feared that the rule might provide a means for massive distributions of unregistered securities into the hands of unprotected members of the investing public. n35 In light of that fear and consistent with its policy of encouraging the registration of securities by construing all exemptions from registration narrowly, the Commission warned that the rule was to be strictly construed. n36

Although the staff of the Commission now appears to view Rule 144 with a more flexible attitude, especially in light of the most recent 2007 amendments to Rule 144, n37 it still takes the position that persons seeking to rely upon the rule's exemption from the Securities Act's registration requirements must sustain the burden of proving both that:

- the rule is available for the proposed resale; and
- every one of the applicable requirements has been or will be timely and fully satisfied. n38

In other words, substantial compliance with the conditions of the rule will normally not suffice. n39 Initially, the

Commission took the position that even technical compliance with all the rule's requirements would not perfect the exemption where the proposed resale was in fact apart of an unregistered distribution. n40 Subsequently, however, the staff appeared to agree that where all of the rule's specific requirements are fully complied with, the proposed resale does indeed fall within the rule's safe harbor. n41

Rule 144 is intended to be self-operating. n42 In other words, the proposed seller of restricted securities or of control securities and his counsel must determine for themselves whether the rule is available for the proposed transaction, and comply with each of the rule's applicable conditions. n43 The staff will generally not issue no-action letters or otherwise furnish advisory opinions regarding proposed sales in reliance upon Rule 144. n44 As indicated in the release promulgating the rule, however, the staff will issue interpretive letters to assist persons in complying with all of the provisions of Rule 144. n45 Since its adoption, several thousand interpretive letters relating to Rule 144 have been issued and are publicly available. n46 Indeed, those letters, particularly in the aggregate, constitute the major source of guidance as to the staff's current interpretation of those aspects of the rule on which it will comment. n47

[c] Nonexclusivity of Rule 144. While Rule 144 provides an exemption for the public resale both of restricted securities and of control securities, it is not the exclusive lawful method of effecting resales of those two types of outstanding securities without registration under the Securities Act. n48 Both restricted securities and control securities may always be lawfully sold in private transactions, i.e., those not involving any public offering, in reliance upon the Section 4(1) resale exemption. n49 In addition, both restricted securities and control securities may be sold publicly outside Rule 144 under some conditions. Both restricted securities and control securities may be resold in reliance upon one of the narrow Section 3 transaction exemptions from registration, n50 and while until 1979 it was the Commission's position that the Section 4(1) exemption outside Rule 144 was never available for the public resale of control securities, n51 this is no longer the case. n52

As to restricted securities held by non-affiliates, however, Rule 144 provides a non-exclusive safe harbor for their public resale pursuant to the resale exemption. While the Commission chose not to make Rule 144 exclusive as to restricted securities, it nevertheless emphasized in the promulgating release that persons choosing to rely upon Section 4(1) outside the rule for the sale of restricted securities will have a substantial burden of proof in establishing the availability of that exemption from registration and, further, that brokers who participate in those sales will do so at their own risk. n53 To further discourage resales of restricted securities by non-affiliates outside of Rule 144, the Commission put all persons on notice that it would no longer consider a change in circumstances as evidence of a person's being other than an underwriter and therefore able to rely upon Section 4(1). n54 Finally, it indicated that no particular holding period in itself would be sufficient to establish the availability of the resale exemption outside of the rule. n55

As a result of those pronouncements by the Commission in 1972, reliance upon Section 4(1) outside Rule 144, because of its substantial uncertainty, is normally avoided, particularly by reputable brokers concerned about the risk of being suspended from trading because of a sale in violation of the Securities Act. n56 In other words, the Commission's attempts to prohibit the creation of public information was available by discouraging the sale of restricted securities outside the rule were largely successful. Presently, however, perhaps in light of the success of Rule 144 and the general lack of abuse surrounding reliance upon the Section 4(1) exemption for the resale of restricted securities, the Commission appears less concerned with prohibiting public resale of these securities outside of the rule. n57

[d] Amendments to Rule 144. The Commission has amended Rule 144 on numerous occasions since its adoption. n58 While many of the changes effected by those amendments simply clarified existing interpretations of the rule n59 or conformed the rule's provisions to related changes in other rules under the Securities Act, n60 some of the changes broadened the rule's safe harbor to provide a Section 4(1) exemption for an ever greater variety of sales transactions by affiliates and transactions involving restricted securities. Gradually, the rule's conditions became easier to satisfy. First, the requirement that the securities be sold in brokers' transactions was eased by permitting certain inquiries to be made without jeopardizing the requirement that there be no solicitations of buy orders. n61 Then the rule's volume limitations were modified to allow a larger amount of securities to be sold in a shorter period of time. n62 In addition, the manner

of sale requirement was subsequently eased by an amendment permitting the securities to be sold in transactions directly with a market maker as well as in brokers' transactions. n63 In 1983 the Commission added paragraph (k) to the rule, which permitted the resale of restricted securities by non-affiliates without compliance with any of the rule's requirements provided that at least two years (three years at the time of adoption of Rule 144(k)) had elapsed since the securities were acquired from the issuer or an affiliate of the issuer. n64 In 1990, the Commission revised Rule 144 to permit the tacking of holding periods so that the holding period would commence at the time securities were initially acquired from the issuer or an affiliate of the issuer and would continue throughout subsequent transfers, instead of commencing anew for each holder at the time that holder acquired the securities. n65 In 1997, the Commission amended the rule to permit limited volume resales to commence after a holding period of one year (previously two years) and to permit unlimited resales in reliance on Rule 144(k) after two years (previously three years). n66

On November 15, 2007, the Commission adopted the *first amendments* to Rule 144 since 1997. n67 These amendments, effective February 15, 2008, are applicable to securities acquired before or after the aforementioned effective date. n68 The Commission amended Rule 144 to "make it easier to understand and apply" n69 and stated that it believed that the new amendments will increase the liquidity of privately issued securities, enabling companies to raise private capital more efficiently. n70

The 2007 amendments adopted major changes to Rule 144, n71 codified several of the Commission's interpretations and substantially reduced the Rule 144 compliance obligations for resales by non-affiliates of an issuer. n72 Prior to the adoption of the 2007 amendments to Rule 144, both affiliates and non-affiliates were subject to all of the requirements of Rule 144, with the exception that pursuant to Rule 144(k) a non-affiliate who had not been an affiliate during the three months prior to the sales could sell their restricted securities (and remove the restricted legends if the issuer permitted) after a two year holding period without complying with any of the other requirements of Rule 144. Now, given the amendments adopted to paragraph (d), paragraph (k) is moot and no longer part of Rule 144.

The 2007 amendments shortened the paragraph (d) holding period requirements, relaxed the requirements for sales of debt securities, and eliminated the necessity for non-affiliates to comply with any paragraph but the paragraph (d) holding periods, in that the only paragraph of Rule 144 that now applies to a non-affiliate seller is paragraph (d). When selling securities of a reporting issuer, a non-affiliate can sell securities after six months has elapsed (instead of the previous one year) and freely after one year has elapsed, while when selling securities of a non-reporting issuer a non-affiliate may sell securities after one year has elapsed. An affiliate seller is still subject to all of the requirements of Rule 144, but can take advantage of the shortened holding periods as well as the other modifications to Rule 144 provided by the 2007 amendments, all of which are discussed in this chapter, where applicable.

The following diagram, included in the 2007 Final Rule Release No. 8869 (the "Final Rule Release"), details the revisions to Rule 144 adopted by the 2007 amendments for restricted securities:

	Affiliate or Person Selling on Behalf of an Affiliate	Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)
Restricted Securities of Reporting Issuers	During six-month holding period - no resales under Rule 144 permitted.	During six-month holding period - no resales under Rule 144 permitted.
	After six-month holding period but before one year -- unlimited public resales under Rule 144 except that the current public information requirement still applies.	
	After six-month holding period but before one year -- unlimited public resales under Rule 144 except that the current public information requirement still applies.	

144 requirements including:

- current public information, After one-year holding period - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

- volume limitations,

- manner of sale requirements for equity securities, and

- filing of Form 144.

Restricted Securities of Non-Reporting Issuers	During one-year holding period - no resales under Rule 144 permitted.	During one-year holding period - no resales under Rule 144 permitted.

After one-year holding period - may resell in accordance with all Rule 144 requirements, including:	After one-year holding period - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

- current public information,

- volume limitations,

- manner of sale requirements for equity securities, and

- filing of Form 144.

[2] Availability of Rule 144

As explained above, n73 Rule 144 provides a safe harbor for the resale of certain categories of outstanding securities under the resale exemption contained in Section 4(1) of the Securities Act. n74 Provided that the rule is available for the

transaction proposed by the investor, any investor, n75 including an affiliate of the issuer of the securities involved, may rely upon Rule 144 exemption from the Securities Act's registration provisions by complying with all of the rule's applicable conditions. The two transactions that expressly fall within the scope of the rule are resales of restricted securities and resales of control securities. It should be borne in mind that some securities held by affiliates are both restricted and control securities. In addition, the rule may frequently be relied upon by a non-affiliate of the issuer for the resale of certain unrestricted securities that are not otherwise freely tradeable under Section 4(1) of the Securities Act. n76

[a] Resale of Restricted Securities. Paragraph (b) of Rule 144 provides that the rule is available for the resale of restricted securities by both affiliates and non-affiliates of the issuer of those securities. n77 The scope of the rule for resales of restricted securities, therefore, is dependent upon the scope of the term "restricted securities." n78

[b] Sales of Control Securities. Paragraph (b) of Rule 144 also provides that the rule may be relied upon for the sale of "any other securities" by an affiliate of the issuer of those securities. n79 In other words, all sales of control securities appear to come within the scope of Rule 144. n80 As in the case of transactions in restricted securities, the scope of the rule for resales of control securities turns on the scope of the phrase "affiliate of the issuer." As explained above, any investor who, directly or indirectly, controls, or is controlled by, or is under common control with, the issuer of the securities involved falls within the Rule 144(a)(1) definition of an affiliate and may therefore rely upon the rule for the sale of any securities of the issuer owned by the investor. n81

[c] Limitations on Availability for Sales of Restricted Securities and Control Securities.

On its face, Rule 144 appears available for all resales of restricted securities and all resales of control securities, provided only that the several applicable requirements can be satisfied. n82 In interpreting the scope of the rule, however, the Commission has added several substantial limitations on its apparent broad availability. Certain of those limitations on the rule's use have been softened or even abandoned in more recent interpretations. Nevertheless, even as presently interpreted, the rule may not be used for certain resales of restricted securities or control securities.

Additionally, the use of equity swaps and other derivative instruments have given rise to a number of issues with respect to the availability of Rule 144. In 1995, the Commission stated that it was examining Rule 144 to address new trading strategies by which holders of restricted and control securities sold interests in their shares while retaining legal ownership of the "underlying" securities. The Commission asked whether it was appropriate to treat securities as held in the private markets when the economic risk of the investment was shifted to the public markets, and whether "tolling" of the holding period or other revisions should be introduced to reflect risk shifting transactions. n83 Some commenters on this concept expressed concern at the potential re-introduction of the concept of "fungibility" if tolling of the restricted period were to be introduced for risk--shifting transactions. n84

The Commission gave further consideration to whether hedging arrangements are inconsistent with the principles underlying registration under the Securities Act and the Rule 144 safe harbor. In 1997, it stated that:

The Commission recognizes that arguments can be made in favor of treating "short against the box" transactions and equity swaps as sales of the underlying restricted securities since these transactions typically hedge fully a holder of restricted securities against any economic risk. Without risk, there is arguably no investment intent, suggesting the holder is more of an underwriter than an investor. At the same time, it can be argued that hedging transactions do not raise Section 5 issues because the restricted securities are not being sold into the open marketplace. Instead, only freely tradeable securities are actually redistributed to the public. Proponents of this view argue that the two types of securities are not fungible or interchangeable.

The economic substance of the transactions, however, gives rise to concern. n85

The Commission suggested several alternative methods of dealing with this concern, including again, making Rule 144 unavailable for risk-shifting transactions.

Recently, the Commission took up the discussion again in the Proposing Release to the 2007 amendments to Rule 144 (the "2007 Proposing Release"), recognizing the effect the proposed alteration of 144(d) from a one year holding period to a six month holding period could potentially have on hedging activities. n86 The Commission proposed to reintroduce the Rule 144 "tolling" provision while a security holder engaged in certain hedging activities, with the caveat that the suspension of the holding period caused by the tolling provision could not extend the holding period for more than one year. n87 The "tolling" provision as proposed would also have ramifications on the tacking of holding periods, as the individual wishing to sell securities would have to first determine if the securities had been hedged n88 when calculating the holding period in advance of a sale. Subsequent to the 2007 Proposing Release, the Commission received several comments objecting to the reintroduction of the "tolling" provision. For example, one commentator noted that "hedging transactions involve costs and risks for the security holder and do not entirely transfer the risk of the economic investment of the securities," n89 while another commentator suggested that the tolling provision was moot as there is not a lot of hedging activity with restricted securities because the amount of restricted securities is limited. n90 The Commission decided not to adopt the "tolling" provision after receiving and considering the comments received and stated in the Final Rule Release that:

We note, in particular, the comments asserting that, in the current environment, the tolling provision would unduly complicate Rule 144 and could require security holders or brokers to incur significant costs to monitor hedging positions for purposes of determining whether they have met the holding period requirement. This would frustrate our primary objectives to streamline Rule 144 and reduce the costs of capital for issuers. We will revisit the issue if we observe abuse relating to the hedging activities of holders of restricted securities. n91

Therefore, as the Commission has indicated the "tolling" provision will be reassessed if abuses occur in conjunction with hedging activities.

[i] Sales of Securities Subject to Registration Rights. Initially, the staff of the Commission, presumably because of its strong bias in favor of registration over reliance upon any exemption from registration, n92 took the position that Rule 144 could not be used for the sale of securities that were or would be registered through the exercise of registration rights or otherwise. Now, however, securities may be sold under Rule 144 if the seller has contractual or other registration rights, n93 or even if the securities proposed to be sold are covered by an effective registration statement expressly providing that the securities being offered may be sold either in compliance with the registration requirements or pursuant to the rule. n94 Although disclosure in the registration statement of an alternative method of resale is encouraged, the absence of such disclosure would not preclude the availability of Rule 144, or another available exemption for such resales. n95 Finally, the holder of restricted securities may sell some of them pursuant to Rule 144 even if it sells others of them pursuant to an effective registration statement or pursuant to another of the available exemptions from the Securities Act's registration requirements. n96

The 2007 amendments may impact registration rights with respect to private offerings of non-convertible debt securities. The change in the holding period to six months for reporting companies and one year for non-reporting companies as well as the elimination of the majority of the Rule 144 requirements for non-affiliates may have eliminated, in some cases, the need for registration rights in these types of offerings (which typically gave non-reporting registrants up to a year to register resales of the privately placed securities) because the securities will already be freely tradable no later than one year from issuance.

[ii] Sales of Restricted Securities to be Followed by Purchases of Unrestricted Securities. Shortly after the rule's promulgation, the staff of the Commission faced the issue of whether Rule 144 could be used to implement a plan

for changing the character of portfolio securities. That plan would involve the sale of the portfolio's restricted securities pursuant to Rule 144 and the contemporaneous repurchase of the same number of unrestricted securities of the same class of the same issuer. While such a use of the rule is permissible, in 1972, the staff suggested that the investor should avoid possible violations of the antimanipulation rules by waiting a period of at least thirty days after selling securities under Rule 144 before commencing repurchases in the open market and waiting an additional period of at least thirty days from the last repurchase before effecting additional sales pursuant to Rule 144. n97 That position was reversed in 1994. n98

[iii] Short Sales Against the Box. A "short sale against the box" is a sale in which the seller owns an amount of securities equivalent to the amount he sells short, but nevertheless asks the broker to borrow the necessary securities to deliver to the broker for the purchaser. n99 The seller's securities are normally held by the broker and used subsequently to replace the borrowed securities. Once again, the staff's early responses to requests that such sales be permitted under Rule 144 were generally negative. n100 Presently, however, the Commission permits the rule to be relied upon by affiliates or holders of restricted securities for short sales against the box, provided that all of the applicable requirements of the rule are satisfied at the time of the short sale rather than at the time the short position is covered. n101 Indeed, the seller may actually cover a Rule 144 short sale against the box with either the securities held in the box or with securities acquired in the open market. n102 If a holder of restricted securities actually covers his short position with unrestricted securities acquired later in the open market, however, the restricted securities that were placed in the box would continue to be restricted securities despite the earlier compliance with all of the rule's requirements for their public sale. n103

In contrast, however, restricted or control securities eligible for sale under Rule 144 and lent to a counterparty in a forward contract and sold in a manner complying with Rule 144 will not be restricted securities when returned to the lender. n104

[iv] Listed Call and Put Options. A "call option" is a contract that gives its holder the right to purchase a specified amount of the underlying securities at a specified price within a specified period of time. n105 In other words, it is an offer to sell the underlying securities that obligates the offeror to complete the sale if and when the option is exercised within the option period. Presently Rule 144 may be relied upon by an affiliate desiring to write call options on his securities of the issuer, provided that all of the rule's applicable conditions are complied with at the time the option is written. n106

Rule 144 may also be used by a non-affiliate holder of restricted securities who desires to write a call option and use the restricted securities either to cover the option position or to meet his margin obligation. n107 Because the writing of a call option by a non-affiliate will not be subject to Rule 144 until the non-affiliate either segregates restricted securities to cover or to meet the margin obligation for that option position or delivers the restricted securities upon exercise of that call option, the non-affiliate need not comply with all of the requirements of the rule until the time of the segregation or delivery of the restricted securities. n108 In addition, only the amount of those restricted securities actually segregated or delivered rather than the total amount of securities underlying the option must be considered in complying with the volume limitations requirement of the rule. n109

A "put option" gives the person who buys it (the holder) the right to sell a specified amount of the underlying securities at a specified price within a specified period of time. The person selling the put (the writer of the option) is obligated to buy the specified underlying securities on the specified terms if the option is exercised before it expires.

The Commission staff has taken the position that, subject to certain conditions, restricted and control securities may be sold through the exercise of a put option which is listed on a national securities exchange upon compliance with the conditions of Rule 144. n110 The staff stated that in general the conditions of the rule must be satisfied both at the time the put option is purchased and at the time it is exercised. n111 The notice required by Rule 144(h) is to be filed with the Commission at the time the put option is purchased, n112 The staff was of the view that exercise of an

over-the-counter put option could not be made under the rule because the sale would not comply with the manner of sale conditions of Rule 144(f). n113

[v] Sales by Broker-Dealers. Rule 144 provides a safe harbor for the resale of restricted securities and of control securities under the Section 4(1) resale exemption. n114 The rule accomplishes that result by removing both the proposed seller and any participating broker from the category of underwriters, a category of persons for whom the resale exemption is by its express terms never available. n115 Section 4(1) is also never available for a broker-dealer that is selling the securities for the account of the seller. n116 Accordingly, Rule 144 does not and cannot provide an exemption for that broker-dealer. Normally, however, the broker-dealer may act for the seller without rendering Rule 144 unavailable to the seller and may itself rely upon the companion exemption for brokers transactions contained in Section 4(4) of the Securities Act. n117

Rule 144 is available to broker-dealers that are the owners of restricted securities or control securities and proposes to sell those securities, despite the language of Section 4(1), provided that all of the rule's applicable requirements can and will be satisfied. n118 That availability, however, is subject to two limitations. First, the selling broker-dealer may not effect the sale itself, but rather must engage another broker to execute the trade. n119 Second, the selling broker-dealer may not be making a market in any securities of the issuer of the securities that it proposes to sell pursuant to the rule. n120

[vi] Sales by Subsidiaries of the Issuer. Although a subsidiary of the issuer clearly falls within the definition of an affiliate contained in paragraph (a)(1) of Rule 144, n121 the Commission has taken and continues to take the position that generally the rule may not be relied upon by a subsidiary for the sale of either restricted or unrestricted securities issued by its parent. n122 The stated basis for this position is that since the rule is unavailable to the issuer for the sale of its securities and since the issuer is in control of the subsidiary, the parent issuer should not be permitted to do indirectly through the subsidiary what it may not do directly. n123 Although the Commission's general position with respect to subsidiaries of the issuer has a reasonable basis, it is troublesome because the staff has allowed numerous exceptions that add a considerable measure of uncertainty respecting the availability of the rule for a sale of securities by a seller that is or may be a subsidiary of the issuer.

The staff has permitted some subsidiaries to rely upon the rule for the sale of securities issued by the parent, apparently because the circumstances involved suggested that the subsidiary's proposed sale was other than for the benefit of or at the direction of that issuer. For example, the staff permitted an insurance company to rely on the rule for the sale of securities issued by its parent for the following three reasons:

- the securities were purchased by the insurance company before it became a subsidiary of the issuer;
- the securities were purchased by the insurance company in the ordinary course of its investment activities; and
- the decision to sell the securities was made by the insurance company in the ordinary course of its investment activities without consulting the parent issuer. n124

The staff has permitted a wholly-owned subsidiary acting as trustee for an employee benefit plan to sell the plan's securities of the parent issuer apparently because the sales were required to fund benefit payments to or withdrawals by employees. n125

The staff has on several occasions permitted a bank to sell securities issued by its parent where the bank was acting solely in its capacity as a fiduciary of a trust or estate and where the bank acquired the parent's securities:

- through an exercise of preemptive rights;

- pursuant to a rights offering;
- through the exercise of stock options acquired by the settlor or deceased; or
- otherwise in a manner not involving the exercise of any investment discretion. n126

The staff has also allowed a wholly-owned broker-dealer subsidiary to use Rule 144 to sell securities of its parent that were acquired from an individual affiliate of the broker-dealer and the parent upon default by the affiliate on an obligation that was secured by a bona fide pledge of the securities. The broker-dealer represented that the situation could arise in the ordinary course of its business where individual affiliates maintained margin accounts and the broker-dealer would only be doing what the individual affiliate could do directly, that is, sell pledged securities to satisfy obligations under a margin agreement. n127

In light of the Commission's stated position and the staff's frequent exceptions to that position, it is often difficult for a subsidiary proposing to sell securities issued by its parent to determine whether it may rely upon Rule 144 for the proposed sale. The uncertainty increases when the proposed seller is not a wholly-owned subsidiary but is under the control of the issuer to some lesser degree. Nowhere has the Commission suggested at what level of control an affiliate of the issuer will be considered a subsidiary for purposes of applying this limitation on the rule's availability. Accordingly, an affiliate that is wholly-owned by or, because of a somewhat lesser degree of control by the issuer, may otherwise be considered a subsidiary of an issuer of securities, should refrain from relying upon Rule 144 for sales of that issuer's securities in the absence of a favorable interpretive letter.

[d] Sales of Unrestricted Securities by Non-affiliates. The safe harbor provided by Rule 144 is available to exempt from the Securities Act's registration requirements sales of restricted securities and control securities only. n128 It is technically not available for holders of other securities that are not freely tradeable under the Securities Act.

Although unrestricted securities are generally freely tradeable by ordinary investors under the Securities Act, there are, as explained above, a few relatively common exceptions to that statement. n129 The resale exemption contained in Section 4(1) may in some cases not be available to:

- holders of underwriters' compensation and similar unrestricted securities; n130
- holders of substantial amounts of unrestricted securities; n131 or
- holders of unrestricted securities that are deemed to be underwriters as a result of receiving the securities in a Rule 145 reorganization or similar transaction relating to certain issuers. n132

Similarly, holders of securities who received them in an unregistered offering to foreign nationals outside the United States prior to 1990 were often unable to resell them in reliance upon the resale exemption. n133 The availability of the resale exemption for the resale of securities acquired overseas in reliance on Regulation S, which was adopted in 1990, n134 has not been clearly stated, although since the Commission decided in 1998 to treat the equity securities of U.S. issuers sold overseas in reliance on Regulation S as restricted (and thus the Section 4(1) resale exemption is clearly unavailable), the staff would treat such resales in the same way as those occurring prior to the adoption of Regulation S. n135

Although Rule 144 is not available to any of the above-listed persons proposing to sell their securities, frequently the staff will permit their resales under Section 4(1) of the Securities Act based on the seller's compliance with certain of the rule's conditions. As to underwriters' compensation and similar securities, the staff presently permits resales by non-affiliates in compliance with all of the rule's conditions except the filing of notice requirements and upon

satisfaction of certain other additional requirements. n136 As to proposed resales of unrestricted securities by non-affiliates who are presumed or deemed to be underwriters, the staff regularly allows them to be made in compliance with all of the rule's conditions other than the holding period and filing of notice requirements. n137 Similarly, the staff has permitted the resale of securities acquired in an unregistered public distribution, for which the availability of the resale exemption would be doubtful, in accordance with certain of the rule's conditions. n138 Finally, the staff has permitted foreign holders of unregistered securities to resell them in compliance with all of the rule's conditions except the filing of notice requirement. n139

[3] Adequate Current Public Information Requirement--Rule 144(c)

The first requirement that must be satisfied before a sale of restricted securities or a sale by an affiliate of control securities may be made under Rule 144, for both reporting issuers and non-reporting issuers, is that there be available "adequate current public information" about the issuer of those securities. n140

[a] Basis for Conditions of Rule 144(c). Prior to the promulgation of Rule 144, the availability of the resale exemption was not conditioned upon the existence of public information. Indeed, nothing in the statutory language of Section 4(1) or in the crucial Section 2(11) definition of the term "underwriter" suggests such a condition. n141 The requirement that adequate current public information about the issuer of outstanding securities be available prior to their lawful resale was first suggested in the Wheat Report. n142 In adopting that suggestion, the Commission introduced a new factor into the determination of when a person will be deemed not to be engaged in a distribution. In doing so, it relied upon the purposes and the underlying policy of the Securities Act to protect investors through the full and fair disclosure of information regarding securities sold in interstate commerce. n143 In effect, the availability of information requirement in Rule 144 makes the rule consistent with and in fact an implementing part of the Commission's overall continuous disclosure philosophy. In addition, and also consistent with the recommendations contained in the Wheat Report, the Commission fashioned the information requirement of the rule to distinguish between reporting issuers and those issuers not subject to the reporting requirements of the Exchange Act. n144

[b] Requirements for Reporting Issuers.

Paragraph (c)(1) of Rule 144 provides that where the issuer of the securities proposed to be sold has been subject to the reporting requirements of Section 13 of the Exchange Act, n145 or has had securities registered pursuant to the Securities Act, and is therefore subject to the reporting requirements of Section 15(d) of the Exchange Act, n146 adequate current information is available, provided that:

- at the time of the proposed sale, the issuer has been subject to the reporting requirements for at least ninety days immediately before the sale; and
- the issuer has filed all reports required to be filed during the preceding twelve months, other than Form 8-K reports.

The Note to paragraph (c)(1) also provides that a proposed seller of securities under Rule 144 is entitled to rely upon the issuer's statements in its most recent report, annual or quarterly, or elsewhere as to whether it has filed all reports that were required to be filed during the last twelve months and as to whether it has been subject to those requirements for at least ninety days unless the proposed seller knows or has reason to believe that those statements are incorrect. n147

[i] Ninety-Day Waiting Period. Rule 144 may not be relied upon for the sale of any securities of an issuer that has not been subject to the reporting requirements for at least ninety days. In other words, where an issuer files a registration statement under either the Securities Act or the Exchange Act, sales pursuant to Rule 144 may not begin until the 91st day following the day on which the registration statement becomes effective. n148 However, where an issuer has been subject to the reporting requirements for more than ninety days prior to filing a registration statement, the current public

information requirement is considered satisfied throughout the ninety days following effectiveness of that registration statement. n149 There is no need for another waiting period since adequate information has been continuously available.

Similarly, there is no waiting period imposed in the case of an issuer that becomes subject to the reporting requirements as a result of either a registered reorganization or a reorganization that is exempt from registration, provided that the other party to that reorganization has been subject to the reporting requirements for over ninety days and is deemed a predecessor of the issuer. A company is generally deemed a predecessor where it had substantially the same assets, liabilities, business and management as the issuer. This is often the case when a company forms a holding company n150 or reincorporates in a different jurisdiction, n151 without otherwise changing its assets, liabilities and operations. In the case of spin-offs and liquidating distributions, shareholders may use the Exchange Act reporting history of the distributing entity to determine compliance with Rule 144(c)(1) requirement only if the spun-off entity has substantially all the assets, liabilities and operations of the distributing entity n152 or the distributing entity reported the spin-off operations as a separate identifiable unit in its previous Exchange Act filings. n153 A company formed in a merger of Exchange Act reporting companies may use the reporting history of the constituent corporations for Rule 144(c)(1) compliance. n154 A company that has reorganized pursuant to *Section 1145 of the Bankruptcy Code* is treated as the same company for purposes of Rule 144(c)(1). n155 Additionally, the staff has permitted a holding company that had been subject to the relevant reporting requirements for ninety days, to issue debt securities guaranteed by subsidiaries that were not subject to reporting requirements of either the Securities Act or the Exchange Act. n156

[ii] Adequate Current Filings. With respect to a reporting issuer, adequate current public information is available if all the filings required to be made for the twelve months preceding the proposed sale have been made in a timely manner. It is not necessary that reports for the full twelve months preceding the sale be available unless the issuer has been subject to the reporting requirements for that entire time. n157 If the issuer has been subject to those requirements for a shorter period of time, then only the reports required to be filed during that shorter period of time are necessary. n158 Where the issuer has failed to make a timely filing of a required report, the available information is not current for purposes of the Rule 144(c) requirement. n159 In that type of case, however, the information will become current upon the late actual filing of the report. n160

Although Rule 144 is never available for sales of securities of a reporting issuer unless it or a predecessor has been a reporting issuer for at least ninety days and unless every required report has been filed, n161 the staff rarely questions the accuracy of the reports provided that they contain all the information specified by the respective forms. For example, where an issuer's counsel refused to opine that the issuer had satisfied all of its disclosure obligations, perhaps because the issuer was subject to an inactive private investigation that was never formally terminated by the Commission, the staff nevertheless permitted a proposed seller of restricted securities of that issuer to rely upon the rule. n162 Generally, neither does an outstanding letter of comment on a particular report n163 nor an accountant's disclaimer of an opinion respecting the financial statements in a report n164 render the information inadequate. Indeed, the staff has even allowed the rule to be relied upon by non-affiliates, but not by affiliates, where certain of the issuer's financial statements failed to meet the financial requirements of the respective forms. n165 Although the staff is unlikely to object to the use of Rule 144 by a non-affiliate holder of restricted securities because of a deficiency in a filed report that the holder would normally not be aware of, an affiliate, or a proposed seller who is actually aware of the deficiency, should not risk reliance upon Rule 144 in the absence of an interpretive letter from the staff of the Commission.

Issuers that are reorganizing or liquidating under the provisions of the United States Bankruptcy Code are permitted to file modified Exchange Act reports. Such issuers are not considered "current" in their reporting obligations. n166

[c] Requirements for Non-reporting Issuers.

If the issuer of the securities proposed to be sold under Rule 144 is not required to file periodic reports by Section 13 or

15(d) of the Exchange Act, adequate current public information about that issuer may not be available. In such a case Rule 144 would not be an alternative to registration for proposed sellers of restricted securities or control securities of that non-reporting issuer unless that issuer chose to or was contractually required to satisfy the rule's disclosure requirement. n167

The non-reporting issuer may satisfy the rule's requirement of adequate current information by voluntarily registering a class of its equity securities under Section 12(g) of the Exchange Act (even if it has less than 300 shareholders in the United States and has thus not triggered the Section 12(g) registration requirement) n168 thereby causing itself to be subject to that Act's reporting requirements. Following a waiting period of ninety days from the effective date of the registration statement and upon completion of all required filing during that period, the rule would become available for proposed sellers of that issuer's restricted securities and for its affiliates. n169 Where an issuer discovers that it is no longer required to file reports under Section 15(d) of the Exchange Act because the number of its shareholders has decreased to less than 300, it may voluntarily continue to file reports with no hiatus in the availability of Rule 144 for its affiliates and for the holders of its restricted securities. n170

[i] Adequate Current Information. In addition to voluntary filings, paragraph (c)(2) of Rule 144 allows any non-reporting issuer to satisfy the rule's disclosure requirement simply by making certain specified information "publicly available." The information deemed adequate under paragraph (c)(2) of Rule 144 is that information concerning the issuer specified in clauses (1) through (14) and clause (16) of paragraph (a)(4) of Rule 15c2-11 under the Exchange Act. n171 If a non-reporting issuer is an insurance company, the information specified in Section 12(g)(2)(G)(i) of the Act will constitute compliance with the rule's requirement if current and publicly available. n172

Although the rule provides that all of that enumerated information is required for compliance with Rule 144(c)(2), n173 it prescribes no particular form for that information. Frequently, the information is provided in annual and quarterly reports or proxy statements, press releases, or any combination of those documents. n174 It is not necessary, however, that any of the commonplace documents be utilized or that all of the information be contained in a single rather than two or more documents. n175 Similarly, while the financial information provided is often audited or audited in part, n176 unaudited financial statements are adequate under Rule 15c2-11(a)(4) under the Exchange Act and, in most cases, for purposes of complying with Rule 144(c)(2). n177

The required information must be current as well as complete. For purposes of Rule 144(c)(2), the information is satisfactory only if "reasonably current" as that term is defined in Rule 15c2-11(g) under the Exchange Act. n178 Under that rule, financial information will be presumed to be "reasonably current" only if it is less than six months old, and all other information will be so presumed only if it is less than twelve months old. n179 In the absence of meeting these presumptions, the staff will not consider the rule's requirement satisfied. n180

Persons wishing to rely on Rule 144 must currently make their own determination whether the issuer of the securities has complied with Rule 144(c)(2), because the Commission staff has indicated it will no longer provide interpretive advice about either whether particular reports contain the required information or whether such reports have been made to the generally investing public. n181

[ii] Public Availability of Information. In addition to preparing adequate current information, the non-reporting issuer must ensure that the information is "publicly available" to fully comply with Rule 144(c)(2). Compliance with that standard is a factual matter and must be decided on a case-by-case basis. In general, information about an issuer is "publicly available" if it is made available on "an ongoing and continuous basis ... to security holders, market makers, brokers, financial statistical services, and any other interested persons." n182 Normally, this requirement of regular dissemination is satisfied by regular mailings to a mailing list that includes all of those persons. n183 It is not sufficient if the information is provided only to the broker through whom the seller proposes to sell the securities, n184 though it is apparently permissible to provide the necessary information to the issuer's sole market maker, when that information is also provided to the issuer's shareholders, the press, and other interested persons. n185 Furthermore, the staff takes

the position that the required information is not publicly available where the issuer fails to routinely provide it in response to all requests from all interested persons. n186

While the rule is not available to a proposed seller of securities of a reporting issuer until that issuer has been subject to those reporting requirements for at least ninety days, n187 there is no specified minimum period prior to a sale under Rule 144 during which the information required for a non-reporting issuer must be available. n188 Of course, the information will not be considered publicly available for purposes of Rule 144(c)(2) until enough time has passed since dissemination for the public to become aware of it. Presumably, by analogy to the Rule 144(c)(1) ninety day waiting period, information widely disseminated ninety days previous to the date of a proposed sale of securities would be considered "publicly available" on the date of actual sale.

An investor proposing to sell restricted securities or control securities of a non-reporting issuer is not entitled to rely upon a statement from the issuer that the required information is publicly available, unlike the proposed seller of such securities of a reporting issuer. The investor in that case takes the risk that Rule 144 is unavailable and that the sale will be in violation of the Securities Act. Accordingly, any investor proposing to rely upon Rule 144 for the sale of any securities of a non-reporting issuer should make a diligent investigation to determine whether all the information called for by Rule 144(c)(2) is indeed publicly available. Furthermore, in many cases, a broker-dealer will require a legal opinion of counsel authorized to write opinions on behalf of the issuer and accepted by the issuer's transfer agent, that all of the requirements of Rule 15c2-11 have been met prior to selling the securities.

[d] Exemption from Provisions of Rule 144(c). The requirement that there be adequate current public information about the issuer of the securities to be sold need not be complied with by a non-affiliate holder of restricted securities that have not been held by the issuer or any affiliate of the issuer during the one year prior to the date of the proposed sale pursuant to Rule 144. n189

The 2007 amendments removed the requirement from paragraph (c)(1) that the issuer of the securities proposed to be sold have securities registered pursuant to Section 12 of the Exchange Act. n190 The 2007 amendments also made (c)(1) applicable to reporting issuers within six months to one year for resales by non-affiliates and from six months onward for resales by affiliates. n191

[4] Holding Period Requirement--Rule 144(d)

The second requirement that must be satisfied before a sale of restricted securities may be made pursuant to Rule 144 is that a period of at least six months must have elapsed for a reporting company and a period of at least one year must have elapsed for a non-reporting company since those particular restricted securities were acquired from the issuer or an affiliate of the issuer and, if they were acquired by purchase from the issuer or an affiliate of the issuer, since the full purchase price was paid. n192 Unlike all of the other five conditions that must be complied with to ensure the availability of the Rule 144 exemption, the holding period requirement is applicable only to sales of restricted securities. Affiliates proposing to sell unrestricted securities pursuant to the rule may simply ignore it. n193

[a] Basis for Condition of Rule 144(d). At the time of the adoption of Rule 144, the length of time an investor had held restricted securities was regarded as the best evidence of investment intent at the time of the purchase. n194 Accordingly, after the passage of a substantial period of time, the investor was regarded as having purchased the securities without a view to their distribution and, therefore, as not being an underwriter within the meaning of the Section 4(1) resale exemption. n195 Although the rule seemed to codify that thinking and is consistent with the statutory language, the Commission's stated purpose for the holding period requirement was broader, in that it was also intended to assure that investors who purchased restricted securities indeed "have assumed the economic risks of investment and therefore are not acting as conduits" for the sale of unregistered securities to the public by the issuer. n196 This concept was modified in 1988, when the Commission proposed changes to Rule 144 that would start the holding period from the time the securities were acquired from the issuer or an affiliate of the issuer, as opposed to

restarting the holding period each time the securities changed hands. The Commission stated: "[a] single period running from the date of the purchase from the issuer or its affiliate would appear sufficient to prevent the distribution of restricted securities to the public." n197 The "at risk" concept is now relevant in more limited circumstances.

[b] Commencement of Holding Period.

The holding period for restricted securities, that is, six months for securities of a reporting issuer and one year for securities of non-reporting issuers, with certain exceptions commences on the day that a person who is not the issuer or an affiliate of the issuer becomes the beneficial owner of those securities. If the restricted securities were acquired by purchase, the holding period will not commence until the purchaser becomes the beneficial owner *and* the entire purchase price or other consideration has been paid or given. n198

[i] Beneficial Ownership. Although beneficial ownership of securities is often defined in terms of voting or dividend rights, n199 for purposes of the commencement of the Rule 144(d) holding period, a holder of restricted securities becomes the beneficial owner when he assumes the full economic risks of loss. n200 In an ordinary purchase of securities, the purchaser would become the beneficial owner upon the payment of the purchase price and the receipt of the securities, normally contemporaneous events.

A purchaser of restricted securities, however, can sometimes become the beneficial owner before the actual delivery of those securities. For example, where a securities purchase agreement is executed, the purchaser may become the beneficial owner of the securities on the effective date of the agreement only if the purchaser will be deemed to have paid for the securities by execution of the agreement and therefore to have assumed the full risk of loss prior to the delivery of the securities. n201 However, the period commences when the right to receive securities without further consideration matures, not the date of execution of the agreement. n202 If the securities are to be issued pursuant to a merger agreement or other plan of reorganization, beneficial ownership will commence when there is no question that the full economic risk has been assumed by the recipients. n203 Where securities are held in an escrow account subsequent to a reorganization pending adjustments provided for in the plan of reorganization, the holding period will commence on the closing date of the reorganization, providing no further consideration is required for the issuance of the securities. n204 Finally, where the alleged purchaser of securities is litigating his right to those securities, the holding period will normally commence on the date of the ratification or execution of the settlement agreement or court order settling the litigation, n205 unless the agreement or order is persuasive evidence that the purchaser did, in fact, assume the economic risk of loss at an earlier date. n206

When restricted securities are acquired in a private nonsale transaction, it is often more difficult to determine when the holder becomes the beneficial owner for purposes of the commencement of the holding period. Again, in some circumstances, the recipient will become the beneficial owner prior to the actual delivery of the securities, but only if all risk of economic loss has shifted from the transferor to that recipient. If restricted securities are acquired through an employee benefit plan, the employee usually becomes the beneficial owner on the date the securities are credited to his or her account, n207 even if they are subject to forfeiture upon the employee's failure to provide additional service or otherwise, n208 and even if they are subject to restrictions on resale for a period longer than the Rule 144 holding period. n209 Where restricted securities are transferred to individual donees, controlled corporations, trusts, or similar persons, the facts must be carefully scrutinized to determine if and when the transferee becomes the beneficial owner of those securities in order to ascertain the date of commencement of the one year holding period for those securities.

[ii] Full Payment of Purchase Price. If the restricted securities are purchased from the issuer or an affiliate of the issuer, then the holding period will not commence until the purchaser is the beneficial owner and the full purchase price has been paid. n210 Often securities are paid for by delivering to the seller a promissory note of another written obligation to pay. n211 In that case, the full purchase price is unpaid for purpose of Rule 144(d)(1) and the holding period will not commence on the date of the purchase transaction unless the note or the obligation provides for full recourse against the purchaser of the securities, is secured by collateral having a market value at least equal to the

amount of the note or obligation and is discharged by full payment before the date of the sale made in reliance on Rule 144. n212 Acceptable collateral for purpose of causing the holding period to commence includes securities other than those purchased with the note or other obligation n213 as well as unconditional guarantees of the note or other obligation by a bank or other financial institution unrelated to the issuer. n214 Upon satisfaction of these conditions, the holding period will commence, but it will stop running for any period in which the collateral has a fair market value of less than the amount of the outstanding note or obligation. To prevent this tolling of the holding period, collateral may be added. n215 If the collateral becomes worth more than the note or obligation, that portion of it worth more than the obligation may be withdrawn without any tolling of the holding period. n216

Frequently, the purchaser will pay for the securities with an installment obligation. In that case the securities will become fully paid on a staggered basis as payments are made. n217 If the securities are to be paid for by an employee with future services, the holding period will not commence until those services allocatable to those particular securities have been fully rendered. n218 Finally, when an investor acquires restricted securities from the issuer or an affiliate of the issuer upon exercise of an option, those securities are not acquired for purposes of the commencement of the holding period until the exercise price is paid. n219 Only then is that holder of the option to purchase restricted securities actually at risk with respect to the underlying securities, and only then does the six-month or one-year holding period, as applicable, begin to run. Additionally, the seller may only sell those securities whose specific acquisition date satisfies the holding period requirement. n220 Securities sold pursuant to Rule 144 are not fungible with respect to the required holding period. n221

[c] Tacking Provisions.

As discussed above, Rule 144 generally requires that a six months or one year, as applicable, elapse since the restricted securities proposed to be sold were acquired from the issuer or an affiliate of the issuer. Prior to its amendment in 1990, Rule 144 required that each holder hold for two years (then the holding period) before any securities can be sold, and only permitted the "tacking" of previous holders' holding periods in certain circumstances. Now, however, tacking is the rule rather than the exception.

Whether tacking of previous holding periods is permitted is now most relevant in transactions that would otherwise seem to require the holding period to start running again, such as recapitalizations or conversions, where new securities are acquired from the issuer or where securities are acquired from an affiliate of the issuer.

[i] Securities Acquired as Stock Dividends, in Stock Splits or in Recapitalizations. Paragraph (d)(3)(i) of Rule 144 permits an investor who is proposing to sell restricted securities received as a dividend or in a stock split to consider them held from the time the securities with respect to which they were issued were acquired from the issuer or an affiliate of the issuer. n222 The staff has also allowed holders of restricted debentures who received restricted common stock from the same issuer as one-time payment of interest contingent upon a net income formula as required by the provisions of the debentures n223 or stock received in lieu of accumulated cash dividends n224 to treat the stock as acquired at the time the debentures were acquired for purposes of satisfying the holding period requirement.

Similarly, restricted securities acquired from the issuer in exchange for other restricted securities are considered as having been acquired at the time the original securities were acquired, provided that the exchange constitutes a recapitalization. n225 Most exchanges with the issuer, either through adoption of a plan or recapitalization (including one to change par value) or by means of an exchange offer, are regarded as recapitalizations. n226 The 2007 amendments, discussed further in section (ii) below, also codified the Commission's position that, if the securities to be sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities are deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms. n227

Until recently, the term did not include exchange offers where significant numbers of the offerees did not participate, a

situation which occurred primarily in negotiated exchange offers where holders decided on an individual basis whether to accept the exchange offer. n228 More recent no-action responses indicate that the staff will now consider such negotiated exchanges to be recapitalizations under Rule 144(d)(3)(i). n229

Any exchange transaction involving the payment of any consideration other than the securities of the issuer, or an entity that is substantially the same as the issuer, n230 falls outside the scope of the term recapitalization for purposes of the rule's tacking provision. n231

A merger is a recapitalization if there is "no change in the nature of the business or control of the management" of the company. n232 The 1997 amendments to Rule 144 proposed to codify the Commission's previous interpretive position that holders of restricted securities may tack the Rule 144 holding period in connection with transactions made solely to form a holding company but did not codify the interpretation at that time. n233 The Commission proposed to codify the aforementioned interpretive position in the 2007 Proposing Release, n234 and adopted the position in the 2007 amendments in new Rule 144(d)(3)(ix), which provides for tacking if:

- the newly formed holding company's securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;
- holders received securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor company, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company's securities; and
- immediately following the transaction, the holding company had no significant assets other than securities of the predecessor and its existing subsidiaries and had substantially the same assets and liabilities on consolidated basis as the predecessor had before the transaction. n235

The Commission went on to say that tacking is permissible if the above are satisfied because there is no significant change in economic risk of the investment in restricted securities and the securities being exchanged are substantially equivalent. n236

Reincorporation in a different jurisdiction is a recapitalization provided that "the substance of the corporation (that is, the nature of its business and management) remains the same as before." n237 The 2007 amendments did not change this interpretive position, permitting tacking in connection with the reincorporation of the issuer in a different state in certain situations. n238 However, a transaction is not a recapitalization if other changes in capitalization and percentage ownership are accomplished at the same time such that the difference between the successor company and the predecessor company amounts to a new investment decision for the investor. n239 One of the primary considerations of the staff in permitting tacking is that the investor continues to bear the economic risk of its initial investment. n240

The concept of continuing to bear economic risk in the same enterprise means that where partnership interests are exchanged for shares in a new corporation formed to conduct the business formerly conducted by the partnership, the holding period applicable to the partnership interests could be tacked to that of the share where the partnership agreements contemplated that a transfer of the business to a corporation may take place, n241 but where the partnership had not initially contemplated such a transfer, the holding period for the shares did not commence until the exchange took place, or until the partnership agreement was so amended. n242

[ii] Securities Acquired in Conversions.

Prior to the 2007 amendments, an investor who acquired securities upon voluntary surrender of other securities of the

same issuer could tack the holding period of the converted securities to that of the newly acquired securities for the purpose of satisfying the holding period requirement of Rule 144, n243 provided that the conversion involved no additional consideration. n244 Where, however, stock was received partly in exchange for convertible notes and partly in exchange for the interest owed on the notes, the staff had permitted tacking only for those shares of stock received for the notes and had commenced the holding period for those shares received on account of the interest on the date of issuance. n245 It had also not been necessary that the surrendered securities be convertible by their terms. n246 The 1997 Proposing Release had previously proposed codifying the Commission's aforementioned positions. The Commission again proposed such codification in the 2007 Proposing Release. n247 The 2007 amendments codified the aforementioned amendment to Rule 144(d)(3)(ii) and added the following clarifying note:

If the surrendered securities originally did not provide for cashless conversion or exchange by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the surrendered securities to permit cashless conversion or exchange, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the surrendered securities, so long as, in the conversion or exchange, the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer.

Finally, if the conversion takes place in a manner involving no investment decision by the holders of the convertible securities, the staff will sometimes permit tacking for policy reasons even though the securities received are those of an affiliate of the issuer of the convertible securities, n248 or even where some additional consideration is paid to effect the conversion. n249 The staff will permit tacking where the securities surrendered in exchange are issued by a wholly-owned subsidiary of the issuer of the new securities, but only if the parent has fully guaranteed payment by the subsidiary of the exchanged obligations of the subsidiary. n250 The staff has also permitted tacking where debt securities that were issued by a predecessor corporation were assumed by the issuer of new securities in a merger by operation of law. n251 Because the staff has not often permitted tacking in cases where one or more of the express requirements of this tacking provision is not satisfied, an investor should assume that it may not tack in a similar situation in the absence of a favorable interpretive letter.

[iii] Securities Acquired through Contingent Payment Provisions.

If a person sells an equity interest in a business or all of the assets of a business and agrees to accept as part of the consideration for that business restricted securities of the purchaser on a later date if certain conditions later occur, those securities later received will be considered to have been held since the date of the sale of the interest or assets, as long as the conditions triggering the delivery of the securities were other than the payment of further consideration. n252

[iv] Pledged Securities.

Paragraph (d)(3)(iv) of Rule 144 is the first of the rule's four express tacking provisions that allow non-affiliates under certain conditions to deem restricted securities not to have been held by the issuer or any affiliate of the issuer during a period in which the issuer or an affiliate in fact held the securities. n253 Specifically, Rule 144(d)(3)(iv) provides that a holder of restricted securities, who acquired them from an affiliate of the issuer n254 as security for the repayment of a loan or other obligation, n255 may tack to his holding period the holding period of the pledgor of those securities provided that the pledge was both with recourse and bona fide. n256 Although the bona fide requirement has been the subject of almost no comment, n257 it was apparently intended to prohibit the tacking of holding periods where either party to the loan transaction intended that the pledged securities would be the primary source of repayment of the loan rather than merely the security for the repayment from other sources. n258 Regarding the "with recourse" requirement, paragraph (d)(3)(iv) further provides that if the restricted securities are pledged without full recourse, the pledgee's holding period will commence at the time of the pledge transaction or, in the case of a person acquiring pledged securities upon a default of the obligation secured by the pledge, at the time of purchase. n259

It should be noted that the language of paragraph (d)(3)(iv) extends the full benefit of this tacking provision to a

nonpledgee purchaser of securities pledged with recourse. In other words, the purchaser may tack his holding period to both the pledgee's holding period and the pledgor's holding period, provided that the non-pledgee purchaser purchased the securities in a sale pursuant to a default in the underlying obligation. n260 This extended tacking benefit does not, however, accrue to a purchaser of the restricted securities from a pledgee who has himself purchased them following a default in the underlying obligation. n261 That purchaser and the purchaser following a default in the case of a pledge without recourse are treated in the same manner as any other purchaser in an ordinary purchase situation is treated. n262 In short, the purchaser's holding period commences upon his acquisition of beneficial ownership and payment of the purchase price, *i.e.*, normally at the time of purchase. n263

This tacking provision and indeed the Rule 144 holding period requirement itself is relevant only where the pledged securities are restricted securities. If an investor, whether or not an affiliate of the issuer, transfers restricted securities in a private transaction to secure an obligation, those securities are also restricted in the hands of the pledgee. n264 If a non-affiliate so pledges unrestricted securities, they remain unrestricted and are freely tradeable by the pledgee on default. n265

Where, however, an affiliate of the issuer transfers unrestricted securities to a pledgee, the application of Rule 144(d) and the tacking provision is less clear. Since the pledgee acquired the securities from an affiliate of the issuer in a private transaction, under a literal interpretation of the Rule 144(a)(3) definition of restricted securities, those previously unrestricted securities would become restricted in the hands of the pledgee. n266 Although unrestricted securities that are acquired from affiliates in nonsale transactions are not considered restricted securities because the transferees are regarded as simply standing in the shoes of the respective transferor affiliates, n267 a pledge is viewed as a sale rather than a nonsale transaction. n268 As a result, it is difficult to argue that the pledged securities are unrestricted for purposes of free trade ability under Section 4(1) of the Securities Act. On its face, the language of paragraph (d)(3)(iv) would seem to allow a pledgee in such circumstances to tack the affiliate's holding period (even though the concept of a holding period is foreign to a holder of unrestricted securities). However, the SEC has stated that such sales may take place without regard to the Rule 144 holding period. n269

[v] Securities Acquired as Gifts.

Paragraph (d)(3)(v) of Rule 144 permits a proposed seller of restricted securities n270 who received them as a gift from an affiliate of the issuer n271 to tack to his holding period the holding period of the donor for the purpose of satisfying the rule's holding period requirement. n272 The availability of this tacking provision depends solely upon the securities having been acquired in a gift rather than a sale transaction. n273 A gift is simply a transfer for no consideration. The existence of consideration, money, services, or anything of value, is a factual issue. In general, transfers between entities with a business relationship are presumed to be for consideration of some sort rather than gifts. n274

[vi] Securities Acquired by Trusts. Paragraph (d)(3)(vi) of Rule 144 permits a trust proposing to sell restricted securities that were donated to it by a settlor of the trust who is an affiliate of the issuer to tack to its holding period the holding period of the settlor for purposes of satisfying the rule's holding period requirement. n275 However, the staff has taken the view that the tacking benefit is not available for restricted securities purchased by the trust from the settlor, n276 from a beneficiary of the trust, n277 or indeed from the issuer or any other holder of restricted securities, n278 because that purchase would result from an investment decision on the part of the trustee. n279 The tacking benefit available to the trust is also available to any beneficiary of the trust who may regard any restricted securities distributed to him as acquired on the date of their acquisition by the settlor of the trust. n280

[vii] Securities Acquired by Estates. Rule 144's express tacking provisions also provide that securities held by the estate of an affiliate of the issuer are deemed to be acquired when acquired by the deceased. n281 This is a unique provision in that it exempts the sales of those restricted securities by an estate that is not an affiliate of the issuer (even if one or more of the estate's beneficiaries is an affiliate) from the holding period and volume limitations requirements of Rule 144 altogether. n282 Similarly, paragraph (d)(3)(vii) of Rule 144 also exempts any sales of those restricted

securities by any distributee beneficiaries who are non-affiliates from the rule's holding period and volume limitations requirement. n283 As to an estate and any beneficiaries that are affiliates of the issuer n284 of the restricted securities proposed to be sold, the provision allows the estate to tack to its holding period the holding period of the decedent. It further allows the beneficiaries to tack to their holding periods the holding periods of both the estate and the decedent, in each case to satisfy the six-month or one-year holding period requirement of the rule, as applicable. n285

The benefits of paragraph (d)(3)(vii) are available only for restricted securities that are acquired from the decedent, either directly through descent or bequest or indirectly through a partnership agreement or otherwise not involving any investment decision by the executor of the estate. n286 Accordingly, those benefits are not available for the sale by the estate of restricted securities acquired by it through the exercise of options to purchase the same that it received from the decedent, n287 through an exchange for securities that it received from the decedent, n288 or otherwise in a manner involving an investment decision by the executor of the estate. The 2007 amendments removed paragraph (i) from the note to paragraph (d)(3)(vii), as paragraph (i) now pertains to shell companies, described later in this chapter.

[viii] Securities Acquired upon Reclassifications, Mergers and Sales of Assets. Rule 144(d)(3)(viii), added in 1990 and amended in 2007, provides that a new holding period will apply to restricted securities that are acquired in the case of any of the corporate transactions described in Rule 145(a), except as otherwise provided in paragraphs (d)(3)(ii) and (ix) of Rule 144. n289 Rule 145(a) applies to transactions in which, pursuant to applicable law or the charter documents of an issuer, the security holders are called upon to vote or give their consent for one of the following:

- a reclassification of securities other than a stock split, reverse stock split, or change in par value, which involves the substitution of a security for another security;
- a statutory merger or consolidation (unless the sole purpose is to change the issuer's domicile within the United States); or
- certain transfers of assets of the issuer in exchange for securities of another person.

Such transactions have historically been treated as purchases of new securities. Therefore, the Commission takes the position that the new securities are not mere economic equivalents of the surrendered securities, and a new holding period is needed to prevent an unregistered two-step distribution of securities.

However, a transaction that is effected only to create a holding company, where the former security holders of an operating company become security holders of the new holding company, is not treated as the creation of a new restricted security, but instead is analyzed as a recapitalization covered by new Rule 144(d)(3)(ix). n290 That means that the new securities of the holding company are deemed to have been acquired from the issuer or an affiliate on the date that the securities of the operating company were acquired, for purposes of determining when resales may be made in reliance on Rule 144. n291

Moreover, the staff has also agreed that the adoption of Rule 144(d)(3)(viii) did not prevent tacking in the cases where it has been allowed under paragraph (d)(3)(i) or (ii) of Rule 144, even if the transaction is of a type described in Rule 145(a). n292 The 2007 amendments codified the position with respect to paragraph (d)(3)(ii) relating to conversions and exchanges of securities discussed in *Section 6.05[4][c][ii]* on page 86 of this chapter.

[ix] Securities Acquired in Divorce Settlements. The staff occasionally permits tacking in nonsale situations perhaps not contemplated when the rule was adopted, often by interpreting beneficial ownership to have actually begun prior to the date on which the proposed seller of restricted securities actually acquired restricted securities. n293 One such situation involves marital separations or divorces. One effect of a separation or divorce is that each spouse is no longer the same person as the other under Rule 144(a)(2). n294 Arguably, however, the spouse who acquires restricted securities from the other who is an affiliate of the issuer pursuant to a divorce settlement agreement has really been a

beneficial owner of those securities since they were acquired by the transferor spouse. Based on the view that the acquired restricted securities represent the acquiring spouse's beneficial interest in the total assets of the marriage, prior to the adoption of changes to Rule 144 in 1990, the staff normally allowed such a recipient of restricted securities to tack to his or her holding period the holding period of the transferor spouse. n295 There appears to be no reason why this position should not be continued. If the transfer of restricted securities to a former spouse involves the payment of consideration or otherwise appears to be a sale rather than a transfer pursuant to a divorce settlement agreement, however, tacking is not permitted because the former spouse's payment of consideration evidences that he or she in fact had no prior beneficial interest in those securities. n296

[x] Securities Acquired from Closely Related Persons. Similarly, a holder of restricted securities, who acquired such securities privately from an affiliate of the issuer who is also so closely related to that holder that there was no shift in the economic risk of the investment, may tack to his holding period the holding period of that closely related transferor for purposes of satisfying the Rule 144 holding period requirement. n297 For example, tacking is permitted where a corporation converts indirect ownership of restricted securities into direct ownership. n298 In addition, tacking has been permitted where an individual transfers restricted securities to a corporation in exchange for all of its outstanding stock because such a transaction would represent a change in form without any change in either control over, or risk of loss from, the restricted securities. n299 On the other hand, the staff has held that if an individual were to transfer restricted securities to a corporation in exchange for only some of its outstanding stock, there would be a shift in risk, resulting in a new holding period for the acquiring corporation without any tacking benefit. n300

In sum, whenever restricted securities are acquired by an entity which is either under the control of a transferor affiliated to the issuer or under the control of the same persons who control that transferor, and in the same proportions, there is no real change in beneficial ownership of, or risk of loss from, the securities. Hence, there is no justification for beginning a new holding period. Accordingly, any such entity, individual, partnership or corporation proposing to sell restricted securities acquired from such a transferor that is in a control relationship with it presumably may tack to its holding period the holding period of that transferor for purposes of satisfying the holding period requirement of Rule 144. In light of the absence of any express authority for the above analysis, however, and the fact that the need for such tacking now only exists where the transferor is an affiliate of the issuer, it is advisable for proposed sellers of restricted securities in these often unique fact situations to obtain an interpretive letter to avoid the risk of improper reliance on the rule. n301

[xi] Securities Acquired in Spin-offs or Liquidating Distributions. Frequently, a partnership or a corporation that has acquired the securities of other issuers for investment or otherwise will distribute those securities pro rata to its partners or shareholders. Often the distributing entity simply wishes to spin-off, that is divest itself of, a particular holding or holdings in its portfolio. On other occasions, the distributing entity is distributing all of its holdings incident to its own liquidation. n302 In either case, if the distributed securities were restricted securities in the hands of the distributing partnership or corporation, they may also be restricted securities in the hands of the partner or shareholder distributees. n303 Where restricted securities are acquired in such a spin-off or liquidating distribution from an affiliate of the issuer, the partner or shareholder recipient may normally tack to his holding period the holding period of the distributing partnership or corporation for the purpose of satisfying the Rule 144(d) holding period requirement. n304 Again, the basis for this implied tacking provision appears to be that these sorts of distributions that involve no additional consideration for the distributed securities involve no real change in their beneficial ownership. n305 In light of the analysis, it is not surprising that the staff allowed a shareholder of a close corporation who received his one-third share of the corporation's restricted securities of another issuer upon his termination of employment to tack to his holding period the holding period of the distributing close corporation, even though he was the only shareholder to be so cashed out. n306 Despite considerable evidence that the staff is now likely to permit tacking to persons who acquire restricted securities from affiliates in transactions similar to spin-offs or liquidating distributions that seem to involve no significant change in who bears the risk of economic loss, it is nevertheless advisable to secure an interpretive letter whenever the particular circumstances have not yet come before the staff of the Commission.

[xii] Cashless Exercise of Options and Warrants

The Commission received several comments to the 1997 Proposing Release asking for the codification of the position that the securities acquired from a cashless exercise of options or warrants be deemed to have been acquired when the options or warrants were granted, even if the options and warrants as initially granted did not permit cashless exercises. n307 The Commission proposed this revision in the 2007 Proposing Release and adopted new paragraph (d)(3)(x) in the final rule, as well as the two corresponding clarifying notes, which read as follows:

If the securities sold were acquired from the issuer solely upon cashless exercise of options or warrants issued by the issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the exercised options or warrants, even if the options or warrants exercised originally did not provide for cashless exercise by their terms.

Note 1 to Rule 230.144(d)(3)(x). If the options or warrants originally did not provide for cashless exercise by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the options or warrants to permit cashless exercise, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the options or warrants so long as the exercise itself was cashless.

Note 2 to Rule 230.144(d)(3)(x). If the options or warrants are not purchased for cash or property and do not create any investment risk to the holder, as in the case of employee stock options, the newly acquired securities shall be deemed to have been acquired at the time the options or warrants are exercised, so long as the full purchase price or other consideration for the newly acquired securities has been paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer at the time of exercise.

[xiii] Section 3(a)(10) Securities. Securities that are acquired through an exchange transaction that is exempt from the registration requirements of the Securities Act by reason of the exemption contained in Section 3(a)(10) are normally not restricted securities, n308 even when the securities initially exchanged were restricted securities, n309 and thus tacking provisions are inapplicable.

[xiv] Other Securities Subject to Tacking Provisions. Although the staff of the Commission has stated that the only tacking provisions available to a proposed seller of restricted securities are those contained in paragraphs (d)(3)(i) through (vii) (now (x)) of Rule 144, it has regularly permitted tacking in certain other situations, as discussed above. n310 For example, as discussed in this chapter the Commission has codified additional positions with regard to tacking with the 2007 amendments. n311 Occasionally, the staff will allow a proposed seller of restricted securities to tack the holding period of other securities or of another holder to satisfy the Rule 144(d) holding period requirement just "because of special circumstances and policy reasons," even without the benefit of a reason necessarily deriving from the purpose of the holding period requirement n312 Accordingly, in a case involving unique circumstances or policy considerations, a proposed seller may obtain a favorable interpretive letter respecting the availability of tacking.

[5] Volume Limitation Requirement--Rule144(e)

The 2007 amendments revised paragraph (e) so that it now only applies to sales of restricted or control securities by affiliates and raised the volume limitation for debt securities. n313 The third requirement that must be complied with by an affiliate who proposes to sell restricted or control equity securities, is that the amount of securities to be sold pursuant to Rule 144, together with the amount of such securities already sold (by such affiliate or any person or entity that the affiliate aggregates with) during the three month period preceding the date of the proposed sale, must be limited to the greater of one percent of the outstanding securities of the class being sold or the average weekly trading volume for the class during the four week period preceding the date of the proposed sale. n314

The proposed affiliate seller must aggregate his sales of both restricted and unrestricted securities of the same class during the three-month period for purposes of determining the maximum amount of securities that may be sold within the rule's volume limitation requirement. n315 In either case, however, the proposed seller is not required to aggregate any sales of securities made pursuant to an effective registration statement or pursuant to the exemption provided by Regulation A or any private sales of securities made pursuant to Section 4 of the Securities Act or any sales made pursuant to Regulation S for purposes of determining compliance with the Rule 144 volume limitation requirement for the relevant three month period. n316

[a] Basis for Conditions of Rule 144(e). At the time of the promulgation of Rule 144, the availability of the resale exemption contained in Section 4(1) of the Securities Act depended on the proposed seller's not being a statutory underwriter, which in turn depended in part on whether the contemplated resale would constitute a distribution within the meaning of Section 2(11). n317 In the Commission's view, any transaction involving a substantial amount of securities, that is, an amount large enough to have an impact on the trading markets, did constitute a distribution, n318 and would likely cause the proposed seller to be an underwriter and therefore unable to rely on the resale exemption. n319 That interpretation of the statutory format was consistent with the fact that Section 4(1) was intended to exempt only routine trading transactions between individual investors as distinguished from distributions by issuers or others. n320 By including the volume limitation requirement in the version of Rule 144 that was adopted, the Commission simply reaffirmed its long standing view that a significant characteristic of a transaction that is not a distribution is that it involves an amount of securities that is limited enough to have little, if any, impact on the relevant trading markets. n321

[b] Amount of Limitations-Equity Securities. To comply with the rule's volume limitation requirement, an affiliate proposing to sell restricted or control equity securities pursuant to Rule 144 must first calculate the maximum amount of securities of the same class that he may sell in the three month period ending on the date of the proposed sale n322 and then subtract from that maximum amount the amount of any other such securities that he sold during that three month period. The maximum amount of securities that may be sold in the particular period is the greater of the two figures. The one percent is simply one percent of the number of shares of the same class that is shown to be outstanding by the most recent report or statement of the issuer. n323 Although that figure should not include treasury shares or issued shares that are held by a wholly-owned subsidiary of the issuer, n324 a proposed seller may rely on the issuer's most recent statement or report regarding the number of shares outstanding unless he is aware of an inaccuracy therein. n325 Where shares of a class of security are represented in the United States by depositary shares, the one percent figure is calculated on the basis of all shares of the underlying security outstanding on a worldwide basis, not on the number of depositary shares or the number of shares of the underlying security held in the United States. n326

The alternative maximum amount of securities that may be sold during the three month period is essentially the average weekly reported volume of trading in the securities of the same class for the four calendar weeks preceding the date on which the Form 144 is to be filed. n327 If no notice is required to be filed by Rule 144(h), then the measuring date is the date on which the broker receives the sell order or the date the transaction is executed by the market marker, as the case may be. n328 If the trading volume decreases subsequent to the filing of Form 144, but before the sale occurs, the proposed seller may nevertheless sell the amount "locked in" by that filing. n329 In the event the trading volume increases during that same period, the proposed seller may file a new Form 144 (not an amended Form 144) n330 to obtain the benefit of the larger figure. n331

After determining the maximum amount of securities that may be sold under the rule's volume limitation requirement for the three month period ending on the proposed sale date, the proposed seller must reduce that maximum amount by the amount of all securities of the same class that he has already sold during that period. n332 For this adjustment, securities that are of the same class as those proposed to be sold are those that do not differ significantly in voting and liquidation rights or in historic market price. n333 Although that determination is an issue of fact, it is apparently a proper subject for an interpretive letter. Finally, the amount of securities that a proposed seller may sell under the rule's volume limitations requirement is unaffected by the amount of securities, if any, sold by that person in any other three

month period in that neither carry-forward nor accumulation is permitted. n334

While the amount of convertible securities that maybe sold pursuant to Rule 144 is determined exactly as explained above, the alternative procedure set forth in paragraph (e)(3)(i) of the rule would be used where both convertible securities and the securities into which they are convertible are sold during the same three month period. n335 In that case, the computation is made as if only the underlying securities are to be sold and the convertible securities are counted as the amount of underlying securities into which they are convertible. Where, however, the calculation made according to paragraph (e)(3)(i) would allow the seller to circumvent the volume limitations of Rule 144(e)(1) or (2), the alternative calculation is not applicable. n336

[c] Amount of Limitations -- Debt Securities.

While the 2007 amendments exempted non-affiliates from the volume requirements, as noted above, affiliates still remain subject to volume requirements for sales of equity securities and debt securities. For sales of debt securities, affiliates may use a new additional volume test adopted by the 2007 amendments in the form of revised paragraph (e)(2), which aims to rectify concerns that the previous volume limitations prevented sales of debt securities due to the fact that debt securities are usually issued in tranches. n337 New paragraph (e)(2) reads as follows:

If the securities sold are debt securities, then the amount of debt securities sold for the account of an affiliate of the issuer, regardless of whether those securities are restricted, shall not exceed the greater of the limitation set forth in paragraph (e)(1) of this section or, together with all sales of securities of the same tranche (or class when the securities are non-participatory preferred stock) sold for the account of such person within the preceding three months, ten percent of the principal amount of the tranche (or class when the securities are non-participatory preferred stock) attributable to the securities sold.

The Commission thinks that this additional volume limitation will allow for more trading of debt securities (including non-participatory preferred stock and asset-backed securities) than the one percent limitation had previously allowed. n338

[d] Aggregation Provisions.

As explained above, a proposed seller of restricted or control equity or debt securities will satisfy the Rule 144(e) volume limitation requirement only if the amount of the securities proposed to be sold when added to the amounts of all restricted securities or control securities sold by that seller during the three month period preceding the proposed sale do not exceed in the aggregate the maximum amount specified by paragraph (e)(2) or (e)(1), respectively. In other words, the proposed seller is required to aggregate the amount of all such securities that he sold with the amount proposed to be sold pursuant to the rule to determine whether the proposed sale will comply with the volume limitations requirement.

In addition, certain of the rule's provisions require that proposed seller to aggregate or count against the maximum amount that he may sell during the relevant three month period the amount of restricted securities or control securities sold during that period by specified other persons. Those aggregation rules, which are apparently designed to prohibit the proposed seller from circumventing the volume limitations requirement by selling through others, are contained in the Rule 144(a)(2) definition of "person" and in the provisions of paragraph (e)(3) of the rule that require aggregation of sales by persons having certain relationships with the proposed seller, which relationships generally led to the tacking of such persons' holding periods being permitted before tacking became the general rule. Finally, the staff of the Commission has implied other aggregation principles that go beyond the provisions of the rule. n339

[i] Aggregation through Definition of "Person". The Rule 144(e) volume limitation requirement is applicable to proposed sales of securities by persons who are affiliates of the issuer. For purposes of that requirement, Rule 144(a)(2) defines a person to include, in addition to the person for whose account securities are to be sold, the following:

- Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person;
- Any trust or estate in which such person or any of the persons specified in paragraph (a)(2)(i) of this section collectively own 10 percent or more of the total beneficial interest or of which any of such persons serve as trustee, executor or in any similar capacity; and
- Any corporation or other organization (other than the issuer) in which such person or any of the persons specified in paragraph (a)(2)(i) of this section are the beneficial owners collectively of 10 percent or more of any class of equity securities or ten percent or more of the equity interest. n340

In general, all sales of restricted securities or control securities made or proposed to be made by any one included in the rule's definition of a person must be aggregated for purposes of the rule's volume limitation requirement. n341

The aggregation of sales required by paragraphs (e) and (a)(2) of Rule 144 is generally a two-way street. In other words, just as a mother must aggregate with her proposed sales any includable sales within the applicable three month period by her son residing in the same home, so must the son similarly aggregate her sales with his. n342 A significant exception to that rule involves the case of a non-affiliate trust or estate that is administered by an affiliate trustee or executor. In that circumstance, the affiliate trustee or executor is required to aggregate with his sales all sales made during the relevant period by the trust or estate. n343 Although Rule 144(a)(2)(ii) would also seem to require aggregation by a person who exercises responsibilities "in any other capacity" comparable to those of a trustee, the SEC interprets such "other capacity" narrowly, based on the similarity with a trustee or executor. n344 The trust or estate, of course, would be not subject to the volume restrictions. n345 In addition, while an entity that serves as trustee or executor for several trusts and estates must aggregate all sales by all of those trusts and estates with sales for its own account, n346 the trusts and estates are not required to aggregate with each other unless they are as a result of their common administration acting in concert for purposes of paragraph (e)(3)(vi) of Rule 144. n347

[iii] Pledged Securities. Paragraph (e)(3)(ii) of Rule 144 expressly requires that a pledgee proposing to sell pledged securities, or a purchaser of pledged securities after a default, n348 must aggregate with those securities proposed to be sold the amount of all restricted securities of the same class as those pledged that were sold for the account of the pledgor during the relevant three month period. n349 Such aggregation is required of the pledgee or purchaser for a period of six months for a reporting issuer and one year for non-reporting issuers from a default in the underlying obligation. n350

Since this aggregation provision is a two-way street, a pledgor proposing to sell restricted securities or control securities under the rule is also required to aggregate any sales of such pledged securities by the pledgee (or a purchaser from the pledgee) for as long as the aggregation provision is applicable. While the pledgor and the pledgee must aggregate all of their sales (including those of persons attributable to them under Rule 144(a)(2)), paragraph (e)(3)(ii) does not require horizontal aggregation, that is aggregation by pledgees with other pledgees of the same pledgor. n351 The 2007 amendments codified this position in a note to paragraph (e)(3)(ii), which reads as follows:

Sales by a pledgee of securities pledged by a borrower will not be aggregated under paragraph (e)(3)(ii) with sales of the securities of the same issuer by other pledgees of such borrower in the absence of concerted action by such pledgees. n352

Since a pledgor can render Rule 144 unavailable to a pledgee at any time simply by selling the maximum amount of securities of the type pledged that is permitted by the volume limitation requirement, a proposed pledgee is advised to consider contractually restricting, at the time the pledge transaction is negotiated, the pledgor's right to sell any such securities of the same class as those pledged while the pledge is outstanding.

[iii] Securities Acquired as Gifts.

Paragraph (e)(3)(iii) of Rule 144 requires a donee proposing to sell donated restricted securities or control securities pursuant to Rule 144 to aggregate those securities with any sales of such securities of the same class for the account of the donor during the relevant three month period for a period of six months for a reporting issuer and one year for non-reporting issuers. n353 The rule does not distinguish between gift securities acquired from an individual and gift securities acquired from a corporation or charitable institution. n354 Again, this aggregation provision is reversible. n355 The donor, however, is required to aggregate with all of his donees, whereas the donees are not required to aggregate with other of the donor's donees for compliance with the Rule 144 volume limitation requirement. n356

[iv] Securities Acquired by Trusts. Paragraph (e)(3)(iv) of Rule 144 requires affiliate trusts and their beneficiaries proposing to sell securities acquired from the settlor of the trust to aggregate those securities with any sales of such securities of the same class during the relevant three month period by the settlor. This aggregation provision, like those applicable to pledged and donated securities, is applicable until either six months or one year has elapsed (depending on the type of issuer as noted above) following the settlor's transfer. n357 Similarly, the provision is reversible, and while the settlor must aggregate with the trust and all beneficiaries while the provision is applicable, the beneficiaries are not required to aggregate with each other. n358 Where a proposed seller of restricted securities or of control securities subject to volume restrictions is a trust or a beneficiary of a trust, it should be kept in mind that the sales of such securities of the same class by other persons may be attributable to the seller under the aggregation provision deriving from the definition of persons for the purpose of the Rule 144(e) volume limitation requirement. n359

[v] Securities Acquired by Estates. Paragraph(e)(3)(v) of Rule 144 permits an estate to sell restricted securities that it acquired as a result solely of the decedent's death n360 without regard to the rule's volume limitation requirement, provided that the estate is not an affiliate of the issuer n361 even if one or more of the beneficiaries of the estate are such affiliates. n362 In addition, Rule 144(e)(3)(v) exempts non-affiliate beneficiaries proposing to sell such securities from the volume limitation requirement. n363 Therefore, an estate that is an affiliate of the issuer of the securities proposed to be sold is required to aggregate with the amount of the restricted securities received from the deceased the amount of any securities sold by the deceased during the three month period preceding the proposed sale.

Similarly, an affiliate beneficiary is required to aggregate with his proposed sale of such securities any sales of such securities of the same class by the estate or the deceased during the measuring period. Once again, even where the rule's aggregation provision is applicable to the estate or certain of the beneficiaries, horizontal aggregation is not required for compliance with the Rule 144(e) volume limitation requirement. n364 Finally, as with a trust, the executor of an estate or a beneficiary with a ten percent or more interest in that estate and his counsel should not overlook the possibility that aggregation may be required as a result of the Rule 144(a)(2) definition of the term "person" for purposes of the volume limitations requirement. n365

[vi] Securities Sold by Persons Acting in Concert. The last of Rule 144's express aggregation provisions neither derives from the rule's definition of a person nor relates to the Rule 144(d) tacking provisions. Apparently included as a catch-all provision to be used if necessary to deter attempts to circumvent the rule's volume limitation requirement, paragraph (e)(3)(vi) of Rule 144 simply requires that affiliate holders of restricted or control securities who agree to "act in concert for the purpose of selling securities of an issuer" must aggregate their sales during the relevant three month period to determine whether the Rule 144(e) volume limitation requirement has been met. n366

In general, simultaneous sales even by affiliates fall short of constituting acting in concert. n367 The critical requirement is that the proposed sellers have reached some agreement, written or oral, about selling their shares. In other words, aggregation is required whenever there are concerted activities by any persons as to resales of securities covered by Rule 144. Often, but not always, an agreement by persons who receive the securities in the same transaction to limit their resales will necessitate aggregation of their sales. n368

The determination of whether parties are acting in concert for the purpose of selling securities is determined on a case-by-case basis and depends upon the particular facts and circumstances involved, including the relationships among the parties. n369

Although the staff will frequently provide an interpretive letter, its view is generally that whether the activities of particular persons constitute "acting in concert" within the meaning of Rule 144(e)(3)(vi) is a factual matter best decided by the issuer, the proposed sellers and their counsel. n370

[vii] Securities Acquired in Divorce Settlements. Following a divorce, former spouses are no longer a single "person" for purposes of the Rule 144 aggregation provisions. n371 However, a spouse who receives restricted securities from the transferor spouse as part of a divorce settlement agreement was normally permitted to tack to his holding period the holding period of the transferor spouse for the purpose of satisfying the old Rule 144(d) (prior to the 1990 amendments) under which holding periods generally ran from the last sale of restricted securities, not from the last sale by the issuer or an affiliate. n372 That tacking benefit raises the question of whether there should be a corresponding aggregation rule applied to the sales of former spouses either on the theory that their sales constitute acting in concert or otherwise. The staff's current position is that sales by the transferee spouse of restricted securities received pursuant to a divorce settlement need not be aggregated with any other sales of restricted securities of the same class by the transferor spouse, provided the former spouses maintain independent homes and are not otherwise acting in concert. n373

[viii] Securities Acquired from Closely Related Persons. A person who acquired restricted securities in a private transaction from another person so closely related to the transferee that there was in fact no shift in the economic risk of the investment was generally permitted to tack to his or her holding period the holding period of the transferor closely related person for purposes of Rule 144(d) prior to the 1990 amendments as explained above. n374 Typically, the transferee is a corporation under the control of the transferor. n375 Just as the closely related entities were regarded as the same person (no change in beneficial ownership) under the Rule 144 holding period requirement, they should be and are still required to aggregate their sales of restricted securities or indeed control securities of the same class for purposes of the rule's volume limitations requirement. In virtually all cases, aggregation results because the closely related parties are considered the same person as defined by the rule. n376 Nevertheless, aggregation has on occasion been required on the ground that the securities were donated to the controlled corporation n377 and could, of course, also be required under the rule's acting in concert aggregation provision. n378

[ix] Securities Acquired in Spin-offs or Liquidating Distributions. Where restricted securities are received by the partners or the shareholders of a distributing partnership or corporation in a spin-off or liquidating distribution, the distributees could normally tack to their holding periods the holding period of the distributing entity for purpose of Rule 144(d) prior to the 1990 amendments, as explained above. n379 Predictably, the Commission takes the position that where partners who receive restricted securities in such a transaction from the partnership utilize that implied tacking benefit, then all of the partners must aggregate their sales of such securities for the purpose of the rule's volume limitations until two years (presumably now six months or one year, depending on the type of issuer) have elapsed since the distribution or the unlimited resale provision is available, whichever is earlier. n380

Where the distributing entity is a partnership, this horizontal aggregation requirement appears applicable regardless of the number of partner distributees. n381 Where the distributing entity is a corporation, however, the shareholders receiving restricted securities are subject to this horizontal aggregation requirement for up to six months or one year, depending on the type of issuer, only if the distributing corporation is or was closely held. n382 If the distributing corporation is or was other than closely held, then the distributee shareholders are required to aggregate with each other only if they are as a matter of fact facing in concert. n383

Presumably, the dichotomy between the case of a distributing partnership and that of a distributing corporation results

only from the fact that most, if not all, of the partnership cases have involved closely held partnerships. To impose this rule on widely held corporations or indeed widely held partnerships would be both unreasonable and unworkable. Whenever the number of distributees is substantial, horizontal aggregation can be logically justified only where the distributees are in fact, or can be rebuttably presumed to be, acting in concert. In light of the uncertainty of the applicability of this implied aggregation provision, however, partners or shareholders proposing to rely on Rule 144 for the sale of restricted securities distributed by a partnership or corporation, as the case may be, are advised to comply with this horizontal aggregation rule for purpose of complying with the volume limitation requirement in the absence of a favorable interpretative letter from the staff.

[e] Exemptions from Provisions of Rule 144(e). As previously stated, since the 2007 amendments, the volume limitations requirement need not be complied with by a non-affiliate holder of restricted securities. n384 In addition, non-affiliate estates and non-affiliate beneficiaries of those estates who receive restricted securities as a result solely of the death of the decedent are completely exempt from the Rule 144(e) volume limitations requirement with respect to those securities. n385

[6] Manner of Sale Requirement--Rule 144(f)

The 2007 amendments to Rule 144 modified paragraphs (f) and (g), which were the *first amendments* to the manner of sale requirements since 1978. n386 The Commission stated that it had come to believe that it was time to alter the manner of sale requirements so that they could better reflect the present market. n387

Paragraphs (f) and (g) of Rule 144 detail the role of the broker in transactions effected in accordance with Rule 144. Specifically, paragraph (f) details the way in which securities must be sold while paragraph (g) sets forth transactions that are included within the definition of brokers transactions n388 for the purposes of Rule 144. The 2007 amendments amended paragraph (f) to permit sales in riskless principal transactions n389 and added a new subparagraph to paragraph (g) covering the posting of bid and ask quotations in alternative trading systems that will also be deemed not to be a solicitation. n390 Further, due to the 2007 amendments, the manner of sale requirements are now only applicable to sales by affiliates of equity securities. n391

After a proposed affiliate seller of restricted or control equity securities determines that the Rule 144 adequate current public information and volume limitations requirements and, if the securities proposed to be sold are restricted securities, the holding period requirement can be satisfied, then the proposed seller must arrange for the securities to be sold consistent with the rule's manner of sale requirement. The manner of sale requirement will be satisfied only if the securities are sold in brokers' transactions, in transactions directly with a market maker or in riskless principal transactions. n392 In all three of the preceding circumstances, the seller is precluded from soliciting or arranging for the solicitation of orders to buy the securities proposed to be sold and from making any payments respecting the proposed sale to anyone other than the broker executing the order to sell the securities. n393

[a] Basis for Conditions of Rule 144(f). At the time of the adoption of Rule 144, routine trading transactions were exempted from the Securities Act's registration provisions by Section 4(1) and 4(4). The seller relied upon Sections 4(1), n394 and the participating broker relied on Section 4(4), which exempts "brokers' transactions executed upon customer's orders ... but not the solicitation of such orders." n395 By 1972, transactions that qualified as "brokers' transactions" as that term had been interpreted were viewed as too limited to be considered distributions. n396 The Commission simply embodied that notion in Rule 144 by excluding from the term "distribution" only those sales that qualified as brokers' transactions. In 1978, after the Commission was apparently convinced that some relaxation of the rule's manner of sale requirement would be possible without abuse, it amended the rule to permit transactions directly with a market maker to also satisfy the Rule 144(f) requirement. n397 In 2007 as previously discussed, the Commission added riskless principal transactions as an additional method of satisfying the Rule 144(f) requirements. n398

[b] Brokers' Transactions. The Rule 144(f) manner of sale requirement is satisfied if the proposed sale is made through brokers' transactions within the meaning of Section 4(4) of the Securities Act. The only issue, therefore, is the

scope of the term "brokers' transactions." Essentially, brokers' transactions are routine trading transactions in an established market rather than transfers that would serve to create, expand, disrupt or even significantly influence the market in the securities being sold. n399 The first requirement, therefore, for brokers' transactions is simply that there be an existing market that can be used by the broker to effect the sale.

A second requirement is that the transaction must be executed by a "broker," defined by Section 3(a)(4) of the Exchange Act as a person engaged in the business of effecting transactions in securities for the account of others. n400 Accordingly, a transaction executed by a bank trust department for its own account is not a brokers' transaction. n401 Neither is a transaction by a dealer n402 or any other person in the securities business that is not functioning in the transaction solely as an agent for a customer. n403 However, where the broker itself is not a market maker for the securities to be sold, it may execute the customer order with a market maker affiliated with the broker, and such transaction would still be treated as a brokers' transaction. n404 In addition, use of a foreign broker may well disqualify the transaction unless such broker either directly or through an affiliated entity, is registered with the Commission under the Exchange Act. n405

Where a proposed seller of securities under Rule 144 has engaged a qualified broker to sell those securities as his agent in the existing market, the sale or sales will constitute brokers' transactions, provided the broker limits its activities to those permitted by Rule 144(g), namely:

- it does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold; n406
- it receives no more than the usual and customary broker's commission n407, though it may act for both the seller and the buyer and receive the amount from each of those customers; n408
- Neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction. n409

Despite these prohibitions, the broker is nevertheless permitted to contact other brokers or dealers who have indicated an interest in the securities to be sold within the preceding sixty days n410 and the broker's customers who have indicated an unsolicited *bona fide* interest in those securities during the preceding ten business days. n411 Persons who have indicated such an interest in the securities proposed to be sold are customers for purpose of Rule 144(g) even if they have not previously effected transactions with the specific broker now selling the securities under the rule. n412 In addition, the broker will not be regarded as soliciting buy orders if it continues to issue its regular research reports containing information about the issuer of the securities proposed to be sold n413 or if it continues to make a two-way market in these securities, provided it had been doing so to the extent of publishing *bona fide* quotations in an inter-dealer quotation system on at least twelve of the preceding thirty days with no hiatus of more than four consecutive business days and such publication is incident to the maintenance of a *bona fide* inter-dealer market for the securities n414 or, as added by the 2007 amendments, the publication by the broker of bid and ask quotations for the security in an alternative trading system, provided that the broker has published bona fide bid and ask quotations for the security in the alternative trading system on each of the last twelve business days. n415 Previously, prior to the 2007 amendments, if a broker structures a riskless transaction such as a series of installment sales, on behalf of the seller, to customers who have expressed an interest in such securities then it could not be regarded as a solicitation. n416 The 2007 amendments added new paragraph (f)(1)(iii) to allow for the sale of securities through riskless principal transactions where trades are executed at the same price (without any commission equivalent, fees of any kind, markdown or markup), as the Commission believes riskless principal transactions to be the equivalent of agency trades. n417 The broker or dealer effecting the agency trade must meet all of the requirements of paragraph (g), except for paragraph (g)(1), as with agency trades. n418

The fourth brokers' transactions requirement, contained in paragraph (g)(4) of Rule 144, is that the selling broker must

make a reasonable inquiry respecting, and be unaware thereafter of, any circumstances indicating that the proposed seller is an underwriter or that the proposed sale is part of a distribution. n419 A reasonable inquiry must include ascertaining at least the following information:

- the length of time the securities have been held by the person for whose account they are to be sold, and if practicable, the inquiry should include physical inspection of the securities;
- the nature of the transaction in which the securities were acquired by the proposed seller;
- the amount of securities of the same class sold during the past three months by all persons whose sales are required to be aggregated;
- whether the proposed seller intends to sell additional securities of the same class through any other means;
- whether the proposed seller has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;
- whether the proposed seller has made any payment to any other person in connection with the proposed sale of the securities; and
- the number of shares or other units of the class outstanding or the relevant trading volume. n420

In addition, the broker is, of course, deemed to be aware of all the information contained in Form 144, n421 and in the report or other statement from the issuer respecting the adequate current public information requirement.

[c] Transactions with a Market Maker. As mentioned above, an alternative method by which a proposed seller of restricted securities or of control securities may presently comply with the Rule 144(f) manner of sale requirement is to sell those securities directly to a market maker. n422 Often the choice between this alternative, the brokers' transactions alternative, and the riskless principal alternative is irrelevant to the seller and becomes that of the broker that is involved. If the broker qualifies as a market maker, it may either limit its sale to that of an agent and proceed to comply with all of the rule's requirements applicable to brokers' transactions n423 or purchase the securities itself in compliance with all of the Rule 144(f) requirements applicable to a market maker, or sell the securities in a riskless principal transaction as permitted by the 2007 amendments. n424, n425

A broker qualifies as a market maker for purposes of Rule 144(f) only if it falls within one of the following three classes of persons specified in Section 3(a)(38) of the Exchange Act: n426

- any specialist that is permitted to act as a dealer;
- any dealer acting as a block positioner; and
- any dealer that holds itself out as willing to buy and sell a particular security on a regular and continuous basis. n427

Only in the case of a sale of securities directly to a specialist is the transaction clearly with a market maker within the meaning of Rule 144(f).

Since the term "block positioner" is not defined in the Exchange Act, it is not always obvious that a dealer is functioning as such and that its Rule 144 purchases will constitute qualifying transactions under Rule 144(f). In general,

the Commission's view is that a dealer who qualifies as a block positioner for purposes of Exchange Act Rules 17a-17(b)(1) and (3) n428 will also be a block positioner for Rule 144 purposes, provided that:

- the Rule 144 transaction involves securities with the same type of trading characteristics as those the block positioner generally holds itself out as being ready and able to purchase; n429 and
- the amount of securities to be purchased by the block positioner from the Rule 144 seller constitutes a "block." n430

While the term "block" is also not defined in the Exchange Act, the Commission has indicated in the past that a block transaction is a transaction in which the dealer, by reason of the size of the order in relation to the conditions in the exchange market, reasonably concludes that it is in the customer's best interests to search and negotiate for a matching interest on the other side of the market rather than to attempt to execute the order in the ordinary course of the auction market. n431

Where a proposed seller desires to satisfy the Rule 144(f) manner of sale requirement by selling to a dealer that falls within the third category of qualifying market makers, the seller must confirm that the dealer is not a so-called "instant" market maker. In other words, a dealer cannot become a market maker through the Rule 144 transaction itself. n432 Rather, the dealer qualifies only if it has previously held itself out, and is currently holding itself out, as being willing to buy and sell the security being offered in the Rule 144 transaction. n433 Rule 144(g)(3)(iii) provides an objective guideline for whether a dealer is in fact a bona fide market maker for purposes of the rule, n434 a fact that the proposed seller should ascertain and document in his files. n435

Similar to a broker executing brokers' transactions for purposes of Rule 144(f), a market maker is also precluded from soliciting buy orders for the securities it intends to purchase in the Rule 144 transaction. n436 The normal activities of a market maker, however, will not constitute such an impermissible solicitation, provided they are not altered as part of a special campaign to generate interest in the securities that the market maker anticipates purchasing. n437 Once the Rule 144 transaction is completed, the securities are unrestricted in the hands of the market maker and maybe treated by the market maker as any other tradeable securities. n438 In other words, the market maker, unless it is an affiliate of the issuer, may solicit buy orders for the securities that it purchased in a Rule 144 transaction after its purchase from the holder is completed. n439

The rule against prior solicitations of buy orders for the securities that the market maker expects to purchase, however, has been somewhat relaxed for block positioners. Normally, a block positioner will attempt to cover its block by soliciting buy orders before it commits itself to purchase that block. It cannot do so in a Rule 144 transaction. If the securities to be purchased by the block positioner are listed or admitted to unlisted trading privileges on an exchange that has restrictions on the off-board trading of its members and the block positioner is a member of that exchange, the block positioner must execute the block on the exchange, causing a delay from the time the deal is made with the seller until its execution on an exchange. During that period the block positioner may solicit the buy side of the block as if the purchase were completed. n440

If a market maker purchases in a Rule 144 transaction an amount of securities in excess of the maximum amount permitted by Rule 144(f) prior to the 1978 amendments, n441 the market maker should consider whether the resale of those securities would constitute a distribution for purposes of Regulation M (which replaced Rule 10b-6) under the Exchange Act. n442 If so, then Regulation M may affect the market maker's purchase of any of the class of securities that are the subject of the distribution until the distribution is completed. n443 In determining whether the resales of securities purchased under Rule 144 will be viewed as a Regulation M distribution, the market maker should consider:

- the magnitude of the offering;

- the selling efforts required; and
- the selling methods to be used. n444

As to the magnitude of the offering, the market maker must aggregate with those Rule 144 securities to be resold all securities of the same class being offered by that market maker, including those not purchased by him in a Rule 144 transaction. n445 In light of the substantial uncertainty surrounding this determination, market makers should proceed cautiously with the resale of large amounts of securities purchased in Rule 144 transactions.

[d] Exemptions from Provisions of Rule 144(f).

As previously mentioned, a non-affiliate seller of debt securities need not comply with the manner of sale requirement. In addition, non-affiliate estates and non-affiliate beneficiaries of those estates who receive restricted securities solely as a result of the death of the decedent are completely exempt from the Rule 144(f) manner of sale requirement for those securities. n446

[7] Notice of Proposed Sale Requirement--Rule 144(h)

The final requirement that must be satisfied before a sale of restricted or control securities by an affiliate (since the 2007 amendments, Rule 144(h) no longer applies to sales by non-affiliates) may be made under Rule 144 is that three copies of a notice on Form 144 be filed with the Commission and one copy with the principal exchange, if any, on which the securities proposed to be sold are admitted to trading. n447 The notice must be placed in the mailer or otherwise transmitted not later than either the placing of the sell order with a broker or the execution of the Rule 144 sale with a market maker. n448 As specified by the form, certain information about the issuer, the securities to be sold, and the seller's other sales (including the sales of other persons required to be aggregated) of those securities during the three month period preceding the date of filing must be included. n449 The Form 144 must be signed by the person for whose account the securities are to be sold. n450 Finally, the proposed seller must have, at the time of filing, a *bona fide* intention of actually selling the securities referred to in the Form 144 within a reasonable time after the filing. n451 Any amendments to Form 144, whether to change the selling broker, n452 to increase the amount of securities to be sold in light of an increased trading volume n453 or for any other reasons, n454 are subject to the same requirements as the original notice. n455 The Commission also solicited comments in the 2007 Proposing Release as to whether the Form 144 and Form 4 filing requirements should be coordinated, in response to which they received many supporting comments. n456 However, while the Commission declined to adopt the changes in the 2007 amendments, the Commission did say that they expect to issue a separate release to address the coordination of these two filings in the future. n457 The 2007 amendments amended paragraph (h) to modify the filing thresholds for the first time since 1972. n458 The Commission raised the filing thresholds to \$50,000 (to adjust for inflation since 1972) and 5,000 shares as the Commission believes this to be a suitable threshold for trades that do not reach the \$50,000 threshold but nevertheless are worth notice to the market. n459 A proposed seller need not consider the sales of persons with whom he may be required to aggregate for purposes of the Rule 144 volume limitation requirement in determining whether a Form 144 must be filed, unless he is acting in concert with another such person. n460

Form 144 requires that a seller represent that as of the date that the Form 144 is signed that the seller "does not know any material adverse information in regards to the current and prospective operations of the issuer of the securities to be sold which has not been publicly disclosed." n461 This representation presents a problem when it comes to a seller that is selling the shares pursuant to a Rule 10b5-1 trading plan. The Commission had previously indicated that a seller with an effective 10b5-1 selling plan in place can modify the Form 144 representation indicating that as of the date on which the plan was adopted or the trading instructions were given, the seller had no knowledge of material adverse information pertaining to the issuer. n462 The Commission adopted this position in the 2007 amendments.

[8] Unavailability to Securities of Issuers with No or Nominal Operations and No or Nominal Non-Cash

Assets

The 2007 amendments replaced previous paragraph (i), n463 with language regarding the treatment of securities issued by reporting or non-reporting shell companies, n464 codifying a previous interpretation by the Commission. n465 Under new paragraph (i), Rule 144 is not available for resales of the securities of reporting and non-reporting shell companies, or for resales of the securities of blank check companies, n466 other than business combination related shell companies and asset-backed issuers. However, Rule 144 is available for sales of securities of a former shell company, provided that the shell company has been subject to the reporting requirements of Section 13 or Section 15(d) of the Exchange Act during the preceding 12 months (or a shorter period that it was subject to the reporting requirements) and at least one year n467 has passed since the former shell company issuer filed the information known as "Form 10" information with the Commission demonstrating that it is no longer a shell company. n468 The Commission further noted that Form 10 information is deemed to have been filed when the initial filing is made with the Commission, rather than when the Commission's review is complete or the amended Form 10 is filed in response to comments from the Commission. n469

[9] Procedures for Sales under Rule 144

Although the promulgation of Rule 144 was intended in part to facilitate the sale of restricted securities and of control securities by basing the availability of the resale exemption on more objective standards, n470 it was initially avoided rather than embraced by prospective sellers because of the often cumbersome and nonuniform selling procedures imposed upon them by fearful issuers and brokers. As a result, delays in effecting the sales were common and the costs to the sellers sometimes prohibitive. n471 Despite numerous requests for guidance from the staff for acceptable procedures and documentation that would ensure compliance with the rule's requirements, the staff has consistently taken the position that these matters are the responsibilities of the parties involved. n472 After over two decades of working with sales pursuant to Rule 144, however, both brokers and issuers have gained considerable experience and are generally able to effect most Rule 144 sales with a minimum of expense and inconvenience for all concerned parties.

[a] Responsibilities of Sellers.

Rule 144 places the responsibility for complying with all of the rule's applicable requirements on the proposed seller of securities pursuant to the rule. The seller is presumably the person most familiar with the facts relating to his purchase and ownership of the securities proposed to be sold and to his affiliate or non-affiliate status under the rule. The seller is, however, often not qualified to ascertain whether the rule is available and to satisfy each of the rule's sometimes rather technical requirements, as well as to satisfy the issuer's conditions for the transfer of the securities proposed to be sold n473 and the broker's requirements for effecting the transaction in compliance with Rule 144(f). n474 Formerly, the seller was virtually required to rely on counsel to shepherd the transaction through all of the procedures required by the rule, by the broker, by the issuer, and by the transfer agent. n475 While a proposed seller may still wish to consult counsel, especially for an atypical transaction or at the point where a stumbling block is encountered, normally an experienced broker will be able to effect the transaction with an experienced and cooperative issuer.

[b] Responsibilities of Sellers' Brokers.

In the absence of counsel for the seller, the broker will assume the primary responsibility for effecting the proposed sale of restricted securities or of control securities pursuant to Rule 144. Assuming it is willing and able to participate, the broker will cause the proposed seller to complete its standard form cover representation letter designed to indicate:

- the nature of the seller's relationship, if any, with the issuer;
- the restricted character of the securities;

- the period since the shares were last held by the issuer of any affiliate of the issuer (giving effect to any applicable tacking provisions where these are necessary); and
- any sales of securities of the same class during the preceding three months by the seller (after giving effect to any aggregation provisions and excluding any securities not required to be included in the calculation). n476

If the representation letter demonstrates that the securities may be sold free of all of the rule's requirements, (i.e., non-affiliate selling shares after holding the shares for a period of one year), the broker should contact the issuer to ensure that the issuer, upon receipt of the seller's representation letter, will instruct the transfer agent to process the transfer after the sale has been made and the duly executed certificates have been delivered. Since the purchasers will demand unlegended certificates, n477 the broker should not actually effect the sale until the issuer either delivers clean certificates or agrees to issue them to the purchaser promptly following completion of the transaction.

If the results of the seller's representation letter to the broker indicate that Rule 144 is available for the proposed sale, the broker will make any further investigation it feels appropriate to satisfy its Rule 144(g) responsibility to make reasonable inquiry as to whether the proposed sale will involve a distribution. n478 Where the rule appears available for the proposed sale, the broker should next contact the issuer to ascertain whether the issuer is current in its Exchange Act filings n479 and to obtain the factual information necessary to assist the seller to complete and file Form 144. n480 At that time, the broker should also verify exactly what documentation the issuer will require to instruct its transfer agent to process the transfer and deliver clean certificates to the purchaser.

Normally, the issuer will require the following documentation:

- a completed and executed copy of Form 144 and representation that copies were timely filed with the Commission and any required exchange;
- an executed copy of the seller's representation letter to the broker;
- a letter from the broker representing that the sale was completed either through a brokers' transaction in transactions directly with a market maker or in a riskless principal transaction, in each case in compliance with Rule 144(f); n481 and
- duly executed certificates representing the securities to be transferred to the purchaser.

The broker should confirm that no opinion of seller's counsel will be required and that upon delivery of the required documentation, the transfer agent will be instructed to complete the transfer and deliver clean certificates promptly to the purchasers.

Finally, the broker will request a letter from the proposed seller to effect that he or she has made no attempts to solicit buy orders in violation of Rule 144(f). After having done all of the above, the broker will:

- file Form 144 as required for the seller;
- either execute the sell order or itself purchase the securities from the seller; and
- deliver the required documents to the issuer or its transfer agent for processing and delivery of the securities to the Rule 144 purchaser of purchasers.

[c] Responsibilities of Issuers. When an issuer sells securities pursuant to one of the private offering exemptions from registration under the Securities Act, it is required to take steps to prevent the public resale of those securities including;

- obtaining investment representations from the purchaser;
- legending the certificates; and
- issuing stop transfer instructions to the issuer's transfer agent. n482

Although the obligations are more explicit in the case of restricted securities, issuers are also concerned about aiding and abetting the unlawful resale of unrestricted securities by their affiliates. n483 Accordingly, in both cases the issuers of restricted securities and control securities shoulder the burden of policing resales of their securities made pursuant to Rule 144. Generally, the form of that policing is that counsel for the issuer will:

- set the requirements for documentation required from the seller and his broker;
- review all of the documentation; and
- issue instructions (usually in the form of an opinion letter) to the issuer's transfer agent to proceed with the transfer and issuance of clean certificates to the Rule 144 purchaser of purchasers.

Of course, if the availability of the rule is not clear, the issuer (and its counsel) may refuse to effect the transfer in the absence of either a favorable interpretive letter from the staff of the Commission or a favorable opinion letter from counsel of substantial reputation for the seller.

[d] Responsibilities of Transfer Agents. Although the Exchange Act regulates transfer agents, n484 a transfer agent is essentially just that, a person performing a ministerial function pursuant to the issuer instructions. Except in the egregious case of an issuer participating in an unlawful distribution under the federal securities laws, a seller of securities under Rule 144 and his broker (and counsel, if any) should be unconcerned about the issuer's transfer agent, provided that the issuer instructs or agrees to instruct the transfer agent to effect the Rule 144 transfer and deliver the certificates in unrestricted form to the purchasers.

[10] Effects of Compliance with Rule 144

Rule 144 offers a safe harbor for the public resale of restricted securities and control securities under the resale exemption from registration contained in Section 4(1) of the Securities Act. Accordingly, if all of the applicable requirements of the rule are complied with by the seller and broker, the transaction is exempt from the registration and prospectus delivery requirements of Securities Act. In other words, a Rule 144 seller is not in violation of Section 5 of the Securities Act, the issuer is not in danger of losing a private offering exemption, n485 the broker is not in violation of the Securities Act and the purchaser receives freely tradeable securities under the Securities Act, n486 unless of course, the purchaser is an affiliate of the issuer of those securities.

FOOTNOTES:

(n1)Footnote 1. On November 29, 1967, because of the increasing number of privately offered securities and the growing uncertainty regarding the resale of both "letter" securities and control securities under the prevailing subjective standards used to determine whether the transaction involved a statutory underwriter and was therefore outside the resale exemption, the Commission created a study group to consider the situation. In March of 1969, that group headed by Commissioner Francis M. Wheat, published its findings and recommendations in what came to be called "the Wheat Report," SEC, Disclosures to Investors--A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts (the Wheat Report) (March 27, 1969).

In essence the Wheat Report called for a completely new set of rules for the resale of both restricted securities and control securities to provide greater certainty and to better effect the continuous disclosure purposes of the Act and the Exchange Act of 1934. *Id.* at 155. The securities bar generally agreed, calling upon the Commission to provide "greater certainty, predictability and consistency in applying and interpreting the 1933 Act." Carl W. Schneider and Robert S. Kant, *Uncertainty Under the Securities Acts*, 26 *Bus. Law* 1623, 1623 (1971). Accordingly, the Commission proposed and considered a number of rules to cover resales of restricted securities and resales by affiliates prior to arriving at the form of Rule 144 finally adopted.

For a more detailed discussion of the origins of Rule 144, see Dan Goldwasser, A Guide to Rule 144, 47-64 (2d ed. 1978). 1933 Act Rule 144 is reprinted in the Securities Primary Law Sourcebook, Volume A, Part C (Matthew Bender 2008).

(n2)Footnote 2. Sec. Act Rel. No. 5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,487 (Jan. 11, 1972).

(n3)Footnote 3. The purpose of the Commission in adopting the rule was clearly not to facilitate the sale of larger amounts of restricted securities, an effect perhaps desired by numerous securities law practitioners. See *Background and Purpose*, Sec. Act Rel. No. 5223, *supra* n.2; PLI, *The SEC Speaks* 111 (1972) (comments of Alan B. Levenson, then Director of the Division of Corporation Finance of the Commission).

(n4)Footnote 4. Rule 144(b).

(n5)Footnote 5. Rule 144(a)(3). The 2007 amendments discussed herein added a new subparagraph (viii) to Rule 144(a)(3), which states that securities acquired in a transaction subject to exemption under Section 4(6) of the Securities Act are now part of the definition of restricted securities. Section 4(6) provides for an exemption from registration for an offering that does not exceed \$5,000,000 that is made only to accredited investors, that does not involve any advertising or public solicitation by the issuer or anyone acting on the issuer's behalf and for which a Form D has been filed. See 15 U.S.C. 77d(6). Section 4(6) is discussed in § 4.06 *supra*.

(n6)Footnote 6. *Id.*; Rule 144(a)(1).

(n7)Footnote 7. See § 4.02 *supra*.

(n8)Footnote 8. The term "investor" will be used throughout this chapter to refer to a holder of outstanding securities who is not a dealer within the meaning of Section 2(12).

(n9)Footnote 9. If Section 4(1) is available to the selling investor because he is not an underwriter or an affiliate of the issuer, then the broker may normally rely on the brokers' transactions exemption contained in Section 4(4) or the dealer's exemption contained in Section 4(3). See § 4.03 *supra*. The Securities Act of 1933 is reprinted in the Securities Primary Law Sourcebook, Volume A, Part B (Matthew Bender 2008).

For a definition of the term "brokers' transactions," see Rule 144(g) and § 6.05[6][b] *infra*. Although the broker is a

dealer as that term is defined by Section 2(12), discussed in § 9.04 *infra*, that fact does not render the resale exemption unavailable to the selling investor despite the language of Section 4(1). David S. Ruder, *Federal Restrictions on the Sale of Securities*, 67 Nw. U. L. Rev. 1, 36 (Supp. 1972).

(n10)Footnote 10. See § 6.02[1] *supra*.

(n11)Footnote 11. See Section 2(11), discussed in § 4.02[2] *supra*, and analysis contained in § 6.04[3] *supra* .

(n12)Footnote 12. Stephen R. Volk & Carl W. Schneider, *The Sale of Restricted Securities Outside of Rule 144*, 8 Inst. Sec. Reg. 135-48 (1977).

(n13)Footnote 13. Sec. Act Rel. No. 33-5223, n.2 *supra* at 80,629.

See Martin Lipton, *Rule 144 Updated*, N.Y. Law Journal, October 11, 1972, at 6, col.6, in which a highly respected securities lawyer indicated that a holding period of approximately five years would be necessary for resales of restricted securities under Section 4(1) outside Rule 144 (the Rule 144 holding period at that time was three years).

See, e.g., Vicon Fiber Optics Corp., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2961 (October 25, 1982), an interpretive letter in which the staff refused to allow the resale of restricted securities held for ten years by a non-affiliate of the issuer.

(n14)Footnote 14. See analysis contained in § 6.02[3] *supra* .

(n15)Footnote 15. See generally §§ 6.07 and 6.08 *infra* .

(n16)Footnote 16. Rule 144(b).

(n17)Footnote 17. This text describes Rule 144 as it exists after the 2007 amendments. See § 6.05[1][d] *infra*.

(n18)Footnote 18. For discussion of the holding period requirement of Rule 144(d), see § 6.05[4] *infra*.

(n19)Footnote 19. *Id.*

(n20)Footnote 20. For discussion of the adequate current public information requirement of Rule 144 (c), see § 6.05[3] *infra*.

(n21)Footnote 21. For discussion of the volume limitation requirement of Rule 144(e), see § 6.05[5] *infra*.

(n22)Footnote 22. For discussion of the manner of sale requirement of Rule 144(f), see § 6.05[6] *infra*.

(n23)Footnote 23. For discussion of the notice of proposed sale requirement of Rule 144(h), see § 6.05[7] *infra*.

(n24)Footnote 24. *Id.*

(n25)Footnote 25. For discussion of the holding period requirement of Rule 144(d), see § 6.05[4] *infra*.

(n26)Footnote 26. *Id.*

(n27)Footnote 27. For discussion of the adequate current public information requirement of Rule 144 (c), see § 6.05[3] *infra*.

(n28)Footnote 28. For discussion of the manner of sale requirement of Rule 144(f), see § 6.05[6] *infra*.

(n29)Footnote 29. For discussion of the volume limitation requirement of Rule 144(e), see § 6.05[5] *infra*.

(n30)Footnote 30. Rule 144(d).

(n31)Footnote 31. See Section 2(11), discussed in § 4.02[2] *supra*, and § 6.02[1] *supra* .

(n32)Footnote 32. Sec. Act Rel. No. 6488, *supra* n.24. Section 4(1), and its availability (or non-availability) for restricted and control securities, is discussed in § 4.02 *supra*.

(n33)Footnote 33. Sec. Act Rel. No. 5223, *supra* n.2.

(n34)Footnote 34. See Richard B. Smith, *Fungibility, Tacking, and Registration Covenants*. 3 Inst. Sec. Reg. 55, 75 (1972) (comments of Commissioner Philip A. Loomis, Jr.).

(n35)Footnote 35. *Id.* See also PLI, *The SEC Speaks*, n.3 *supra* at 111 (comments of Alan B. Levenson, then Director of the Commission's Division of Corporation Finance).

(n36)Footnote 36. Sec. Act Rel. No. 5223, *supra* n.2

(n37)Footnote 37. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n38)Footnote 38. *Id.*

(n39)Footnote 39. See, e.g., Wright Air Lines, Inc.; SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3393 (June 23, 1980).

(n40)Footnote 40. Sec. Act Rel. No. 5223, *supra* n.2.

(n41)Footnote 41. WCS International, SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2028 (January 12, 1979), in which the staff agreed that the safe harbor of the rule was available despite the possible adverse impact on the trading market.

(n42)Footnote 42. Sec. Act Rel. No. 6099, 1 Fed. Sec. L. Rep. (CCH) P 2705H, Section I, Question 2 (August 2, 1979).

See also Buck-Man Electronics, Inc., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3170 (March 4, 1981).

(n43)Footnote 43. The Lehigh Press, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2667 (August 5, 1983); Victor Kellering, Inc., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3939 (August 27, 1981).

(n44)Footnote 44. Sec. Act Rel. No. 5223, *supra* n.2.

(n45)Footnote 45. *Id.*

(n46)Footnote 46. Rule 144 interpretive letters are available on Lexis and Westlaw.

(n47)Footnote 47. One aspect of Rule 144 on which the staff will normally not comment is the affiliate or control status of a proposed seller because that determination involves a question of fact which it believes it is not in a position to resolve. Sec. Act Rel. No. 6253, P21 SEC Docket 320 (October 28, 1980). In addition, the staff will not provide advice respecting the removal of restrictive legends or the availability of Section 4(1) outside Rule 144 for the sale of restricted securities except for those securities acquired prior to April 15, 1972. *Id.*

(n48)Footnote 48. Rule 144(j). Although paragraph (j) was added by an amendment to Rule 144 that became effective on March 12, 1979, see Sec. Act Rel. No. 6032, [Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,992 (March 5, 1979), it did not change, but only clarified, the position of the Commission at the time of the rule's adoption. Sec. Act

Rel. No. 5223, *supra* n.2.

(n49)Footnote 49. *See* §§ 6.07 and 6.08 *infra* .

(n50)Footnote 50. *See* § 6.06[2] *infra*.

(n51)Footnote 51. *See* PLI, *The SEC Speaks*, n.3 *supra* at 114 (comments of Neal S. McCoy, then Chief Counsel of the Commission's Division of Corporation Finance, regarding the exclusive nature of Rule 144 for public sales by affiliate). In that regard, Rule 144 continued the Commission's policy as to resales by affiliates that was formerly reflected in Rule 154. Rule 154 was rescinded effective April 15, 1972.

(n52)Footnote 52. Rule 144(j).

(n53)Footnote 53. Sec. Act Rel. No. 5223, *supra* n.2.

(n54)Footnote 54. *Id. But see G. Eugene England Foundation v. First Federal Corp.*, 663 F.2d 988 (10th Cir. 1973) , in which the court endorsed the change of circumstances doctrine.

(n55)Footnote 55. Sec. Act Rel. No. 5223, *supra* n.2.

At present, however, there is no doubt that a specified holding period in itself establishes the availability of the Section 4(1) exemption both outside and pursuant to Rule 144. *See* discussion of the introduction of Rule 144(k) in § 6.05[1][d] *supra* .

(n56)Footnote 56. *See* A. A. Sommer, *Considerations Leading to the Adoption of Rule 144*, 67 Nw. L. Rev. 65, 74 (Supp. 1972) .; *see also* Robert A. Barron, *Some Comments on the Gift of Non-Restricted Securities by an Affiliate of the Issuer to a Non-Affiliate Donee*, 35 Sec. Reg. L. J. 4 at pg. 2 (2007).

(n57)Footnote 57. For a discussion of the availability of the Section 4(1) resale exemption for resales of restricted securities outside Rule 144, *see generally* § 6.06[1] *infra*.

(n58)Footnote 58. Those amendments were promulgated by the following releases; Sec. Act Rel. No. 5307, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,001 (September 26, 1972); Sec. Act Rel. No. 5452, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,633 (February 1, 1974); Sec. Act Rel. No. 5560, [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,066 (January 24, 1975); Sec. Act Rel. No. 5613, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,293 (September 11, 1975); Sec. Act Rel. No. 5717, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,601 (June 8, 1976); Sec. Act Rel. No. 5979, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,731 (September 19, 1978); Sec. Act Rel. No. 5995, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,759 (November 8, 1978); Sec. Act Rel. No. 6032, n.41 *supra*; Sec. Act Rel. No. 6180, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,246 (January 17, 1980); Sec. Act Rel. No. 6286, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,821 (February 6, 1981); Sec. Act Rel. No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,106 (March 8, 1982); Sec. Act Rel. No. 6488, n.24 *supra*; Sec. Act Rel. No. 6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,523 (April 23, 1990); Sec. Act Rel. No. 6874, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,622 (September 24, 1990); Sec. Act Rel. No. 7035, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,307 (December 15, 1993); Sec. Act Rel. No. 7390 [Current Decisions] Fed. Sec. L. Rep (CCH) P 85,907 (February 20, 1997); *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)* .

(n59)Footnote 59. *See, e.g.*, paragraph (j) of Rule 144, which simply provides that the rule is not the exclusive means for reselling restricted securities or control securities without registration under the Act. That paragraph, added to Rule 144 effective March 12, 1979, by the amendment promulgated by Sec. Act Rel. No. 6032, *supra* n.41, simply confirmed the position on nonexclusivity taken by the Commission at the time the rule was originally adopted.

(n60)Footnote 60. *See, e.g.*, Sec. Act Rel. No. 6389, *supra* n.51, that amended the definition of restricted securities to take account of the adoption of Regulation D and the rescission of Rules 240, 242 and 146.

(n61)Footnote 61. *See* the amendment to Rule 144 (g) contained in Sec. Act Rel. No. 5452, *supra* n.51.

(n62)Footnote 62. *See* the amendments to Rule 144(e) contained in Sec. Act Rel. Nos. 5452, 5613, 5717 and 5979, *supra* n.51.

(n63)Footnote 63. *See* the amendment to Rule 144(f) contained in Sec. Act Rel. No. 5979, *supra* n.51.

(n64)Footnote 64. *See* Rule 144(k), as amended effective October 31, 1983§ .

(n65)Footnote 65. *See* Sec. Act Rel. No. 6862 [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,523 (April 23, 1990).

(n66)Footnote 66. Sec. Act Rel. No. 7390 [Current Decisions] Fed. Sec. L. Rep. (CCH) P 85,907 (February 20, 1997).

(n67)Footnote 67. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .*

(n68)Footnote 68. *Id.*

(n69)Footnote 69. *Id.* at 79.

(n70)Footnote 70. *Id.*

(n71)Footnote 71. *See* § 6.05[1][a] *supra*.

(N72)Footnote 72. *Id.*

(n73)Footnote 73. *See* § 6.02[1] *supra*.

(n74)Footnote 74. Rule 144 is, of course, never available for sales by the issuer because Section 4(1) is available only for "transactions by any *person other than an issuer*, underwriter, or dealer" (emphasis added).

(n75)Footnote 75. Rule 144 is available to all investors including a broker-dealer that is selling its own securities through another broker (but not those as to which it is issuer) in compliance with all of the rule's requirements.

See § 6.05[2][c][v] *infra* for limitations on the availability of the rule for broker-dealers.

In the case of restricted securities held through an employee stock plan, the plan trustee may rely on Rule 144 for sales made at the direction of a plan participant as if it were the participant. *See* Intergraph Corporation, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 583 (May 15, 2002).

(n76)Footnote 76. *See* § 6.02[4] *supra*.

(n77)Footnote 77. Rule 144(b).

(n78)Footnote 78. For an analysis of the meaning of the term "restricted securities," including the treatment of securities that do not fall within the literal definition of restricted securities but are treated as such, *see* § 6.03 *supra*.

(n79)Footnote 79. Rule 144(b).

(n80)Footnote 80. For an analysis of the meaning of the term "control securities," *see* § 6.04 *supra*.

(n81)Footnote 81. *Id.*

(n82)Footnote 82. Rule 144(b).

(n83)Footnote 83. Sec. Act Rel. No. 7187, 59 S.E.C. Docket 1630 (June 27, 1995).

(n84)Footnote 84. *See, e.g.,* comment letter of ABA Section of Business Law, September 6, 1995.

(n85)Footnote 85. Sec. Act Rel. No. 7391, 63 SEC Docket 2082-69 (February 20, 1997).

(n86)Footnote 86. *Sec. Act Rel. No. 8813, 72 Fed. Reg. 36822 (July 5, 2007) .*

(n87)Footnote 87. *Sec. Act Rel. No. 8813, 72 Fed. Reg. 36822 (July 5, 2007) .*

(n88)Footnote 88. For example, the holding period would have been tolled for any period where the previous owner of the particular securities had held a "short position" or a put equivalent position. According to the Final Rule Release, if the new owner reasonably believed that there was no hedging by the previous owner there would be no tolling of the holding period. *See Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .*

(n89)Footnote 89. *See, e.g.,* Feldman, Weinstein and Smith LLP, Comment on Sec. Act Rel. No. 8813 (July 19, 2007); Securities Industry and Financial Markets Association, Comment on Sec. Act Rel. No. 8813 (Sept. 21, 2007); Richardson and Patel LLP, Comment on Sec. Act Rel. No. 8813 (Sept. 4, 2007).

(n90)Footnote 90. *See* American Bar Association Section of Business Law, Comment on Sec. Act Rel. 8813 (Sept. 6, 2007).

(n91)Footnote 91. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .*

(n92)Footnote 92. Sec. Act Rel. No. 5223, *supra* n.2.

(n93)Footnote 93. Sec. Act Rel. No. 5306, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,000 (September 26, 1972), at Section I, Illustration 1.

(n94)Footnote 94. Sec. Act Rel. No. 6099, 1 Fed. Sec. L. Rep. (CCH) P 2705H (August 2, 1979), Section II(H), Question 84.

(n95)Footnote 95. Goldman Sachs & Co., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 540 (June 9, 1995).

(n96)Footnote 96. Sec. Act. Rel. No. 6099, *supra* n.34 at Section II(E), Question 41. *See also* discussion of earlier election theory abandoned by the staff in 1973, D. Goldwasser, *supra* n.1 at 77-79.

(n97)Footnote 97. Bio-Medical Sciences, Inc., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4238 (November 29, 1972).

The staff was apparently concerned that the investor's purchases of unrestricted securities may constitute a violation of Rule 10b-6 under the Exchange Act (since superseded by Regulation M under the Exchange Act), which prohibits purchases of securities by a person who is participating in a "distribution" of those securities. Since sales of securities pursuant to Rule 144 do not involve a "distribution" for the purposes of Section 2(11) of the Act, the staff's concern indicates that in its view the term "distribution" was otherwise defined for purposes of Rule 10b-6 under the Exchange Act. Shortly thereafter the staff took the position that sales of securities pursuant to Rule 144 would not be viewed as distributions for purposes of Exchange Act Rule 10b-6. General Electric Company, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 966 (May 21, 1975). When the Commission amended the volume limitations requirement of the rule to permit larger amounts of securities to be sold, however, it once again suggested that sales of securities in the larger

amounts could involve a distribution for purposes of Exchange Act Rule 10b-6. This view is reiterated in the context of sales that are not "distributions" under the Securities Act pursuant to Rule 144A. *See* Sec. Act Rel. No. 6806, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,335, (October 25, 1988) at n.145.

(n98)Footnote 98. Smith Barney Shearson, SEC No-action Letter, 1994 SEC No-Act. LEXIS 594 (July 8, 1994).

(n99)Footnote 99. Sec. Act Rel. No. 6099, *supra* n.34 at Section II(H), n.94

An ordinary short sale is a sale of securities that the seller does not own, but will borrow from his broker. The usual purpose is to profit in a declining market. In the case of a short sale against the box, the seller usually wishes to hedge against a price decline in securities that he owns but does not wish to sell for one reason or another.

(n100)Footnote 100. *See generally* D. Goldwasser, *supra* n.1 at 76-77.

(n101)Footnote 101. Sec. Act Rel. No. 6099, *supra* n.34 at Section II(H), Question 80. *See also* Goldman Sachs & Co., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 974 (December 20, 1999); *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546* at n. 90 and accompanying text (Dec. 17, 2007); SEC Division of Corporate Finance, Compliance and Disclosure Interpretations for Rule 144, Section 201.03 (April 2, 2007).

(n102)Footnote 102. *Id.* at Question 81; Shearson Hayden Stone Inc., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2080 (January 22, 1979).

(n103)Footnote 103. Jesse M. Brill, Esq., SEC No-Action Letter, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,431 (September 24, 1979) at Item 6.

(n104)Footnote 104. Goldman Sachs, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 974 (December 20, 1999).

(n105)Footnote 105. *See, e.g.*, Sec. Act Rel. No. 6099, *supra* n.34 at Section II(H), n.31. Note that the options under consideration are listed, not over-the-counter, options.

(n106)Footnote 106. *Id.* at Section II(H), Questions 69 and 71(a). It should be noted that the staff's earlier position that the conditions of Rule 144 must be complied with by the affiliate both at the time of writing the option and at the time of its exercise has been abandoned.

(n107)Footnote 107. *Id.* at Question 70.

(n108)Footnote 108. *Id.* at Questions 70(b), 70(c), 70(d), 71(b) and 72.

(n109)Footnote 109. *Id.* at Question 70(c).

(n110)Footnote 110. Bear, Stearns and Co., Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 567 (April 4, 1991).

(n111)Footnote 111. The staff stated:

More particularly, the public information condition must be observed both when the put is purchased and exercised. In the case of a restricted security, the two-year [now one-year for non-reporting companies and six months for reporting companies] holding period requirement of Rule 144(d) must have been completed not later than the date the put is purchased. When the put is purchased, the number of securities covered by the option must be taken into account in the calculation of available volume under Rule 144(e).

Id.

(n112)Footnote 112. *Id.*

(n113)Footnote 113. *Id.*

(n114)Footnote 114. *See § 6.05[1][a] supra.*

(n115)Footnote 115. Section 4(1), discussed in § 4.02 *supra*, exempts only "transactions by and person *other than* an issuer, underwriter, or dealer" (emphasis added).

(n116)Footnote 116. Section 2(12), discussed in § 9.04 *infra*, defines the term "dealer" for purposes of Section 4(1) to include the broker that is acting as an agent for the seller.

(n117)Footnote 117. For further explanation, see § 6.02[1] *supra*.

(n118)Footnote 118. D. Goldwasser, *supra* n.1 at 76-77.

It should be noted, however, that Rule 144 is not technically available for the sale of underwriters' compensation securities because they are not restricted securities within the meaning of Rule 144(a)(3). *See § 6.03[3][d][i] supra*. It should also be noted that the staff of the Commission, nevertheless, regularly permits those resales pursuant to most of the conditions of the rule under certain usually present circumstances. *See § 6.02[4][a] infra*.

(n119)Footnote 119. Insilco Corporation, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 2176 (May 2, 1974); Unicapital Corporation, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4485 (December 22, 1972).

(n120)Footnote 120. National Environmental Controls, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 4486 (December 26, 1972).

(n121)Footnote 121. Rule 144(a)(1) defines the phrase "affiliate of an issuer" to include a person that is controlled by such issuer.

(n122)Footnote 122. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(H), Question 83. *See also* Sec. Act Rel. No. 5306, *supra* n.71 at Section IV.

(n123)Footnote 123. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(H), Question 83.

(n124)Footnote 124. CIT Financial Corporation, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 1826 (February 21, 1983).

(n125)Footnote 125. First Pennsylvania Corp., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2334 (March 5, 1979). *See also* CBT Corp., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2030 (October 6, 1975) and Winkelman Stores, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 1589 (April 13, 1972), in which controlled plans of the respective issuers were allowed to rely on Rule 144 for the sale of securities of that issuer.

(n126)Footnote 126. *See* James Fogelson, *Rule 144--A Summary review*, 37 *Bus. Law.* 1519, 1522 n.22 (1982). *See also* D. Goldwasser, *supra* n.1 at 72-74.

(n127)Footnote 127. The broker-dealer represented that individual affiliates of itself and its corporate parent were required to purchase securities of the parent through it as part of the parent's securities law compliance program, thereby creating the need to give the broker-dealer a way to resell such securities which had been purchased on margin. *See* The Charles Schwab Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 764 (June 7, 1991).

(n128)Footnote 128. 1933 Act Rule 144(b), reprinted in the Securities Primary Law Sourcebook, Volume A, Part C (Matthew Bender 2008).

(n129)Footnote 129. *See generally* § 6.02[4] *supra*.

(n130)Footnote 130. *See* § 6.02[4][a] *supra*.

(n131)Footnote 131. *See* § 6.02[4][b] *supra*.

(n132)Footnote 132. *See* § 6.02[4][c] *supra*. It is important to note that the 2007 amendments to Rule 145 eliminated the presumptive underwriter provision except for when a party to a Rule 145 transaction is a shell company. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)* ; § 6.02[4][c] *supra* .

(n133)Footnote 133. These offerings were previously not registered in reliance upon Sec. Act Rel. No. 4708, 1 Fed. Sec. L. Rep. (CCH) PP 1361-1363 (July 9, 1964).

(n134)Footnote 134. *See* discussion of Regulation S, which superseded Rel. 4708, at § 6.03[3][d][ix] *supra* .

(n135)Footnote 135. Sec. Act Rel. No. 7505, 66 SEC Docket 1069-1 (February 17, 1998).

(n136)Footnote 136. *See* § 6.02[4][a] *supra*.

(n137)Footnote 137. *See* § 6.02[4][b] n.79 and accompanying text *supra* and § 6.04[3][c] *supra* .

(n138)Footnote 138. Tucker Drilling Co., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 3774 (November 26, 1979); Fluid Power Pump Company, SEC No-Action Letter, 1976 SEC No-Act. LEXIS 2667 (December 16, 1976).

(n139)Footnote 139. International Income Property, Inc., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 4064 (December 12, 1980). *But see* Reynolds Diversified Corporation, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 3112 (December 1, 1982).

(n140)Footnote 140. Rule 144(c).

(n141)Footnote 141. *See* Sections 4(1), discussed in § 4.02 *supra*, and 2(11), discussed in § 4.02 *supra*. The Securities Act of 1933 is reprinted in the Securities Primary Law Sourcebook, Volume A, Part B (Matthew Bender 2008).

(n142)Footnote 142. Wheat Report, *supra* n.1 at 178.

(n143)Footnote 143. Preamble of the Securities Act. *See also* Preliminary Note to Rule 144. The 2007 amendments to Rule 144 simplified the text of the *Preliminary Note*. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)* .

(n144)Footnote 144. Wheat Report, *supra* n.1 at 178.

(n145)Footnote 145. Section 13(a) of the Exchange Act requires that all issuers with securities registered under Section 12 of that Act file with the Commission the following periodic reports:

- an annual report on Form 10-K (20-F for foreign issuers, with different reporting deadlines than those for Form 10-K), discussed in *Federal Securities Exchange Act of 1934* § 4.02[1], containing considerable information about the business, management, properties and securities of the issuer among other things, plus financial statements, within 90 days following the end of the fiscal year covered by the report (accelerated reporting deadlines have been phased in for certain filers: the deadline for "accelerated filers" is 75 days, and the deadline for "large accelerated filers" is 60 days. *See Sec. Act Rel.*

No. 8644, 70 Fed. Reg. 76626 (December 21, 2005)) ;

- quarterly reports on Form 10-Q (not required for foreign issuers), discussed *supra* at § 4.02[2], for each of the issuer's first three quarters, containing primarily financial statements, within 45 days following the end of each quarter (accelerated reporting deadlines have been phased in for certain filers: the deadline for accelerated filers is 40 days after the end of the fiscal quarter for issuers. See Sec. Act Rel. No. 8644, 70 Fed. Reg. 76626 (December 21, 2005)) ; and

- current reports on Form 8-K (6-K for foreign issuers), discussed *supra* at § 4.02[3], generally within four business days of the occurrence of specified events. The Forms under the Securities Exchange Act of 1934 are reprinted in the Securities Primary Law Sourcebook, Volume B, Part H (Matthew Bender 2008). For further discussion of the reporting requirements pursuant to Section 13(a) of the Exchange Act, see *Federal Securities Exchange Act of 1934*, § 4.02 (Matthew Bender 2008).

(n146)Footnote 146. Section 15(d) of the Exchange Act requires that all issuers that have filed a registration statement pursuant to the Securities Act, which has become effective, file those periodic reports required by Section 13 of the Exchange Act during the fiscal year within which the registration statement became effective and thereafter, for so long thereafter as there are 300 or more holders of record of those securities that were the subject of that registration statement under the Securities Act. The reporting requirements of Section 15(d), discussed *supra* at § 4.02 are inapplicable to issuers that already have securities registered under Section 12 of the Exchange Act.

(n147)Footnote 147. See Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Questions 14 and 16, especially the accompanying illustrations. At the time it adopted Rule 144, the Commission also adopted amendments to Forms 10-K and 10-Q requiring issuers to provide such information on the cover pages of those reports. See Sec. Exc. Act Rels. 9442 and 9443 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,486 (January 10, 1972); See also Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n148)Footnote 148. Johnson, Swanson & Barbee, SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3962 (November 24, 1980), correcting Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Questions 14 and 15.

(n149)Footnote 149. Andros Analyzers, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2550 (July 1, 1983).

(n150)Footnote 150. See, e.g., Mentor Corporation, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 565 (September 26, 2008); Shire Pharmaceuticals Group Plc and Shire Plc, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 790 (November 17, 2005); Royal Dutch Shell, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 604 (May 17, 2005); INDRESCO, Inc., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 789 (October 31, 1995). Par Pharmaceutical, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 803 (June 19, 1991); Adolph Coors Co., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 605 (March 30, 1990).

(n151)Footnote 151. See, e.g., Oncothyreon Inc. and Biomira Inc., SEC No-Action Letter (January 31, 2008); Southwestern Energy Company, SEC No-Action Letter, 2006 SEC No-Act. LEXIS 527 (June 29, 2006); Mercer International Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 832 (December 12, 2005); Varsity Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1190 (October 15, 1991); Clothestime Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 710 (May 16, 1991); International Movie Group, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 57 (January 14, 1991).

(n152)Footnote 152. See, e.g., Ashland Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 669 (August 8, 2005); Ramtrons Holdings Ltd., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1277 (November 19, 1991).

(n153)Footnote 153. See SEC Staff Legal Bulletin No. 4 (CF), Fed. Sec. L. Rep. (CCH) P60,002, (September 16, 1997) (outlines the segment data that must be included). While Staff Legal Bulletin No. 4 specifically addresses spin-offs, the policy set out in the Bulletin also applies to separations of businesses effected by means other than spin-offs. United States Steel, SEC No-Action Letter, 2001 SEC No-Act. LEXIS 853 (December 28, 2001). For transactions prior to issuance of that Bulletin in which the staff concluded that an 90-day waiting period was not required and in which the spun off operations had been separately reported as segments, *see, e.g.*, Electronic Data Systems Holding Corporation, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 450 (April 29, 1996); Willcox & Gibbs, SEC No-Action Letter, 1992 SEC No-Act. LEXIS 904 (September 1, 1992); Johnson Controls, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1087 (September 13, 1991); Whitman Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 582 (April 4, 1991); Santa Fe Pacific Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 1105 (September 11, 1990); Tyler Three, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 614 (March 30, 1990).

By contrast, the staff has imposed the 90-day waiting period where the distribution entity had not provided "extensive segment-like financial and narrative reporting" of the spun off operations. VWR Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 292 (February 7, 1990); *see also* Church Loans & Investment Trust, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 544 (March 16, 1990).

(n154)Footnote 154. See The Walt Disney Co., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 176 (February 9, 1996); The Horn & Hardart Co., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 776 (June 18, 1993); Avantor Financial Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 575 (March 29, 1990).

(n155)Footnote 155. I.C.H. Corporation, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 528 (April 14, 1997). *But see* text accompanying n.166 *infra* (regarding whether filings by such companies are "current").

(n156)Footnote 156. See Del Webb Corp., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 254 (February 26, 1992); Union Texas Petroleum Holdings, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 380 (March 5, 1993).

(n157)Footnote 157. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Question 16.

(n158)Footnote 158. *Id.*

(n159)Footnote 159. Equinox Solar, Inc., No-Action Letter, 1989 SEC No-Act. LEXIS 550 (March 31, 1989); Tidal Marine International Corp., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 3128 (August 21, 1972).

(n160)Footnote 160. See Rule 12b-25 under the Exchange Act concerning a registrant's inability to timely file any required information, document, or report. *See also* SEC Division of Corporate Finance, Compliance and Disclosure Interpretations for Rule 144, Question 107.02 (April 2, 2007).

(n161)Footnote 161. A reporting issuer may not satisfy the adequate current public information requirement of Rule 144 by providing the information called for by paragraph (c)(2) of Rule 144. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Questions 15 and 18.

(n162)Footnote 162. Love Oil Co. Inc., SEC No-Action Letter, 1978 SEC No-Act. LEXIS 2335 (December 14, 1978).

(n163)Footnote 163. American Nuclear Corp., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 2902 (July 31, 1972).

(n164)Footnote 164. *See, e.g.*, Jetco, Inc., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 1608 (August 11, 1975); Digital Information Devices, Inc., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 1470 (April 12, 1972).

(n165)Footnote 165. Advanced Computer Techniques Corp., SEC No-Action Letter, 1983 SEC No-Act. LEXIS

2836 (September 23, 1983). *See also* Minstar, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2797 (September 8, 1983).

(n166)Footnote 166. SEC Staff Legal Bulletin No. 2 (CF), Fed. Sec L. Rep. (CCH) P60,002, (April 15, 1997).

(n167)Footnote 167. Under the circumstances, it is now commonplace and certainly advisable for purchasers of securities in private offerings to require the issuer to agree to register under Section 12(g) of the Exchange Act of 1934 and to timely file the required periodic reports in time to assure the availability of Rule 144 by the end of the six month holding period required by Rule 144(d).

(n168)Footnote 168. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Questions 17 and 18.

(n169)Footnote 169. *See* §§ 6.05[3][b][i] and [ii] *supra*.

(n170)Footnote 170. Anitec Image Technology Corp., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1722 (February 10, 1986); Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Question 17.

See also Andros Analyzers, Inc., *supra* n.149; Great American Management and Investment, Inc., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 878 (August 17, 1992).

It should be noted, however, that if an issuer, in compliance with paragraph (c)(2) of Rule 144 through voluntarily having made the specified information publicly available, subsequently files a registration statement, it may no longer rely upon paragraph (c)(2) of the Rule and must wait until the 91st day after the effective date of that registration statement. Johnson, Swanson & Barbee, *supra* n.148.

(n171)Footnote 171. *See, e.g.*, Evergood Products Corp., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 2721 (November 21, 1977); Tender Care, Inc., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 1760 10318 (September 8, 1975); Educational Technology, Inc., SEC No-Action Letter, 1976 SEC No-Act. LEXIS 1081 (May 17, 1976).

Paragraph (a)(4) of Exchange Act Rule 15c2-11 specifies the information:

(i) The exact name of the issuer and its predecessor (if any); (ii) the address of its principal executive offices; (iii) the state of incorporation, if it is a corporation; (iv) the exact title and class of security; (v) the par or stated value of the security; (vi) the number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year; (vii) the name and address of the transfer agent; (viii) the nature of the issuer's business; (ix) the nature of products or services offered; (x) the nature and extent of the issuer's facilities; (xi) the name of the chief executive officer and members of the board of directors; (xii) the issuer's most recent balance sheet and profit and loss and retained earnings statements; (xiii) similar financial information for such part of the 2 preceding fiscal years as the issuer or its predecessor has been in existence; (xiv) whether the broker or dealer or any associated person is affiliated, directly or indirectly, with the issuer; ... and (xvi) whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly, the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

(n172)Footnote 172. Section 12(g)(2)(G)(i) of the Exchange Act, discussed in § 7.04 *supra*, specifies only an annual statement in the form required by the state agency regulating the particular insurance company.

(n173)Footnote 173. Rule 144(c)(2). *See, e.g.*, Arlington TeleCommunications Corporation, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2372 (May 3, 1982) and Computel Systems, Ltd., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 82 (July 2, 1973).

But see Energy Minerals Corporation, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 3377 (September 8, 1972), in which the staff deemed the requirements of Rule 144(c)(2) satisfied by substantially all, rather than all, of the specified information.

(n174)Footnote 174. *See, e.g.*, FilmTec Corp., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 2605 (January 3, 1980).

(n175)Footnote 175. Unicorn Oil and Development, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2678 (August 15, 1983); Scientific Energy Systems Corporation, SEC No-Action Letter, 1973 SEC No-Act. LEXIS 2992 (July 2, 1973).

(n176)Footnote 176. *See, e.g.*, Reeves Southeastern Corporation, SEC No-Action Letter, z 1981 SEC No-Act. LEXIS 3596 (May 25, 1981) (five years of audited annual and quarterly reports); FilmTec Corp., *supra* n.174 (audited annual and unaudited quarterly reports).

(n177)Footnote 177. SEC Division of Corporate Finance, Compliance and Disclosure Interpretations for Rule 144, Section 108.02 (April 2, 2007). Unicorn Oil and Development, *supra* n.175; American Home Shield Corp., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 1907 (September 15, 1975). *But see* Donut Kastle, Inc., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 2945 (June 25, 1973) and Lucky Friday Extension Mining Company, SEC No-Action Letter, 1973 SEC No-Act. LEXIS 1950 (April 5, 1973), two early instances in which the staff decided that unaudited financial statements were insufficient.

(n178)Footnote 178. Classic Mining Corporation, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3410 (April 16, 1981); American Home Shield Corp. *supra* n.177. *Cf.* the "reasonably current" information requirement of Rule 144A(d)(4)(ii), discussed at § 6.07 *infra*.

(n179)Footnote 179. *See* Rule 15c2-11(g)(1) and (2) under the Exchange Act concerning these presumptions.

(n180)Footnote 180. *See, e.g.*, American Uranium Corporation, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3453 (April 27, 1981).

(n181)Footnote 181. *See* ANADAC, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 671 (March 15, 1990). Public availability of information is discussed in § 6.05[3][c][ii] *infra*.

(n182)Footnote 182. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Question 20.

(n183)Footnote 183. *See, e.g.*, FilmTec Corp., *supra* n.174.

(n184)Footnote 184. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Question 20 (Illustration).

(n185)Footnote 185. Reeves Southeastern Corporation, *supra* n.176. It should be noted that a foreign issuer must provide the required information to United States market makers and financial services, as well as those in the country of its domicile. Grove Explorations Ltd., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3413 (April 20, 1981).

(n186)Footnote 186. The Cannon Group, Inc., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3852 (October 27, 1980).

(n187)Footnote 187. Rule 144(c)(1).

(n188)Footnote 188. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(C), Question 19.

But see American Home Shield Corp., *supra* n.177, representing a view now reversed by the Commission.

(n189)Footnote 189. Rule 144(§ b)(1)(i).

(n190)Footnote 190. Prior to the 2007 amendments, Section 12 of the Exchange Act, reprinted in The Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender), required the registration of all securities traded on a national securities exchange, Section 12(b) (discussed in § 7.04 *infra*), and all equity securities of issuers that had total assets exceeding three million dollars and five hundred or more holders of record of those equity securities, Section 12(g)(1), discussed in § 7.04 *infra*, and Rule 12g-1, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

(n191)Footnote 191. See § 6.05[4] *infra*.

(n192)Footnote 192. Rule 144(d)(1). The original holding period was two years, which was reduced in 1997 to one year. Sec. Act Rel. No. 7390 [current decisions] Fed. Sec. L. Rep. (CCH) P 85,907 (February 20, 1997). Since the rule is available for specific restricted securities (they are no longer being regarded as fungible), an investor who acquired restricted securities at different times must be able to trace all of his securities to the date upon which each were last held by the issuer or an affiliate to ascertain whether two years have elapsed. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 21.

(n193)Footnote 193. As explained in § 6.04 *supra*, where an affiliate transfers unrestricted securities to donee or beneficiary in a private nonsale transaction, that donee or beneficiary may acquire unrestricted securities despite the language of Rule 144(a)(3). That donee or beneficiary, however, may be deemed an affiliate for purposes of any resale of those securities for as long as the affiliate transferor remains an affiliate. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(A), Question 9; § 6.03[3][b] ns.59-61 and accompanying text and § 6.04[4] n.42 and accompanying text *supra*. In such cases, the holding period requirement of Rule 144 is not applicable to the sale of those securities by a donee or beneficiary. Gannett Co., Inc., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 4042 (December 5, 1980). The SEC has also stated that the holding period requirement is not applicable to sale upon foreclosure by an affiliate pledgor, although on apparently different reasoning. First Bank System, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 777 (July 30, 1997) (discussed at n.269 *infra*).

(n194)Footnote 194. See § 6.02[1] *supra*.

(n195)Footnote 195. See language of Sections 2(11) and 4(1), discussed in § 4.02 *supra*.

(n196)Footnote 196. Preliminary Note to Rule 144.

(n197)Footnote 197. Sec. Act Rel. No. 6806, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,355 (October 25, 1988).

(n198)Footnote 198. Rule 144(d)(1).

(n199)Footnote 199. See, e.g., the Commission's discussion of the term "beneficial ownership" for purposes of Section 16 of the Exchange Act, concerning the disclosure requirements of corporate insiders and short-swing trading, contained in Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 (February 8, 1991).

(n200)Footnote 200. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 23. See also Digitech, Inc., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 693 (February 3, 1989).

(n201)Footnote 201. *Id.* See also Hadron, Inc., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2995 (November 12, 1982), where the holding period was deemed to commence on the date the securities should have been delivered, but were not because of an inadvertent error.

(n202)Footnote 202. See John D. Elliott SEC No-Action Letter, 1990 SEC No-Act. LEXIS 893 (June 11, 1990); Societe Generale, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 1219 (October 30, 1990).

(n203)Footnote 203. See, e.g., DNA Medical Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2783 (September 12, 1983) (effective date of merger agreement); Gearhart-Owen Industries, Inc., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3474 (July 18, 1980) (date disappearing corporation received securities to be distributed to its shareholders).

(n204)Footnote 204. General Maritime Corporation, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 606 (June 14, 2002), where the plan of reorganization provided for escrow accounts for various purposes, including indemnity and price adjustment.

(n205)Footnote 205. Hesse & Jones, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 928 (December 13, 1996); International Institute of Applied Technology, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 1827 (February 21, 1983).

(n206)Footnote 206. Vicon Fiber Optics, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 604 (March 30, 1990); Onyx-IMI, Inc., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2747 (September 6, 1982).

See also staff comments in Zenex Synthetic Lubricants, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3172 (March 5, 1981).

(n207)Footnote 207. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 22. See also Intergraph Corporation, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 583 (May 15, 2002).

(n208)Footnote 208. Id.

(n209)Footnote 209. Monsanto Company, SEC No-Action Letter (July 8, 1983).

(n210)Footnote 210. Rule 144(d)(1).

(n211)Footnote 211. If the purchaser pays for the restricted securities with cash, they are fully paid for purposes of Rule 144(d)(2) even if that cash was borrowed from a bank or other person unrelated to the issuer and the securities are pledged as collateral for the repayment of the loan. Sec. Act Rel. No. 6099, *supra* n.35 at Section II(D), Question 25. Securities may not be deemed paid for where the purchase is financed by a person who is, or who becomes at the same time, an affiliate of the issuer. See Clinical Technologies Associates, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1355 (December 10, 1991); Psychomedics Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1259 (November 12, 1991).

(n212)Footnote 212. Rule 144(d)(2).

(n213)Footnote 213. See, e.g., Rollins, Inc., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3721 (September 26, 1980).

(n214)Footnote 214. See, e.g., MCI Corp., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 2617 (January 3, 1980).

(n215)Footnote 215. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 27.

(n216)Footnote 216. Id.

(n217)Footnote 217. Each time an installment payment is made a pro rata portion of the securities purchased is fully paid, as illustrated by Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 28 (Illustration);

Bio-Response, Inc., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 4155 (October 29, 1981).

(n218)Footnote 218. Bourns, Inc., SEC No-Action Letter, 1974 SEC No-Act. LEXIS 1355 (January 28, 1974).

(n219)Footnote 219. Mosteck Corp., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 4297 (November 23, 1981).

(n220)Footnote 220. Sec. Act Rel. No. 6099, *supra* n.42 at Question 21.

(n221)Footnote 221. *See, e.g.*, Ultrasystems, Inc., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 4455 (December 30, 1981).

(n222)Footnote 222. Rule 144(d)(3)(i). *See, e.g.*, Associated Communications Corporation, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2710 (August 18, 1983). For an analysis of when securities received as dividends or in stock splits are restricted securities, *see* § 6.03[3][d][vi] *supra*.

(n223)Footnote 223. Shearson Hayden Stone, Inc., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2335 (March 2, 1979). *See also* Elliott Associates, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 43 (January 18, 1999).

(n224)Footnote 224. Warburg, Pincus Investors, L.P., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 716 (September 4, 1996).

(n225)Footnote 225. Rule 144(d)(3)(i). *See, e.g.*, Roper Industries, Inc., SEC No-Action Letter, 2007 SEC No-Act. LEXIS 535 (July 19, 2007); Tele-communications, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2152 (April 11, 1983) and Universal Health Services, Inc., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2506 (June 12, 1982).

For an analysis of under what circumstances securities issued in unregistered recapitalizations are restricted securities, *see generally* §§ 6.03[3][d][iii], and [3][d][iv] *supra*.

(n226)Footnote 226. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 35; D. Goldwasser, *supra* n.1 at 245-47.

(n227)Footnote 227. Rule 144(d)(3)(ii).

(n228)Footnote 228. Shelter Resources Corporation, SEC No-Action Letter 1982 SEC No-Act. LEXIS 2954 (October 29, 1982) (less than forty percent of the relevant securities were involved); Southeast SBIC, Inc., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1262 (May 16, 1977).

(n229)Footnote 229. *See, e.g.*, M-Wave, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 886 (July 30, 1993).

(n230)Footnote 230. James River Corp., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2678 (August 29, 1985).

(n231)Footnote 231. Nuclear Dynamics, Inc., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 3621 (October 24, 1979).

(n232)Footnote 232. Sec. Act. Rel. No. 5306, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,000 (September 26, 1972).

(n233)Footnote 233. *See* Roper Industries, Inc., SEC No-Action Letter, 2007 SEC No-Act. LEXIS 535 (July 19, 2007); The Presley Companies, SEC No-Action Letter 1992 SEC No-Act. LEXIS 475 (March 30, 1992); Equitable Resources, Inc., SEC No-Action Letter, 2007 SEC No-Act. LEXIS 459 (April 25, 2007); Sec. Act. Rel. No. 33-6806,

n.197 *supra*, (1988) at n.209; Morgan, Olmstead, Kennedy & Gardner Capital Corp., SEC No-Action Letter, 1988 SEC No-Act. LEXIS 6 (January 8, 1988). The Commission has proposed codifying its position on tacking with respect to the formation of holding companies in a new rule. Sec. Act Rel. No. 33-7391 [current decisions] Fed. Sec. L. Rep. (CCH) P 85,908 (1997). *See also* Biospecifics Technology Corp., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 1036 (November 13, 1992) (Delaware holding company stock exchanged for substantially all shares of two operating companies, a New York corporation and a Netherlands Antilles corporation).

(n234)Footnote 234. *Sec. Act Rel. No. 8813, 72 Fed. Reg. 36822 (July 5, 2007)* .

(n235)Footnote 235. Rule 144(d)(3)(ix)

(n236)Footnote 236. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)* .

(n237)Footnote 237. Oncothyreon Inc. and Biomira Inc., SEC No-Action Letter, 2008 WL 310587 (January 31, 2008); Southwestern Energy Company, SEC No-Action Letter, 2006 SEC No-Act. LEXIS 527 (June 29, 2006); Agristar, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 250 (February 6, 1990); Sec. Act. Rel. No. 6099, *supra* n.42 at Question 35.

(n238)Footnote 238. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)* .

(n239)Footnote 239. *See* RehabClinics, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 411 (March 12, 1993) (tacking denied to holders of company, which was formed to avoid legal problems of predecessor company and which then merged with predecessor company, based on the differing levels of investment risk); Urcarco, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 278 (February 6, 1990) (notes exchanged for stock and private placement conducted simultaneously with holding company formation); New Golf Concepts, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 220 (February 6, 1990) (public offering conducted at same time); Pinnacle Environmental, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 34 (January 17, 1990) (holding company purchased real property by issuing stock before it acquired two operating companies); Costilla Energy, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 540 (April 18, 1997) (tacking denied upon conversion of limited liability company into a corporation). *But see* Biospecifics Technology Corp., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 1036 (November 13, 1992) (public offering contemplated before and commenced six months after exchange).

(n240)Footnote 240. *See* The ARA Group, SEC No-Action Letter, 1990 SEC No-Act. LEXIS 1318 (December 19, 1990).

(n241)Footnote 241. Peapod, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 999 (November 10, 1997); Hygeia Sciences, Inc., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1897 (March 13, 1986); *see also* SEC Division of Corporate Finance, Compliance and Disclosure Interpretations for Rule 144, Section 112.01 (April 2, 2007). Where the partnership agreement grants the general partner the right to make the decision to convert into a corporation, the limited partners may tack their partnership interest holding period to their holding period for the corporation shares, but the general partner's holding period for the shares starts on the date of succession. Juno Online Services, Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 906 (November 17, 1999). In the context of limited liability companies, *see* Cravath, Swaine, & Moore, 2000 SEC No-Act. LEXIS 141 (February 11, 2000); Texas Roadhouse, Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 654 (July 28, 2005); Smart Move, Inc., SEC No-Action Letter, 2007 SEC No-Act. LEXIS 479 (May 16, 2007) (staff rejected request to tack holding period of LLC ownership interests despite amended operating agreement arguably contemplating transfer to a corporation); Banc of America Investors, L.P., SEC No-Action Letter, 2004 SEC No-Act. LEXIS 376 (February 25, 2004).

(n242)Footnote 242. The Petersen Companies, Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 892 (July 16, 1998); MarkWest Hydrocarbon, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 466 (March 25, 1997).

(n243)Footnote 243. 1933 Act Rule 144(d)(3)(ii), reprinted in the Securities Primary Law Sourcebook, Part C

(Matthew Bender 2008).

(n244)Footnote 244. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 36; Technology funding Secured Investors II, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 912 (July 23, 1991); Northrop Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 765 (June 6, 1991) (exercise of warrants); Radyne Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 227 (February 6, 1990) (exchange of old debentures for new debentures or new debentures plus stocks); Mr. Coffee, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 766 (June 6, 1991) (exchange of preferred stock for common); Sports/Leisure, Inc., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 922 (September 11, 1992).

Additional consideration of no value, however, will not cause a loss of the tacking benefit. Ford Foundation, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2550 (June 25, 1982).

(n245)Footnote 245. Energy Exchange Corporation, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2838 (September 26, 1983).

(n246)Footnote 246. Sec. Act Rel. No. 7391 [current decisions] Fed. Sec. L. Rep. (CCH) P 85,908 (February 20, 1997).

(n247)Footnote 247. *Sec. Act Rel. No. 8813, 72 Fed. Reg. 36822 (July 5, 2007)* .

(n248)Footnote 248. Gentiva Health Services, Inc. and Gentiva Trust, SEC No-Action Letter, 2001 SEC No-Act. LEXIS 672 (July 27, 2001); Bairnco Corp., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 2785 (July 27, 1981).

(n249)Footnote 249. Specialized Systems, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2267 (April 25, 1983).

(n250)Footnote 250. *See, e.g.*, Vanguard Cellular Systems, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1017 (August 20, 1991); Attwoods plc, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 150 (January 28, 1991). Holders may tack their holding periods for the exchanged obligations even if the guarantee was not established until after the issue date of the exchanged obligations. *See* Verio Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 551 (May 25, 1999). Tacking was denied where the obligations of the subsidiary were not guaranteed by the parent making the exchange offer. *See* Taro Vit Industries Ltd., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1219 (June 13, 1991).

(n251)Footnote 251. *See* Auto Finance Group, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1313 (December 3, 1991).

(n252)Footnote 252. Rule 144(d)(3)(iii). *See, e.g.*, Medeva PLC, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 1145 (December 10, 1993); T-G Enterprises, Inc., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2231 (April 1, 1982); Electronic Data Technologies, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 832 (July 13, 1989).

(n253)Footnote 253. The three others are paragraphs (d)(3)(v), (vi), and (vii) of Rule 144, discussed in § 6.05[4][c][v], [vi] and [vii] *infra*.

(n254)Footnote 254. If the pledgee accepts restricted securities from the issuer in a pledge transaction, the tacking benefit is not available, Rule 144(d)(3)(iv); and the pledgee's independent holding period will commence upon his assuming the full economic risk of loss, normally at the time funds equal to or greater than the value of the pledged securities are advanced, Tokyu Building, Inc., PSEC No-Action Letter, 1982 SEC No-Act. LEXIS 2505 (June 11, 1982). Since a subsidiary of an issuer is viewed as the issuer for purposes of the availability of Rule 144, *see* § 6.05[2][c][vi] *supra*, it is likely that a pledgee who acquires restricted securities from a subsidiary of their issuer will be treated as having received them from the issuer and therefore, unable to benefit from the Rule 144(d)(3)(iv) tacking

provision.

(n255)Footnote 255. The method of acquisition need not be foreclosure; realization of shares pursuant to a workout agreement in lieu of foreclosure may also result in a pledgee-bank tacking its holding period with that of the pledgor. Bankers Trust New York Corp., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 517 (May 16, 1995).

(n256)Footnote 256. Rule 144(d)(3)(iv).

(n257)Footnote 257. Puritan Investors Corp., [Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,920 (July 5, 1974). Cf. Internal Revenue Service, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 3125 (August 21, 1972).

(n258)Footnote 258. *SEC v. Guild Films Co.*, 279 F.2d 485, 489 (2d Cir. 1960) , cert. denied subnom *Santa Monica Bank v. SEC*, 364 U.S. 819 (1960) .

(n259)Footnote 259. Rule 144(d)(3)(iv).

(n260)Footnote 260. *Id.*; Valicenti Leighton Reid & Pine, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 1604 (April 14, 1972). It should also be noted that where a pledgor pledged restricted securities to secure a note, and the securities were there after reacquired by the pledgor after paying the note, the pledgor was deemed to have held the securities since his original acquisition. He was not treated as a new purchaser. Chemex Corporation, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2998 (November 12, 1982).

(n261)Footnote 261. Jack H. Bookey, SEC No-Action Letter, 1973 SEC No-Act. LEXIS 2644 (June 4, 1973).

(n262)Footnote 262. *Id.*

(n263)Footnote 263. See § 6.05[4][b] *supra*.

(n264)Footnote 264. See § 6.03[4] *supra*.

(n265)Footnote 265. See § 6.03[3] *supra*.

(n266)Footnote 266. See Rule 144(a)(3), discussed in § 6.03 *supra*.

(n267)Footnote 267. See § 6.03[3][a] *supra*.

(n268)Footnote 268. *Rubin v. United States*, 449 U.S. 424, (1981) ; *SEC v. Guild Films Co.*, *supra* n.227 . See also SEC Division of Corporate Finance, Compliance and Disclosure Interpretations for Rule 144, Question 109.03 (April 2, 2007).

(n269)Footnote 269. First Bank System, Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 777 (July 30, 1997).

(n270)Footnote 270. It should be noted that where an affiliate donates unrestricted securities in a private transaction, those securities do not become restricted securities in the hands of the donee despite the literal language of Rule 144(a)(3). See § 6.03[3][b] *supra*.

(n271)Footnote 271. If the donee receives restricted securities from the issuer, the tacking benefit is not available. Rule 144(d)(3)(v). That donee is in the same position, therefore, as a purchaser of restricted securities. Also, since a subsidiary of an issuer is viewed as that issuer for purposes of the availability of Rule 144, see § 6.05[2][c][vi] *supra*, it is likely that a donee who receives restricted securities from a subsidiary of the issuer will be treated as having received them from the issuer and therefore unable to benefit from the Rule 144(d)(3)(v) tacking provision.

(n272)Footnote 272. *See, e.g.*, R. E. Turner and the Turner Foundation, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 489 (March 19, 1993); John J. Moores and the Moores Foundation, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 991 (August 14, 1991).

(n273)Footnote 273. Rule 144(d)(3)(v).

(n274)Footnote 274. *See, e.g.*, Chemed Corporation, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2204 (April 15, 1983). *See generally* D. Goldwasser, *supra* n.1 at 274-76.

(n275)Footnote 275. Rule 144(d)(3)(vi).

(n276)Footnote 276. Jesse M. Brill, *supra* n. 103 at Item 4; Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 31.

But see Chesapeake Corporation of Virginia, SEC No-Action Letter, 1978 SEC No-Act. LEXIS 1964 (October 6, 1978).

(n277)Footnote 277. Schlumberger, Ltd., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 2769 (February 11, 1980).

(n278)Footnote 278. Rule 144(d)(3)(vi) relates to restricted securities acquired from the settlor of that trust only.

(n279)Footnote 279. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 31.

(n280)Footnote 280. Rule 144(d)(3)(vi).

(n281)Footnote 281. Rule 144(d)(3)(vii).

(n282)Footnote 282. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 32.

(n283)Footnote 283. *Id.*

(n284)Footnote 284. *See* Rule 144(a)(1) for the definition of the term "affiliate of the issuer." For an analysis of when an estate is such an affiliate, *see* § 6.04 *supra*.

(n285)Footnote 285. Rule 144(d)(3)(vii).

(n286)Footnote 286. McDonald & Co., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2487 (June 24, 1983).

(n287)Footnote 287. SEC Division of Corporate Finance, Compliance and Disclosure Interpretations for Rule 144, Question 109.04 (April 2, 2007); Gemco National, Inc., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 3128 (December 8, 1982).

(n288)Footnote 288. Virginia National Bank, SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3767 (October 2, 1980).

(n289)Footnote 289. Rule 144(d)(3)(viii); § 6.02[4][c] *supra* . *But see* JPMorgan Chase & Co., SEC No-Action Letter (March 17, 2008) (based on the "extraordinary circumstances" the staff did not recommend enforcement action if JPMorgan sold Bear Stearns securities prior to the execution of the merger agreement with JPMorgan without compliance with Rule 144 for a limited time). *See* discussion in § 6.02[4][c] *supra*.

(n290)Footnote 290. *See* discussion in &§ 6.05[4][c][i] *supra* .

(n291)Footnote 291. *See* § 6.05[4][c][i] *supra*.

(n292)Footnote 292. See The ARA Group, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 1318 (December 19, 1990). See also Aether Systems, Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 558 (April 26, 2005); J.P. Morgan Capital Corp., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 1087 (December 4, 1992).

(n293)Footnote 293. See Rule 144(d)(1) and § 6.05[4][b][i] *supra* .

(n294)Footnote 294. See Rule 144(a)(2)(i).

(n295)Footnote 295. Van Dusen Air Incorporated, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 4130 (October 26, 1981); Jesse E. Brill, *supra* n.103 at Item 7.

(n296)Footnote 296. Citizens and Southern Corporation, SEC No-Action Letter, 1981 SEC No-Act. LEXIS 4257 (November 16, 1981).

(n297)Footnote 297. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 33.

(n298)Footnote 298. Physica B.V. and Solvay S.A., SEC No-Action Letter, 2003 SEC No-Act. LEXIS 525 (April 8, 2003); CompleTel Europe N.V., SEC No-Action Letter, 2001 SEC No-Act. LEXIS 698 (August 20, 2001); Borg-Warner Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1251 (November 7, 1991).

(n299)Footnote 299. See, e.g., Worthington Industries, Inc., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3394 (June 23, 1980). Similarly, where no shift in the risk of loss respecting the restricted securities occurs, tacking is permitted where they are transferred:

- from one partnership to another, Robert R. Barker & Co., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2488 (June 20, 1983);
- from a partnership to a corporation, Convergent Technologies, Inc., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2211 (March 23, 1982); or
- from a corporation to a partnership, J. H. Foster & Co. Ltd. Partnership, SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3015 (March 17, 1980).

(n300)Footnote 300. Walnut Street Capital Co., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2489 (June 17, 1983); Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 33(a).

(n301)Footnote 301. For examples of rather unique situations where the staff permitted tacking under this reasoning, see Micron Corporation, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 1632 (January 17, 1983) and Concord Fabrics, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2203 (April 11, 1983).

(n302)Footnote 302. For a discussion of spin-offs and liquidating distributions, see generally § 6.03[3][d][vii] *supra*.

(n303)Footnote 303. Id.

(n304)Footnote 304. See, e.g., Triad Guaranty, Inc. and Collateral Investment Corp., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 686 (August 12, 2005); Ashland Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 669 (August 08, 2005); TB&C Bancshares, Inc., SEC No-Action Letter, 2001 SEC No-Act. LEXIS 664 (July 25, 2001) (shareholders receiving shares which were primarily asset of company permitted to tack); Hale & Dorr, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 780 (June 12, 1991) (limited partners receiving distributions of restricted securities from partnership portfolio permitted to tack); First Southern Capital Corp., SEC No-Action Letter, 1982 SEC No-Act.

LEXIS 2230 (April 1, 1982) (shareholder who acquired restricted securities in an ordinary spin-off permitted to tack) and Intercontinental Industries, Inc..

See also Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 34(b).

(n305)Footnote 305. *See* Lee Data Corporation, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2834 (September 26, 1983).

See also Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 34, n.11.

(n306)Footnote 306. International Clinical Laboratories, Inc., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2746 (August 20, 1982).

(n307)Footnote 307. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations on Rule 144 (Updated April 2, 2007), at Section 212 (Rule 144(d)(3)), Interpretation No. 212.01.

(n308)Footnote 308. *See* § 6.03[3][d][iii] *supra*.

(n309)Footnote 309. St. Ives Holding Co., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2250 (July 22, 1987).

(n310)Footnote 310. §§ 6.05[4][c][ix], [x] and [xi] *supra*.

(n311)Footnote 311. Rule 144(d)(3).

(n312)Footnote 312. Communications Investment Corp., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3811 (October 14, 1980).

(n313)Footnote 313. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)* .

(n314)Footnote 314. Rule 144(e).

(n315)Footnote 315. Rule 144(e)(1).

(n316)Footnote 316. Rule 144(e)(3)(vii); Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), § Question 41.

(n317)Footnote 317. *See* Sections 4(1), discussed in § 4.02 *supra*, and 2(11), discussed in § 4.02[2] *supra*.

(n318)Footnote 318. *Ira Haupt & Co., 23 S.E.C. 589, 597-98* , P(August 20, 1946). *See also* Rule 154, *supra* n.44.

(n319)Footnote 319. This interpretation is commonly referred to as the presumptive underwriter doctrine. For further information about that informal (and now defunct) doctrine, *see* § 6.02[4][b] *supra*.

(n320)Footnote 320. Sec. Act Rel. No. 5223, *supra* n.2.

(n321)Footnote 321. Preliminary note to previous Rule 144 prior.

(n322)Footnote 322. The relevant three month period is three full calendar months ending on the date of sale such as, for example, January 16 through April 15. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), Question 37.

(n323)Footnote 323. Rule 144(e)(1)(i).

(n324)Footnote 324. Trust Company of Georgia, SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2027 (January 11, 1979).

(n325)Footnote 325. D. Goldwasser, *supra* n.1 at 300. Subsequent to the 2007 amendments, this is now only applicable to affiliates of the issuer.

(n326)Footnote 326. See Kyocera Corp., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 662 (March 30, 1990).

(n327)Footnote 327. Rule 144(e)(1)(ii) and (iii); Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), Question 38.

As indicated by the rule, the reported volume used may be the national exchange volume, the NASDAQ volume, a combination of the two or when available the consolidated transaction reporting system volume. See also Sec. Act Rel. No. 5995, *supra* n.58.

(n328)Footnote 328. Rule 144(e)(1)(ii).

(n329)Footnote 329. Sec. Act. Rel. No. 6099, *supra* n.42 at Section II(E), Question 40.

(n330)Footnote 330. SEC Division of Corporate Finance, Compliance and Disclosure Interpretations for Rule 144, Section 222.03 (April 2, 2007).

(n331)Footnote 331. *Id.* at Question 39; Jesse M. Brill, *supra* n.103 at Item 5.

(n332)Footnote 332. There is no need to include in the calculation of securities already sold securities sold pursuant to a registration statement under the Securities Act, see Chs. 7 and 7A *infra*, pursuant to the exemption provided by Regulation A, see Ch. 5 *supra*, or in an exempt transaction pursuant to Section 4 of the Act and not involving any public offering, see Ch. 4 *supra* or for sales effected pursuant to Regulation S, see § 6.09 . Rule 144(e)(3)(vii). It should be recalled that short sales against the box and call options must be included for purposes of calculating the volume limitation at the time the short sale is made or the call option is written, respectively. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(H), Questions 80 and 71(a), respectively. See also § 6.05[2][c][iii] and [iv] *supra*. Again, short sales against the box and call options must be included for purposes of calculating the volume limitation at the time the short sale is made or in the case of the call option at such time as the restricted securities are segregated to cover or are delivered. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(H), Question 80 and 70, 71(b), 72, 73 and 74, respectively.

(n333)Footnote 333. Revenue Properties Company Limited, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2745 (August 25, 1983). See also Gulf & Western Industries, Inc., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 1177 (June 16, 1975). (Debentures treated as same class "considering the identity of terms, market price and market treatment.")

(n334)Footnote 334. Sec. Act Rel. No. 5980, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,732 (September 20, 1978); Sec. Act Rel. No. 5223, n.2 *supra*.

(n335)Footnote 335. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), Question 46.

(n336)Footnote 336. *Id.*; Associated Dry Goods Corporation, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2679 (August 12, 1983).

(n337)Footnote 337. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n338)Footnote 338. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n339)Footnote 339. See §§ 6.05[5][d][viii] and [ix] *infra* and the corresponding tacking provisions described in §§ 6.05[4][c][x] and [xi] *supra*.

(n340)Footnote 340. Rule 144(a)(2).

(n341)Footnote 341. Sec. Act Rel. No.6099, *supra* n.42 at Section II(A), Questions 3, 5 and 8; Fogelson, *supra* n.126 at 1532.

(n342)Footnote 342. Jesse M. Brill, *supra* n.103 at Item 3; Carolina Securities Corp., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 3766 (November 23, 1979).

See also Sec. Act Rel. No. 6099, *supra* n.42 at Section II(A), question 8, indicating that aggregation of sales by a parent corporation and its subsidiary is also a two-way street.

(n343)Footnote 343. Jesse M. Brill, Esq., *supra* n.103 at Item 2. *See also* Wells Fargo Bank, N.A., SEC No-Action Letter 1975 SEC No-Act. LEXIS 1998 (September 29, 1975), requiring aggregation with a trust by an affiliate ten percent beneficiary of the trust.

(n344)Footnote 344. *See* Sec. Act. Rel. No. 6099, *supra* n.42 at 2819-6 Question 7; Gap, Inc., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 928 (September 16, 1992); Turner Foundation, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 489 (March 19, 1993); BMC Software, Inc., SEC No-Action Letter, 1991 SEC No-Act LEXIS 991 (August 14, 1991).

(n345)Footnote 345. Jesse M. Brill, Esq., *supra* n.103 at Item 2.

(n346)Footnote 346. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(A), Question 5. *But see* First Pennsylvania Corp., *supra* n.125, and NCA Corporation, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2996 (November 12, 1982). In addition, it should be noted that the directors of a charitable organization are not viewed as trustees or executors or in a similar capacity for purposes of the Rule 144(e) aggregation rules.

(n347)Footnote 347. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(A), Question 6; Wix Corp., SEC No-Action Letter, 1978 SEC No-Act. LEXIS 597 (February 20, 1978).

(n348)Footnote 348. A purchaser of pledged securities is required to aggregate his sales with those of the pledgee and the pledgor only if the securities were privately purchased rather than purchased in a Rule 144 sale by the pledgee, Valicenti, Leighton, Reid and Pine, *supra* n.260.

(n349)Footnote 349. Rule 144(e)(3)(ii).

(n350)Footnote 350. *Id.* *See also* Met-Pro Corporation, SEC No-Action Letter, 1976 SEC No-Act. LEXIS 1784 (August 22, 1976) (obligation in default for more than two years); Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), Question 47, relating to donated securities, but equally applicable to pledged securities. If the pledgee (or the purchaser) is an affiliate of the issuer of the securities proposed to be sold, the unlimited resale provision contained in Rule 144(k) will not be available. § It is important to note that Rule 144(k) no longer exists following the 2007 amendments to Rule 144, but that an affiliate must resell in accordance with the applicable paragraphs of Rule 144 which do not permit unlimited resales by affiliates in any circumstance. In other words sales by affiliates are always subject to the volume restrictions set forth in paragraph (e) of Rule 144.

(n351)Footnote 351. Frost National Bank of San Antonio, SEC No-Action Letter, 1976 SEC No-Act. LEXIS 1182 (June 7, 1976).

(n352)Footnote 352. Rule 144(e)(3)(ii).

(n353)Footnote 353. Rule 144(e)(3)(iii); Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), Question 47.

(n354)Footnote 354. *See, e.g.,* Turner Foundation, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 489 (March 19, 1993).

Since paragraph (e)(3)(iii) of Rule 144 is substantially the same as paragraph (e)(3)(ii) of the rule, *see generally* § 6.05[5][c][ii] *supra*.

(n355)Footnote 355. Rule 144(e)(3)(iii).

(n356)Footnote 356. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), Question 48.

(n357)Footnote 357. Rule 144(e)(3)(iv).

(n358)Footnote 358. Equitable of Iowa Companies, SEC No-Action Letter, 1980 SEC No-Act. LEXIS 2808 (February 19, 1980).

(n359)Footnote 359. *See* § 6.05[5][d][i] *supra*.

(n360)Footnote 360. *See* § 6.05[4][c][vii] *supra* regarding those securities that are covered by both paragraphs (d)(3)(vii) and (e)(3)(v) of Rule 144.

(n361)Footnote 361. For analysis of the meaning of the term "affiliate," *see generally* § 6.03 *supra*.

(n362)Footnote 362. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(E), Question 49.

(n363)Footnote 363. Since the codification of the 2007 amendments, Rule 144(c) is not applicable to non-affiliates anymore.

(n364)Footnote 364. *See* Equitable of Iowa Companies, *supra* n.358, containing a view equally applicable to estate beneficiaries.

(n365)Footnote 365. *See* § 6.05[5][d][i] *supra*.

(n366)Footnote 366. Rule 144(e)(3)(vi).

(n367)Footnote 367. Lewis D. Lowenfels, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 2147 (May 31, 1972).

(n368)Footnote 368. *See, e.g.*, AMP Inc., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3680 (June 22, 1981). *But see* Carnation Co., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 2742 (February 3, 1980), in which the staff viewed a shareholders agreement limiting the resale of shares distributed in a liquidation as applying individually to each shareholder and therefore not constituting an agreement to act in concert.

For other circumstances possibly indicative of acting in concert, *see* Carolina Securities Corp., *supra* n.342 (relatives not sharing the same home must aggregate if acting in concert); Fogelson, *supra* n.126 at 1530, n.87 (multiple pledgees, donees or beneficiaries required to aggregate horizontally if acting in concert).

(n369)Footnote 369. The Gap, Inc., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 928 (September 16, 1992).

(n370)Footnote 370. Lewis D. Lowenfels, *supra* n.367; Gap, Inc., *supra* n.344.

(n371)Footnote 371. § 6.05[4][c][ix] *supra* .

(n372)Footnote 372. *Id.*

(n373)Footnote 373. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(A), Question 4.

(n374)Footnote 374. § 6.05[4][c][x] *supra* .

(n375)Footnote 375. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(A), Question 8.

(n376)Footnote 376. Rule 144(a)(2)(iii); Sec. Act Rel. No. 6099, *supra* n.42 at Section II(A), Question 8.

(n377)Footnote 377. Continental Alliance Corporation, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 126 (August 12, 1974).

(n378)Footnote 378. Rule 144(e)(3)(vi) and § 6.05[5][d][vi] *supra* .

(n379)Footnote 379. § 6.05[4][c][xi] *supra* .

(n380)Footnote 380. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 34 and Section II(E), Question 45; Sec. Act Rel. No. 5306, *supra* n.72 at Section VII(A).

(n381)Footnote 381. Convergent Technologies, SEC No-Action Letter 1983 SEC No-Act. LEXIS 1876 (February 24, 1983). *But see* Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 34 and Section II(E), Question 45 (references to closely-held corporations).

(n382)Footnote 382. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(D), Question 34 and Section II(E), Question 45. *See also* Abacus Investments Limited, SEC No-Action Letter (October 5, 2007).

(n383)Footnote 383. Carnation Co., *supra* n.368 (76 shareholder distributees).

(n384)Footnote 384. § Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n385)Footnote 385. Rule 144(e)(3)(v). *See* discussion in § 6.05[5][d][vii] *supra*.

(n386)Footnote 386. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n387)Footnote 387. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n388)Footnote 388. That is, within the definition of "brokers' transactions" set forth in Section 4(4) of the Securities Act.

(n389)Footnote 389. *See* new Rule 144(f)(1)(iii). A "riskless principal transaction" is defined as a principal transaction where, after having received from a customer an order to buy, a broker or dealer purchases the security as principal in the market to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to the market to satisfy the order to sell; *see also* Note to Rule 144(f)(1).

(n390)Footnote 390. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n391)Footnote 391. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) . Rule 144(f) does not apply to sales by non-affiliates or sales of debt securities.

(n392)Footnote 392. Rule 144(f).

(n393)Footnote 393. *Id.*

(n394)Footnote 394. *See* analysis contained in § 6.02[1] *supra* .

(n395)Footnote 395. Section 4(4) of the Act is also discussed in § 4.06 *supra*.

(n396)Footnote 396. See *Ira Haupt & Co.*, *supra* n.318 . See also Rule 154, *supra* n.51.

(n397)Footnote 397. See Sec. Act Rel. No. 5979, *supra* n.58.

(n398)Footnote 398. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n399)Footnote 399. Arthur M. Borden & Edward A. Fleischman, *The Continuing Development of Rule 144: Significant SEC Staff Interpretations*, 8 Inst. Sec. Reg. 91, 112 (1977).

(n400)Footnote 400. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 61, n.28.

(n401)Footnote 401. Id.

(n402)Footnote 402. A dealer acts as a principal rather than an agent. It buys for its own account and sells to customers from its own account, making a profit from the difference between the price it pays and the price it receives for the securities. *In re Ryan*, Exchange Act Release No. 18,617, 24 SEC Docket 1716 (April 15, 1982).

(n403)Footnote 403. Rule 144(g)(1).

(n404)Footnote 404. Merrill, Lynch, Pierce, Fenner & Smith, SEC No-Action Letter, 2001 SEC No-Act. LEXIS 586 (May 30, 2001).

(n405)Footnote 405. Revenue Properties, *supra* n.333.

(n406)Footnote 406. Rule 144(g)(1). Section 4(4) of the Act, discussed in § 4.06 *supra*.

(n407)Footnote 407. Rule 144(g)(2).

(n408)Footnote 408. Sec. Act Rel. No. 33-6099, n.42 *supra*, at Section II(F), Question 59.

(n409)Footnote 409. Rule 144(g)(3).

(n410)Footnote 410. Rule 144(g)(3)(i).

(n411)Footnote 411. Rule 144(g)(3)(ii). Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 60.

The broker should maintain written records of all the unsolicited indications of interest when received. See Note to Rule 144(g)(3)(ii).

(n412)Footnote 412. Investment Corp. of Virginia, SEC No-Action Letter, 1976 SEC No-Act. LEXIS 1712 (August 16, 1976).

(n413)Footnote 413. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 62.

(n414)Footnote 414. Rule 144(g)(3)(iii).

(n415)Footnote 415. Rule 144(3)(iv).

(n416)Footnote 416. Jeffries & Company, Inc., SEC No-Action Letter (November 29, 1982).

(n417)Footnote 417. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n418)Footnote 418. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n419)Footnote 419. Jeffries & Company, Inc., SEC No-Action Letter (November 29, 1982). Rule 144(g)(4).

(n420)Footnote 420. Note (ii) to Rule 144(g)(4).

(n421)Footnote 421. Rule 144(g)(4) and Note (i) thereto.

(n422)Footnote 422. Rule 144(f).

(n423)Footnote 423. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 51.

(n424)Footnote 424. *Id.* A sale to the parent of a market maker, and in fact an installment sale, was viewed by the staff as a transaction directly with a market maker satisfying the requirement of Rule 144(f). SBHU Holdings, Inc., SEC No-Action Letter (October 18, 1981).

(n425)Footnote 425. *Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007)* .

(n426)Footnote 426. Rule 144(f).

(n427)Footnote 427. Section 3(a)(38) of the Exchange Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Part F (Matthew Bender 2008).

(n428)Footnote 428. Rule 17a-17(b) under the Exchange Act was rescinded in Exch. Act Rel. No. 20,121, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,418 (August 26, 1983), effective September 1, 1983. At the same time, Exchange Act Rule 3b-8 was adopted that provides in pertinent part that a qualified block positioner is

[a] dealer who is ... registered pursuant to Section 15 of the [Exchange] Act., ... is subject to and in compliance with Rule 15c3-1 ... has and maintains minimum net capital ... of \$1,000,000 and ... meets all of the following conditions: (i) he engages in the activity of purchasing long or selling short, from time to time, from or to a customer ... a block of stock ... in a single transaction, or in several transactions at approximately the same time, from a single source to facilitate a sale or purchase by such customer ... (iii) he sells the shares comprising the block as rapidly as possible commensurate with the circumstances.

The adoption of Exchange Act Rule 3b-8 was announced in Exch. Act Rel. No. 34-20,121, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,418 (August 26, 1983). The Rules under the Securities Exchange Act of 1934 are reprinted in the Securities Primary Law Sourcebook, Volume B, Part G (Matthew Bender 2008).

(n429)Footnote 429. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 52.

(n430)Footnote 430. *Id.* at Question 53. The block may consist of securities subject to Rule 144 and securities of the same class not subject to the rule.

(n431)Footnote 431. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 54.

(n432)Footnote 432. *In re Ryan*, *supra* n.402.

(n433)Footnote 433. *See* Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 55.

(n434)Footnote 434. *Id.*

(n435)Footnote 435. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 55, n.20.

(n436)Footnote 436. *See SEC v. Aaron*, 605 F.2d 612 (2d Cir. 1979) .

(n437)Footnote 437. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 56.

(n438)Footnote 438. *Id.* at Question 50.

(n439)Footnote 439. Jim G. Rhodes, SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3204 (January 17, 1980).

(n440)Footnote 440. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 56.

(n441)Footnote 441. Prior to the 1978 amendments, the maximum amount of securities that could be sold under Rule 144(e) was the *lesser* of one percent of the number outstanding or the average trading volume during a period of six rather than three months.

(n442)Footnote 442. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Question 57.

(n443)Footnote 443. *See* Rule 101, Regulation M under the Exchange Act.

(n444)Footnote 444. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(F), Questions 57 and 58.

(n445)Footnote 445. *Id.* at Question 58.

(n446)Footnote 446. Rule 144(f).

(n447)Footnote 447. Rule 144(h).

(n448)Footnote 448. *Id.*

(n449)Footnote 449. *See* Form 144. Regarding the proper time to file Form 144 in the case of call options, *see* Sec. Act Rel. No. 6099, *supra* n.42 at Section II(H), questions 76 through 79, and for put options, *see* § 6.05[2][c][iv] *supra*.

(n450)Footnote 450. Rule 144(h). In a proposed sale by a pledgee of securities following a default in the loan obligation, the pledgee may sign the Form 144. Securities Act Release No. 6099, *supra* n.42 at Section II(G), Question 64.

(n451)Footnote 451. Rule 144(i). Where a proposed seller filed a Form 144 but instructed his broker not to actually sell any of the securities for 65 days, the staff took the position that the proposed seller did not have the required bona fide intention to sell within a reasonable time. Flight Safety International, SEC No-Action Letter, 1976 SEC No-Act. LEXIS 1233 (May 31, 1976).

See also Sec. Act Rel. No. 6099, *supra* n.42 at Section II(H), Question 76, regarding the intent of a person who files a Form 144 for securities to be used to cover a call option, but then delivers other securities.

(n452)Footnote 452. Sec. Act Rel. No. 6099, *supra* n.42 at Section II(G), Question 65.

(n453)Footnote 453. *Id.* at Section II(E), Question 39.

(n454)Footnote 454. *See, e.g., Id.* at Section II(G), Question 66.

(n455)Footnote 455. Sec. Act Rel. No. 5995, *supra* n.58.

(n456)Footnote 456. Sec. Act Rel. No. 8813, 72 Fed. Reg. 36822 (July 5, 2007) .

(n457)Footnote 457. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n458)Footnote 458. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) . Prior to the 2007 amendments,

144(h) was not applicable to proposed sales that involved 500 or fewer shares or other units and an aggregate sale price of not more than \$10,000.

(n459)Footnote 459. Sec. Act Rel. No.P 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n460)Footnote 460. See, e.g., Sec. Act Rel. No. 6099, *supra* n.42 at Section II(G), Questions 67 and 68.

(n461)Footnote 461. Form 144

(n462)Footnote 462. See SEC Division of Corporate Finance Manual of Publicly Available Telephone Interpretations, Fourth Supplement at Rule 10b5-1 (May 30, 2001); Form 144, Interpretation No.2.

(n463)Footnote 463. Previous to the 2007 amendments, paragraph (i) required a seller to have a bona fide intention to sell. Previous paragraph (i) is now contained in paragraph (h).

(n464)Footnote 464. Rule 144(i).

(n465)Footnote 465. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n466)Footnote 466. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) ; NASD Regulation, Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 42 (Jan. 21, 2000).

(n467)Footnote 467. The 2007 Proposing Release initially suggested a 90 day requirement for the filing of Form 10 information. Sec. Act Rel. No. 8813, 72 Fed. Reg. 36822 (July 5, 2007) .

(n468)Footnote 468. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) (" "Form 10" information is equivalent to information that a company would be required to file if it were registering a class of securities on Form 10 or Form 20-F under the Exchange Act"). It is important to note that both restricted and control securities are subject to the one year requirement regarding the filing of Form 10 information.

(n469)Footnote 469. Sec. Act Rel. No. 8869, 72 Fed. Reg. 71546 (Dec. 17, 2007) .

(n470)Footnote 470. See generally § 6.05[1][a] *supra*.

(n471)Footnote 471. See D. Goldwasser, *supra* n.1; Bernard Cedarbaum, *Executing Rule 144 Sales*, 5 Rev. Sec. Reg. 851 (October 19, 1972).

(n472)Footnote 472. See, e.g., Union Bank, SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2153 (February 5, 1979).

(n473)Footnote 473. See § 6.05[9][c] *infra*.

(n474)Footnote 474. See Rule 144(f) and (g) and § 6.05[9][b] *infra* .

(n475)Footnote 475. Cedarbaum, *supra* n.471 at 851.

(n476)Footnote 476. For examples of a typical representation letter, see Denis T. Rice and Charles P. Ortmeyer, 6 Securities Regulation Forms § 2:22 (Westlaw 2008); Fogelson, *supra* n.126 at 1547, Exhibit A; § 4.02[1] *supra* ; D. Goldwasser, *supra* n.1 at 381-97.

(n477)Footnote 477. Legended certificates are not deemed good delivery under the rules of the self-regulatory agencies. National Ass'n of Securities Dealers, Inc., [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,808 (April 21, 1972).

(n478)Footnote 478. See Rule 144(g)(3) and § 6.05[6][b] *supra* .

(n479)Footnote 479. If the issuer is not a reporting issuer under the Exchange Act, see § 6.05[3][c] *supra*.

(n480)Footnote 480. See § 6.05[7] *supra*.

(n481)Footnote 481. In view of the logistical difficulties involved in settling a Rule 144 transaction three days after the trade ("T+3"), as required by Rule 15c6-1(a), the SEC permits "future tense" representation letters from brokers. Smith Barney, Inc., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 549 (June 20, 1995).

(n482)Footnote 482. See the requirements of Rule 502(d) of Regulation D, discussed in § 4.04 *supra*.

(n483)Footnote 483. See D. Goldwasser, *supra* n.1 at 371.

(n484)Footnote 484. Registration and regulation of transfer agents under Section 17 of the Exchange Act is discussed in *Federal Securities Exchange Act of 1934*, § 2A.03 (Matthew Bender 2008).

(n485)Footnote 485. See § 6.02 n.65 and accompanying text *supra*.

(n486)Footnote 486. Grove Explorations, Ltd., *supra* n.185, Sec. Act. Rel. No. 6099, *supra* n.42 at Section I, Question 1.



75 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.06

§ 6.06 Public Resales of Restricted Securities and "Control Securities" Outside Rule 144

Although Rule 144 is the vehicle for most unregistered public resales of restricted securities and control securities that are sold today, it is nevertheless not the sole option for their lawful resale.

[1] Availability of Resale Exemption

As a result of the safe harbor provided by Rule 144, the resale exemption contained in Section 4(1) of the Securities Act is currently available for most resales of restricted securities and most resale of control securities that comply with all of the rule's applicable requirements. n1 By its own terms, however, Rule 144 is not the only means by which holders of restricted and control securities can rely on the resale exemption provided by Section 4(1) of the Securities Act. n2 At least in theory, such proposed sellers may rely upon Section 4(1) outside of the Rule 144 safe harbor. In light of the Commission's warning, however, that a seller and any participating broker will have a heavy burden of proving the availability of the resale exemption outside of the rule, n3 such proposed sellers will most likely resort to this alternative only where one or more of the rule's requirements cannot be satisfied. The proposed sellers will almost certainly encounter reluctance on the part of most issuer and brokers to effect transfers of restricted securities and deliver clean certificates to the purchasers, absent convincing opinion letters from both the seller's and its own experienced counsel regarding the availability of the statutory exemption outside of Rule 144. n4

Since the unlimited resale provision contained in Rule 144 was broadened to permit non-affiliate holders of restricted securities that have not been held by the issuer or any affiliate of the issuer during the holding period to resell those securities, free of all restrictions, it is only in the case of restricted securities that have been held for less than the availability of the resale exemption outside of the rule is relevant. n5 In other words, where the specified holding period has elapsed since restricted securities were acquired from the issuer or an affiliate, those securities are now as freely tradeable under Rule 144 as unrestricted securities under the Section 4(1) resale exemption. n6 While Rule 144 in its present form has virtually eliminated the difference in tradeability between unrestricted securities and restricted securities that have been so owned for the applicable holding period, it is likely to cause Rule 144 to become, by implication, the nearly exclusive method by which restricted securities may be publicly sold under the Securities Act's resale exemption. n7

As explained above, the resale exemption was intended to permit only private resales and ordinary trading transactions without registration under the Securities Act. n8 Although most resales of unrestricted securities by non-affiliates in less

than substantial amounts are regarded as ordinary trading transactions rather than unlawful distributions, public resales of restricted securities are always presumed to involve a distribution. n9 Accordingly, a proposed seller of restricted securities may not safely rely upon the resale exemption for public resales unless it can establish that:

- the original purchase was with investment intent rather than resale intent;
- the resale is other than a sale for the issuer; and
- the resale does not amount to a participation in a distribution. n10

These arguments are difficult to make until a substantial period of time, probably close to the applicable holding period has passed. Only where a proposed seller of restricted securities can convince the issuer, presumably through an opinion of counsel that the resale does not involve a distribution is the resale exemption outside of the rule a realistic possibility for the lawful resale of those securities without registration under the Securities Act.

In light the availability of the resale exemption outside Rule 144 for the sale of restricted securities is extremely limited. Accordingly, counsel is likely to feel comfortable rendering a favorable opinion letter respecting the resale of restricted securities only where there is substantial, though perhaps not literal, compliance with the rule's several requirements. n11 For example, a favorable opinion letter may be appropriate where a Form 144 was inadvertently filed late, n12 where public information has been available for only eighty days, n13 where a holder who has held the subject securities for one year has been a non-affiliate for only two months, n14 and where in each case where all of the rule's other requirements were or could be satisfied. In light of the disclosure philosophy underlying the whole of Securities Act and the staff's vigorous policy against taking a position on the availability of the resale exemption absent adequate current public information about the issuer, even for restricted securities acquired prior to the adoption of the rule, n15 it should be exceedingly difficult to justify a favorable Section 4(1) opinion letter in the absence of such adequate current public information.

In sum, the resale exemption outside Rule 144 is probably presently available for the public resale of restricted securities by non-affiliates only in circumstances that are substantially in compliance with all of the rule's requirements. n16 If a proposed sale of restricted securities would deviate substantially from meeting any of the rule's requirements, other than perhaps the notice of proposed sale requirement, the proposed seller should consider a private sale, or another available exemption from the Securities Act's registration requirements rather than the Section 4(1) resale exemption. n17

[2] Availability of Other Exemptions

As stated above, both restricted securities and control securities may also be publicly sold without registration under the Securities Act where the transaction meets the requirements of one of the limited number of rather narrow transaction exemptions contained in Section 3 of the Securities Act. Those possibilities include the exemption provided by Regulation A pursuant to Section 3(b) n18 and those contained in Sections 3(a)(10) n19 and 3(a)(11) of the Securities Act. n20

Also, the possibility has arisen that restricted securities that have "come to rest" and are no longer in distribution may be resold publicly or privately without registration reliance on Section 4(1). However, the circumstances in which such an exemption is available are more likely to be encountered in a private resale rather than a public one. n21

FOOTNOTES:

(n1)Footnote 1. *But see* exceptions discussed in § 6.05[2][c] *supra*.

(n2)Footnote 2. *See* Rule 144(j), under the Securities Act of 1933, reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender), and discussed in § 6.05[1][c] *supra*.

(n3)Footnote 3. *See* § 6.05 ns.53-55 and accompanying text *supra*.

(n4)Footnote 4. *See* § 6.05[9][b] and [c] *supra*.

(n5)Footnote 5. Rule 144. *See* analysis in §§ 6.05[4] *supra* .

(n6)Footnote 6. Indeed the restricted securities are perhaps more freely tradeable given the safe harbor protection of Rule 144 occurring without any affirmative action on the part of the seller, as well as the fact that there are some limitations on the tradeability of unrestricted securities by non-affiliates. *See* § 6.04[2] *supra* for discussion of those limitations.

(n7)Footnote 7. *See*, however, discussion of sale of securities that have "come to rest" in §§ 6.06[2] and 6.08[2] *infra* .

(n8)Footnote 8. *See* analysis in § 6.02[1] *supra* , the six month or one year holding peirod.

(n9)Footnote 9. *See* analysis in § 6.02[2] *supra* .

(n10)Footnote 10. *Id.*

(n11)Footnote 11. *See* Folgelson, § 6.05 n.126 *supra* , at 1541-42.

(n12)Footnote 12. *See* § 6.05[7] *supra*.

(n13)Footnote 13. *See* 6.05[3][b][i] *supra* .

(n14)Footnote 14. *See* § 6.05[4] *supra*.

(n15)Footnote 15. *See, e.g.,* American Uranium Corp., SEC No-Action Letter 1980 SEC No-Act. LEXIS 3804 (October 14, 1980).

(n16)Footnote 16. *See, e.g.,* General Automation, Inc., SEC No-Action Letter 1980 SEC No-Act. LEXIS 3783 (October 9, 1980).

Since the staff will generally not comment of the availability of Section 4(1) outside of Rule 144 for the sale of restricted securities acquired after April 15, 1972, guidance is limited, Sec. Act Rel. No. 33-6253.

(n17)Footnote 17. An exemption might be made for the sale of large amounts of debt securities to institutional investors. In that regard, *see generally* Study Group on Resales of Debt Securities, ABA Committee on Developments in Business Financing, *Resale by Institutional Investors of Debt Securities Acquired in Private Placements*, 34 *Bus. Law.* 1927 (1979) (hereinafter "ABA Debt Report"). Even in that case, a private sale might be the more appropriate alternative to registration, *see* § 6.07 *infra*.

(n18)Footnote 18. *See* § 6.03[3][b] *supra*.

(n19)Footnote 19. *See* § 6.03[3][d][iii] *supra*.

(n20)Footnote 20. *See* § 6.03[3][d][v] *supra*. *See also* § 3.12 *supra*.

(n21)Footnote 21. *See* § 6.08[2] *infra*.



76 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.07

§ 6.07 Private Resales of Restricted Securities and Control Securities to Qualified Institutional Buyers under Rule 144A

[1] Nature and Philosophy of Rule 144A

During the 1980's, the market for privately placed securities in the U.S. grew faster than the public offering market and became increasingly important. n1 According to the NASDAQ Stock Market, the value of new private placements of unregistered securities, or 144A transactions reached \$162 billion in 2006, surpassing the \$154 billion raised in initial and secondary public offerings. Secondary private transactions for unregistered securities in U.S. private companies increased to \$3 billion (approximately up 140%) according to a 2007 NYPPEX Private Markets report. n2 Issuers saved a substantial amount of money and minimized their information disclosure obligations by arranging placement of their securities with institutional investors without any public offering, thereby avoiding the need for registration under the Securities Act. Foreign issuers especially were attracted to private placements because those placements provided access to the U.S. capital market without making all the disclosures required for the registration of a public offering and periodic disclosure required thereafter under the Exchange Act.

The Commission decided to facilitate such private placements and encourage the participation of foreign issuers in the U.S. market by increasing the efficiency and liquidity of the secondary market for restricted securities. n3 It found that registration under the Securities Act was not intended to protect large institutional investors and that, given minimal procedural protections, such institutions were presumably able to fend for themselves in the securities market. It concluded that offering and selling to such institutions does not involve a distribution. n4

The Commission adopted Rule 144A on April 23, 1990. n5 The rule provides safe harbors under Sections 4(1) (for ordinary investors) and 4(3) (for dealers) of the Securities Act. If all the conditions of the rule are complied with, any holder of restricted securities other than the issuer may resell restricted securities at any time without registration in reliance on the rule. The rule provides that such sales will be deemed not part of a distribution, the seller will be deemed not as underwriter, and securities will be deemed not offered to the public. Thus, ordinary investors may rely on Section 4(1), which provides an exemption from registration for transactions by persons other than issuers, underwriters or dealers. n6 Dealers may rely on Section 4(3), which provides an exemption from registration for transactions by dealers except in circumstances involving a distribution or within forty days of a public offering. n7

Unlike Rule 144, Rule 144A requires no holding period. This facilitates firm underwriting of privately placed securities.

An issuer may sell to an underwriter (using the term underwriter in its factual, not its statutory sense) in a transaction to which the registration provisions of the Securities Act do not apply either because it involves no public offering (in reliance on Section 4(2) or Regulation D) n8 or is conducted outside the United States in compliance with Regulation S. n9 The underwriter may immediately resell the securities to institutional investors, provided the requirements of the rule are satisfied. The Commission has stated explicitly that purchasing securities from an issuer with a view to reselling under Rule 144A does not affect the availability of the Section 4(2) or Regulation D exemption for the issuer. n10

The rule also increases the opportunities for every holder of restricted securities to resell those securities at any time, albeit to a limited universe of potential buyers. There is no explicit limitation on the means that can be used to solicit such sales, provided that offers and sales are made only to "qualified institutional buyers" ("QIBs") in compliance with the rule. The nature of such solicitation may, however, affect the availability of the Section 4(2) exemption for the original private placement by the issuer, so all parties involved in reselling securities under Rule 144A should proceed on the basis that Section 4(2)'s prohibition on general solicitation n11 probably applies to the resales. n12 The Commission permits Rule 144A offers to be made by means of Internet roadshows whose attendees are limited to QIBs. n13

Like all other exemptions from registration, Rule 144A relates only to Section 5 of the Securities Act. It does not provide exemption from any other provision of the securities laws, including the antifraud provisions of the Securities Act and the Exchange Act.

[2] Conditions of the Rule 144A Exemption

The conditions of the exemption provided by Rule 144A are as follows:

- the seller must reasonably believe the buyer is a QIB;
- the seller must take reasonable steps to ensure that the buyer knows the sale may be made in reliance on Rule 144A;
- the securities resold may not be issued by certain investment companies, or be of the same class or convertible or exchangeable for securities of the same class as those listed on a U.S. securities exchange or quoted on NASDAQ; and
- prospective buyers must have a right to receive certain specified information about the issuer.

[a] Reasonable Belief Buyer is a QIB

[i] Definition of QIB. Rule 144A applies only if the seller reasonably believes that the buyer is a "qualified institutional buyer." The rule contains a very detailed and specific definition of "qualified institutional buyer." Generally, a QIB is an entity falling into one of the categories listed in the rule that owns and has investment power n14 over at least \$100 million of securities not issued by the entity or any affiliate of the entity. If the entity is a bank or savings and loan association, it must additionally have an audited net worth of at least \$25 million. A dealer registered as such under Section 15 of the Exchange Act need own only \$10 million of securities. Dealers engaging in "riskless principal transactions" on behalf of QIBs and entities of which all the equity owners are QIBs are also defined as QIBs. Some types of securities, including certificates of deposit, swap contracts and securities subject to repurchase agreements are not counted as eligible "securities" for this test. n15 In 1992, the SEC amended Rule 144A to permit the inclusion of U.S. government and similar securities in calculations of the amount of securities owned or invested by a particular institutional investor. n16

In its adopting release, the Commission stated that it had considered including additional tiers of investors defined by

less stringent criteria, but that it decided to begin with a narrow definition and consider changes in the future based on experience with the rule. n17

[ii] Basis for Reasonable Belief. The safe harbor of Rule 144A is available only if the buyer is a QIB or the seller and any person acting on behalf of the seller reasonably believe the buyer is a QIB. Although this is a question of fact, the rule provides that, with respect to the prospective purchaser's ownership of and investment power over securities, prospective sellers and persons acting on their behalf may rely on any of the following: a recent publicly available financial statement; any document filed by the issuer with government agency or self-regulatory organization either in the United States or elsewhere; the current edition of a "recognized securities manual"; n18 or a certification by the chief financial officer of the issuer. n19

[b] Notice to Buyer of Reliance on Rule 144A. The safe harbor of Rule 144A is available only if the seller takes reasonable steps to ensure that the buyer is aware the seller may be relying on the exemption provided by the rule. The rule does not elaborate what would constitute reasonable steps. Presumably, the notice of possible reliance on the rule would be included in the original offering documents for the securities. In subsequent resales, the seller should give a notice directly to the buyer or cause such a notice to be given.

This notice requirement is important because, although a legend is not required on securities sold in reliance on Rule 144A, such securities are deemed to be restricted securities n20 and purchasers need to be aware of that restricted status. Securities distributed through resales in reliance on Rule 144A frequently do contain a legend stating that the securities have not been registered under the Securities Act and that resales are limited to certain specified circumstances, including resales made in compliance with Rule 144A. However, whether such a legend by itself satisfies the notice requirement for a subsequent resale made in reliance on the rule is doubtful, especially in cases where the securities may not be seen by the purchaser (for example, where they are held in book-entry form).

[c] Eligible Securities; Fungibility Prohibition.

The safe harbor of Rule 144A is available only if the security being sold was not, when issued, fungible with any class of securities that are either listed on a U.S. securities exchange that is registered under Section 6 of the Exchange Act or quoted on an "automated inter-dealer quotation system." n21 The purpose of this requirement is to prevent unregistered offerings of securities that can readily flow into a public market. However, in the case of securities that are mandatorily exchangeable for securities of an unrelated issuer, and those underlying securities are themselves eligible to be traded in the public market (whether because they are not restricted securities or because they are restricted securities eligible to be resold under Rule 144), Rule 144A is available for the overlying securities. n22 Securities of an open-end investment company, unit investment trust or face-amount certificate company each of which is, or is required to be, registered under Section 8 of the Investment Company Act, may not be sold in reliance on the rule. n23 All other securities are eligible to be resold under the rule. n24

[i] Not of the Same Class. The adopting release states generally that securities should be considered of the same class if they entitle their holders to substantially similar rights and privileges, even if the securities have different names or designations. n25

Securities underlying American Depositary Shares ("ADSs") are treated as being the same class of securities as ADSs. n26 Thus, if ADSs are listed on a U.S. securities exchange, the underlying securities may not be offered pursuant to Rule 144A.

[ii] Not Convertible or Exchangeable for Same Class. A security that was, at the time of issuance, convertible into or exchangeable for another security is considered fungible with that other security unless it was subject to a conversion premium of at least 10 percent at the time of issuance. n27 Warrants are considered fungible with the security that can be purchased upon their exercise unless, at the time of issuance, the warrant had a life of at least three years and an effective exercise premium of at least 10 percent. n28 The adopting release contains an explanation of

"effective conversion premium" and "effective exercise premium." n29

[iii] When Issued. It should be noted that the prohibition on fungible securities applies at the time the securities are issued. If the securities were issued prior to a listing on a U.S. exchange or a NASDAQ quotation, the fungibility prohibition does not apply. Thus, where a private company issues shares to its founders, and subsequently becomes public and listed on a U.S. exchange, the founders may use Rule 144A to resell their securities privately. They may wish to do so, for example, to avoid adversely affecting the price of the publicly traded securities by a public resale pursuant to Rule 144.

[iv] Not Issued by an Investment Company. Rule 144A is not available for resales of securities issued by an open-end investment company, unit investment trust or face-amount certificate company that is or is required to be registered under Section 8 of the Investment Company Act. n30

[d] Information Requirement.

Rule 144A is available for resales of securities only when prospective purchasers have a right to obtain information about the issuer. The Commission has taken the position that even substantial institutional investors need to be protected by a right to obtain some information, although not necessarily all the information they would be able to obtain if the sale of securities were required to be registered under the Securities Act or the issuer were required to make periodic disclosure under the Exchange Act. The Commission intended to lighten the burden of traditional disclosure for Rule 144A issuers while retaining a limited right of prospective securities buyers to have information about the issuer's affairs.

The information requirement does not apply to securities issued by foreign government eligible to register securities under Schedule B of the Securities Act n31 28 nor to debt securities issued by an agency or instrumentality of a foreign government eligible to use Schedule B under the Securities Act, if such securities are fully and unconditionally guaranteed by such foreign government. n32 If prospective purchasers have a right to obtain the specified information about the parent of the issuer and the parent unconditionally guarantees the debt securities of its wholly-owned subsidiary, the information requirement of the rule is satisfied. n33

[i] How Right May be Ensured. The information requirement may be satisfied three ways:

- if the issuer is subject to periodic disclosure under Section 13 or Section 15(d) of the Exchange Act; n34
- if the issuer is entitled to the exemption from periodic reporting under Rule 12g3-2(b); n35 or
- if the prospective purchaser otherwise has a right to obtain, at or prior to the sale, certain basic information about the issuer that is reasonably current. n36

The Commission stated that the obligation to provide current basic information may arise by contract, by applicable corporate law or by a rule of an applicable self-regulatory organization. n37

[ii] What Information Must be Available. The information that must be available includes a very brief statement of the nature of the issuer's business, including the products and services it produces, and financial statements (balance sheet, profit and loss and retained earnings) for as much of the previous two fiscal years as the issuer has been in operation. With regard to timeliness, the financial statements must either meet the timing requirements of the issuer's home country or principal trading market or the following schedule. The balance sheet must be as of a date less than 16 months before the date of sale, the profit and loss and retained earnings statements must cover the 12 months preceding such balance sheet, and, if the balance sheet is as of a date more than 6 months prior to the resale, the profit and loss and retained earnings statements must be updated from the date of the balance sheet to a date no more than 6 months before

the date of resale. n38

[3] Rule 144A Trading Markets

The Rule 144A exemption creates the opportunity for development of quasi-public trading markets in restricted securities, in which would-be sellers can freely offer restricted securities for sale, provided the universe of offerees is limited to institutions that are QIBs. Almost simultaneously with the adoption of the rule, the Commission gave the FINRA authority to establish what was then designated as the "Private Offering, Resale and Trading Through Automated Linkages" system, generally known as the PORTAL market. n39 The PORTAL rules as approved by the Commission permit a system in which QIBs and brokers acting as agents for QIBs can electronically post quotations and bids for restricted securities and execute trades with confidence that all offers and sales will be to QIBs or will otherwise be exempt transactions. All securities that can be sold in compliance with Rule 144A can be declared PORTAL-eligible and then can be entered PORTAL by depositing the securities in a PORTAL participant's specially designated account at a PORTAL depository institution. PORTAL also facilitates solicitation of offers to buy eligible securities that have not yet been issued. Restricted securities that have been declared PORTAL-eligible by FINRA may also be held and transferred, by book-entry, by the Depository Trust Company ("DTC") even if those transfers are not made through PORTAL.

Recently, alternative 144A trading systems have emerged, such as Goldman Sachs's GStrUE (GS Tradable Unregistered Equity OTC Market) which opened in 2007. GStrUE will live under the shadow of U.S. regulation, as in order to avoid triggering Exchange Act reporting requirements for any listed company, Goldman and any such listed U.S. entity will need to make sure that the company does not exceed more than 500 shareholders. n40

The market is run by a Goldman Sachs trading system, which allows the members of GStrUE to view bid and ask offers and recent sales. Because of the lack of disclosure in GStrUE, shares on the market are expected to trade at a discount to the equivalent price achievable if the shares were listed on a public market. It is expected that 144A trading platforms, such as GStrUE, will ultimately consolidate into a revised PORTAL.

FOOTNOTES:

(n1)Footnote 1. Sec. Act Rel. No. 33-6806, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,335 (1988), at 89,526-89,528.

(n2)Footnote 2. See Business & Finance Week, Expanded Reporting Section, pg 267, July 14, 2008.

(n3)Footnote 3. Act Rel. No. 33-6806, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,335 (1988), at 89,533.

(n4)Footnote 4. *Id.* at 89,539.

(n5)Footnote 5. Sec. Act. Rel. No. 33-6862 (1990).

(n6)Footnote 6. Rule 144A(b). See also Ch. 4 *supra* and discussion of Section 4(1) at § 6.02[2] *supra*. Section 4(1) i of the 1933 Act is reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

(n7)Footnote 7. Rule 144A(c). See also Ch. 4 *supra*.

(n8)Footnote 8. See also Ch. 4 *supra*.

(n9)Footnote 9. See discussion of Regulation S at § 6.03[1] *supra*.

(n10)Footnote 10. See Preliminary Note 7 to Rule 144A.

(n11)Footnote 11. See Ch. 4 *supra*.

(n12)Footnote 12. See Hanks, *Rule 144A: Another Cabbage in the Chop Suey*, 24 G.W.J. Int'l Law and Ec. 305, 338-41 (1990).

(n13)Footnote 13. See Net Roadshow, Inc., SEC No-Action Letter 1998 SEC No-Act. LEXIS 107 (January 30, 1998). In 2005, the Commission adopted the Securities Offering Reform which has since expanded the scope of permitted communications relating to road shows in the registered offering context. See Securities Release No. 33-8591, § III(3)(b)(iii)(D)(4), 70 Fed. Reg. 44,722 (July 19, 2005) .

(n14)Footnote 14. While this provision may be read to imply that prospective QIB must have investment power over all the securities that it owns (thus disqualifying many large institutions whose assets are managed by other persons), current market practice is to read the provision as permitting prospective QIBs to aggregate assets over which they have investment power (but do not own) with those that they own (but do not have investment power over) in meeting the size test. There is, however, no written authority for this.

(n15)Footnote 15. Rule 144A(a)(1). Investments that are within the Securities Act definition of a security and are not specifically excluded by Rule 144A(a)(2) and which represent undivided interests in a pool of mortgages or receivables count in determining the amount of securities owned for determination of QIB status. See UNUM Life Insurance Co., SEC No-Action Letter 1990 SEC No-Act. LEXIS 1250 (November 21, 1990).

(n16)Footnote 16. See Sec. Act Rel. No. 33-6393, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,202, adding Rule 144A(a)(1)(i)(F).

(n17)Footnote 17. See Sec. Act Rel. No. 33-6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,523 (1990) at II.A.

(n18)Footnote 18. "Recognized securities manuals" include Standard & Poor's Corporation Records, the Moody's manuals and Best's Insurance Reports. The staff has explicitly approved S&P's method of establishing and maintaining its list of QIBs. See Standard & Poor's Corp., SEC No-Action Letter 1991 SEC No-Act. LEXIS 847 (July 8, 1991). See also CommScan LLC, SEC No-Action Letter 1999 SEC No-Act. LEXIS 116 (February 3, 1999) and Communicator Inc., SEC No-Action Letter 2002 SEC No-Act. LEXIS 783 (September 20, 2002), approving similar commercially available lists of QIBs.

(n19)Footnote 19. Rule 144A(d)(1).

(n20)Footnote 20. Preliminary Note 6 to Rule 144A; § 6.03[1] *supra* .

(n21)Footnote 21. Rule 144(d)(3). "Automated inter-dealer quotation system" includes NASDAQ but not the "pink sheet" over-the-counter market. Sec. Act Rel. No. 33-6862.

(n22)Footnote 22. See Mandatorily Exchangeable Issuer Securities, SEC No-Action Letter 1999 SEC No-Act. LEXIS 854 (October 25, 1999).

(n23)Footnote 23. Rule 144A(d)(3)(ii). See Ch. 7B *infra*.

(n24)Footnote 24. Securities received without additional consideration upon exchange of securities that could be resold under the Rule may also be resold under the Rule. Debevoise & Plimpton, SEC No-Action Letter 1990 SEC No-Act. LEXIS 992 (July 23, 1990).

(n25)Footnote 25. Sec. Act Rel. No. 33-6862, § 6.05, n.58, *supra* , text accompanying ns. 23-24.

(n26)Footnote 26. *Id.* at n.26 *supra*.

(n27)Footnote 27. *Id.* at n.25.

(n28)Footnote 28. Rule 144A(d)(3)(i).

(n29)Footnote 29. Sec. Act Rel. No. 33-6862, § 6.05, n.58 at n.25, *supra*. The Commission stated that this rule is intended not to interfere with "common financing activities" and that the power to designate other securities as "not fungible" with listed or quoted securities is delegated to the Director of the Division of Corporation Finance. *Id.*

(n30)Footnote 30. Rule 144A(d)(3)(ii). Note that Rule 144A would be available for resales of the securities of such entities *not* required to register under the Investment Company Act. *See* Ch. 7B *infra*.

(n31)Footnote 31. Rule 144(d)(4)(i).

(n32)Footnote 32. *See* Rule 144A, SEC No-Action Letter (May 30, 1990).

(n33)Footnote 33. *See* British Aerospace PLC, SEC No-Action Letter 1990 SEC No-Act. LEXIS 793 (May 9, 1990).

(n34)Footnote 34. *See* Federal Securities Exchange Act of 1934, Ch. 4 (Matthew Bender). The Exchange Act is reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender).

(n35)Footnote 35. This exemption from reporting under the Exchange Act is available to a foreign private issuer makes available on its website the same information it furnishes to its home government or securities exchange (and which is made public) or to its securities holders.

(n36)Footnote 36. Rule 144(d)(4)(i).

(n37)Footnote 37. Sec. Act Rel. No. 33-6862, § 6.05 n.58, *supra* .

(n38)Footnote 38. Rule 144A(d)(4)(ii).

(n39)Footnote 39. Exch. Act Rel. No. 34-27,956, 55 *F.R.* 18781 (*April 27, 1990*) . The system was later renamed simply "PORTAL."

(n40)Footnote 40. *See* Section 12(g) of the Exchange Act.



77 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.08

§ 6.08 Private Resales of Restricted Securities and Control Securities Outside Rule 144A

The Securities Act was never intended to prohibit the private sale of securities in the absence of compliance with its registration requirements. n1 As stated above, literally billions of dollars of securities, have been offered by issuers to institutional and other sophisticated investors in reliance upon the private placement exemption contained in Section 4(2) of the Securities Act. n2 Similarly, private resales of both restricted securities and control securities in the absence of registration have always taken place with the tacit approval of the courts, the Commission and members of the securities industry and their counsel. n3

[1] Section 4(11/2) Phenomenon

Although even the staff of the Commission has on occasion implied that private resales of outstanding restricted securities are permitted by Section 4(2) of the Securities Act, n4 that exemption is available only to "transactions *by an issuer* not involving any public offering" (emphasis added). n5 Instead, the proper statutory exemption for the private resale of all outstanding securities, including restricted securities and control securities, is once again the Section 4(1) resale exemption. In other words, it permits both routine trading transactions and private resales, in each case as distinguished from distributions that are subject to registration in the absence of an exemption other than that contained in Section 4(1).

As explained above, n6 Section 4(1) permits the resale of all outstanding securities, provided that neither the seller nor any other participant in the transaction is an underwriter within the meaning of Section 2(11) of the Securities Act. As the language of Section 2(11) makes clear, n7 it is never possible for the seller or any other participant in the transaction to fall into the category of statutory underwriter unless the transaction involves a distribution. In other words, if the transaction does not involve a distribution, neither the seller nor any other participant is an underwriter, and the resale exemption is available. Although the availability of the Section 4(1) exemption under this analysis turns on the meaning of the term "distribution," that term is not defined in the Securities Act and it has not been defined by the Commission other than in the context of Rule 144.

The so-called Section 4(11/2) phenomenon n8 is the result of judicial construction of the term distribution for purposes of defining the scope of Section 4(1) for private resales, particularly resales by holders of restricted securities and by affiliates of the issuer. Because of the relationship between Sections 4(1) and 4(2) of the Securities Act, i.e., that both Sections address private sales of securities, the courts have equated the Section 2(11) term "distribution" with the

Section 4(2) term "public offering." n9 In other words, where a particular transaction would constitute a public offering for purposes of a Section 4(2) exemption, it would also constitute a distribution. If a distribution exists, a proposed seller may possibly be an underwriter and is therefore unable to rely upon the Section 4(1) exemption. n10 Accordingly, where the transaction does not amount to a distribution, that is, a public offering under Section 4(2) of the Securities Act, the restricted securities or control securities may be lawfully resold in reliance upon the Section 4(1) resale exemption.

[a] Availability of Exemption. Essentially, a proposed sale of securities is a private rather than a public offering whenever the offerees do not need the sort of protection provided by the registration process. n11 Based on the several decisions that have focused on the availability of Section 4(1) for private resales, a resale is clearly private where the persons purchasing the securities are

- few in number;
- sophisticated in investment matters;
- privy to (or have access to) the basic information relevant to the decision to purchase the offered securities; and
- purchasing with investment intent rather than resale intent. n12

Neither the amount of securities offered n13 nor the period of time during which the proposed seller has held the securities n14 is relevant to whether the transaction is other than a distribution and therefore permitted by the so-called Section 4(1/2) private offering exemption. n15

While the staff has responded to relatively few requests for no-action positions concerning proposed private sales of restricted securities or of "control securities," and has done so with little consistency, there is no question that it concurs that such resales are permissible under Section 4(1) of the Securities Act. n16 The staff is likely, however, to refuse to take a no-action position n17 except in those cases where all of the requirements for private offering under the safe harbor of Regulation D are satisfied. n18 Accordingly, in most cases, sellers proposing to effect private resales will be forced to secure a favorable opinion of counsel in order to cause the issuer to instruct its transfer agent to make the transfer to the purchaser of the securities sold.

As stated above, both affiliates and holders of restricted securities may sell their securities in private transactions under Section 4(1). For most non-affiliate holders of restricted securities, the private sale alternative to relying upon Rule 144 is attractive only where the holder has not owned the securities for the applicable holding period. The private sale alternative is also appealing to pledgees who cannot rely on Rule 144 for one or more reasons and who, following a default, are required to sell those securities in a commercially reasonable manner under the applicable state law. n19 In those cases, despite the fact that public notice of the forthcoming sale is given to a large number of offerees, the staff will normally take a no-action position provided that the final purchasers are few in number, sophisticated, provided with information, and purchasing for investment rather than for resale. n20

For affiliates of the issuer, on the other hand, the private resale option is tremendously appealing because it is normally the sole alternative to a sale that must be in compliance with the adequate current public information, the volume limitations, the manner of sale, the proposed notice of sale, and possibly the holding period requirements of Rule 144. As stated above, the unlimited resale provision even after the applicable holding periods is never available to affiliates, n21 and a public resale outside of Rule 144 under Section 4(1) is difficult for affiliates. n22 In light of the Commission's more restrictive attitude respecting the resale of control securities at a time when it appears more flexible with respect to the resale of restricted securities at least after a specified holding period, it is likely that the Commission would take a narrower view of the availability of Section 4(1) for a private resale by an affiliate than for a non-affiliate seller of

restricted securities. n23 Accordingly, counsel for the affiliate sellers and counsel for the issuer of the securities proposed to be sold should give careful consideration to the availability of the exemption when rendering or reviewing favorable opinion letters.

[b] Effects of Use of Exemption. Where restricted securities or control securities are privately sold in proper reliance upon Section 4(1), the seller and any agent will not be in violation of the Securities Act's registration requirements. Neither should the issuer's exemption in the case of restricted securities be affected. The purchaser, however, will receive in either case, restricted securities with all of the consequent restrictions on their lawful resale under the Securities Act. n24

[2] Non-4(11/2) Resales

In view of the fact that the conditions for reliance on Section 4(11/2) are not clearly established, it may seem inconsistent to discuss resales "outside" Section 4(11/2). However, there is a school of thought that holds that if securities have "come to rest," i.e., if the holder can demonstrate that he did not buy with a view to distribution and was not making the resale for the issuer (which factors could best be established by a sufficiently long holding period), there should be no further restriction on the manner of sale. n25 This is not, of course, a private Section 4(11/2) sale, nor necessarily a Rule 144 sale, but rather a resale in reliance on the resale exemption of Section 4(1) because the securities are no longer in distribution, which is why the holding period, not deemed relevant to a Section 4(11/2) transaction, is so important.

The American Bar Association ("ABA") Committee on Federal Regulation of Securities also reached this conclusion—at least with respect to institutional resales. n26 The Committee's report recognized the existence of an active institutional market for the resale of privately placed debt securities. n27 The ABA Committee concluded that such resales could be made in reliance on Section 4(1). n28 The Committee noted that such sales were usually made on the basis of representations from the buyer as to investment intent, n29 and information was generally provided by the seller or dealer only where requested or where such information was not available to the purchaser from the issuer. n30 The type of information given generally varied according to the amount of information about the issuer that was available to the market. n31 The Committee closely examined Rule 144, which, as discussed above, provides that resales of restricted securities made in accordance with its conditions are not distributions. n32 The Committee noted that such institutional resales of privately placed debt securities met the four substantive conditions of Rule 144 n33 and consequently involved no distribution. Thus, where adequate current information concerning the issuer is available, where the securities have been held for long enough to ensure that the seller is not a conduit for an unregistered distribution (although not necessarily for a fixed period of time such as Rule 144's minimum applicable holding period), where the quantity of securities resold does not disrupt the market, and where the manner of sales similarly does not disrupt the market (although not limited to brokers' or market maker transactions as in Rule 144), n34 resales can be made without registration.

FOOTNOTES:

(n1)Footnote 1. *See The Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted" Securities*, 34 *Bus. Law.* 1961, 1963-65 (1979).

(n2)Footnote 2. *See* § 6.01, n.4 *supra*; *see also* § 4.03 *supra*.

(n3)Footnote 3. *The Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted" Securities*, n.1 *supra*. at 1962.

(n4)Footnote 4. *See, e.g.,* Whittaker Corporation, SEC No-Action Letter 1976 SEC No-Act. LEXIS 1002 (April 30, 1976).

(n5)Footnote 5. Section 4(2) of the 1933 Act, reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender), is discussed in § 4.03 *supra*.

(n6)Footnote 6. *See* analysis contained in § 6.02[1] *supra* .

(n7)Footnote 7. *See* Section 2(11), discussed in § 4.02[2] *supra*.

(n8)Footnote 8. *See generally* *The Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted" Securities*, n.1 *supra*.

(n9)Footnote 9. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959) , *cert. denied*, 361 U.S. 896 (1959) .

(n10)Footnote 10. *See* discussion in §§ 6.02[1] and [3] *supra*.

(n11)Footnote 11. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) .

(n12)Footnote 12. *See, e.g., Neuwirth Investment Fund v. Swanton*, 422 F. Supp. 1187 (S.D.N.Y. 1975) ; *Fuller v. Dilbert*, 32 F.R.D. 60 (S.D.N.Y. 1962) .

(n13)Footnote 13. *See, e.g., Value Line Income Funds, Inc. v. Marcus*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,523 (S.D.N.Y. 1965).

(n14)Footnote 14. *Id.*; Cf. discussion of securities that have "come to rest" at § 6.08[2] *infra* .

(n15)Footnote 15. For a summary of the elements that various commentators have found necessary for § 4(1-1/2) resale, see Hanks, § 6.07, n.12 *supra* , at n.75.

(n16)Footnote 16. Rule 144 (e)(3)(vii); Sec. Act Rel. No. 33-6188, [Transfer Binder] Fed. Sec. L. Rep. (CCH) P 1051 (1980) at n.178.

(n17)Footnote 17. *See, e.g., Hazel, Inc.*, SEC No-Action Letter 1980 SEC No-Act. LEXIS 3206 (April 25, 1980).

(n18)Footnote 18. *But see* *McJunkin Corporation*, SEC No-Action Letter 1982 SEC No-Act. LEXIS 2866 (October 4, 1982) (all requirements met).

(n19)Footnote 19. *See Hueter, The Plight of the Pledgee Under Rule 144*, 3 Sec. Reg. L. J. 111 150-51 (1975).

(n20)Footnote 20. *See, e.g., Capital Facilities Corporation*, SEC No-Action Letter 1982 SEC No-Act. LEXIS 2599 (July 8, 1982); *American Security Bank*, SEC No-Action Letter 1980 SEC No-Act. LEXIS 3341 (May 29, 1980).

(n21)Footnote 21. *See* § 6.05[4] *supra*.

(n22)Footnote 22. *See* § 6.05[1][c] *supra*.

(n23)Footnote 23. *See* *Hazel, Inc.*, n.17 *supra*.

(n24)Footnote 24. *See, e.g., Bank of New Hampshire Corp.*, SEC No-Action Letter 1981 SEC No-Act. LEXIS 3179 (March 4, 1981). *See also* analysis contained in § 6.03[3] *supra* .

(n25)Footnote 25. *The Section "4(11/2)" Phenomenon: Private Resales of "Restricted" Securities*, n.1 *supra*, at 1975. The concept of coming to rest existed prior to the adoption of Rule 144 and the ABA Study Group and that produced this report felt it had continuing validity. *Id.* Louis Loss has discussed a similar idea:

It follows that, if the person who bought from an issuer (or affiliate) has held the securities long enough to make credible his assertion that he did not take them with a view to distribution--so that, as it used to be said, the securities have come to rest in his hands ... his later distribution should be exempted under § 4(1).

L. Loss, *Fundamentals of Securities Regulation* (Little, Brown & Co. 1988), at 375.

(n26)Footnote 26. ABA Debt Report, § 6.06, *n.17 supra* , at 1953; see also Schneider, *Section 4(11/2)--Private Resales of Restricted or Control Securities*, 49 Ohio St. L. J.501-510-11 (1988).

(n27)Footnote 27. ABA Debt Report, § 6.06, *n.17 supra* , 1931.

(n28)Footnote 28. *Id.* at 1958.

(n29)Footnote 29. *Id.* at 1930.

(n30)Footnote 30. *Id.* at 1935.

(n31)Footnote 31. *Id.* at 1949-50.

(n32)Footnote 32. *Id.* at 1953.

(n33)Footnote 33. In such circumstances, all the conditions of Rule 144, except the filing of a notice and the requirement that the seller have the intent to resell shortly after that filing, would be met. *Id.* at 1949-53.

(n34)Footnote 34. ABA Debt Report, § 6.06, *n.17 supra* . This type of market is generally not disrupted by resales of securities. *Id.* at 1932-33.



78 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 6 Restricted and Control Securities under the Federal Securities Laws

1-6 Federal Securities Act of 1933 § 6.09

§ 6.09 Resales Overseas

Restricted and control securities may also be resold overseas in reliance on Regulation S under the Securities Act. n1 Rule 904 of Regulation S permits securities of any kind to be resold outside the United States without registration provided that:

- The relevant offer or sale is made in an "offshore transaction"; n2 and
- No "directed selling efforts" are made. n3

Additional restrictions are imposed on certain persons reselling securities that were originally sold pursuant to Regulation S. n4 Equity securities of U.S. issuers sold pursuant to Regulation S are restricted, and the restricted securities of such issuers remain restricted even after resales pursuant to Regulation S. n5

FOOTNOTES:

(n1)Footnote 1. *See* discussion of Regulation S at § 6.03[3][d][ix] *supra* .

(n2)Footnote 2. Rule 904(a). An offshore transaction for this purpose requires that no offer be made to a person in the United States and that either the buyer be physically located outside the United States at the time the buy order is originated, or that the transaction is executed through a "designated offshore securities market" (there are currently 18 such markets), without being prearranged in the United States. Rule 902(i).

(n3)Footnote 3. Rule 904(b). Directed selling efforts means any activity undertaken for the purpose of, or that reasonably could have the effect of, conditioning the market in the United States for the securities offered overseas. Rule 902(b).

(n4)Footnote 4. *See* § 6.03[3][d][ix].

(n5)Footnote 5. Sec. Act Rel. No. 33-7505 (1998).



79 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 7

1-SA Federal Securities Act of 1933 SA.syn

§ SA.syn Synopsis to Chapter SA: Special Alert to Chapter 7

Special Alert to Chapter 7



80 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

SA Special Alert to Chapter 7

1-SA Federal Securities Act of 1933

Special Alert to Chapter 7

SEC ADOPTS SECURITIES OFFERING REFORM

On July 19, 2005, the Securities and Exchange Commission (the "SEC") adopted final rules (the "2005 Rules") that will significantly modify the registration, communications and offering processes under the Securities Act of 1933 (the "Securities Act"). The new rules are intended to modernize the offering process to recognize the evolution of the securities markets and the proliferation of new technologies, including the Internet. They are part of the continuing efforts by the SEC to integrate the disclosure and other processes under the Securities Act and the Securities Exchange Act of 1934 (the "Exchange Act"). The 2005 Rules became effective on December 1, 2005.

The rules, which are substantially similar to those proposed in November 2004, effect reforms in three main areas:

- communications related to registered securities offerings;
- registration and other procedures in the offering process, including the provision of a new automatic shelf registration process for large companies and a simplified shelf registration process for other companies; and
- delivery of information to investors, including "delivery" through access and notice, and the timeliness of that delivery.

Chapter 7, "Registration Forms," has been revised to reflect the changes made to existing registration forms and procedures by the 2005 Rules. The revised Chapter 7 will be published in the next release of the Securities Regulation Series.

Principal areas of reform that affect the registration forms and that will be discussed in the revised chapter include (1) changes to the eligibility requirements to register securities using Form S-3, (2) expansion of the use of incorporation by reference to previously filed reports, (3) liberalized prospectus requirements for shelf registration statements, (4) eliminating limits on the amount of securities registered in a primary offering, (5) revisions to issuer undertakings, (6) creation of an automatic shelf registration process for well-known seasoned issuers and (7) an "access equals delivery model" for delivery of a final prospectus.



81 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 7.syn

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.syn Synopsis to Chapter 7: Registration Forms

§ 7.01 Introduction

§ 7.02 Preparation of the Registration Statement

[1] Introduction

[2] Drafting the Prospectus

[a] Guides for Preparation and Filing of Registration Statements.

[3] Integrated Disclosure

[a] Regulation S-K.

[b] Regulation C.

[c] Commission Policy on Projections.

[d] Commission Policy on Security Ratings

[4] EDGAR

§ 7.03 Form S-1--Registration of Securities of Issuers For Whom No Other Form is Authorized

[1] Facing Page

[a] Calculation of Registration Fee.

[2] The Prospectus

[a] Item 1. Forepart of the Registration Statement and Outside Front Cover Page of Prospectus.

[b] Item 2. Inside Front and Outside Back Cover Pages of Prospectus.

[c] Item 3. Summary Information, Risk Factors and Ratio of Earnings to Fixed Charges.

[i] Summary of Prospectus Information.

[ii] Address and Telephone Number.

[iii] Risk Factors.

[iv] Ratio of Earnings to Fixed Charges.

[d] Item 4. Use of Proceeds.

[e] Item 5. Determination of Offering Price.

[i] Common Equity.

[ii] Warrants, Rights and Convertible Securities.

[f] Item 6. Dilution.

[g] Item 7. Selling Security Holders.

[h] Item 8. Plan of Distribution.

[i] Underwriters and Underwriting Obligation.

[ii] New Underwriters.

[iii] Other Distributions.

[iv] Offerings on Exchange.

[v] Underwriter's Compensation.

[vi] Underwriter's Representative on Board of Directors.

[vii] Indemnification of Underwriters.

[viii] Dealers' Compensation.

[ix] Finders.

[x] Discretionary Accounts.

[xi] Passive Market Making.

[xii] Stabilization and Other Transactions.

[i] Item 9. Description of Securities to be Registered.

[i] Capital Stock.

[ii] Debt Securities.

[iii] Warrants and Rights.

[iv] Other Securities.

[v] Market Information for Securities Other Than Common Equity.

[vi] American Depositary Receipts.

[j] Item 10. Interests of Named Experts and Counsel.

[k] Item 11. Information With Respect to the Registrant.

[i] Business.

[A] General Development of Business.

[B] Financial Information About Segments.

[C] Narrative Description of Business.

[D] Financial Information About Geographic Areas.

[E] Available Information.

[F] Reports to Security Holders.

[G] Enforceability of Civil Liabilities Against Foreign Persons.

[H] Smaller Reporting Companies.

[ii] Property.

[A] Extractive Enterprises and Estimates of Reserves.

[B] Oil and Gas Producing Activities

[aa] Disclosures and Estimates of Reserves

[bb] Production Activities

[cc] Properties, Wells, Operations and Acreage

[iii] Legal Proceedings.

[iv] Common Equity.

[A] Market Information.

[B] Holders.

[C] Dividends.

[v] Financial Statements.

[vi] Selected Financial Data.

[vii] Supplementary Financial Information.

[A] Selected Quarterly Financial Data.

[B] Information About Oil and Gas Producing Activities.

[viii] Management's Discussion and Analysis of Financial Condition and Results of Operations.

[A] Full Fiscal Years.

[B] Interim Periods.

[C] Safe Harbor.

[ix] Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

[x] Quantitative and Qualitative Disclosures About Market Risk.

[A] Quantitative Information About Market Risk.

[B] Qualitative Information About Market Risk.

[C] Interim Periods.

[D] Safe Harbor.

[xi] Directors, Executive Officers, Promoters and Control Persons.

[A] Identification of Directors.

[B] Identification of Executive Officers.

[C] Identification of Certain Significant Employees.

[D] Family Relationships.

- [E] Business Experience.
- [F] Involvement in Certain Legal Proceedings.
- [G] Promoters and Control Persons.
- [H] Audit Committee Financial Expert.
- [xii] Executive Compensation.
- [A] General.
- [B] Compensation Discussion and Analysis.
- [C] Summary Compensation Table.
- [D] Grants of Plan-Based Awards Table.
- [E] Narrative Disclosure to Summary Compensation Table and Grants of Plan-Based Awards Table.
- [F] Outstanding Equity Awards at Fiscal Year-End Table.
- [G] Option Exercises and Stock Vested Table.
- [H] Pension Benefits.
- [I] Nonqualified Defined Contribution and Other Nonqualified Deferred Compensation Plans.
- [J] Potential Payments Upon Termination or Change-in-Control.
- [K] Compensation of Directors.
- [L] Smaller Reporting Companies.
- [M] Smaller Reporting Companies--General.
- [N] Smaller Reporting Companies--Summary Compensation Table.
- [O] Smaller Reporting Companies--Narrative Disclosure to Summary Compensation Table.
- [P] Smaller Reporting Companies--Outstanding Equity Awards at Fiscal Year-End Table.
- [Q] Smaller Reporting Companies--Additional Narrative Disclosure.
- [R] Smaller Reporting Companies--Compensation of Directors.
- [xiii] Security Ownership of Certain Beneficial Owners and Management.
- [A] Security Ownership of Certain Beneficial Owners.

[B] Security Ownership of Management.

[C] Changes in Control.

[xiv] Certain Relationships and Related Transactions and Corporate Governance.

[A] Transactions With Related Persons.

[B] Review, Approval or Ratification of Transactions with Related Person.

[C] Promoters and Certain Control Persons.

[D] Smaller Reporting Companies.

[E] Director Independence.

[l] Item 11A. Material Changes.

[m] Item 12. Incorporation of Certain Information by Reference.

[n] Item 12A. Disclosure of Commission Position on Indemnification for Securities Act Liabilities.

[o] Summary Prospectus.

[3] Information Included in the Registration Statement But Not Required in Prospectus.

[a] Item 13. Other Expenses of Issuance and Distribution.

[b] Item 14. Indemnification of Directors and Officers.

[c] Item 15. Recent Sales of Unregistered Securities.

[d] Item 16. Exhibits and Financial Statement Schedules.

[i] Exhibits.

[ii] Financial Statements.

[e] Item 17. Undertakings.

[i] Rule 415 Offering.

[ii] Warrants and Rights Offerings.

[iii] Competitive Bids.

[iv] Equity Offerings of Nonreporting Registrants.

[v] Acceleration of Effective Date.

[vi] Rule 430A.

[vii] Qualification of Trust Indentures for Delayed Offerings.

[f] Signatures.

§ 7.04 Registration of Securities of Reporting Issuers--Form S-3

[1] Form S-3--Registration of Securities of Reporting Issuers Considered to be Widely Followed by Professional Securities Analysts

[a] Eligibility Standards.

[i] Registrant Requirements.

[A] Domestic Corporations.

[B] Successors.

[C] Foreign Private Issuers.

[D] Electronic Filings.

[ii] Transaction Requirements.

[A] Primary and Secondary Offerings By Certain Registrants.

[B] Primary Offerings of Non-convertible Preferred Securities.

[C] Transactions Involving Secondary Offerings.

[D] Rights Offerings, Dividend or Interest Reinvestment Plans and Conversions or Warrants.

[E] Offerings of Investment Grade Asset-backed Securities.

[F] Limited Primary Offerings by Certain Other Registrants.

[iii] Majority-Owned Subsidiaries.

[iv] Automatic Shelf Offerings by Well-Known Seasoned Issuers.

[b] Dividend or Interest Reinvestment Plans: Filing and Effectiveness of Registration Statement; Requests for Confidential Treatment.

[c] Facing Page.

[d] Registration of Additional Securities and Additional Classes of Securities.

[e] The Prospectus.

- [i] Item 1. Forepart of the Registration Statement and Outside Front Cover Page of Prospectus.
- [ii] Item 2. Inside Front and Outside Back Cover Pages of Prospectus.
- [iii] Items 3. Summary Information, 4. Use of Proceeds and 5. Determination of Offering Price.
- [iv] Item 6. Dilution.
- [v] Item 7. Selling Security Holders.
- [vi] Item 8. Plan of Distribution.
- [vii] Items 9. Description of Securities to be Registered and 10. Interests of Named Experts and Counsel.
- [viii] Item 11. Material Changes.
- [ix] Item 12. Incorporation of Certain Information by Reference.
- [x] Item 13. Disclosure of Commission Position on Indemnification for Securities Act Liabilities.
- [f] Information Included in the Registration Statement But Not Required in Prospectus.
 - [i] Items 14. Other Expenses of Issuance and Distribution; and 15 Indemnification of Directors and Officers.
 - [ii] Item 16. Exhibits.
 - [iii] Item 17. Undertakings.
 - [A] Rule 415 Offering.
 - [B] Filings Incorporating Subsequent Exchange Act Documents by Reference.
 - [C] Warrants and Rights Offerings and Competitive Bids.
 - [D] Incorporated Annual and Quarterly Reports.
 - [E] Acceleration of Effectiveness.
 - [F] Rule 430A.
- [iv] Signatures.

§ 7.05 Registration of Securities of Smaller Reporting Companies

- [1] New Category of "Smaller Reporting Companies"
- [2] Qualifications of a Smaller Reporting Company
- [3] Scaled Disclosure Requirements Applicable to Smaller Reporting Companies under Regulation S-K

- [a] Item 101. Description of Business.
- [b] Item 201. Market Price of and Dividends on Registrant's Common Equity and Related Stockholder Matters.
- [c] Item 301. Selected Financial Data.
- [d] Item 302. Supplementary Financial Information.
- [e] Item 303. Management's Discussion and Analysis of Financial Condition and Results of Operations.
- [f] Item 305. Quantitative and Qualitative Disclosures About Market Risk.
- [g] Item 402. Executive Compensation.
- [h] Item 404. Transactions with Related Persons, Promoters and Certain Control Persons.
- [i] Item 503. Prospectus Summary, Risk Factors and Ratio of Earnings to Fixed Charges.
- [j] Item 504. Use of Proceeds.
- [k] Item 601. Exhibits.

§ 7.06 Registration of Certain Business Combinations

[1] Form S-4 Registration of Securities Issued in Business Combination Transactions

- [a] Facing Page.
- [b] The Prospectus.
 - [i] Information About the Transaction.
 - [A] Item 1. Forepart of Registration Statement and Outside Front Cover Page of Prospectus.
 - [B] Item 2. Inside Front and Outside Back Cover Pages of Prospectus.
 - [C] Item 3. Risk Factors, Ratio of Earnings to Fixed Charges and Other Information.
 - [D] Item 4. Terms of the Transaction.
 - [E] Item 5. Pro Forma Financial Information.
 - [F] Item 6. Material Contracts with the Company Being Acquired.
 - [G] Item 7. Additional Information Required for Reoffering by Persons and Parties Deemed to be Underwriters.
 - [H] Item 8. Interests of Named Experts and Counsel.
 - [I] Item 9. Disclosure of Commission Position on Indemnification for Securities Act Liabilities.

[ii] Information About the Registrant.

[A] Item 10. Information With Respect to S-3 Registrants.

[B] Item 11. Incorporation of Certain Information by Reference.

[C] Item 12. Information with Respect to S-3 Registrants.

[D] Item 13. Incorporation of Certain Information by Reference.

[E] Item 14. Information with Respect to Registrants Other Than S-3 Registrants.

[iii] Information About the Company Being Acquired.

[A] Item 15. Information With Respect to S-3 Companies.

[B] Item 16. Information With Respect to S-3 Companies.

[C] Item 17. Information With Respect to Companies Other Than S-3 Companies.

[iv] Voting and Management Information.

[A] Item 18. Information if Proxies, Consents or Authorizations are to be Solicited.

[B] Item 19. Information if Proxies, Consents or Authorizations Are Not to be Solicited or in an Exchange Offer.

[c] Information Included in the Registration Statement But Not Required in Prospectus.

[i] Item 20. Indemnification of Officers and Directors.

[ii] Item 21. Exhibits and Financial Statements Schedules.

[iii] Item 22. Undertakings.

[d] Roll-Up Transactions.

[i] Item 902. Individual Partnership Supplements.

[ii] Item 903. Summary.

[iii] Item 904. Risk Factors and Other Considerations.

[iv] Item 905. Comparative Information.

[v] Item 906. Allocation of Roll-Up Consideration.

[vi] Item 907. Background of the Roll-Up Transaction.

[vii] Item 908. Reasons for and Alternatives to the Roll-Up Transaction.

[viii] Item 909. Conflicts of Interest.

[ix] Item 910. Fairness of the Transaction.

[x] Item 911. Reports, Opinions and Appraisals.

[xi] Item 912. Source and Amount of Funds and Transaction Expenses.

[xii] Item 913. Other Provisions of the Transaction.

[xiii] Item 914. Pro Forma Financial Statements; Selected Financial Data.

[xiv] Item 915. Federal Income Tax Consequences.

§ 7.07 Foreign Registration Forms

[1] Form F-1--Registration of Securities of Foreign Private Issuers For Whom No Other Form is Authorized

[a] Eligibility Standards.

[b] Application of General Rules and Regulations.

[c] Exchange Offers.

[d] Roll-up Transactions.

[e] Registration of Additional Securities.

[f] Facing Page.

[g] The Prospectus.

[i] Items 1-3.

[ii] Item 4. Information with Respect to the Registrant and the Offering.

[A] Identity of Directors, Senior Management and Advisors.

[B] Offer Statistics and Expected Timetable.

[C] Key Information.

[D] Information on the Company.

[E] Operating and Financial Review and Prospects.

[F] Directors, Senior Management and Employees.

[G] Major Shareholders and Related Party Transactions.

[H] Financial Information.

[I] The Offer and Listing.

[J] Additional Information.

[K] Quantitative and Qualitative Disclosures About Market Risk.

[L] Description of Securities Other than Equity Securities.

[iii] Item 4A. Material Changes.

[iv] Item 5. Incorporation of Certain Information by Reference.

[v] Item 5. Disclosure of Commission Position on Indemnification for Securities Act Liabilities.

[h] Instructions as to Summary Prospectuses.

[i] Information Included in the Registration Statement but Not Required in the Prospectus.

[i] Items 6-9.

[j] Signatures.

[2] Form F-3--Registration of Securities of Reporting Issuers Widely Followed by Professional Securities Analysts.

[a] Eligibility Requirements.

[i] Registrant Requirements. All registrants must meet the following conditions in order to use Form F-3 for registration:

[ii] Transaction Requirements.

[b] Automatic Shelf Offerings by Well-Known Seasoned Issuers.

[c] Application of General Rules and Regulations.

[d] Dividend or Interest Reinvestment Plans.

[e] Registration of Additional Securities.

[f] Facing Page.

[g] The Prospectus.

[i] Items 1-3.

[ii] Item 4. Information About the Offering.

[iii] Item 5. Material Changes.

[iv] Item 6. Incorporation of Certain Information by Reference.

[v] Item 7. Disclosure of Commission Position on Indemnification for Securities Act Liabilities.

[h] Information Included in the Registration Statement but Not Required in the Prospectus.

[i] Items 8-10.

[i] Signatures.

Cristopher Greer
Melinda I. Wang
Jeffery C. Fang
Amanda M. Burke
Andrew R. Meyerson n*

FOOTNOTES:

(n1)Footnote *. This chapter was revised by Cristopher Greer (J.D., 1995, Fordham University School of Law), Melinda I. Wang (J.D., 2002, University of Pennsylvania Law School), Jeffery C. Fang (J.D., 2006, Georgetown University Law Center), Amanda M. Burke (J.D., 2009, Cornell Law School), and Andrew R. Meyerson (J.D., 2009, New York University School of Law; M.B.A., 2009, New York University Leonard N. Stern School of Business), all of whom are attorneys with the firm of Willkie Farr & Gallagher LLP, New York.



82 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 § 7.01

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.01 Introduction

Unless an exemption can be identified, securities that are not exempt must be registered and a prospectus must be given to purchasers, to satisfy the full and fair disclosure objective of the securities laws. The information included in the prospectus must be factually complete and correct, not misleading and presented in clear, concise and understandable language. Regulation S-K, a pattern of "integrated disclosure," sets forth the content requirements for disclosure documents filed with the Securities and Exchange Commission (the "Commission") under the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Regulation S-K contains ten major sections: (1) General; (2) Business; (3) Securities of the Registrant; (4) Financial Information; (5) Management and Certain Security Holders; (6) Registration Statement and Prospectus Provisions; (7) Exhibits; (8) Miscellaneous; (9) List of Industry Guides and (10) Roll-Up Transactions. Regulation S-K requires that any projections contained in disclosure documents be accompanied by information with respect to the basis of the projections. Regulation S-K also sets forth requirements governing the use in disclosure documents of ratings of registrants' securities. n1 Regulation S-K's disclosure requirements are supplemented by other regulations, including Regulation S-X, which governs the requirements for financial statements under the Securities Act and the Exchange Act, and Regulation S-T, which governs the types of documents the Commission requires to be filed electronically.

In an effort to reform the regulation of capital formation, in July 2005 the Commission adopted rules (the "2005 Rules") significantly modifying the offering process under the Securities Act. n2 The 2005 Rules were intended to modernize and streamline the offering process and continue the evolution into a more integrated disclosure system. The 2005 Rules effect reforms in three main areas: (1) registration and other procedures in the offering process, including the provision of a new automatic shelf registration process for large companies and a simplified shelf registration process for other companies; (2) communications related to registered securities offerings; and (3) delivery of information to investors and the timeliness of that delivery. The 2005 Rules distinguish among four categories of issuers and create a new category of issuer, the "well-known seasoned issuer" (referred to as "WKSIs") that benefits from the most far-reaching reforms. Changes made to existing registration forms and procedures by the 2005 Rules will be addressed in the appropriate sections of this chapter. n3

WKSIs are generally defined as an issuer eligible to file on Form S-3 or Form F-3 with at least \$700 million of worldwide common equity market capitalization held by non-affiliates or \$1 billion aggregate amount of

non-convertible (other than common equity) registered in primary offerings during the past three years. n4

Registration on Form S-1 is for use by registrants for whom no other form is prescribed. It is generally used by registrants who have never filed or who have been filing reports under the Exchange Act for less than one year. Form S-1 requires more extensive disclosure than any of the other forms used for registration of securities under the Securities Act, requiring that information relating to the offering and information concerning the registrant be included in the prospectus. In describing the offering on Form S-1, the registrant must provide information concerning: the risk factors present in the offering; the registrant's ratio of earnings to fixed charges; the use that the issuer will make of the proceeds of the offering; the plan of distribution of the offered securities, including any compensation to be paid or given to underwriters and dealers; a description of the securities being offered; and how the price of the securities was determined. In describing the registrant, Form S-1 must include the information specified by Regulation S-K, including information describing the registrant's business, properties and common equity securities; details with respect to legal proceedings to which the registrant is a party; the identity, business background and compensation of the registrant's directors and officers; n5 and an account of the security holdings of officers, directors and certain other beneficial owners of the registrant's securities and of certain transactions between the registrant and its management. In addition, Form S-1 must include the registrant's audited financial statements and management's discussion and analysis of the registrant's financial condition and the results of its operations. The 2005 Rules amended Form S-1 to expand the types of issuers that may incorporate information by reference, without requiring delivery of the incorporated documents (except on request). n6

Special registration forms, which provide for less extensive prospectus disclosure than Form S-1, are available for use by certain registrants. Generally, these forms are available to registrants that have been reporting companies under Section 13 or Section 15(d) of the Exchange Act. n7

Seasoned registrants may use Form S-3 to register their securities. Form S-3 relies on incorporation by reference of Exchange Act filings, and only requires disclosure in the prospectus of information concerning the offering and material facts not previously disclosed by the registrant in its Exchange Act filings. n8

Effective February 2008, registrants could no longer use Form SB-1 and Form SB-2 to offer securities to the public, as those forms were rescinded. n9 In an effort to further simplify and streamline the disclosure requirements for small issuers, the Commission adopted amendments that created a new designation, "smaller reporting company," to replace the "small business issuer" definition found in Regulation S-B. n10 Such companies must file on the appropriate Securities Act registration form without an "SB" designation.

Form S-4 is used to register securities issued in certain business combination transactions described in Rule 145. In general, Form S-4 requires information about the transaction including the terms of the transaction; the business of each of the parties; the percentage of voting shares required for approval; what state or federal regulatory requirements must be complied with to proceed with the transaction; and the tax consequences of the transaction. n11

Registration Forms F-1 and F-3 are available for use by foreign private issuers. n12 The forms are substantially similar to Forms S-1 and S-3, with certain notable exceptions. Perhaps most significantly, the financial statements can be prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board (the "IASB"), without reconciliation to generally accepted accounting principles in the United States. n13

FOOTNOTES:

(n1)Footnote 1. *See* § 7.03[3] *infra*. Regulation S-K is reprinted in the Securities Primary Law Sourcebook, Volume D, Section K (Matthew Bender).

(n2)Footnote 2. Sec. Act. Rel. No. 33-8591 (2005).

(n3)Footnote 3. One way in which the 2005 Rules liberalized communications restrictions is by permitting written communications that constitute offers outside the statutory prospectus, under certain conditions. Such a written communication is defined as a "free writing prospectus." If the conditions of the rules are satisfied, a free writing prospectus can be used to communicate information about an offering outside of the statutory prospectus. Permitted free writing prospectuses are not deemed part of the registration statement (though certain free writing prospectuses must satisfy their own filing conditions). Because they are distinct from the registration forms and the statutory prospectus they have not been addressed further in this chapter.

Certain issuers and offerings will not be eligible to use free writing prospectuses or the other new communications safe harbors and exemptions. Ineligible issuers include reporting issuers that are not current in their Exchange Act reporting obligations, blank check issuers, shell companies and penny stock issuers. Ineligible offerings include offerings by registered investments companies or business development companies and offerings that are exchange offers or business combination transactions that are subject to Regulation M-A. *See* § 7.04[1] *infra*.

(n4)Footnote 4. *See* § 7.04[1] *infra*. Whether an issuer satisfies the eligibility requirements of Form S-3 or F-3 and its status as an "eligible issuer" is determined at the time of filing of the relevant registration statement and thereafter at the time of the annual update of that registration statement pursuant to Section 10(a)(3) under the Securities Act upon the filing of the issuer's annual report on Form 10-K or 20-F. Issuers' non-affiliate equity market capitalization and the aggregate amount of their non-convertible securities issuances are measured within 60 days of such eligibility determination.

(n5)Footnote 5. Effective November 7, 2006, the Commission significantly amended the executive compensation disclosure requirements of Regulation S-K in an effort to provide investors with a clearer and more complete picture of compensation earned by a company's principal executive officer, principal financial officer and highest paid executive officers and members of its board of directors. *See* § 7.03[2][k][xii] *infra*; *see also* Sec. Act Rel. No. 33-8732 (2006).

(n6)Footnote 6. *See* § 7.03 *infra*.

(n7)Footnote 7. Prior to the adoption of the 2005 Rules, Form S-2 was available for use by registrants to incorporate information about themselves from the registrant's annual report to security holders pursuant to Exchange Act Rules 14a-3 or 14c-3 and the registrant's latest quarterly report if copies of those reports were delivered together with the prospectus and contained the latest financial information specified by Form S-2. If the registrant's latest annual report was not delivered with the prospectus, Form S-2 required the registrant to include in the prospectus a description of its business and certain financial information. Further, a registrant filing on Form S-2 specifically incorporated by reference in the prospectus certain portions of the registrant's Exchange Act filings.

Form S-2 was meant to minimize duplicative reporting while providing for incorporated information to be delivered with the prospectus. The form was rendered superfluous by the expansion of the types of issuers that may incorporate information by reference using other forms and, therefore, was eliminated by the 2005 Rules.

(n8)Footnote 8. *See* § 7.04[1] *infra*. The 2005 Rules allow for additional Form S-3 or Form F-3 disclosures to be included through prospectus supplements and Exchange Act reports.

(n9)Footnote 9. *See* SEC Act Rel. No. 33-8876.

(n10)Footnote 10. For a discussion on how a registrant qualifies as a "smaller reporting company," *see* § 7.05 *infra*. The amendments also rescinded Regulation S-B and consolidated the scaled disclosure requirements applicable to

smaller reporting companies into Regulation S-K. Sec. Act Rel. No. 33-8876.

(n11)Footnote 11. *See § 7.06 infra.*

(n12)Footnote 12. Form F-2 was eliminated along with Form S-2 by the 2005 Rules, under the same rationale.

(n13)Footnote 13. *See § 7.07 infra.*



83 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 § 7.02

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.02 Preparation of the Registration Statement

[1] Introduction

The basic objectives of the Securities Act are to provide full and fair disclosure with respect to securities sold in interstate commerce or through the mails and to prevent fraud in such sales. The registration provisions of the Securities Act also attempt to prevent fraud. n1 The objective of full and fair disclosure is accomplished by requiring registration. Broadly stated, before a public offering of securities may be made through the mails or in interstate commerce, a registration statement must be filed with the Commission. A prospectus based on the information in the registration statement must be provided to purchasers. Only when the registration statement has become effective may the securities be sold. n2

Section 7 of the Securities Act states that the information and documents that must be included in a registration statement are those specified in Schedule A or Schedule B:

- the registration statement for a security other than a security issued by a foreign government, or a political subdivision thereof, must contain the information and documents specified in Schedule A; n3 and
- the registration statement for a security issued by a foreign government or its political subdivision must include the information and documents specified in Schedule B.

Under certain circumstances, however, the Commission may provide that any of the information or documents specified in Schedule A or B need not be included in a registration statement for a class of issuers or securities. n4 The Commission also may, by rule or regulation, require the inclusion of additional information and documents as the Commission deems necessary or appropriate in the public interest or for the protection of investors. n5

The process of registration, from the standpoint of filing and processing procedures, is discussed in a later chapter. n6 This chapter is concerned with the actual preparation of a registration statement.

Form S-1 is the general form for registration of securities under the Securities Act. Form S-1 consists of Part I and Part II. n7 Part I, the prospectus, calls for 12 items of information, including financial statements. However, since the prospectus is written in narrative form, the information required need not be presented in the numerical order in which the items appear. n8

Part II calls for five items of information not required in the prospectus; it is prepared and filed in item-and-answer form. n9

[2] Drafting the Prospectus

Since the prospectus is usually the only document read by prospective investors and upon which those investors can base an informed judgment, great care must be exercised in its preparation.

The prospectus should present full and fair disclosure about the registrant in *factual* terms. This sort of presentation often conflicts with the desire of the issuer and the underwriters to present the issuer in the most favorable light possible in order to sell the securities. The most persuasive response to this type of pressure is to remind the client that the Securities Act imposes stringent civil liabilities upon the company, directors, underwriters, accountants and certain other persons for any untrue statement of a material fact or omission of a material fact. n10 A sales-oriented document may distort material facts and may result in exposure to these liabilities. The answer that such sales statements constitute mere "puffing" may be no answer. As Franklin D. Roosevelt stated in the part of his message of March 29, 1933 dealing with the Securities Act: "This proposal adds to the ancient rule of *caveat emptor*, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller." n11 On that same point, the Commission stated:

The concept of 'puffing' is derived from the doctrine of *caveat emptor* and arises primarily in the sale of tangibles where it appears that examination by the purchaser may offset exaggerated statements and expressions of opinion by the salesman. It can have little application to the merchandising of securities. Particularly [this is] true under the anti-fraud provisions of the securities laws, which were designed to protect against sharp and inequitable practices whether or not they meet the requisites of common law fraud. Indeed, a basic purpose of this remedial legislation was to supplement the doctrine of *caveat emptor* with high standards of responsibility for sellers of securities. n12

There is a fairly common misconception that supplying the information called for by the registration form satisfies all disclosure obligations. *This is definitely not the case.* In short, the prospective investor is entitled to all material information that will permit an informed judgment, *whether or not that information is called for by the registration form.* n13 The investor is entitled to *full* and *fair* disclosure.

Moreover, the *literal* correctness of a statement is unimportant if the general effect of the statement is to present a misleading impression. By way of illustration, suppose that the portion of a new oil company's prospectus dealing with management and background states that, prior to his association with the company, "Mr. Jones was associated with the JSD Refining Company." Suppose further that Mr. Jones was associated with the JSD Refining Company in the capacity of a service station attendant. It is obvious that the statement that "Mr. Jones was associated with the JSD Refining Company," standing alone, conveys the misleading impression that he was associated with JSD in an executive capacity. n14 Similarly, presentation of the material in the prospectus in a way that facts bearing upon the same subject matter are segregated to conceal their relevance is less than full and fair disclosure. n15

Troublesome questions may arise with respect to the use in the prospectus of estimates of earning power, dividend prospects, projections and appraisals of physical property because of the difficulty of fully and fairly disclosing underlying assumptions and conditions. Generally speaking, however, statements with respect to future earning power

and dividend prospects and subsequent reaffirmations of those statements will not be deemed false or misleading if the statements were made or reaffirmed with a reasonable basis and in good faith. n16 Notwithstanding the provisions of this rule, however, many issuers are reluctant to volunteer forward-looking information.

The prospectus should contain clear language. Technical or complicated legal descriptions are not appropriate. As the Commission has observed, "The prospectus is designed to be read by people making business judgments. Meticulousness, which lawyers use in such documents as corporate indentures, is out of place in a prospectus. The resulting verbiage is without meaning except to those skilled in legalistic language." n17 Similarly, "meaningless, high-sounding, pseudo-scientific phrases designed principally to impress the uninformed" may be misleading. n18 In sum, the purpose of the prospectus is to inform investors. Hence, the information set forth in the prospectus should be presented in clear, concise, understandable fashion. Avoid unnecessary and irrelevant details, repetition or the unnecessary use of technical language. The complex nature of the prospectus frequently makes it an ineffective communication tool for the average investor. Too often, its principal value is as a communication line between the issuer and the underwriter; it is a prospectus for the Commission, not the public. The Commission, acutely aware of this problem for many years, issued a release in 1970 encouraging the use of brevity and conciseness without sacrificing adequate disclosure for investors. n19 In the same release, the Commission issued a public invitation to lawyers, accountants, analysts, broker-dealers and other persons to offer comments and suggestions. The determination to make the prospectus a more readable and understandable document culminated in the Commission's major revision of prospectus content and presentation in 1973.

The Commission, continuing to seek greater clarity in the drafting of prospectuses, implemented "plain English" requirements in 1998 for the introduction to the prospectus. n20 Though the plain English rules apply only to the cover page, summary and risk factors section of the prospectus, registrants must prepare the entire prospectus using the following standards:

- Present information in clear, concise sections, paragraphs and sentences, and wherever possible, use short, explanatory sentences and bullet lists;
- Use descriptive headings and subheadings; and
- Avoid frequent reliance on glossaries or defined terms as the primary means of explaining information. Registrants should use defined terms only if the meaning is unclear from the context, and a glossary only if it facilitates understanding of the disclosure. n21

Registrants should avoid the following:

- Legalistic or overly complex presentations that make the substance of the disclosure difficult to understand;
- Vague "boilerplate" explanations that are imprecise and readily subject to different interpretations;
- Complex information copied directly from legal documents without any clear and concise explanation of the provision; and
- Disclosure repeated in different sections of the document that increases the size of the document but does not readily enhance the quality of the information. n22

On the cover page and the summary and risk factors sections of the prospectus, registrants must use:

- Short sentences;
- Definite, concrete, everyday language;
- Active voice;
- Tabular presentation of complex information;
- No legal or business jargon; and
- No multiple negatives. n23

Registrants must also design these sections to make them inviting to the reader. Registrants may use pictures, logos, charts, graphs or other design elements so long as the design is not misleading and the required information is clear. Registrants are encouraged to use tables, schedules, charts and graphic illustrations (drawn to scale) of the results of operations, balance sheet or other financial data that present the data in an understandable manner. Any presentation must be consistent with the financial statements and non-financial information in the prospectus. The intent of the plain English rules is not to reduce or offset the substantive disclosure requirements. Rather, it is to ensure that the required full and fair disclosure is in a form easily understood by the average investor. In addition to these general drafting guidelines, the Commission made several specific amendments to Regulations S-K and S-B to improve the readability of the forms. n24

[a] Guides for Preparation and Filing of Registration Statements. In 1968, the Commission published "Guides for Preparation and Filing of Registration Statements" (hereinafter, "the Guides") n25 which were based upon, and closely followed, proposals outlined in two previous releases. n26 In adopting these guides, the Commission observed that they represented "policies and practices followed by the Commission's Division of Corporation Finance," but that they were "subject to review and modification from time to time" and did not "purport to furnish complete criteria for the preparation of registration statements." n27

In 1972-73, the Commission issued releases containing major revisions to prospectus content and presentation. n28 These revisions were "designed to result in disclosure of more meaningful information concerning all registrants and to communicate more effectively to the investing public the economic realities concerning new registrants." Prior to 1980, the Guides had never been the subject of an overall review. Consistent with the Commission's sunset review of existing rules and regulations under the Securities Act and the recommendation of the Advisory Committee on Corporate Disclosure, n29 the Commission undertook a sunset review of the Guides. The review, part of the Commission's integrated disclosure program, was undertaken in three stages. In 1979, the Commission issued a concept release, soliciting comments to assist in reevaluating the Guides. n30 In response to comments, the Commission proposed the deletion of certain Guides and the centralization of others into the rules and regulations under the Securities Act. n31 In 1981, the Commission published the final integration proposals concerning the Guides. n32

In 1982, the Commission, in conclusion of its sunset review of the Guides and reorganization of Regulation S-K as the repository for content requirements for disclosure documents filed with the Commission under the Securities Act and the Exchange Act:

- (1) rescinded all but five of the Guides;
- (2) incorporated the substance of the Guides relating to disclosure requirements into Regulation S-K;

(3) incorporated the Guides relating to procedural matters into Regulation C and the General Rules under the Securities and Exchange Acts, particularly Regulation 12B under the Exchange Act; and

(4) relocated the remaining Guides concerning disclosure by registrants in particular industries in a new section of Regulation S-K under the heading "List of Industry Guides." n33

[3] Integrated Disclosure

In 1982, the Commission, pursuant to its integrated disclosure program under the Securities Act and the Exchange Act, adopted: n34

(1) new Forms S-1, S-2 and S-3, which constitute the basic framework for registration statements under the Securities Act; n35

(2) an expanded and reorganized Regulation S-K providing for the uniform disclosure requirements for documents filed with the Commission under the Securities Act and the Exchange Act; n36

(3) revised procedural requirements under Regulation C and Exchange Act Regulation 12B, which update and coordinate procedures for filing registration statements and reports with the Commission under the Securities Act and the Exchange Act, respectively; n37

(4) Rule 415 governing the registration of securities to be sold in a continuous or delayed offering ("shelf" registration); n38

(5) Rule 176 identifying circumstances affecting the determination of what constitutes reasonable investigation and reasonable grounds for belief under Section 11 of the Securities Act; n39

(6) Rule 436(g) permitting disclosure of security ratings in registration statements; n40

(7) revisions of Forms S-8, S-11, S-14 [replaced by Form S-4] and S-15 [replaced by Form S-4] and Rules 135, 138, 175 and 412 conforming the forms and rules with Regulation S-K; n41 and

(8) technical amendments to Securities Act and Exchange Act rules, forms, and schedules rescinding obsolete forms. n42

With the 2005 Rules, the Commission continued the evolution of the integrated disclosure program under the Securities Act and the Exchange Act by adopting, among other things:

(1) Rule 430B which implements liberalized prospectus requirements for shelf registration statements for registered securities offerings other than those in connection with business combination transactions and exchange offers;

(2) Rule 430C which implements similar liberalized prospectus requirements for offerings not covered by Rule 430B;

(3) amendments to Rule 415 concerning the limitation on the amount of securities that can be registered, permitting immediate takedowns off of shelf registration statements and "at-the-market" offerings of equity securities;

- (4) revisions to issuer undertakings pursuant to Item 512 of Regulation S-K;
- (5) "automatic shelf registration" for offerings on Form S-3 and F-3 for securities offerings of certain issuers who meet eligibility conditions, other than those in connection with business combination transactions and exchange offers; and
- (6) Rule 172, which sets up an "access equals delivery" model for delivery of a final prospectus. n43

In approaching the integrated disclosure system for guidance as to the applicable requirements for registration of securities or the preparation of registration statements or reports, the registrant must look first to the registration and report forms to determine the proper form to be used. After identifying the proper form, the registrant is directed by the form to the relevant portions of Regulation S-K for the specific disclosure requirements for each form. After identifying the disclosure requirements, the registrant must look to Regulation C for the procedures to be followed in preparing and filing the particular registration statement.

[a] Regulation S-K. Regulation S-K is the principal source of content requirements for registration statements and reports filed with the Commission under the Securities Act and the Exchange Act. n44 It contains ten major sections: (1) General; (2) Business; (3) Securities of the Registrant; (4) Financial Information; (5) Management and Certain Security Holders; (6) Registration Statement and Prospectus Provisions; (7) Exhibits; (8) Miscellaneous; (9) List of Industry Guides; and (10) Roll-Up Transactions.

Regulation S-K is not self-executing. The reporting of the information specified in Regulation S-K is required only to the extent a form or schedule governing a document specifically directs inclusion of the information prescribed by an item of Regulation S-K. There are two exceptions to this general rule:

- (1) the Commission's policies on projections n45 and security ratings n46 apply to all disclosure documents regardless of whether there is a direct reference in a form or schedule to the specific provision of Regulation S-K setting forth the policies and whether the form or schedule incorporates any item of Regulation S-K; and
- (2) the industry Guides apply to the disclosure documents indicated in the Guides regardless of whether the applicable form or schedule refers to Regulation S-K or to an industry Guide. n47

Registrants, therefore, must report the information called for by the Commission's policies on projections and security ratings and by the industry Guides whenever appropriate, even if the applicable form or schedule does not specifically provide that the information be reported.

[b] Regulation C. Regulation C contains the procedures for preparing and filing Securities Act registration statements. n48

Regulation C is organized to locate rules specifically relating to registration statements for investment companies and business development companies under separate headings. n49

[c] Commission Policy on Projections. n50 Paragraph (b) of the general section of Regulation S-K (17 C.F.R. § 229.10) contains the Commission's policy on disclosure of projections. Under this policy, the Commission encourages the use in documents specified in Rule 175 of management's good faith projections of future economic performance that have a reasonable basis and are presented in an appropriate format. n51

In determining the appropriate format for projections, the financial items to be projected, the period to be covered and the manner of presentation to be used must be considered. The projections should also be accompanied by disclosures

that facilitate investor understanding of the bases for, and the limitations of, the projections, including the assumptions that, in management's opinion, are most significant to the projections or are the key factors upon which the financial results of the enterprise depend. Because of the practical difficulties and the potential liability associated with fully and fairly disclosing all material assumptions, contingencies and conditions, most issuers are reluctant to furnish this type of forward-looking information in a prospectus or in other SEC-filed documents.

The provision of projections and other forward-looking statements was intended to be facilitated by the Private Securities Litigation Reform Act of 1995 (the "Act"), adopted as Section 27A of the Securities Act. The Act creates a safe harbor for certain forward-looking statements made by, or on behalf of, companies subject to the reporting requirements of the Exchange Act; forward-looking statements made in initial public offering documents, however, are expressly excluded from the safe harbor protection of the Act. Under the Act, a forward-looking statement means:

- (1) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other financial items;
- (2) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
- (3) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition or in the results of operations;
- (4) any statement of the assumptions underlying any of the foregoing;
- (5) any report issued by an outside reviewer, to the extent that the report assesses a forward-looking statement made by the registrant; or
- (6) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission. n52

Generally, the Act provides that an entity will not be liable with respect to a forward-looking statement to the extent that (1) a forward-looking statement is identified as a forward-looking statement and is accompanied by meaningful cautionary statements identifying substantive factors that could cause actual results to differ materially from those projected, or (2) the executive officers did not have actual knowledge that the forward-looking statement was materially false or misleading. n53

If the forward-looking statement was made orally, no liability will attach if the statement is accompanied by a cautionary statement representing that it is forward-looking and that the actual results could differ materially from those projected, or it is accompanied by an oral statement that additional information concerning factors that could cause actual results to differ materially from those made in the oral forward looking statement is contained in a readily available written document, and the information in such written document is a cautionary statement that satisfies the conditions set forth in (1) or (2) above. n54

The Act's safe harbor provisions do not apply to statements in:

- Financial statements prepared in accordance with generally accepted accounting principles;
- Investment company registration statements;
- Connection with a tender offer;

- Connection with an initial public offering;
- Connection with an offering by, or relating to the operations of, a partnership, limited liability company or a direct participation investment program; or
- A Schedule 13D filing under the Exchange Act. n55

[d] Commission Policy on Security Ratings n56 Paragraph (c) of the general section of Regulation S-K contains the Commission's policy on disclosure of security ratings, which permits registrants to disclose, on a voluntary basis, ratings assigned by:

- (1) rating organizations to classes of debt securities, convertible debt securities and preferred stock, in registration statements and periodic reports; and
- (2) nationally recognized statistical rating organizations, n57 in a communication deemed not to be a prospectus (*e.g.*, a "tombstone advertisement") pursuant to Rule 134. n58

Rule 436(g) states that a rating assigned to debt and convertible debt securities and preferred stock by a rating organization is not part of a registration statement for purposes of Sections 7 and 11. n59

Registrants should consider disclosing in an amendment or additional filing with the Commission any material change in a security rating included in a registration statement or report.

[4] EDGAR

All domestic companies are required to file certain documents, including registration statements and prospectuses, n60 with the Commission electronically via EDGAR. n61

Exhibits to these documents that have not been previously filed with the Commission, as well as any amendments to these documents must also be filed in an electronic format. If an issuer cannot comply with the electronic filing requirements without undue burden or expense, the issuer may apply for a continuing hardship exemption with the Commission, which may be granted in the Commission's discretion. n62 A temporary hardship exemption is available if an issuer experiences unanticipated technical difficulties that prevent the timely preparation and submission of an electronic filing. n63 If a company fails to file a required document electronically and cannot rely on a hardship exemption, the issuer will become ineligible to use Forms S-3, S-8, F-2 and F-3, will have its ability to incorporate paper documents by reference restricted and will not be able to toll certain time periods associated with tender offers and Rule 14e-1(e) under the Exchange Act. n64 The Commission has published an EDGAR Filer Manual which sets forth the manner in which an issuer should make electronic submissions. n65

Documents that must be submitted in paper format and may not be filed electronically, include:

- Confidential treatment requests and the information with respect to which confidential treatment is requested;
- Preliminary proxy materials and information statements with respect to a matter specified in Item 14 of Schedule 14A for which confidential treatment has been requested in the manner prescribed by Rule 14a-6(e)(2) or Rule 14c-5(d)(2);
- Supplemental information, if the submitter requests that the information be protected from public disclosure under the Freedom of Information Act pursuant to a request for confidential treatment under

Rule 83 or if the submitter requests that the information be returned after staff review and the information is of the type typically returned by the staff pursuant to Rule 418(b) or Rule 12b-4 of Regulation 12B;

- Shareholder proposals and all related correspondence submitted pursuant to Rule 14a-8 of the Exchange Act; and
- No-action and interpretive letter requests. n66

FOOTNOTES:

(n1)Footnote 1. Topics involving the definitions of "securities" and "sales," exempted securities and exempted transactions are discussed in chs. 2, 3 and 4 *supra*.

(n2)Footnote 2. Section 5 of the Securities Act. The Securities Act is reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

Section 5 provides that, prior to the effective date of a registration statement, no person may, directly or indirectly, use any means or instruments of interstate commerce:

- (1) to sell any security through the use of a prospectus or otherwise; or
- (2) to carry or cause to be carried any security for the purpose of sale or delivery after sale.

Section 5(a).

After the filing of the registration statement, it is unlawful to carry or transmit in interstate commerce any prospectus relating to any security unless the prospectus meets the requirements of Section 10 of the Securities Act. Similarly, it is unlawful, after filing the registration statement, to carry or cause to be carried in interstate commerce any security for the purpose of sale or delivery after sale, unless the security is accompanied or preceded by a prospectus meeting the Section 10(a) requirements. Section 5(b).

Section 5(c) makes unlawful the use of the mails or any instrumentality of interstate commerce to offer to sell or buy any security through the use or medium of a prospectus or otherwise unless a registration statement for the security has been filed, or while the registration is the subject of a refusal order, stop order or (prior to the effective date of registration) any public proceeding under Section 8 of the Securities Act.

Private civil liability for violations of Section 5 is provided for in Section 12(1), discussed in § 9.03 *infra*. See *Russo v. Bache Halsey Stuart Shields, Inc.*, 554 F. Supp. 613, 621 (N.D. Ill. 1981) .

(n3)Footnote 3. Schedule A under the Securities Act, which must be used only as a guide in the preparation of a registration statement for securities other than securities issued by a foreign government, is reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

(n4)Footnote 4. Section 7(a).

(n5)Footnote 5. *Id.*

See Rule 418, "Supplemental Information," permitting the Commission or its staff to request supplemental information concerning the registrant and the registration statement. The rules under the Securities Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

(n6)Footnote 6. See § 7A.04 *infra*.

(n7)Footnote 7. Section 2(8) of the Securities Act defines the term "registration statement" as meaning "the statement provided for in section 6, and includes any amendment thereto and any report, document or memorandum filed as part of such statement or incorporated therein by reference."

Rule 404(a) provides that a "registration statement shall consist of the facing sheet of the applicable form; a prospectus containing the information called for by Part I ... ; the information, list of exhibits, undertakings and signatures required to be set forth in Part II ... ; financial statements and schedules; exhibits; any other information or documents filed as part of the registration statement; and all documents or information incorporated by reference in the foregoing (whether or not required to be filed)." The prospectus must contain the information called for by all of the items of Part I of the applicable form. No reference is necessary for inapplicable items, and negative answers to any item in Part I may be omitted. Rule 404(c). The Securities Act also provides for the contents of the prospectus. See Section 10(a). The Commission is empowered to prescribe such other information as it "may by rules or regulations require[d] as being necessary or appropriate in the public interest or for the protection of investors." Section 10(c).

(n8)Footnote 8. "A copy of the prospectus may be filed as a part of the registration statement in lieu of furnishing the information in item-and-answer form." Rule 404(c). "The information required in a prospectus need not follow the order of the items or other requirements in the form." Rule 421(a).

(n9)Footnote 9. Rule 404(d).

(n10)Footnote 10. Sections 11 and 12. See §§ 9.02, 9.03 *infra*.

Furthermore, Section 8(d) empowers the Commission to suspend the effectiveness of the registration statement upon a finding that it contains material misstatements or omissions.

(n11)Footnote 11. H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933), reprinted in the Securities Primary Law Sourcebook, Volume A, Section E (Matthew Bender).

(n12)Footnote 12. Sec. Exch. Act Rel. No. 34-6898, Fed. Sec. L. Rep. (CCH) P 76,872 (1962) (footnote omitted); see also, *Casella v. Webb*, 883 F.2d 805 (9th Cir. 1989) ("puffing" may be actionable under the Securities Act); *Greenapple v. Detroit Edison Co.*, 468 F. Supp. 702 (S.D.N.Y.1979), *aff'd*, 618 F.2d 198, 205 (2d Cir. 1980) (where "gloss" on information distorts significance of material fact, it is misleading); *SEC v. First American Bank & Trust Co.*, 481 F.2d 673, 680 (8th Cir. 1973).

(n13)Footnote 13. "The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." Rule 405. This definition of materiality is a modification of the term "material" to conform to the definition set forth by the *Supreme Court* in

TSC Industries, Inc. v. Northway, 426 U.S. 438, 449 ; see also *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (definition of "material" set forth in *TSC Industries* adopted for purposes of Section 10(b) of the Exchange Act).

"The registration forms promulgated by us are guides intended to assist registrants in discharging their statutory duty of full disclosure. They are not and cannot possibly be exhaustive enumerations of each and every item material to investors in the particular circumstances relevant to a specific offering. The kaleidoscopic variety of economic life precludes any attempt at such an enumeration. The preparation of a registration statement is not satisfied, as registrant's position suggests, by a mechanical process of responding narrowly to the specific items of the applicable registration form. On the contrary, Rule 408 under the Securities Act makes clear to prospective registrants that: 'In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading.' " *Franchard Corp. (formerly Glickman Corp.)*, Sec. Act Rel. No. 33-4710, Fed. Sec. L. Rep. (CCH) P 77,113 (1964) (footnotes omitted).

The Division of Corporate Finance and the Office of the Chief Accountant have expressed the view that exclusive reliance on quantitative benchmarks to assess materiality in preparing financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a quantitative benchmark. See Sec. Exch. Act Rel. No. SAB 99, Fed. Sec. L. Rep. (CCH) P 39,062.

(n14)Footnote 14. For similar actual situations, see *Charles A. Howard*, 1 SEC 6, 11 (1934) ; *Oil Ridge Oil & Refining Co.*, 1 SEC 225, 228 (1935) ; *American Terminals & Transit Co.*, 1 SEC 701, 724 (1936) .

(n15)Footnote 15. "The registration statement seeks to ascertain certain very definite particulars of a registrant. In many instances, answers to these may be technically adequate when viewed item by item But it may frequently be true that the cumulative effect of these individual items is carefully and intentionally concealed by their segregation in the prospectus, with the result that the impression left upon the reader by the prospectus is fundamentally untrue and misleading."

National Educators Mut. Ass'n, Inc., 1 SEC 208, 214-215 (1935) .

See also *In re Registration Statements of Income Estates of Am., Inc.*, 2 S.E.C. 434 (1937) ; *Universal Camera Corp.*, 19 SEC 648, 654 (1945) ; Rule 421(a).

(n16)Footnote 16. Rule 175(a).

See § 7.02[3][d] *infra* for discussion of the Commission policy on projections and forward-looking information.

(n17)Footnote 17. Sec. Act Rel. 33-1503 (1937); Sec. Act Rel. No. 33-1580 (1937).

See also *Greenapple v. Detroit Edison Co.*, 468 F. Supp. 702, 711-12 (S.D.N.Y.1979) , *aff'd*, 618 F.2d 198 (2d Cir. 1980) (the issuer need not include in-depth explanation of accounting terms and principles in prospectus).

(n18)Footnote 18. *Franco Mining Corp.*, 1 SEC 285, 292 (1936) .

(n19)Footnote 19. Sec. Act Rel. No. 33-5119, Fed. Sec. L. Rep. (CCH) P 77,939 (1970):

Many prospectuses are lengthy and complex and while they may be accurate and complete, and useful for financial analysts and sophisticated investors, they may be unintelligible to the average investor. In such cases, such documents fail to achieve their statutory purpose of providing full and fair disclosure to investors.

Similarly, the Commission stated:

In order to make prospectuses more readable and understandable, and therefore more useful, registrants should limit their length and complexity by careful organization of the material, appropriate arrangement and subordination of information, use of tables and the avoidance of prolix or technical language and unnecessary detail.

Sec. Act Rel. No. 33-5278, Fed. Sec. L. Rep. (CCH) P 78,888 (1972). *See also* Rule 421(b).

(n20)Footnote 20. Sec. Act Rel. No. 33-7497 (1998).

(n21)Footnote 21. Rule 421(b).

(n22)Footnote 22. Note to Rule 421(b).

(n23)Footnote 23. Rule 421(d)(2).

(n24)Footnote 24. Regulations S-K and S-B are described generally in §§ 7.02[3][a]-[b] *infra*. The individual items of Regulations S-K and S-B are discussed with the items of Forms S-1 and SB-2, respectively, to which they pertain. Regulations S-B and S-K are reprinted in the Securities Primary Law Sourcebook, Volume D, Sections J and K (Matthew Bender).

(n25)Footnote 25. Sec. Act Rel. No. 33-4936, Fed. Sec. L. Rep. (CCH) P 77,636 (1968).

Fifty-three Guides were adopted in 1968 and subsequently ten Guides for the preparation and filing of registration statements under the Securities Act were added.

(n26)Footnote 26. *See* Sec. Act Rel. Nos. 33-4666 (1964) and 33-4890, Fed. Sec. L. Rep. (CCH) P 77,509 (1967).

(n27)Footnote 27. Sec. Act Rel. No. 33-4936, Fed. Sec. L. Rep. (CCH) P 77,636 (1968).

(n28)Footnote 28. Sec. Act Rel. No. 33-5278, Fed. Sec. L. Rep. (CCH) P 78,888 (1972); Sec. Act Rel. No. 33-5395-33-5398, Fed. Sec. L. Rep. (CCH) PP 79,383-79,386 (1973).

(n29)Footnote 29. *See* Report of the Advisory Committee on Corporate Disclosure to the SEC, Committee Print 95-29, House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess. (1977).

(n30)Footnote 30. Sec. Act Rel. No. 33-6163, Fed. Sec. L. Rep. (CCH) P 82,370 (1979).

(n31)Footnote 31. Sec. Act Rel. No. 33-6276, Fed. Sec. L. Rep. (CCH) No. 893, Part II (1980).

(n32)Footnote 32. Sec. Act Rel. No. 33-6332, Fed. Sec. L. Rep. (CCH) No. 926, Part II (1981).

(n33)Footnote 33. Sec. Act Rel. No. 33-6383, ASR 306 Fed. Sec. L. Rep. (CCH) P 72,328 (1982); Sec. Act Rel. No. 33-6384, Fed. Sec. L. Rep. (CCH) (1982), P 3760. In 1996, the Commission released amendments that eliminated one of the remaining five Guides, Industry Guide 1, which required disclosure of the principal sources of electric and gas revenue. Sec. Act Rel. No. 33-7300 (1996).

(n34)Footnote 34. Sec. Act Rel. No. 33-6383, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982), effective for all documents filed on or after May 24, 1982. As part of its disclosure simplification process, the Commission eliminated Guide 1 effective July 15, 1996.

(n35)Footnote 35. For discussion of Form S-1, *see* § 7.03 *infra*; Form S-3, *see* § 7.04[1] *infra*. Form S-2 was rescinded by the 2005 Rules.

The Commission rescinded former Securities Act registration Forms: S-2 (corporations in the development stage); S-3 (mining corporations in the development stage); S-7 (registration of securities of certain issuers to be offered for cash); S-10 (oil and gas interests or rights); S-13 (voting trust certificates); and S-16 (securities to be offered in specified transactions). *See* Sec. Act Rel. No. 33-6383, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

Form S-2 is the successor to former Form S-7, and Form S-3 is the successor to former Form S-16. Sec. Act Rel. No. 33-6331, Fed. Sec. L. Rep. (CCH) No. 926, Extra Edition (1981); Sec. Act Rel. No. 33-6383 n.21, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n36)Footnote 36. For discussion of Regulation S-K, *see* § 7.02[3][a] *infra*. The individual items of Regulation S-K are discussed with the items of Form S-1 to which they pertain. *See* § 7.03 *infra* for discussion of Form S-1.

(n37)Footnote 37. For discussion of Regulation C, *see* § 7.02[3][c] *infra*.

(n38)Footnote 38. For a discussion of Rule 415, *see* §§ 7A.05[5], 7A.05[6], and 7A.06[5] *infra* .

(n39)Footnote 39. For a discussion of Rule 176, *see* § 9.02[6] *infra*.

(n40)Footnote 40. For a discussion of Rule 436(g), *see* § 7.02[3][e] *infra*.

(n41)Footnote 41. For discussion of Form S-4 relating to business combination transactions, *see* § 7.06[1] *infra*.

(n42)Footnote 42. Former Forms C-2 (for certain types of certificates of interest in securities), S-10 (for oil or gas interests or rights), S-13 (for voting trust certificates), D-1 (for certificates of deposit) and D-1A (for certificates of deposit issued by issuers of securities called for deposit) were rescinded in Sec. Act Rel. No. 33-6383, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n43)Footnote 43. Under the "access equals delivery" model adopted by the Commission, a final prospectus will be deemed to precede or accompany a security for sale for purposes of Section 5(b)(2) under the Securities Act as long as a final prospectus meeting the requirements of Section 10(a) of the Securities Act is filed with the Commission or the issuer makes a good faith and reasonable effort to file with the Commission by the required filing date.

(n44)Footnote 44. The individual items of Regulation S-K are discussed in detail with Forms S-1 and S-3, §§ 7.03 and 7.04 *infra* , which incorporate the items of Regulation S-K by reference. The revision and expansion of Regulation S-K was adopted in Sec. Act Rel. No. 33-6383, ASR 306, Fed. Sec. L. Rep. (CCH) P72,328 (1982).

In addition, Items 201, 202, 301, 302, 303, 402, 503, and 512 of Regulation S-K, discussed in § 7.03[2], [3] *infra*, were revised to reflect the adoption of an integrated disclosure system for foreign private issuers. *See* § 7.07 *infra*. Sec. Act Rel. No. 33-6437, Fed. Sec. L. Rep. (CCH) P 72,407 (1982).

The undertakings in Item 512 of Regulation S-K were amended by the 2005 Rules, in Sec. Act Rel. No. 33-8591 (2005).

Earlier releases adopting various items of Regulation S-K were:

(1) Sec. Act Rel. No. 33-5983, ASR 236, Fed. Sec. L. Rep. (CCH) P 72,258 (1977) (Items 1 and 2);

(2) Sec. Act Rel. No. 33-5949, Fed. Sec. L. Rep. (CCH) P 81,649 (1978) (Items 3, 4, 5 and 6);

(3) Sec. Act Rel. No. 33-6230, Fed. Sec. L. Rep. (CCH) P 82,642 (1980) (Item 7);

(4) Sec. Act Rel. No. 33-6231, ASR 279, Fed. Sec. L. Rep. (CCH) P 72,301 (1980) (Items 9,10, and 11);
and

(5) Sec. Act Rel. No. 33-6233, ASR 280, Fed. Sec. L. Rep. (CCH) P 72,302 (1980) (Item 12).

(n45)Footnote 45. The Commission's policy on projections is discussed in § 7.02[3][c] *infra*.

(n46)Footnote 46. The Commission's policy on security ratings is discussed in § 7.02[3][d] *infra*.

(n47)Footnote 47. Sec. Act. Rel. No. 33-6383, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n48)Footnote 48. The adoption of revisions to Regulation C was announced in Sec. Act Rel. No. 33-6383, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982). Various rules of Regulation C are discussed with the Forms in §§ 7.03 and 7.04 *infra*, where appropriate.

(n49)Footnote 49. Rules 445, 446 and 447, which governed registration statements filed in connection with securities offered through competitive bidding, were eliminated by the Commission on July 15, 1996 as part of the Commission's disclosure simplification process. The Commission stated that these rules are no longer needed because issuers may use Rule 430A to satisfy filing obligations when they engage in competitive bidding.

(n50)Footnote 50. For discussion of the safe harbor for forward-looking statements pursuant to Rule 175, *see* § 7A.05[8] *infra*.

(n51)Footnote 51. The Commission encourages management's projections of future economic performance to be disclosed voluntarily or pursuant to Item 303 of Regulation S-K in Securities Act registration statements filed with the Commission by nonreporting issuers. Rule 175(b)(1)(i).

(n52)Footnote 52. Section 27A(i)(1), Securities Act.

(n53)Footnote 53. Section 27A(c)(1), Securities Act.

(n54)Footnote 54. Section 27A(c)(2), Securities Act.

(n55)Footnote 55. Section 27A(b)(2), Securities Act.

(n56)Footnote 56. In July 2008 the SEC began seeking comments on whether to require disclosure of security ratings assigned by credit rating agencies to classes of debt securities, convertible debt securities and preferred stock. Until any final amendments are adopted, the current Commission policy on security ratings remains in effect. Security Ratings, Securities Act Release No. 8940, Securities Exchange Act Release No. 58071 (July 1, 2008).

(n57)Footnote 57. The phrase "nationally recognized statistical rating organization" (NRSRO) is stated in Rules 436 and 134 to have the same meaning as in the Commission's uniform net capital rule (Exchange Act Rule 15c3-1(c)(2)(vi)(F)), discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 3.08 (Matthew Bender). In connection with the adoption of Rules 436 and 134, some commentators objected that the net capital rule does not contain a specific definition of NRSRO. The Commission, as an alternative to a definition of an NRSRO, determined that the following entities are acceptable to the Commission and its staff as NRSROs under the net capital rule:

(1) Standard & Poor's Corporation;

(2) Moody's Investors Services, Inc.;

(3) Fitch Investors Services, Inc.; and

(4) Duff and Phelps, Inc. Sec. Act Rel. No. 33-6383 n.54, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n58)Footnote 58. Rule 134(a)(13)(i) permits disclosure of security ratings assigned by nationally recognized rating organizations to debt, convertible debt securities and preferred stock in a communication deemed not to be a prospectus (*e.g.*, a "tombstone advertisement") if the disclosure is consistent with disclosure of security ratings in registration statements.

In July 2008, the SEC proposed amendments to revise Rule 134 to permit a registrant to disclose the security rating of any credit rating agency, but require a registrant to provide a statement as to whether the entity issuing the rating is an NRSRO if it elects to include a security rating in a communication under Rule 134. Security Ratings, Securities Act Release No. 8940, Securities Exchange Act Release No. 58071 (July 1, 2008).

(n59)Footnote 59. Rule 436(g) was adopted in 1982 and is designed to eliminate the previous requirement to file the consent of rating organizations for any registration statement disclosing the security rating and thus exempt the rating organizations, which are already subject to the antifraud provisions of the federal securities laws, from Section 11 liability.

In July 2008, the SEC proposed amendments that would amend Rule 436(g) and related rules to expand the relief from the consent requirements currently provided to NRSROs to other credit rating agencies that are not NRSROs. Security Ratings, Securities Act Release No. 8940, Securities Exchange Act Release No. 58071 (July 1, 2008).

For a discussion of Section 11 liability, *see* § 9.02 *infra*.

The applicability of Rules 134 and 436(g) and the Commission's policy on security ratings are limited to disclosure of security ratings and do not extend to disclosure of policy holder ratings assigned to insurance companies. Sec. Act Rel. No. 33-6383 n.52, ASR 306, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n60)Footnote 60. Item 101(a)(i), Regulation S-T. The other documents that must be filed electronically are:

(a) statements and applications filed with the Commission pursuant to the Trust Indenture Act other than applications for exemptive relief filed pursuant to Section 304(c) on Form T-4 and Section 310(b)(1)(ii);

(b) statements, reports and schedules filed with the Commission pursuant to Sections 13, 14 or 15(d) of the Exchange Act, except Form 13F, information for which confidential treatment is requested

(c) documents filed with the Commission pursuant to Sections 8, 17, 20, 23(c), 24(e), 24(f) and 30 of the Investment Company Act, provided, however, that in no event shall any submissions under Section 6(c) or 17(g) of the Act or documents related to applications for exemptive relief under any section of the Act be made in electronic format; and

(d) documents filed with the Commission pursuant to the Public Utility Act.

(n61)Footnote 61. Effective as of November 4, 2002, foreign private issuers and foreign governments are required

to file registration statements electronically via EDGAR.

See §§ 7.07[1][b] and [2][b] *infra* for a discussion of the electronic filing requirements of Forms F-1 and F-3.

(n62)Footnote 62. Item 202, Regulation S-T. The application must be made ten business days prior to the due date of the filing and must contain the information set forth in Item 202, including setting forth the reasons the necessary hardware and software is not available without unreasonable burden and expense, the burden and expense involved to employ alternative means to make the electronic submission, or the reasons for not submitting electronically the document or group of documents, as well as justification for the time period of a requested temporary exemption.

(n63)Footnote 63. Item 201, Regulation S-T.

(n64)Footnote 64. Note, Item 101, Regulation S-T.

(n65)Footnote 65. Item 301, Regulation S-T.

(n66)Footnote 66. For a complete list of the documents that are not filed electronically, see Item 101(c), Regulation S-T.



84 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 § 7.03

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.03 Form S-1--Registration of Securities of Issuers For Whom No Other Form is Authorized

Form S-1 is available for use by registrants for whom no other form is prescribed. It is generally used by registrants who have never filed, or who have been filing reports under the Exchange Act for less than one year, such as new issuers engaged in an initial public offering. n1

Form S-1 is also available for the registration of securities issued in an exchange offer for securities of another issuer. n2 It may not be used, however, for the registration of securities of foreign governments or political subdivisions of those governments. n3

Smaller reporting companies that desire to use Form S-1 must check the "smaller reporting company" box n4 Such smaller reporting companies are able to choose, on an item-by-item basis, to comply with either the scaled disclosure and financial reporting requirements made available in Regulation S-K for smaller reporting companies or the requirements for other companies in Regulation S-K.

Form S-1 contains two major parts. Part I (Items 1-12) covers information required to be included in the prospectus and requires full disclosure of all material information about the offering and the registrant. Part II (Items 13-17) covers information not required to be presented in the prospectus and requires disclosure of expenses of issuance and distribution, the SEC policy regarding indemnification of directors and officers, recent sales of unregistered securities, exhibits and financial statement schedules and certain undertakings of the issuer. The nonfinancial substantive disclosure provisions of Form S-1 rely entirely on the provisions of Regulation S-K n5 and include essentially the same information about the registrant as that required to be reported in an annual report to the Commission filed on Exchange Act Form 10-K. A reporting issuer that has filed at least one annual report and that is current in its reporting obligation under the Exchange Act may incorporate such information by reference to previous reports filed under the Exchange Act, pursuant to amendments to Form S-1 adopted as part of the 2005 Rules. Successor registrants can incorporate by reference if their predecessors were eligible. The following issuers will not be able to incorporate by reference into a Form S-1 or Form F-1:

- (1) reporting issuers who are not current in their Exchange Act reports; and

(2) issuers who are, or were or any of whose predecessors were during the past three years:

- blank check issuers;
- shell companies (other than business combination related shell companies); or
- issuers for offerings of penny stock.

In addition, to enhance the availability to investors of incorporated information, the ability to incorporate by reference is conditioned on the issuer making its incorporated Exchange Act reports and other materials readily accessible on a website maintained by or for the issuer. n6 Regulation S-X governs the specific content of the financial statements required in Form S-1. In addition to the information expressly required to be included in the Form S-1 prospectus, the registrant must add any further material information "as may be necessary to make the required information, in the light of the circumstances ... , not misleading." n7

If any information required to be furnished by the registrant is unknown and not reasonably available, that information may be omitted, if:

- (1) obtaining the information would involve unreasonable effort or expense and the registrant includes a statement to that effect; or
- (2) the information rests peculiarly within the knowledge of another person not affiliated with the registrant and the registrant includes a statement indicating the absence of any affiliation and the result of a request made to the other person for the information; and
- (3) in the case of either of the above, the registrant gives as much of the required information (together with the sources of that information) as it possesses or can acquire without unreasonable effort or expense. n8

The General Instructions to Form S-1 direct the registrant's attention to the general rules and regulations under the Securities Act, particularly the provisions of Regulation C that contain the general requirements for the preparation and filing of registration statements. n9 The General Instructions also direct the registrant's attention to Regulation S-K and provide that where Form S-1 requires a registrant to furnish information required by an item of Regulation S-K, the information need only be furnished to the extent appropriate. n10

[1] Facing Page

The facing page of Form S-1 must set forth (i) the exact name of the registrant as specified in its charter, n11 (ii) the state or other jurisdiction of incorporation or organization, (iii) the registrant's primary standard industrial classification code and I.R.S. employer identification numbers and (iv) the address and telephone number of the registrant's principal executive offices.

The approximate date of commencement of the proposed sale to the public must also be included on the facing page of Form S-1, and, where appropriate, the delaying amendment legend set forth in Rule 473 must be included. n12 Since the effective date, the first date on which the securities may be sold to the public, cannot be known at the time of filing, it is customary to state: "as soon as practicable after the effective date of this registration statement."

The facing page must also set forth the name and address of an "agent for service," the person authorized in the

registration statement to receive notices and communications from the Commission. n13 Additionally, agents for service are given powers with respect to the registration statement, including the power of amendment and withdrawal. n14 It is a common practice to name the counsel for the registrant as an agent for service or to receive copies of all notices sent to the agent.

The registrant must also indicate, by checking a box on the facing sheet, (i) whether any of the securities being registered on Form S-1 are to be offered on a delayed or continuous basis ("shelf registration") pursuant to Rule 415, n15 (ii) whether the registrant is registering additional securities for an offering pursuant to Rule 462(b), (iii) whether the filing is a post-effective amendment pursuant to Rule 462(c), (iv) whether the filing is a post-effective amendment pursuant to Rule 462(d) or (v) whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act. n16

[a] Calculation of Registration Fee. The facing page of Form S-1 also requires the registrant to set forth, in tabular form, the following items: n17

- (1) title of each class to be registered;
- (2) amount to be registered;
- (3) proposed maximum offering price per unit;
- (4) proposed maximum aggregate offering price; and
- (5) amount of registration fee.

Effective December 21, 2009, the registration fee for an offering of securities is \$71.30 per \$1,000,000 of the maximum aggregate price at which the securities are proposed to be offered. This rate must also be applied pro rata to amounts less than \$1,000,000. Thus, the fee should be calculated by multiplying the maximum offering amount by .0000713. n18 If the filing fee is based on a bona fide estimate of the maximum aggregate offering price and has been paid, no additional filing fee is required if there is a change in the offering price. n19 If, however, the number of shares or other units of securities, or the principal amount of debt securities, to be offered is increased, and this can only be done by an amendment filed before the effective date of the registration statement, the registrant must pay an additional fee based upon the offering price of the additional securities. n20 In the event that the number of shares to be offered is decreased by amendment no refund is available. n21 If a portion of the securities offered under a registration statement remain unsold after the completion of an offering, or after termination or withdrawal of the registration statement, the total dollar amount of the filing fee associated with the unsold securities may be offset against the filing fee due for a subsequent registration statement or registration statements. n22

The filing of a registration statement is not deemed to have taken place unless it is accompanied by a United States postal money order or a certified bank check or cash for the amount of the fee via wire transfer. n23 Fees for EDGAR filings must be paid to the U.S. Treasury-designated lockbox not later than the time of the filing of the registration statement. Failure to pay an insignificant amount of the required fee at the time of filing as the result of a bona fide error, however, will not affect the date of filing. n24

Rule 457 contains provisions for estimating or determining the registration fee to be paid for different types of offerings. For example, it contains provisions for computing fees for the registration of securities to be offered: in exchange for other securities for which there is no public market, subsection (f)(2); pursuant to warrants, subsection (g); pursuant to an employee benefit plan, subsection (h)(1); and in connection with convertible securities, subsection (i).

[2] The Prospectus

Part I of Form S-1, "Information required in prospectus," requires the registrant to furnish, in response to 12 items, disclosure about the issuer and the offering of the securities. The information required to be presented need not follow the order of the items in Form S-1 but cannot be presented in a manner likely to obscure any of the required information or any information necessary to keep the required information from being incomplete or misleading. n25 Unless otherwise specified, the registrant need not refer to any items that are inapplicable and may omit negative answers to any items. n26

If an item of Form S-1 requires the information to be presented in the prospectus in tabular form, the information must be furnished in substantially the tabular form specified in the item. n27 Except for financial statements and information required in tabular form, the information set forth in the prospectus may be expressed in condensed or summarized form. n28 Instead of repeating information in notes to financial statements, references may be made to other parts of the prospectus containing that information. n29

[a] Item 1. Forepart of the Registration Statement and Outside Front Cover Page of Prospectus. This item requires the registrant to include the information required by Item 501 of Regulation S-K in the forepart of the registration statement and on the outside front cover page of the prospectus. n30

Item 501 of Regulation S-K, "Forepart of registration statement and outside front cover page of prospectus," has two parts: facing page and outside front cover page of prospectus. The disclosure required by Item 501 of Regulation S-K must be drafted in plain English. n31

Item 501(a) of Regulation S-K, "Facing page," requires the facing page of Form S-1 to indicate the approximate date of the proposed sale to the public and, where appropriate, to include the delaying amendment legend pursuant to Rule 473 of Regulation C. n32

Item 501(b) of Regulation S-K, "Outside front cover page of prospectus," requires the registrant to provide information on the outside front cover page of the prospectus with cross references to more detailed discussion elsewhere in the prospectus. The outside front cover page must be limited to one page. n33 The required information includes the name of the registrant n34 and the title, amount and a brief description of the securities being offered, unless the description is not necessary to indicate the material terms of the securities, e.g., an issue of common stock with full voting rights and the dividend and liquidation rights usually associated with common stock. n35 The issuer must also state whether the securities are to be offered for the account of security holders. n36 If so offered, other parts of the prospectus should name each security holder, state the amount of securities owned by such security holder, the amount to be offered for such security holder's account and the amount to be owned by such security holders after the offering.

If there are factors in the offering which make it speculative or high risk, the registrant, on the prospectus' outside front cover, must cross-reference the discussion (required by Item 503 of Regulation S-K) of the material risks associated with a purchase of the securities being offered including the page number where the discussion appears. Such cross-reference must be printed in prominent type. n37

The registrant must also include a statement that the Commission has neither approved nor disapproved the securities. This statement may be combined with any legend or statement required by the law of any state in which the securities are to be offered. n38 The legend required by the Commission should indicate that neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosures in the prospectus and that any contrary representation is a criminal offense. Registrants may use one of the following or other clear, plain language:

- Example A: Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of

this prospectus. Any representation to the contrary is a criminal offense.

- Example B: Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense. n39

The registrant must indicate whether any national securities exchange or the Nasdaq Stock Market will list the securities offered, naming the particular market(s) and identifying the trading symbol(s) for those securities. n40

If the securities are to be offered for cash, the registrant should state the price to the public of the securities, the underwriters' discounts and commissions, the net proceeds to be received by the registrant and any selling security holder's net proceeds. The registrant should present this information on both a per share or unit basis and for the total amount of the offering. If the registrant makes the offering on a minimum/maximum basis, it should show this information based on the total minimum and total maximum amount of the offering. The registrant may present this pricing information in a table, term sheet format or other clear presentation that fits the design of the cover page so long as the information can be easily read and is not misleading. n41

If the price to the public cannot be readily stated, the registrant must explain the method to be used in determining that price. If the securities are to be offered at the market, or if the offering price is to be determined by a formula related to market prices, the registrant must identify the market and indicate the market price as of the latest practicable date. n42

Item 16 of Schedule A provides that where it is proposed to offer any portion of the securities to any persons other than the underwriters at any variation from the proposed public offering price, such variation must be disclosed and such persons named. n43 Similarly, when there is an exchange offer, the prospective investor must be fully apprised of all unfavorable as well as favorable factors of the exchange so that such investor can make an informed judgment whether to accept or reject the offer. If any of the above situations exist, proper reference should be made to them on the cover page and they should be fully disclosed in the body of the prospectus.

Item 501(b)(3) also calls for information relative to "the underwriter's discounts and commissions." n44

Warrants to purchase a block of the company's shares at a price related to the public offering price are sometimes granted to the underwriters.

The registrant should state the name(s) of the lead or managing underwriter(s) and identify the nature of the underwriting arrangements. If the offering is not made on a firm commitment basis, the registrant should provide a brief description of the underwriting arrangements. The registrant may use any clear, concise and accurate description of the underwriting arrangements, such as:

- Example A: (best efforts offering): The underwriters are not required to sell any specific number or dollar amount of securities but will use their best efforts to sell the securities offered.
- Example B: (best efforts, minimum-maximum offering): The underwriters must sell the minimum number of securities offered (insert number) if any are sold. The underwriters are required to use only their best efforts to sell the maximum number of securities offered (insert number).

If the registrant is offering the securities on a best efforts or best efforts minimum-maximum basis, it should state the date the offering will end, any minimum purchase requirements and any arrangements to place the funds in an escrow, trust or similar account. If the registrant has not made any of these arrangements, it should state this fact and describe the effect on investors. n45

The date of the prospectus must be set forth. n46 A preliminary prospectus circulated by a registrant that is not subject to the reporting requirements of the Exchange Act must include a bona fide estimate of the range of the maximum offering price and the maximum number of shares or the principal amount of debt securities to be offered. A preliminary prospectus must also indicate that it is "subject to completion" and must state the date of its issuance. n47

Rule 430A, adopted in 1987 along with other related changes, is designed to prevent disruptions in taking an offering to the market which had sometimes occurred as a result of the need for the Staff to review the final pricing amendment before a registration could be declared effective. A temporary delay sometimes resulted which could cause the underwriting syndicate to miss a market opportunity and adversely affect the offering. Rule 430A permits a registration statement that omits certain pricing information to be declared effective so long as the securities to be registered are offered for cash, the registrant furnishes the undertakings required by Item 512(i) of Regulation S-K (a prospectus required by Section 10(a)(3) of the Securities Act to prevent stale information) and the registrant files a form of prospectus providing the information that was originally omitted.

[b] Item 2. Inside Front and Outside Back Cover Pages of Prospectus. This item requires the registrant to include the information required by Item 502 of Regulation S-K on the inside front cover page of the prospectus or, where permitted, on the outside back cover page.

Item 502 of Regulation S-K, "Inside Front and Outside Back Cover Pages of Prospectus," requires two categories of information to be disclosed. The disclosure required by Item 502 of Regulation S-K must be drafted in plain English. n48

Item 502(a) of Regulation S-K, "Table of contents," requires the registrant to include a reasonably detailed table of contents showing the subject matter of the sections and subdivisions of the prospectus, including any risk factors section set forth in the prospectus pursuant to Item 503(c) of Regulation S-K, and the page number on which the sections and subdivisions begin. n49

Item 502(b) of Regulation S-K, "Dealer prospectus delivery obligation," requires the registrant to apprise all dealers effecting transactions in the registered securities, whether or not participating in the distribution, that they may be required to deliver a prospectus. A statement to that effect should be set forth on the outside back cover page of the prospectus indicating the expiration date of the period prescribed by Section 4(3) of the Securities Act and Rule 174 thereunder, for dealers to deliver the prospectuses. n50

[c] Item 3. Summary Information, Risk Factors and Ratio of Earnings to Fixed Charges.

This item requires the registrant to furnish, in accordance with Item 503 of Regulation S-K, a summary of the information contained in the prospectus, a discussion of the principal factors that make the offering speculative or one of high risk and the ratio of earnings to fixed charges. The disclosure required by Item 503 of Regulation S-K must be drafted in plain English. n51

[i] Summary of Prospectus Information. Item 503(a) of Regulation S-K, "Prospectus Summary," requires the registrant to include a summary of the prospectus information where the length or complexity of the prospectus warrants a summary. The summary should be brief and should not contain, and is required not to contain, all of the detailed information in the prospectus. If the registrant provides summary business or financial information, even if not captioned as a summary, it must provide that information in plain English. n52

The summary should not merely repeat the text of the prospectus but should provide a brief overview of the key aspects of the offering. The registrant should carefully consider and identify those aspects of the offering that are the most significant and determine how best to highlight those points in plain English. n53

[ii] Address and Telephone Number. Item 503(b) of Regulation S-K, "Address and telephone number," requires

the registrant to include the mailing address, including zip code and the telephone number, including area code, of the registrant's principal executive offices. It has also become customary to include an issuer's website, although issuers typically provide that neither the website nor the information contained on the website are incorporated by reference into the prospectus and that neither should be considered part of the prospectus.

[iii] Risk Factors. Item 503(c) of Regulation S-K, "Risk factors," requires the registrant to include, where appropriate, a risk factor discussion which must be set forth under the caption "Risk Factors" on the page immediately following the summary, or if no summary section is included, immediately following the cover page of the prospectus or, if included, a pricing information section that immediately follows the cover page. n54 This discussion must be concise and organized logically. The registrant should not present risks that could apply to any issuer or any offering. The registrant should explain how the risk affects the issuer or the securities being offered. The registrant should set forth each risk factor under a subcaption that adequately describes the risk.

This item requires a discussion of the principal factors that make the offering speculative or one of high risk, including among others:

- (1) the absence of an operating history of the registrant;
- (2) the absence of profitable operations in recent periods;
- (3) the financial position of the registrant;
- (4) the nature of the registrant's business; or
- (5) if common equity or securities convertible into or exercisable for common equity are being offered, the absence of a previous market for the registrant's common equity. n55

[iv] Ratio of Earnings to Fixed Charges. Item 503(d) of Regulation S-K, "Ratio of earnings to fixed charges," n56 requires either the ratio of earnings to fixed charges or the ratio of combined fixed charges and preference dividends to earnings (the "ratio") to be disclosed pursuant to the following rules and definitions:

- (1) the registrant should furnish:
 - (a) the ratio of earnings n57 to fixed charges, n58 if debt securities are being registered; or
 - (b) the ratio of combined fixed charges and preference dividends to earnings, if preference equity securities are being registered.

Disclosure of both ratios, however, is permitted in registration statements relating to debt securities or preferred stock and the registrant may choose to disclose one or both ratios in other filings. n59

- (2) the ratio should be disclosed for each of the last five fiscal years of the registrant (or for the life of the registrant and its predecessors, if less than five years), and for the latest interim period for which financial statements are presented.

Item 503(d) requires a pro forma ratio to be presented in the prospectus if the registration statement is being filed to register debt securities or preferred stock to be used in a refinancing and if the effect of the refinancing changes the historical ratio by at least ten percent. n60 To calculate the pro forma ratio, the registrant should use the net change in interest or dividends from the refinancing. n61 The pro forma ratio may be presented for only the most recent fiscal year

and for the latest interim period. n62

The ratios should also be placed in the Summary section, if the registrant includes one in its prospectus. n63 The calculation of the ratios should be included as an exhibit to the registration statement. n64 A registrant that qualifies as a smaller reporting company need not include a ratio of earnings to fixed charges. n65

[d] Item 4. Use of Proceeds. This item requires the registrant to furnish the information specified in Item 504 of Regulation S-K.

Item 504 of Regulation S-K, "Use of proceeds," requires the registrant to state the principal purposes for which the net proceeds from the offering are intended to be used and the approximate amount for each such purpose. If the registrant has no specific plans for the proceeds or a significant portion of the proceeds, it must make a statement to that effect and discuss the principal reasons for the offering. If material amounts of other funds are required to accomplish a specified purpose, the amounts and sources of those funds should be disclosed. n66 The management of the registrant may reserve the right to change the use of the proceeds if all contingencies are adequately disclosed. n67

If less than all the securities offered may be sold and the proceeds may be used for more than one purpose, the registrant's plans, if substantially less than the maximum proceeds are realized, and the order of priority of such purposes should be discussed. n68 This discussion need not be included, however, if underwriting arrangements for the offering indicate that the actual proceeds will not be substantially less than the aggregate proceeds shown pursuant to Item 501 of Regulation S-K. n69 Details of proposed expenditures need not be given (*i.e.*, a brief outline of any program of construction or additional equipment is sufficient), but the registrant should consider discussing matters specifically addressed in the management's discussion and analysis of financial condition and results of operations, such as liquidity and capital expenditures. n70

If the proceeds to the registrant are to be used to acquire assets other than in the ordinary course of business, the assets should be briefly described and the cost of the assets stated. If the assets are to be acquired from affiliates of the registrant or their associates, the names of persons from whom the assets are to be acquired and the principles followed to determine the cost of the assets to the registrant should be set forth. n71

Where the proceeds to the registrant are to be used to finance acquisitions of other business, the identity of the business, or if not known, the nature of the business to be sought, the status of any negotiations with respect to the acquisition and a brief description of those businesses should be included. If, however, pro forma financial statements reflecting the acquisition of another business are not required by Regulation S-X (including Rule 8-05 of Regulation S-X for smaller reporting companies) to be included in the registration statement, no disclosure need be made of the possible terms of any transaction, the identity of parties to the transaction or the nature of the business being sought, to the extent the registrant reasonably determines that public disclosure of that information would jeopardize the acquisition. n72 If, on the other hand, Regulation S-X (including Rule 8-05 of Regulation S-X for smaller reporting companies) requires financial statements of the business sought to be acquired to be included in the registration statement, the registrant should give a detailed description of the business to be acquired. n73

If existing indebtedness is to be repaid with a material part of the proceeds, the registrant should state the interest rate and maturity of the indebtedness to be repaid. If the indebtedness to be repaid was incurred within one year of the filing of the registration statement, the registrant should describe the use of the proceeds of the indebtedness if the indebtedness was other than short-term borrowing used for working capital. n74

In many respects, this section of the prospectus is the most important from the standpoint of the potential investor, and should be placed near the beginning of the narrative portion of the prospectus. The investor is entitled to a full and clear statement of the uses to which the company intends to apply his funds. Thus, general statements such as "the development and completion to a marketable state of the aircraft, automobile, and other patents" owned by the registrant

will not suffice. n75

[e] Item 5. Determination of Offering Price.

This item requires the registrant to furnish the information specified by Item 505 of Regulation S-K concerning those factors used by the registrant to determine the offering price of common equity, warrants, rights or convertible securities being offered.

[i] Common Equity. Item 505(a) of Regulation S-K requires the registrant to state the factors considered in determining the offering price for common equity being registered

(1) for which no established public trading market exists for the purposes of Item 201(a) of Regulation S-K, n76 or

(2) where there is a material disparity between the offering price of the common equity and the market price of outstanding shares of the same class.

[ii] Warrants, Rights and Convertible Securities. Where warrants, rights or convertible securities exercisable for common equity securities for which there is no market for purposes of Item 201(a) of Regulation S-K are being registered, the registrant should describe the factors considered in determining their exercise or conversion price. n77

[f] Item 6. Dilution. This item requires the registrant to furnish the disclosure called for by Item 506 of Regulation S-K.

Item 506 of Regulation S-K, "Dilution," n78 provides that where common equity securities are being registered and there is a substantial disparity between the public offering price and the effective cash cost to insiders (officers, directors, promoters and affiliated persons) of common equity acquired by them in transactions during the past five years, or which they have the right to acquire, and the registrant is not subject to the reporting requirements of Sections 13(a) or 15(d) of the Exchange Act immediately prior to the filing of the registration statement, the registrant should include a comparison of the public contribution under the proposed public offering and the effective cash contribution of the insiders.

In the above situation and where common equity securities are being registered by a reporting or nonreporting registrant that has suffered losses in each of the last three fiscal years and where there has been a material dilution of the purchasers' equity interest, the registrant should also disclose:

(1) the net tangible book value per share before and after the distribution;

(2) the amount of increase in the net tangible book value per share attributable to all cash payments made by purchasers of the shares being offered; and

(3) the amount of the immediate dilution from the public offering price that will be absorbed by the purchasers in the offering. n79

[g] Item 7. Selling Security Holders. This item requires the registrant to furnish the information required by Item 507 of Regulation S-K.

Item 507 of Regulation S-K, "Selling security holders," provides that if the securities are to be offered for the account of security holders, the registrant should:

(1) name each selling security holder; n80

(2) state the position, office or other material relationship the selling security holder has held or had within the past three years with the registrant, its predecessor, n81 or its affiliates; n82 and

(3) state the amount of securities of the class being sold owned by the security holder prior to the offering, the amount to be offered for the security holder's account and the amount and percentage (if one percent or more) of the class to be owned by the security holder after completion of the offering.

[h] Item 8. Plan of Distribution.

This item requires the registrant to furnish the information required by Item 508 of Regulation S-K. Item 508 of Regulation S-K, "Plan of distribution," contains twelve parts.

[i] Underwriters and Underwriting Obligation. Item 508(a) of Regulation S-K, "Underwriters and underwriting obligation," provides that if the securities are to be offered through underwriters, the registrant should:

(1) name the principal underwriters; n83

(2) state the amounts underwritten by each of the principal underwriters;

(3) identify each principal underwriter that has a material n84 relationship with the registrant and describe the nature of the relationship; and

(4) briefly describe the nature of the underwriter's obligation to take the securities including:

(a) whether the underwriter is committed to take and pay for all of the securities if any securities are taken, or

(b) whether the obligation is merely an agency or a "best efforts" arrangement permitting the underwriter to take and pay for only the securities it may sell to the public. n85

Conditions precedent to the underwriter's taking of the securities, including "market-outs," should be described in response to Item 508(a) only in the case of an agency or "best efforts" arrangement. n86

[ii] New Underwriters. Item 508(b) of Regulation S-K, "New underwriters," provides that where securities of a previously nonreporting registrant under Section 13(a) or 15(d) of the Exchange Act are being registered or where a prospectus is required pursuant to Item 501 of Regulation S-K to include notice of risk factors on its cover page, and at least one of the managing underwriters (or a majority of the principal underwriters, if there are no managing underwriters) has been organized, reactivated or first registered as a broker-dealer within the past three years, the registrant must disclose in the prospectus:

(1) the information concerning the underwriter's experience; and

(2) where applicable (a) that the principal business function of the underwriter will be to sell the securities to be registered, or (b) that the promoters have a material relationship with the underwriter.

The information required by Item 508(b) should be given in sufficient detail to permit a full appreciation of the underwriter's experience and its relationship with the registrant, promoters and their controlling persons. n87

[iii] Other Distributions. Item 508(c) of Regulation S-K, "Other distributions," requires a brief discussion of the plan of distribution of securities to be registered that are to be offered other than through underwriters.

If the securities are to be offered pursuant to dividend or interest reinvestment plans n88 the terms of which provide for the purchase of securities on the market, the registrant must disclose whether the issuer or the participant pays fees, commissions and expenses incurred in connection with the plan. The registrant must disclose the anticipated cost to plan participants by transaction or other convenient reference if the fees, commissions or expenses will be paid by the participant.

If the securities are to be offered through the selling efforts of brokers or dealers, the registrant should describe the plan of distribution and the terms of any agreement, arrangement or understanding made with the broker or dealer before the effective date of the registration statement, including volume limitations on sales, parties to the agreement, conditions for terminating the agreement, and, if known, the identity of the broker or dealer that will participate in the offering and the respective amount of securities to be offered through each broker or dealer.

If any of the securities being registered are to be offered other than for cash, the registrant should state briefly the general purpose of the distribution, the basis upon which the securities are to be offered, the amount of compensation and other expenses of distribution and by whom the expenses are to be borne. n89 If the distribution is to be made pursuant to a plan of acquisition, reorganization, readjustment or succession, the registrant should describe briefly the general effect and operative date of the plan. If any material amount of assets are to be acquired under the plan, the registrant should disclose information similar to that required by Instruction 5 to Item 504 of Regulation S-K, regarding the cost of assets acquired from a material part of the proceeds, and including the names of affiliates and associates, if any, from whom the assets are to be acquired, and the principle followed in determining the cost to the registrant. n90

[iv] Offerings on Exchange. Item 508(d) of Regulation S-K, "Offerings on exchange," provides that if the securities are to be offered on an exchange, the exchange should be identified. If the registered securities are to be offered in connection with the writing of exchange-traded call options, the registrant should briefly describe the transactions.

[v] Underwriter's Compensation. Item 508(e) of Regulation S-K, "Underwriter's compensation," requires the registrant to provide a table that sets out the nature of the compensation and the amount of discounts and commissions n91 to be paid to the underwriter for each security and in total. The table must show the separate amounts to be paid by the company and any selling shareholders. In addition, the table should include all other items considered by the National Association of Securities Dealers ("NASD") n92 to be underwriting compensation for purposes of the NASD's Rules of Fair Practice.

The registrant should show separately in the table the cash commissions paid by the registrant and selling security holders, and should show in the table commissions paid by other persons. The registrant should also disclose any finder's fee or similar payments in the table. n93

In this section, the registrant should also disclose the offering expenses specified in Item 511 of Regulation S-K. n94

If the underwriter has any arrangement with the issuer, such as an over-allotment option, under which the underwriter may purchase additional shares in connection with the offering, the registrant should indicate that this arrangement exists and state the amount of additional shares that the underwriter may purchase under the arrangement. Where the underwriter has such an arrangement, the registrant should present maximum-minimum information in a separate column to the table, based on the purchase of all or none of the shares subject to the arrangement. The registrant should describe the key terms of the arrangement in the narrative. n95

[vi] Underwriter's Representative on Board of Directors. Item 508(f) of Regulation S-K, "Underwriter's representative on board of directors," requires the registrant to:

(1) describe any arrangement granting the underwriter the right to designate or nominate one or more of the members of the registrant's board of directors;

(2) identify any director so chosen by the underwriter; and

(3) state whether the designated or nominated director is or may be an officer, director, partner, employee or affiliate of the underwriter.

[vii] Indemnification of Underwriters. Item 508(g) of Regulation S-K, "Indemnification of underwriters," requires the registrant to briefly describe the provisions for indemnifying the underwriter or its controlling persons against liability arising under the Securities Act.

[viii] Dealers' Compensation. Item 508(h) of Regulation S-K, "Dealers' compensation," requires the registrant to state briefly the discounts and commissions allowable or payable to a dealer, including all cash, securities, contracts or other consideration to be received by the dealer in connection with the sale of the securities. n96 If the dealer acts as a sub-underwriter in connection with the sale of the securities and is paid an additional discount or commission, the registrant should make a general statement to that effect without reporting the additional amounts of securities to be sold.

[ix] Finders. Item 508(i) of Regulation S-K, "Finders," requires the registrant to identify any finder and, if applicable, describe the nature of any material relationship between the finder and the registrant, its officers, directors, principal stockholders, other finders, promoters, n97 principal underwriters or managing underwriters, including, in each case, any affiliates or associates n98 of these persons.

[x] Discretionary Accounts. Item 508(j) of Regulation S-K, "Discretionary accounts," provides that if the registrant was not subject to the reporting requirements of Sections 13(a) or 15(d) of the Exchange Act immediately prior to the filing of the registration statement, the registrant should disclose whether any principal underwriter intends to sell to its discretionary accounts and an estimate of the amount of securities so intended to be sold. The information required by Item 508(j) should be contained in a pre-effective amendment to the prospectus, which should be circulated if the information is not available when the registration statement is filed. n99

[xi] Passive Market Making. Item 508(k) of Regulation S-K, "Passive market making," provides that if the underwriters or any selling group members intend to engage in passive market making transactions as permitted by Rule 103 of Regulation M, the registrant must disclose such intention and briefly describe passive market making.

[xii] Stabilization and Other Transactions. Item 508(l), "Stabilization and other transactions," requires the registrant to briefly describe any transaction that the underwriter intends to conduct during the offering that stabilizes, maintains or otherwise affects the market price of the offered securities. Information on stabilizing transactions, syndicate short covering transactions, penalty bids or any other transaction that affects the offered security's price should be included. The registrant should describe the nature of the transactions clearly, explain how the transactions affect the offered security's price and identify the exchange or other market on which these transactions may occur. If true, it should be disclosed that the underwriter may discontinue these transactions at any time.

If the stabilizing began before the effective date of the registration statement, the registrant should disclose the amount of securities bought, the prices at which they were bought and the period within which they were bought. If the registrant used Rule 430A (relating to delayed pricing), the prospectus filed under Rule 424(b) or a post-effective amendment must contain information on the stabilizing transactions that took place before the determination of the public offering price.

If the registrant is making an offering of warrants or rights offering of securities to existing security holders and any securities not purchased by existing security holders are to be reoffered to the public, the following should be disclosed

in a supplement to the prospectus or in the prospectus used in connection with the reoffering:

- (1) the amount of securities bought in stabilization activities during the offering period and the price or range of prices at which the securities were bought;
- (2) the amount of the offered securities subscribed for during the offering period;
- (3) the amount of the offered securities subscribed for by the underwriter during the offering period;
- (4) the amount of the offered securities sold during the offering period by the underwriter and the price or price ranges at which the securities were sold; and
- (5) the amount of the offered securities that will be reoffered to the public and the public offering price.

[i] Item 9. Description of Securities to be Registered.

This item requires the registrant to furnish the information specified by Item 202 of Regulation S-K.

The introductory Note to Item 202 of Regulation S-K permits the registrant to identify any exchange that has accepted the securities for listing. In doing so, however, the registrant should not convey the impression that it can apply successfully for listing of the securities on a particular exchange or that, in the case of an underwritten offering, the underwriters may request the registrant to apply for exchange listing, unless there is reasonable assurance that the securities to be offered will be acceptable to a securities exchange for listing.

[i] Capital Stock. Item 202(a) of Regulation S-K, "Capital stock," provides that if capital stock is being registered, the registrant should state the title of the class of securities being registered. n100

Wherever the title of securities is required to be stated, the registrant should furnish information that will indicate the type and general character of the securities, including:

- (1) the par or stated value, if any;
- (2) the rate of dividends, if fixed, and whether cumulative or noncumulative and a brief description of the preference, if any; and
- (3) if convertible or redeemable, a statement to that effect. n101

The registrant should also describe each of the following requirements as are relevant to the security: n102

- (1) dividend rights;
- (2) terms of conversion; n103
- (3) sinking fund provisions;
- (4) redemption provisions;
- (5) voting rights, including any provisions specifying the vote required by security holders to take action; n104

- (6) any classification of the board of directors, and the effect of the classification where cumulative voting is permitted or required;
- (7) liquidation rights;
- (8) preemption rights;
- (9) liability to further calls or to assessment by the registrant and liability of the registrant imposed on its stockholders by state law (*e.g.*, to laborers, servants or employees of the registrant), unless the disclosure would be immaterial because the financial resources of the registrant or other factors make it improbable that liability under the state laws would be imposed;
- (10) restrictions on alienability of the securities to be registered; and
- (11) any provision discriminating against any existing or prospective holder of the securities as a result of the security holder owning a substantial amount of securities. n105

In addition, the registrant should describe, to the extent relevant:

- (1) whether the rights of holders of capital stock being registered may be modified other than by a vote of a majority or more of the shares outstanding voting as a class; n106
- (2) if preferred stock is being registered, whether there are restrictions on the repurchase or redemption of shares by the registrant while there are arrearages in the payment of dividends or sinking fund installments; n107
- (3) information regarding the rights of any authorized class of securities that do, or may materially limit or qualify the rights evidenced by, or amounts payable with respect to the rights evidenced by, or amounts payable with respect to the shares being registered. The information must permit investors to understand those limitations or qualifications and no information need be given for any class of securities to be retired, provided appropriate steps to ensure the retirement will be completed prior to or upon delivery by the registrant of the shares; n108 and
- (4) the effect on the control of the registrant (*e.g.*, a delay, deferment or prevention of a change of control) of any of the registrant's charter or by-law provisions applicable only in the case of an extraordinary corporate transaction involving the registrant or its subsidiaries, such as a merger, reorganization, tender offer, sale or transfer of substantially all of its assets or liquidation. n109 This disclosure is required only for the provisions or arrangements created by the registrant and not those provisions required by law. n110

In describing the securities being offered, care should be exercised in the choice of terminology used in connection with debt securities as distinguished from equity securities. The situation is intensified when the securities involved are "hybrids," possessing characteristics common to both debt and equity securities. In this connection, problems have arisen concerning the use of the words "bond," "bond feature," and "guarantee," and the placing of a fixed dollar amount on the face of the security as its maturity value. n111

[iii] Debt Securities. Item 202(b) of Regulation S-K, "Debt securities," calls for a brief description of the debt securities being registered including:

- (1) the title of the securities;

1-7 Federal Securities Act of 1933 § 7.03

(2) the principal amount being registered; and

(3) if a series of securities is being offered, the total amount authorized, and the total amount outstanding as of the most recent practicable date. n112

In providing the title of securities being registered, the type and general character of the securities should be indicated, including:

(1) the rate of interest;

(2) the date of maturity, or, if the issue matures serially, a brief indication of the serial maturities; n113

(3) if the payment of principal or interest is contingent, an appropriate indication of the contingency;

(4) a brief indication of the priority of the issue; and

(5) if the security is convertible or callable, a statement to that effect. n114

In addition, the registrant should outline, as appropriate:

(1) provisions with respect to interest, conversion, maturity, redemption, amortization, sinking fund or retirement;

(2) provisions with respect to the kind and priority of any lien securing the issue, together with a brief identification of the principal properties subject to that lien.

(3) provisions with respect to the subordination of the rights of holders of the securities to other security holders or creditors of the registrant; n115

(4) provisions restricting the declaration of dividends or requiring the maintenance of any ratio of assets or the creation or maintenance of reserves;

(5) provisions restricting the issuance of additional securities or the incurring of additional debt; n116

(6) the general type of event that constitutes a default and whether or not any periodic evidence is required to be furnished as to the absence of default or as to compliance with the terms of the indenture;

(7) provisions relating to modification of the terms of the security or the rights of security holders;

(8) provisions similar to those described in Item 202(a)(4) of Regulation S-K n117 concerning material limitations or qualifications on rights evidenced by the securities being registered;

(9) if the debt securities are offered at a price deemed to be an "original issue discount" as defined under *Section 1273 of the Internal Revenue Code* n118 or if sold in a package with another security and the allocation of the offering price between the two securities may have the effect of offering the debt security at an original issue discount, the tax effects of the original issue discount under *Sections 1271-1278 of the Internal Revenue Code*; and

(10) the name of the trustees and the nature of any material relationship with the registrant or any of its

affiliates, the percentage of securities of the class necessary to require the trustee to take action and what indemnification the trustee may require before proceeding to enforce the lien. n119

[iii] Warrants and Rights. Item 202(c) of Regulation S-K, "Warrants and rights," provides that if the securities are offered pursuant to warrants or rights, the registrant must state:

- (1) the amount of securities called for by the warrants or rights;
- (2) the period during which and the price at which the warrants or rights are exercisable;
- (3) the amount of warrants or rights outstanding;
- (4) provisions for changes to or adjustments in the exercise price; and
- (5) any other material terms of the warrants or rights. n120

[iv] Other Securities. Item 202(d) of Regulation S-K, "Other securities," provides that if securities other than capital stock, debt securities, warrants or rights are being registered, the registrant should include a brief description of the rights evidenced thereby comparable to the description required by Items 202(a), (b) and (c) of Regulation S-K. n121

[v] Market Information for Securities Other Than Common Equity. Item 202(e) of Regulation S-K, "Market information for securities other than common equity," requires disclosure of market information for non-equity securities comparable to that required by Item 201 (a) of Regulation S-K n122 such as the reported high and low bid prices for each full quarterly period during the last two fiscal years and the subsequent interim period during the last two fiscal years and the subsequent interim period for which financial information must be filed pursuant to Article 3 of Regulation S-X in cases where there is an established public trading market for the securities being registered (other than common equity).

If the registrant is a foreign registrant, the description of the securities in response to Item 202 of Regulation S-K should include briefly, to the extent not otherwise disclosed, the following:

- (1) a brief description of any limitations imposed by foreign law or by the registrant's charter or other constituent documents on the right of nonresident or foreign owners to hold or vote the securities and if no such limitations are applicable, it should be so stated;
- (2) a brief description of any governmental laws, decrees or regulations in the registrant's country of organization that affect the remittance of dividends, interest and other payments to nonresident holders of the securities being registered;
- (3) an outline of all taxes, including withholding provisions, to which United States security holders are subject; and
- (4) a brief description of pertinent provisions of any reciprocal tax treaty between the foreign country and the United States regarding withholding, and if there is no treaty, it should be so stated. n123

[vi] American Depositary Receipts. Item 202(f) of Regulation S-K, "American Depositary Receipts," requires disclosure of the following information if Depositary Shares represented by American Depositary Receipts are being registered:

- (1) the name of the depositary and the address of its principal executive office;

(2) the title of the American Depositary Receipts, an identification of the deposited security and a brief description of the terms of the deposit; n124

and

(3) a description of all fees and charges which may be imposed directly or indirectly against the holder of the American Depositary Receipts, indicating the type of service, the amount of fee or charges and to whom paid. n125

[j] Item 10. Interests of Named Experts and Counsel. This item requires the registrant to furnish the information specified in Item 509 of Regulation S-K.

Item 509 of Regulation S-K, "Interests of named experts and counsel," provides that if

(1) any expert n126 named in the registration statement as having prepared or certified any part of the registration statement or a report, or valuation to be used in connection with the registration statement; or

(2) counsel n127 for the registrant, underwriters or selling security holders named in the prospectus as having given an opinion on the validity of the securities being registered or on other legal matters in connection with the registration or the offering;

(a) was employed for that purpose on a contingency basis; or

(b) at the time of preparation, certification or opinion or any time thereafter through the date of effectiveness of the registration statement or that part of the registration statement to which the preparation, certification or opinion relates, had, or is to receive in connection with the offering, a substantial interest, direct or indirect, in the registrant, its parents or subsidiaries; or

(c) was connected with the registrant or any of its parents or subsidiaries as a promoter, managing underwriter or principal underwriter (if there are no managing underwriters), voting trustee, director, officer or employee,

then a brief statement of the nature of the contingent basis, interest or connection should be furnished by the registrant.

If the interest of an expert (other than an accountant) n128 or counsel, including the fair market value of all securities of the registrant owned, received or to be received, or subject to options, warrants or rights received or to be received by the expert or counsel, does not exceed \$50,000, the interest will not be deemed to be substantial and need not be disclosed. n129

Failure to disclose matters concerning the interests of experts or counsel named in the registration statement constitutes a material deficiency in the registration statement. n130

[k] Item 11. Information With Respect to the Registrant.

This item requires the registrant to furnish basic information about the registrant that is required to be furnished in annual reports to the Commission on Exchange Act Form 10-K, n131 regarding information relating to:

(1) the registrant's business;

- (2) property;
- (3) material pending legal proceedings;
- (4) common equity securities;
- (5) financial statements;
- (6) selected financial data;
- (7) supplementary financial information;
- (8) management's discussion and analysis of financial condition and results of operations;
- (9) disagreements with accountants on accounting and financial disclosure;
- (10) quantitative and qualitative disclosures about market risk caused by use of market risk sensitive instruments such as derivative financial instruments;
- (11) directors and executive officers;
- (12) executive compensation;
- (13) security ownership of certain beneficial owners and management; and
- (14) certain relationships, related transactions and corporate governance.

[i] Business.

The information relating to the registrant's business is governed by Item 101 of Regulation S-K.

The description of the registrant's business and its development must be both accurate and adequate. "Investors are protected under the Securities Act of 1933 ... against having to guess on the basis of ambiguous language as to what ... is the nature of the business to be performed." n132 If the nature of the business actually done or to be done is misstated, n133 if previous operating losses are concealed, n134 or if past activities of the registrant are not disclosed, n135 liability may result.

The Commission, upon written request of the registrant and where consistent with the protection of investors, may permit the omission of the information required by Item 101 or the furnishing of appropriate information of comparable character in substitution for that information. n136

Item 101 of Regulation S-K, "Description of business," contains seven major parts:

- (1) general development of business;
- (2) financial information about industry segments;
- (3) narrative description of business;

- (4) financial information about geographic areas;
- (5) available information;
- (6) reports to security holders; and
- (7) enforceability of civil liabilities against foreign persons.

The Commission amended the disclosure requirements of Item 101 to conform to current generally accepted accounting standards. Item 101 now requires disclosure about an issuer's "operating segments." The Commission also incorporated the SFAS No. 131 instructions governing how to present information relating to operating segments. n137

Effective February 2008, the Commission has amended Item 101 to provide for scaled disclosure of the registrant's business if it qualifies as a "smaller reporting company." n138

[A] General Development of Business. Item 101(a) of Regulation S-K, "General development of business," requires a description of the general development of the business of the registrant, its subsidiaries, n139 and any predecessors n140 during the past five years, or for such shorter period as the registrant has been engaged in business, and, if material to an understanding of the general development of the registrant's business, information should be disclosed for earlier periods. In describing the development of the business, the registrant should state:

- (1) the year in which the registrant was organized and the registrant's form of organization;
- (2) the nature and results of any bankruptcy, receivership or similar proceedings involving the registrant or any of its significant subsidiaries; n141
- (3) the nature and results of any material reclassification, merger or consolidation of the registrant or any of its significant subsidiaries;
- (4) the acquisition or disposition of any material amount of assets not in the ordinary course of business; and
- (5) any material changes in the mode of conducting the business. n142

If the registrant is not subject to the reporting requirements of Sections 13(a) or 15(d) of the Exchange Act immediately prior to the filing of the registration statement and the registrant (including predecessors) has not had operating revenues for each of the last three fiscal years, it should also describe its future plan of operation, n143 including a narrative statement of the registrant's opinion as to the period of time that the proceeds from the offering will satisfy cash requirements and whether in the next six months it will be necessary to raise additional funds to meet operating expenses of the registrant. Specific reasons for this opinion should be stated and categories of expenditures and sources of cash resources should be identified, although amounts of expenditures and cash resources need not be provided. If the narrative statement is based on a cash budget, the budget should be furnished to the Commission as supplemental information, rather than as part of the registration statement.

The description of the registrant's future plan of operation should also include:

- (1) an explanation of material product research and development to be performed;
- (2) anticipated material acquisitions and capacity of plant and equipment;

(3) anticipated material changes in the number of employees in the various departments of the registrant such as research and development, production, sales or administration; and

(4) other material areas that may be peculiar to the registrant's business.

[B] Financial Information About Segments. Item 101(b) of Regulation S-K, "Financial information about segments," requires the registrant to disclose the amounts of revenue (with sales to unaffiliated customers and sales or transfers to other segments of the registrant shown separately), n144 operating profit or loss and identifiable assets attributable to each of the registrant's segments. The disclosure is required for each of the registrant's last three fiscal years, or for each fiscal year the registrant has been engaged in business, whichever period is shorter. To the extent that financial information about segments complies with generally accepted accounting principles, the registrant may include in its financial statements a cross reference to Item 101(b) in lieu of presenting duplicate information about its segments in the financial statements, or, the registrant may cross refer to the financial statements, instead of including the information in response to Item 101(b).

The registrant must restate the corresponding information for prior periods, including interim periods, unless impracticable to do so, if it changes the structure of its internal organization in a manner that causes the composition of its reporting segments to change. The registrant must disclose whether it has restated the items for the prior periods following a change in composition of its reportable segments. If it has not restated the items, the registrant must disclose in the year in which the change occurs segment information for the current period under both the old basis and the new basis of information, unless it is impracticable to do so. n145

The prior period information should be restated retroactively, unless not material, with appropriate disclosure of the nature and effect of the restatement:

(1) when the financial statements of the registrant as a whole are restated retroactively; or

(2) when there is a change in the way the registrant's products or services are grouped into segments that affects the reportable segment information. n146

The registrant need not restate the prior period information if its reportable segments change solely because of a change in the nature of the registrant's operations or as a result of the segment's loss of or gain in significance.

If the registrant includes (or is required by Article 3 of Regulation S-X, General Instructions as to Financial Statements, to include) interim financial statements, the registrant should discuss any facts and shall include to the extent necessary, comparative financial information, relating to the performance of any of the segments that, in the opinion of management, show that the three-year segment financial data may not be indicative of current or future operations of the segment. n147

[C] Narrative Description of Business. Item 101(c) of Regulation S-K, "Narrative description of business," requires a description of the business done and intended to be done by the registrant and its subsidiaries, focusing primarily upon the registrant's dominant industry segment or each of the reportable industry segments about which financial information is presented in the financial statements.

The following information required by paragraphs (1) through (11) need only be reported for each segment to the extent it is material to an understanding of the registrant's business as a whole. The following information specified in paragraphs (12) through (14) must be reported as to the business in general and, only where material, the segments to which these matters are significant must be identified:

1-7 Federal Securities Act of 1933 § 7.03

- (1) the principal products produced and services rendered by the registrant in the industry segment and the principal markets for, and methods of distribution of, the segment's principal products and services;
- (2) the amount or percentage of total revenue contributed by any class of similar products or services, stated for each of the last three fiscal years, that accounted for ten percent or more of consolidated revenue in any of the last three fiscal years or fifteen percent or more of consolidated revenue if the registrant's total revenue did not exceed \$50,000,000 during any of the last three fiscal years;
- (3) the status of a new product or industry segment (e.g., whether the product or segment is in the planning stage, whether prototypes exist, the degree to which product design has progressed or whether further engineering is necessary) that would require the investment of a material amount of assets of the registrant or is otherwise material; n148
- (4) the sources and availability of raw materials;
- (5) the importance to the industry segment and the duration and effect of all patents, trademarks, licenses, franchises and concessions held;
- (6) the extent to which the business of the industry segment is or may be seasonal;
- (7) the practices of the registrant and the industry relating to working capital items; n149
- (8) the dependence of the segment on a single or few customers, the loss of any one or more of which would have a material adverse effect on the segment; n150
- (9) the dollar amount of backlog orders believed to be firm, as of a recent date and as of a comparable date in the preceding fiscal year, and an indication of the portion of the orders not reasonably expected to be filled within the current fiscal year together with seasonal or other material aspects of the backlog; n151
- (10) a description of any material portion of the business subject to renegotiation of profits or termination of contracts or subcontracts at the election of the Government;
- (11) competitive conditions in the business; n152
- (12) if material, the estimated dollar amount spent during each of the last three fiscal years on company-sponsored research and development activities and customer-sponsored related research activities relating to the development or improvement of products, services or techniques;
- (13) the material effects of compliance with federal, state and local laws regarding the discharge of materials into the environment, or otherwise relating to the protection of the environment on the capital expenditures, earnings and competitive position of the registrant and its subsidiaries; n153 and
- (14) the number of persons employed by the registrant.

In determining the materiality of the information, the registrant should consider both quantitative and qualitative factors, n154 such as:

- (1) the significance of the matter to the registrant (e.g., whether a matter with a relatively minor effect on the company's business is represented by management to be important to its future profitability);

(2) the pervasiveness of the matter (e.g., whether the matter affects or may affect numerous items in the segment information); and

(3) the real effect of the matter (e.g., whether it distorts the trends reflected in the segment information).

Situations may arise when information should be disclosed about a segment, although the information in quantitative terms may not appear significant to the registrant's business taken as a whole.

[D] Financial Information About Geographic Areas. Item 101(d) of Regulation S-K, "*Financial information about geographic areas*," requires the registrant to disclose the amounts of revenue from unaffiliated customers attributed to, and long lived assets (other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs and deferred tax assets) located in: (i) the registrant's country of domicile; (ii) all foreign countries in total from which the registrant derives revenues and holds assets; and, if material, (iii) any individual foreign country. n155 The disclosure is required for each of the registrant's last three fiscal years or for each fiscal year the registrant has been engaged in business, whichever period is shorter. A registrant must disclose the amounts based on the financial information it uses to produce the general-purpose financial statements. If it is impracticable to provide the geographic information, the registrant must disclose that fact. The registrant may also provide subtotals of geographic information about groups of countries. n156

Item 101(d) permits cross-reference to financial information included in the registrant's financial statements. The disclosure requirements for prior period information that should be restated retroactively pursuant to Item 101(d) are similar to the provisions under Item 101(b), n157 except that Item 101(d) looks to a grouping of geographic areas rather than to industry segments. Item 101(d) requires additional disclosure of any risks attendant to foreign operations and any dependence of one or more of the registrant's industry segments upon those foreign operations. n158 If the registrant includes interim financial statements, it must discuss any facts relating to the information that in the opinion of management indicate that the three-year financial information may not be indicative of current or future operations. If necessary, comparative information should be provided. n159

The registrant should evaluate period comparability to determine whether information about segments is required for a particular fiscal year. For example, period comparability may require the registrant to report segment information that was significant in the immediately preceding period and is expected to be significant in the future although the segment may not be material under the criteria for reportability of SFAS No. 131 in the current fiscal year. n160

[E] Available Information. Item 101(e) of Regulation S-K, "*Available information*," requires the registrant to disclose the following:

(1) whether it files reports with the Commission and, if so, the reports and other information it files;

(2) that the public may read and copy any materials it files with the Commission at the Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The registrant should state that the public may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330. If the registrant is an electronic filer, it should state that the Commission maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the Commission and state the address of that site (<http://www.sec.gov>).

(3) its Internet address, if the registrant is an accelerated filer (it is encouraged to give its Internet address, if available, even if it is not an accelerated filer);

(4) whether it makes available free of charge on or through its Internet website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after filing or furnishing such material with the Commission. If it does not make its filings available in this manner, the registrant must state the reasons it does not do so (including, where applicable, that it does not have an Internet website) and whether it voluntarily will provide electronic or paper copies of the filings free of charge upon request.

[F] Reports to Security Holders. Item 101(f), "Reports to Security Holders," requires the registrant to disclose the following information:

(1) If the Commission's proxy rules or regulations, or stock exchange requirements, do not require the registrant to send an annual report to security holders or to holders of American depository receipts, the registrant should describe briefly the nature and frequency of reports that it will give to security holders. It should specify whether the reports that it gives will contain financial information that has been examined and reported on, with an opinion expressed "by" an independent public or certified public accountant.

(2) For a foreign private issuer, if the reports will not contain financial information prepared in accordance with U.S. generally accepted accounting principles, the registrant must state whether the reports will include a reconciliation of this information with U.S. generally accepted accounting principles.

[G] Enforceability of Civil Liabilities Against Foreign Persons. Item 101(g), "Enforceability of Civil Liabilities Against Foreign Persons," requires the registrant to disclose the following if it is a foreign private issuer:

(1) whether or not investors may bring actions under the civil liability provisions of the U.S. federal securities laws against the foreign private issuer, any of its officers and directors who are residents of a foreign country and any underwriters or experts named in the registration statement that are residents of a foreign country, and whether investors may enforce these civil liability provisions when the assets of the issuer or these other persons are located outside of the United States. The disclosure must address the following matters:

- the investor's ability to effect service of process within the United States on the foreign private issuer or any of those persons;
- the investor's ability to enforce judgments obtained in U.S. courts based upon the civil liability provisions of the U.S. federal securities laws;
- the investor's ability to enforce, in an appropriate foreign court, judgments of U.S. courts based upon the civil liability provisions of the U.S. federal securities laws; and
- the investor's ability to bring an original action in an appropriate foreign court to enforce liabilities based upon the U.S. federal securities laws.

(2) if the registrant provides this disclosure based on an opinion of counsel, it should name counsel in the prospectus and file as an exhibit to the registration statement a signed consent of counsel to the use of its name and opinion.

[H] Smaller Reporting Companies. A registrant that qualifies as a smaller reporting company may satisfy its

obligation under Item 101 of Regulation S-K by describing the development of its business during the last three years, n161 including:

- (1) form and year of organization;
- (2) any bankruptcy, receivership or similar proceeding;
- (3) any material reclassification, merger or consolidation;
- (4) any purchase or sale of a significant amount of assets not in the ordinary course of business;
- (5) the principal products or services and their markets;
- (6) distribution methods;
- (7) status of any publicly announced new product or service;
- (8) competitive business conditions;
- (9) sources and availability of raw materials and the names of principal suppliers;
- (10) dependence on one or a few major customers;
- (11) patents, trademarks, licenses, franchises, concessions, royalty agreements or labor contracts, including duration;
- (12) the need for any government approval, and the status of any such approval not yet received;
- (13) the effect of existing or probable government regulation;
- (14) the approximate amount spent on research and development during the past two years (and the extent to which such amount is borne by customers);
- (15) the cost and effect of compliance with environmental laws; and
- (16) the number of full-time employees. n162

The smaller reporting company's registration statement must also include a statement:

- whether it will voluntarily deliver an annual report if it is not required to do so, and whether such report will include audited financial statements;
- whether it files reports with the Commission. If the company is a reporting company, it must identify the reports it files with the Commission; and
- that the public may read and copy any materials the company files with the Commission at the Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The registrant should also state that the public may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330. If the registrant is an electronic filer, it should state that the Commission maintains an Internet site (<http://www.sec.gov>) that contains reports, proxy and

information statements and other information. n163

The smaller reporting company is encouraged, but not required, to disclose its Internet address. n164 Foreign issuers that qualify as a smaller reporting company must provide the information required by Item 101(g) of Regulation S-K. n165

[iii] Property.

The information relating to the registrant's property is governed by Item 102 of Regulation S-K.

Item 102 of Regulation S-K, "Description of Property," requires a brief description of the location and general character of the principal plants, mines and other materially important physical properties of the registrant and its subsidiaries, with identification of the industry segments that use the properties described. n166 Item 102 also requires the registrant to state whether any of the described property is not held in fee or is held subject to any major encumbrance, and, if so, to briefly describe how the property is held.

[A] Extractive Enterprises and Estimates of Reserves. For each extractive enterprise not involved in oil and gas producing activities, the registrant should give material information about:

- (1) production;
- (2) reserves;
- (3) locations;
- (4) development; and
- (5) the nature of the registrant's interest. n167

If individual properties are of major significance to any industry segment, more detailed information about these matters should be furnished, including maps that disclose the location of significant properties. n168

In the case of extractive enterprises other than oil and gas reserves, estimates other than proven or probable reserves (and any estimated values of such reserves) should not be disclosed in any document publicly filed with the Commission unless such information is required to be disclosed in the document by foreign or state law; however, where such estimates have previously been provided to a person (or any of its affiliates) that is offering to acquire, merge or consolidate with the registrant, or otherwise to acquire the registrant's securities, such estimates may be included in documents relating to such acquisition. n169

Registrants engaged in significant mining operations should disclose the information called for in Guide 7. Registrants engaged in real estate activities should disclose the information called for in Industry Guide 5. Registrants engaged in oil and gas producing activities should disclose the information called for in Securities Act Industry Guide 4. n170

Effective January 1, 2010, a registrant engaged in oil and gas producing activities that are material to the registrant's or its' subsidiaries' business operations or financial position should also disclose the information required by Subpart 1200 of Regulation S-K. n171 Limited partnerships and joint ventures that conduct, operate, manage or report upon oil and gas drilling or income programs, or acquire properties for drilling and production or for the production of oil, gas or geothermal purposes need not include the information required by Subpart 1200. n172

[B] Oil and Gas Producing Activities

[aa] Disclosures and Estimates of Reserves

A registrant engaged in relevant oil and gas producing activities must provide a tabular summary of oil, natural gas, synthetic oil, synthetic gas and sale products of other non-renewable natural resources that are intended to be upgraded into synthetic oil and gas at fiscal year end. n173 The disclosures must be expressed in an oil-barrel-equivalent basis, in the aggregate and by geographic area for each country containing 15% or more of the registrant's proven reserves, using prices and costs under existing economic conditions. n174 The disclosure must contain individual estimates for proved developed reserves, proved undeveloped reserves and total proved reserves, and these disclosures must be updated at the close of each fiscal year. n175 The disclosure may, but need not, contain individual estimates for probable developed reserves, probable undeveloped reserves, possible developed reserves and possible undeveloped reserves. n176 If probable or possible reserves are disclosed, the registrant must also discuss the uncertainty related to such reserve estimates. n177

If the registrant has not previously disclosed reserves estimates in a filing with the Commission or is disclosing material additions to such reserves estimates, the registrant shall discuss the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed. n178

The registrant must also disclose and describe the internal controls used in its reserves estimation effort and the qualifications of the technical person primarily responsible for overseeing the preparation of the reserves estimates. n179 If the registrant represents that a third party prepared or conducted a reserves audit of the registrant's reserves estimates or any estimated valuation thereof, or conducted a process review, the registrant must file a report of the third party as an exhibit to the relevant registration statement or other Commission filing. n180 If the report relates to the preparation of or reserves audit of the registrant's reserves estimates, it must disclose the following, if applicable to the type of filing:

- (i) The purpose for which the report was prepared and for whom it was prepared;
- (ii) The effective date of the report and the date on which the report was completed;
- (iii) The proportion of the registrant's total reserves covered by the report and the geographic area in which the covered reserves are located;
- (iv) The assumptions, data, methods and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods and procedures are appropriate for the purpose served by the report;
- (v) A discussion of primary economic assumptions;
- (vi) A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- (vii) A discussion regarding the inherent uncertainties of reserves estimates;
- (viii) A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report;
- (ix) A brief summary of the third party's conclusions with respect to the reserves estimates and
- (x) The signature of the third party. n181

The registrant may, but is not required to, disclose an estimate of reserves for each product type based on different price and cost criteria, such as a range of prices and costs that may reasonably be achieved, including standardized futures prices or management's own forecasts, as long as the registrant also discloses the price and cost schedules and assumptions on which the disclosed values are based. n182

Estimates of oil or gas resources other than reserves, and any estimated values of such resources, shall not be disclosed in any document publicly filed with the Commission unless such information is required to be disclosed by foreign or state law; however, where such estimates previously have been provided to a person (or any of its affiliates) that is offering to acquire, merge or consolidate with the registrant or otherwise to acquire the registrant's securities, such estimate may be included in documents related to such acquisition. n183

[bb] *Production Activities*

Each registrant must disclose production, by final product sold, of oil, gas and other products for each of the last three fiscal years, unless prohibited by the country in which the reserves are located. n184 The disclosures must be by geographic area for each country containing 15% or more of the registrant's total proved reserves and expressed on an oil-equivalent-barrels basis. n185 The average sales price (including transfers) per unit of oil, gas and other products produced and the average production cost, not including ad valorem and severance taxes, per unit of production and by geographic area, must also be disclosed for each of the last three fiscal years. n186

Each registrant must also disclose the number of net productive and dry exploratory wells drilled; and the number of net productive and dry development wells drilled for each of the last three fiscal years, by geographical area. n187 The disclosure should include any other exploratory or development activities conducted, including implementation of mining methods for purposes of oil and gas producing activities. n188

Further, the registrant must disclose, by geographical area, its present activities, including the number of wells in the process of being drilled (including wells temporarily suspended), waterfloods in process of being installed, pressure maintenance operations and any other related activities of material importance. n189 The disclosure must also include a description of present activities as of a date at the end of the most recent fiscal year or as close to the date that the registrant files the document as reasonably possible. n190

If the registrant is committed to provide a fixed and determinable quantity of oil or gas in the near future under existing contracts or agreements, the registrant must disclose material information concerning the estimated availability of oil and gas from any principal sources, including:

- (1) The principal sources of oil and gas that the registrant will rely upon and the total amounts that the registrant expects to receive from each principal source and from all sources combined;
- (2) The total quantities of oil and gas that are subject to delivery commitments and
- (3) The steps that the registrant has taken to ensure that available reserves and supplies are sufficient to meet such commitments for the next one to three years. n191

If the registrant has been unable to meet any significant delivery commitments in the last three years, it must describe the circumstances concerning such events and their impact on the registrant. n192

[cc] *Properties, Wells, Operations and Acreage*

The registrant must disclose, by geographic area and as of a reasonably current date or as of the end of the fiscal year, the total gross and net productive wells, with oil and gas expressed separately and the total gross and net developed

acreage. n193

In addition, the registrant should include, as of a reasonably current date or as of the end of the fiscal year, the amount of undeveloped acreage, both leases and concessions, if any, expressed in both gross and net acres by geographic area, together with an indication of acreage concentrations, and, if material, the minimum remaining terms of leases and concessions. n194

[iii] Legal Proceedings. The information relating to material pending legal proceedings is governed by Item 103 of Regulation S-K.

Item 103 of Regulation S-K, "Legal Proceedings," requires a brief description of any material n195 pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of its or their property is the subject. n196 The name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, the alleged factual basis underlying the proceeding and the relief sought must be included. There must also be described similar information as to any such proceeding known to be contemplated by governmental authorities. No actions for negligence or other claims need be described if the business ordinarily results in such actions or claims, unless the action or claim departs from the normal. n197 There must also be described any material pending legal proceedings to which any director, officer or affiliate of the registrant, record or beneficial owner of more than five percent of any class of voting securities, or any associate of the foregoing persons, is a party or has a material interest adverse to the registrant or any of its subsidiaries. n198

Notwithstanding the foregoing, administrative or judicial proceedings arising under federal, state or local environmental laws must be described, if:

- (1) the proceeding is material to the business or financial condition of the registrant;
- (2) the proceeding involves primarily a claim for damages or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and if the amount sought, exclusive of interest and costs, is in excess of ten percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or
- (3) the action is a governmental proceeding involving potential monetary sanctions, unless the registrant reasonably believes that the proceeding will result in monetary sanctions, exclusive of interest and costs, of less than \$100,000; provided, however, that such proceedings that are similar in nature may be grouped together and described generically. n199

Although the registrant has no actual knowledge of pending litigation at the time of the *filing* of the registration statement, if the state of the registrant's knowledge changes before the *effective* date, the registration statement must reflect that change. n200 The fact that the registrant considers a pending suit to have no merit is no excuse for not disclosing it. n201

[iv] Common Equity.

Where common equity securities are being offered, the registrant must disclose this information pursuant to Item 201 of Regulation S-K.

Item 201 of Regulation S-K, "Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters," was amended in 2002 and again in 2006. As amended, it contains five parts: market information; holders; dividends; securities authorized for issuance under equity compensation plans; and a performance graph. However, a registration statement does not have to include the information required to be disclosed with respect to the

securities authorized for issuance under equity compensation plans, unless the information is part of a document that is incorporated by reference into a prospectus. n202 Additionally, registration statements filed under the Securities Act need not include a performance graph. n203

[A] Market Information. Item 201(a) of Regulation S-K, "Market information," requires the registrant to:

- (1) identify the principal United States market for each class of the registrant's common equity securities that is traded; n204
- (2) state, if the principal United States market for the registrant's common equity security is an exchange, the high and low sales prices for the security as reported in the consolidated transaction reporting system n205 (or, if not so reported, on the principal exchange market for the security), for each full quarterly period during the past two fiscal years and any subsequent interim period for which financial statements must be filed pursuant to Article 3-01 through 3-04 of Regulation S-X, or Article 8-02 through 8-03 of Regulation S-X in the case of smaller reporting companies; n206
- (3) state, if the principal United States market is not an exchange, the range of high and low bid information for the security as regularly quoted in the automated quotation system of a registered securities association; n207 or if not so quoted, the range of reported high and low bid quotations and the source of these quotations, for each full quarterly period during the past two fiscal years and any subsequent interim period for which financial statements must be filed pursuant to Article 3 of Regulation S-X; n208
- (4) state, where a foreign registrant has identified a principal established foreign public trading market pursuant to paragraph (1) above, market price information comparable, to the extent practicable, to that required for the principal United States market and the source of the information; n209 and
- (5) include price information as of the latest practicable date and, in the case of securities to be issued in connection with an acquisition, business combination or other reorganization, as of the date immediately prior to the public announcement of the transaction. n210

Market prices reported pursuant to Item 201 of Regulation S-K should be adjusted to give retroactive effect to material changes resulting from stock dividends, stock splits and reverse stock splits. n211 If the market information is being presented in connection with a class of common equity securities for which at the time of filing there is no established United States public trading market, the registrant should indicate the amounts of common equity securities that:

- (1) are issuable pursuant to outstanding options or warrants to purchase, or are securities convertible into, common equity of the registrant;
- (2) could be sold pursuant to Rule 144 n212 under the Securities Act or that the registrant has agreed to register under the Securities Act for sale by security holders; or
- (3) are publicly proposed to be publicly offered by the registrant (unless the common equity securities are being offered pursuant to an employee benefit plan or dividend reinvestment plan), where the offering could have a material effect on the market price of the registrant's common equity securities. n213

[B] Holders. Item 201(b) of Regulation S-K, "Holders," requires the registrant to state the approximate number of holders of each class of its common equity securities as of the latest practicable date. n214 The registrant must indicate the effect of the offering on the amount and percentage of present holdings of the registrant's common equity securities

by:

- (1) the beneficial owners of more than five percent of any class of the securities;
- (2) each director and director-nominee; and
- (3) all directors and officers as a group. n215

[C] Dividends. Item 201(c) of Regulation S-K, "Dividends," requires the registrant to state the frequency and amount of any cash dividends declared on each class of its common equity securities for the two most recent fiscal years and any subsequent interim period for which financial statements are presented pursuant to Article 3 of Regulation S-X. n216 A brief description of any restriction on the registrant's current or future ability to pay cash dividends and any restriction on the ability of the registrant's subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances should be given. This information may be provided by cross-reference to descriptions of material dividend limitations in the management's discussion and analysis of financial condition and operating results pursuant to Item 303 of Regulation S-K n217 and the financial statements pursuant to Regulation S-X. n218

If the registrant has a record of paying no cash dividends although its earnings indicate that it has the ability to do so, the registrant is encouraged to consider the question of its intention to pay cash dividends in the foreseeable future. n219 If the registrant has no intention to pay cash dividends, it should so state. A registrant that has a history of paying cash dividends is encouraged to indicate whether it intends to pay comparable cash dividends in the future and, if not, to indicate the nature of the change in the amount or rate of cash dividend payments.

If the registrant is a foreign issuer, it should briefly describe any governmental laws, decrees or regulations in the country in which the registrant is organized relating to:

- (1) restrictions on the export or import of capital, foreign exchange controls, remittance of dividends or other payments to nonresident holders of the registrant's common equity securities; and
- (2) taxes, including withholding provisions, to which United States common equity holders are subject. n220

[v] Financial Statements. Financial statements that meet the requirements of Regulation S-X n221 (schedules required under Regulation S-X should be filed as "Financial Statement Schedules" pursuant to Item 16 of Form S-1) n222 and financial information required by Rule 3-05, "Financial Statements of Businesses Acquired or to be Acquired," and Article 11, "Pro Forma Financial Information," of Regulation S-X should be included in response to Item 11 of Form S-1. n223 A smaller reporting company may provide the information in Rules 8-04 and 8-05 of Regulation S-X in lieu of the financial information required by Rule 3-05 and Article 11 of Regulation S-X. n224

[vi] Selected Financial Data. The selected financial data required to be furnished is governed by Item 301 of Regulation S-K. A registrant that qualifies as a smaller reporting company is not required to provide the selected financial data required by Item 301. n225

Item 301 of Regulation S-K, "Selected Financial Data," requires the registrant to furnish, in comparative columnar form, the selected financial data for the registrant for each of the last five fiscal years of the registrant (or for the life of the registrant and its predecessors, if less than five fiscal years) and for any additional fiscal year necessary to keep the information from being misleading. n226 The items included in the table of selected financial data are:

- (1) net sales or operating revenues;

- (2) income (loss) from continuing operations;
- (3) income (loss) from continuing operations per common share;
- (4) total assets;
- (5) long-term obligations and redeemable preferred stock (including long-term debt, capital leases and redeemable preferred stock as defined in Rule 5-02.28(a) of Regulation S-X); and
- (6) cash dividends declared per common share. n227

The registrant should briefly discuss (or cross-reference to a discussion elsewhere of) factors such as accounting changes, business combinations or dispositions of business operations, that materially affect the comparability of the five-year information as well as certain contingencies reflected in the selected financial data. A discussion of (or cross-reference to a discussion elsewhere of) any material uncertainties should also be included where such matters may cause the financial data presented not to be indicative of the registrant's future financial condition or results of operations. n228

If interim period financial statements are included in the table of selected financial data pursuant to Article 3 of Regulation S-X, the registrant should consider updating, on a comparative basis, the selected financial data for the interim period to reflect any material changes in the trends indicated in its financial condition and results of operations. n229

A foreign private issuer must also disclose the following information in all filings containing financial statements:

- (1) In the forepart of the document and as of the latest practicable date, the exchange rate into U.S. currency of the foreign currency in which the financial statements are denominated;
- (2) A history of exchange rates for the five most recent years and any subsequent interim period for which financial statements are presented setting forth the rates for period end, the average rates and the range of high and low rates for each year; and
- (3) If equity securities are being registered, a five year summary of dividends per share stated in both the currency in which the financial statements are denominated and United States currency based on the exchange rates at each respective payment date. n230

[vii] Supplementary Financial Information.

The supplementary financial information required is governed by Item 302 of Regulation S-K.

Item 302 of Regulation S-K, "Supplementary Financial Information," requires the registrant to make disclosures in two areas: selected quarterly financial data and information about oil and gas producing activities. Additionally, a registrant that qualifies as a smaller reporting company is not required to provide the information required by Item 302. n231

[A] Selected Quarterly Financial Data. Item 302(a) of Regulation S-K, "Selected quarterly financial data," requires certain registrants to disclose:

- (1) net sales;
- (2) gross profit; n232

(3) income (loss) before extraordinary items and cumulative effect of a change in accounting;

(4) per share data based upon income (loss) before extraordinary items and cumulative effect of a change in accounting; and

(5) per share data based upon such income (loss) and net income (loss). n233

The information required in paragraphs (1) through (5) should be given for each full quarter within the last two fiscal years and any subsequent interim period for which financial statements are included pursuant to Article 3 of Regulation S-X. n234

The registrant should describe the effect of any disposals of segments of a business and extraordinary, unusual or infrequently occurring items recognized in each full fiscal quarter within the two most recent years and for any subsequent interim period for which financial statements are included pursuant to Article 3 of Regulation S-X. The registrant should also discuss the aggregate effect and nature of any year-end or other adjustments that are material to the results of that quarter. n235

Item 302(a) of Regulation S-K applies to any registrant (except foreign private issuers) that has securities registered under either Section 12(b) or 12(g) of the Exchange Act. n236

[B] Information About Oil and Gas Producing Activities. Item 302(b) of Regulations S-K, "Information about oil and gas producing activities," requires registrants engaged in oil and gas producing activities to provide specified information about those activities required by Statement of Financial Accounting Standards ("SFAS") No. 69, "Disclosures about Oil and Gas Producing Activities," if the activities are deemed significant under SFAS No. 69. n237

[viii] Management's Discussion and Analysis of Financial Condition and Results of Operations.

The management's discussion and analysis of financial condition and operating results is governed by Item 303 of Regulation S-K.

Item 303 of Regulation S-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations," requires the registrant to make disclosures covering two distinct periods: full fiscal years and interim periods. n238

[A] Full Fiscal Years. Item 303(a), "Full fiscal years," requires the registrant to discuss and analyze its financial condition, changes in financial condition and results of operations, based on the financial statements and any other statistical data that the registrant believes will enhance a reader's understanding of these factors. n239 The purpose of the discussion and analysis is to provide information relevant from management's perspective to an assessment of the registrant's financial condition and results of its operations by evaluating the amounts and certainty of cash flows from operations and outside sources. n240 The registrant should specifically focus on material events and uncertainties that would cause reported financial information not to be necessarily indicative of future financial condition or operating results, *e.g.*, matters that have not had an effect on operations in the past but may in the future or matters that have had an effect on reported operations and are not expected to have an effect on operations in the future. n241 If, in the registrant's judgment, a discussion of segment information or of other subdivisions of the registrant's business would be appropriate to an understanding of the business, the discussion should also focus on each relevant, reportable segment or other subdivision of the business and on the registrant as a whole. n242 The discussion of financial condition and results of operations should generally cover the three-year period covered by the financial statements and should use year-to-year comparisons or any other formats that in the registrant's judgment enhance a reader's understanding of financial conditions and results of operations. n243 A registrant that qualifies as a smaller reporting company need only

cover the two-year period required in Article 8 of Regulation S-X and should also use year-to-year comparisons or any other formats that enhance a reader's understanding. n244

The registrant also should provide the following information pursuant to Item 303(a):

(1) Liquidity. n245 The registrant must identify any known trends or demands, commitments, events or uncertainties reasonably likely to result in a material increase or decrease in the registrant's liquidity. n246

Liquidity should be discussed on both a long-term and short-term basis and in the context of the registrant's own business. n247 The registrant should also indicate those balance sheet conditions or income or cash flow items that it believes may be indicators of its liquidity condition. n248 The course of action that the registrant has taken or proposes to take to remedy any material deficiency in liquidity must be identified. n249 In addition, the registrant must identify and separately describe internal and external sources of liquidity and must briefly discuss any material unused sources of liquid assets. n250

(2) Capital Resources. n251 The registrant is required to describe its material commitments for capital expenditures as of the end of the latest fiscal periods, the general purpose of those commitments and the anticipated source of funds to meet those commitments. n252 The registrant is also required to describe any known material trends in its capital resources and any expected material changes in the mix and relative cost of those resources. n253 The discussion of capital resources should include consideration of changes between equity, debt and any off-balance sheet financing arrangements. n254

(3) Results of Operations. The registrant is required to describe:

1. any unusual or infrequent events or transactions or any significant economic changes that materially affected reported income from continuing operations and the extent to which reported income was affected;
2. any significant components of revenues or expenses that in the registrant's judgment should be described to understand its results of operations;
3. any known trends or uncertainties that have had or that the registrant reasonably expects will have a material effect on net sales or revenues or income from continuing operations;
4. any known event that will cause a material change in the relationship between costs and revenues, e.g., future increases in costs of labor or materials;
5. by narrative discussion, the extent to which any material increases in net sales or revenues disclosed in the financial statements are attributable to:
 - a. increases in prices,
 - b. increases in volume or amount of goods or services being sold or
 - c. the introduction of new products or services; and
6. the effect of inflation and changing prices on the registrant's net sales and revenues and on income from continuing operations, for:
 - a. the three most recent fiscal years (a smaller reporting company need only provide such

information for the last two most recent fiscal years), or

b. the fiscal years in which the registrant has been engaged in business, whichever period is shortest. n255

Any forward-looking information supplied is expressly covered by the safe harbor rule for projections. n256

In addition, the registrant should provide any other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial conditions and results of operations. n257

(4) Off-Balance Sheet Arrangements. In a separately captioned section, the registrant must discuss its off-balance sheet arrangements n258 that have or are reasonably likely to have a current or future effect, material to investors, on (i) the registrant's financial condition, (ii) changes in financial condition, (iii) revenues or expenses, (iv) results of operations, (v) liquidity, (vi) capital expenditures or (vii) capital resources. To the extent necessary to an understanding of the off-balance sheet arrangements, the items below are to be included in the disclosure, as well as other information that the registrant believes is necessary for an understanding of such arrangements. n259

1. The nature and business purpose to the registrant of such off-balance sheet arrangements;
2. The importance of such off-balance sheet arrangements to the registrant, with respect to its liquidity, capital resources, market risk support, credit risk support or other benefits;
3. The amounts of revenues, expenses and cash flows of the registrant arising from such arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the registrant in connection with such arrangements; and the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; and
4. Any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination, or material reduction in availability to the registrant, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the registrant has taken or proposes to take in response to any such circumstances.

The registrant has no obligation under Item 303(a)(4) to make disclosure of an off-balance sheet arrangement until a definitive agreement that is unconditionally binding (or subject only to customary closing conditions) exists or, if there is no such agreement, when settlement of the transaction occurs. n260 The discussion of off-balance sheet arrangements need not repeat information provided in the footnotes to the financial statements, provided that the discussion clearly cross-references to specific information in the relevant footnotes and integrates the substance of the footnotes in a manner designed to inform readers of the significance of the information that is not included within the body of such discussion. n261

(5) Tabular Disclosure of Contractual Obligations. The registrant is required to provide the information as of the latest fiscal year end balance sheet date, with respect to the registrant's known contractual obligations, in tabular format for the periods set forth in Item 303(a)(5). Amounts must be provided, aggregated by type of contractual obligation, though the registrant may disaggregate the specified categories of contractual obligations using other categories suitable to its business. The presentation as whole must include all of the obligations of the registrant that fall within the specified categories. A presentation covering at least the periods specified must be included. The tabular presentation may be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the registrant's specified contractual obligations.

1-7 Federal Securities Act of 1933 § 7.03

n262 A registrant that qualifies as a smaller reporting company is not required to provide the tabular disclosure required by Item 303(a)(5). n263

Payments due by period					
Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
[Long-Term Debt Obligations]					
[Capital Lease Obligations]					
[Operating Lease Obligations]					
[Purchase Obligations]					
[Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under U.S. GAAP]					
Total					

1. Long-Term Debt Obligations. Payment obligations under long-term borrowings referenced in FASB Statement of Financial Accounting Standards No. 47, "Disclosure of Long-Term Obligations" (March 1981).

2. Capital Lease Obligation. Payment obligations under a lease classified as a capital lease pursuant to FASB Statement of Financial Accounting Standards No. 13, "Accounting for Leases" (November 1976).

3. Operating Lease Obligation. A payment obligation under a lease classified as an operating lease and disclosed pursuant to FASB Statement of Financial Accounting Standards No. 13, "Accounting for Leases" (November 1976).

4. Purchase Obligations. Agreements to purchase goods or services that are enforceable and legally binding on the registrant that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.

[B] Interim Periods. Item 303(b), "Interim periods," requires a registrant to provide a management's discussion and analysis of financial conditions and results of operations, providing the same information as required under Item 303(a) with the exception of the effect of inflation and changing prices on operations, with respect to any interim period for which financial statements are included or are required to be included by Article 3 of Regulation S-X. n264

The registrant is required to discuss any material changes in its financial condition, including any seasonal aspects of the registrant's business that may have had a material effect upon its financial condition n265 from the end of the preceding fiscal year to the date of the most recent interim balance sheet provided. n266 If the interim financial statements include an interim balance sheet as of the corresponding interim date of the preceding fiscal year, any material changes in financial condition from that date to the date of the most recent interim balance sheet provided should also be discussed. n267

The registrant is also required to discuss any material changes in its results of operations, including any significant elements of the registrant's income or loss from continuing operations that do not arise from or are not necessarily representative of the registrant's ongoing business, n268 for the most recent fiscal year-to-date period for which an income statement is provided and the corresponding year-to-date period of the preceding fiscal year. n269 If the registrant is required to provide, or has provided, an income statement for the most recent fiscal quarter, the discussion should also cover material changes in results of operations for that fiscal quarter and the corresponding fiscal quarter in the preceding fiscal year. n270 In addition, if the registrant has provided an income statement for the twelve-month period ended as of the date of the most recent interim balance sheet provided, the discussion should cover material changes for that twelve-month period and the twelve-month period ended as of the corresponding interim balance sheet date of the preceding fiscal year. n271

[C] Safe Harbor. Forward-looking information provided under Item 303(a)(4) and 303(a)(5) is protected by the safe harbor provided in Section 27A of the Securities Act and Section 21E of the Exchange Act ("statutory safe harbors"), provided that the disclosure is made by:

- (1) an issuer;
- (2) a person acting on behalf of the issuer;
- (3) an outside reviewer retained by the issuer making a statement on behalf of the issuer; or
- (4) an underwriter, with respect to information provided by or derived from information provided by the issuer. n272

Any forward-looking information supplied is expressly covered by the safe harbor protections of Rule 175 under the Securities Act. n273

[ix] Changes in and Disagreements with Accountants on Accounting and Financial Disclosure. Item 304 of Regulation S-K, "Changes in and Disagreements with Accountants on Accounting and Financial Disclosure," requires that if, during the registrant's two most recent fiscal years or any subsequent interim period, an independent accountant who was previously engaged as the principal accountant to audit the registrant's financial statements, or an independent accountant who was previously engaged to audit a significant subsidiary and on whom the principal accountant expressed reliance in its report, either resigned, indicated an intention not to stand for re-election after completion of the current audit, or was dismissed, the registrant must provide information with respect to:

- (1) whether the former accountant resigned, declined to stand for re-election or was dismissed and the date of whichever of the foregoing events is applicable;
- (2) whether the principal accountant's report on the financial statements for either of the past two years contained an adverse opinion, a disclaimer of opinion or was modified or qualified as to uncertainty, audit scope or accounting principles and the nature of any such adverse opinion, disclaimer of opinion, modification or qualification;
- (3) whether the decision to change accountants was recommended or approved by any audit or similar committee of the board of directors if the registrant has such a committee or by the board of directors the registrant does not have such a committee; and
- (4) whether, during the registrant's two most recent fiscal years and any subsequent interim period preceding such resignation, declination or dismissal, there were any disagreements with the former

1-7 Federal Securities Act of 1933 § 7.03

accountant on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreement(s), if not resolved to the satisfaction of the former accountant, would have caused the accountant to make a reference to the subject matter of the disagreement(s) in connection with its report. n274

The registrant must also provide all of the information required by paragraph (4) above with respect to any of the events described below, of which the former accountant advised the registrant within the registrant's two most recent fiscal years and any subsequent interim period which preceded the former accountant's resignation, declination to stand for re-election, or dismissal, even though the registrant and the former accountant did not express a difference of opinion regarding the event ("reportable events"): n275

- (1) that the internal controls necessary for the registrant to develop reliable financial statements do not exist;
- (2) that information had come to the accountant's attention that led the accountant to conclude that it can no longer rely on management's representations or that it is unwilling to continue to be associated with the financial statements prepared by management;
- (3) that the scope of the audit needed to be expanded significantly, not acted upon because of the accountant's resignation or dismissal or for any other reason, or advice that information had come to the attention of the accountant during the two preceding fiscal years and any subsequent interim period which, although not further investigated due to the accountant's resignation or dismissal or for any other reason, could, if further investigated:
 - (a) materially impact the fairness or reliability of either a previously issued audit report or the underlying financial statements, or the financial statements issued or to be issued covering the fiscal period(s) subsequent to the date of the most recent financial statements covered by an audit report (including information that may prevent the accountants from rendering an unqualified audit report on those financial statements), or
 - (b) cause the accountant to be unwilling to rely on management's representations or be associated with the registrant's financial statements; or
- (4) that information has come to the accountant's attention which creates an issue which was not resolved to the accountant's satisfaction prior to the accountant's resignation, dismissal or declination to stand for re-election because the accountant has concluded that the information materially impacts the fairness or reliability of either
 - (a) a previously issued audit report or the underlying financial statements, or
 - (b) the financial statements issued or to be issued covering the fiscal period(s) subsequent to the date of the most recent financial statements covered by an audit report (including information that, unless resolved to the accountant's satisfaction, would prevent the accountant from rendering an unqualified audit report on the subject financial statements).

n276

If the "reportable event" led to a disagreement or difference of opinion, then the event should be reported as a disagreement under paragraph (a)(1)(iv) of Item 304 and need not be reported under paragraph (a)(1)(v). n277

If, during the registrant's two most recent fiscal years or any subsequent interim period, a new independent accountant

has been engaged as either the principal accountant to audit the registrant's financial statements or as an independent accountant to audit a significant subsidiary and on whom the principal accountant is expected to express reliance in its report, the registrant shall identify the newly engaged accountant and indicate the date of engagement. If, during the same time period, the registrant or someone on the registrant's behalf consulted the newly engaged accountant regarding:

- (a) the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the registrant's financial statements and there was provided to the registrant by such newly engaged accountant either a written report or oral advice which the new accountant concluded was an important factor considered by the registrant in reaching a decision as to the accounting, auditing or financial reporting issue; or
- (b) any matter that was either the subject of a "disagreement" as defined in Item 304(a)(1)(iv) and the related instructions to Item 304 or a "reportable event" as described in Item 304(a)(1)(v),

then the registrant shall:

- (1) so state and identify the issues that were the subject of the consultations;
- (2) briefly describe the views of the newly engaged accountant as expressed orally or in writing to the registrant on each such issue and, if written views were received by the registrant, file them as an exhibit to the subject report or registration statement;
- (3) state whether the former accountant was consulted by the registrant regarding any such issues, and, if so, provide a summary of the former accountant's views; and
- (4) request the newly engaged accountant to review the disclosure required by Item 304(a) before it is filed with the Commission and provide the new accountant the opportunity to furnish the registrant with a letter addressed to the Commission containing any new information, clarification of the registrant's expression of its views, or the respects in which the new accountant does not agree with the statements made by the registrant. n278

The registrant shall file any such letter as an exhibit to the report or registration statement containing the disclosure required by Item 304. n279 The registrant shall request the former accountant to furnish the registrant with a letter addressed to the Commission stating whether the accountant agrees with the statements made by the registrant in response to Item 304(a) and, if not, stating the respects in which it does not agree. The registrant shall file the former accountant's letter as an exhibit to the report or registration statement containing the disclosure. If the former accountant's letter is not available at the time of filing, it shall be filed by amendment within ten days thereafter. n280

If in connection with a change in accountants subject to paragraph (a) of Item 304, there was any "disagreement" of the type described in paragraph (a)(1)(iv) or any "reportable event" as described in paragraph (a)(1)(v) of Item 304 and during the fiscal year in which the change of accountants took place or during the subsequent fiscal year there have been transactions or events similar to those which involved the disagreement or reportable event, and such transactions or events were material and were accounted for or disclosed in a manner different from that which the former accountants apparently would have concluded was required, then the registrant shall state:

- (1) the existence and nature of the disagreement or reportable event; and
- (2) the effect on the financial statements if the method had been followed which the former accountants apparently would have concluded was required. n281

[x] Quantitative and Qualitative Disclosures About Market Risk.

The information concerning market risk caused by use of market risk sensitive instruments such as derivative financial instruments is governed by Item 305 of Regulation S-K. n282 A registrant that qualifies as a smaller reporting company is not required to provide the information required by Item 305.

Item 305 of Regulation S-K, "Quantitative and qualitative disclosures about market risk," requires the registrant to provide information on market risk sensitive instruments. The Commission recognized the value of market risk sensitive instruments as effective tools for managing exposures to market risk, but noted the significant, and sometimes unexpected, losses resulting from changes in interest rates, foreign currency exchange rates and commodity prices, among other things. n283

The disclosures called for by Item 305 are intended to clarify the registrant's exposures to market risk associated with activities in "derivative financial instruments," "other financial instruments" and "derivative commodity instruments". n284

These terms are defined as follows:

- "Derivative financial instruments" has the same meaning as defined by U.S. GAAP and includes futures, forwards, swaps, options and other financial instruments with similar characteristics; n285
- "Other financial instruments" means all financial instruments as defined by generally accepted accounting principles for which fair value disclosures are required, except for derivative financial instruments; n286 and
- "Derivative commodity instruments" includes (to the extent such instruments are not derivative financial instruments) commodity futures, commodity forwards, commodity swaps, commodity options and other commodity instruments with similar characteristics that are permitted by contract or business custom to be settled in cash or with another financial instrument. Settlement in cash includes settlement in cash of the net change in value of the derivative commodity instrument (e.g., net cash settlement based on changes in the price of the underlying commodity). n287

In addition to these instruments, registrants are encouraged to include other market risk sensitive instruments, positions and transactions within these disclosures. n288 Such instruments, positions and transactions might include commodity positions, derivative commodity instruments that are not permitted by contract or business custom to be settled in cash or with another financial instrument, cash flows from anticipated transactions n289 and financial instruments excluded from the definition of "other financial instruments." n290 If a registrant elects to include voluntarily a particular type of instrument, position or transaction in their quantitative disclosures about market risk, that registrant should include all, rather than some, of those instruments, positions or transactions within those disclosures. n291

Registrants should present the information required by Item 305 outside of, and not incorporate the information into, the financial statements (including the footnotes to the financial statements). In addition, registrants are encouraged to provide the required information in one location. However, alternative presentation, such as inclusion of all or part of the information in Management's Discussion and Analysis, may be used at the discretion of the registrant. If information is disclosed in more than one location, registrants should provide cross-references to the locations of the related disclosures. n292

[A] Quantitative Information About Market Risk. Item 305(a), "Quantitative information about market risk," requires the registrant to provide, in its reporting currency, quantitative information about market risk. This information

should be presented in one of three alternative disclosure formats, tabular presentation, sensitivity analysis and value at risk, each of which is discussed in detail below. Under any of these three disclosure alternatives, registrants should characterize market risk sensitive instruments into instruments entered into (i) for trading purposes, n293 or (ii) for other purposes. Within each of these portfolios, separate quantitative information shall be presented, to the extent material, for each market risk exposure category (i.e., interest rate risk, foreign currency exchange rate risk, commodity price risk and other relevant market risks, such as equity price risk). n294

A registrant may use one of the three disclosure alternatives for all of the required quantitative disclosures about market risk. A registrant may also choose, from among the three alternatives, one disclosure alternative for market risk sensitive instruments entered into for trading purposes, and another disclosure alternative for market risk sensitive instruments entered into for other than trading purposes. Alternatively, a registrant may choose any disclosure alternative, from among the three alternatives, for each risk exposure category within the trading and other than trading portfolios. n295

The first alternative disclosure format is tabular presentation of information related to market risk sensitive instruments. n296 This presentation should include fair values of the market risk sensitive instruments and contract terms sufficient to determine future cash flows from those instruments, categorized by expected maturity dates. n297 Tabular information relating to contract terms should allow readers of the table to determine expected cash flows from the market risk sensitive instruments for each of the next five years. Comparable tabular information for any remaining years should be displayed as an aggregate amount. n298

Within each risk exposure category, the market risk sensitive instruments should be grouped based on common characteristics, within the foreign currency exchange rate risk category, by functional currency, and within the commodity price risk category, by type of commodity. n299

When grouping based on common characteristics, instruments should be categorized, at a minimum, by the following characteristics, when material:

- Fixed rate or variable rate assets or liabilities;
- Long or short forwards and futures;
- Written or purchased put or call options with similar strike prices;
- Receive fixed and pay variable swaps, receive variable and pay fixed swaps and receive variable and pay variable swaps;
- The currency in which the instruments' cash flows are denominated;
- Financial instruments for which foreign currency transaction gains and losses are reported in the same manner as translation adjustments under generally accepted accounting principles; and
- Derivatives used to manage risks inherent in anticipated transactions. n300

Registrants may aggregate information regarding functional currencies that are economically related, managed together for internal risk management purposes, and have statistical correlations of greater than 75% over each of the past three years. n301

Market risk sensitive instruments that are exposed to rate or price changes in more than one market risk exposure category should be presented within the tabular information for each of the risk exposure categories to which those

instruments are exposed. n302

If a currency swap eliminates all foreign currency exposures in the cash flows of a foreign currency denominated debt instrument, neither the currency swap nor the foreign currency denominated debt instrument are required to be disclosed in the foreign currency risk exposure category. However, both the currency swap and the foreign currency denominated debt instrument should be disclosed in the interest rate risk exposure category. n303

The contents of the table and related assumptions that should be described include, but are not limited to:

- The different amounts reported in the table for various categories of the market risk sensitive instruments (e.g., principal amounts for debt, notional amounts for swaps and contract amounts for options and futures);
- The different types of reported market rates or prices (e.g. contractual rates or prices, spot rates or prices, forward rates or prices); and
- Key prepayment or reinvestment assumptions relating to the timing of reported amounts. n304

The second alternative disclosure format is sensitivity analysis disclosure that expresses the potential loss in future earnings, fair values or cash flows of market risk sensitive instruments resulting from one or more selected hypothetical changes in interest rates, foreign currency exchange rates, commodity prices and other relevant market rates or prices over a selected period of time. n305 The magnitude of selected hypothetical changes in rates or prices may differ among and within market risk exposure categories. Registrants should provide a description of the contents of the table and any related assumptions necessary to understand these disclosures. n306

Registrants should select hypothetical changes in market rates or prices that are expected to reflect reasonably possible near-term changes in those rates and prices. In this regard, absent economic justification for the selection of a different amount, registrants should use changes that are not less than 10% of end of period market rates or prices. n307

Market risk sensitive instruments that are exposed to rate or price changes in more than one market risk exposure category should be included in the sensitivity analysis disclosures for each market risk category to which those instruments are exposed. n308

Registrants with multiple foreign currency exchange rate exposures should prepare foreign currency sensitivity analysis disclosures that measure the aggregate sensitivity to changes in all foreign currency exchange rate exposures, including the effects of changes in both transactional currency/functional currency exchange rate exposures and functional currency/reporting currency exchange rate exposures. n309

Models, assumptions and parameters that should be described include, but are not limited to, how loss is defined by the model (e.g., loss in earnings, fair values or cash flows), a general description of the modeling technique (e.g., duration modeling, modeling that measures the change in net present values arising from selected hypothetical changes in market rates or prices and a description as to how optionality is addressed by the model), the types of instruments covered by the model (e.g., derivative financial instruments, other financial instruments, derivative commodity instruments and whether other instruments are included voluntarily, such as certain commodity instruments and positions, cash flows from anticipated transactions and financial instruments excluded from the definition of "other financial instruments," and other relevant information about the model's assumptions and parameters (e.g., the magnitude and timing of selected hypothetical changes in market rates or prices used, the method by which discount rates are determined and key prepayment or reinvestment assumptions). n310

The third alternative disclosure format is value at risk disclosure that express the potential loss in future earnings, fair

values or cash flows of market risk sensitive instruments over a selected period of time, with a selected likelihood of occurrence, from changes in interest rates, foreign currency exchange rates, commodity prices and other relevant market rates or prices. n311 For each category for which value at risk disclosures are required, the registrant should provide either:

- The average, high and low amounts, or the distribution of the value at risk amounts for the reporting period;
- The average, high and low amounts, or the distribution of actual changes in fair values, earnings or cash flows from the market risk sensitive instruments occurring during the reporting period; or
- The percentage or number of times the actual changes in fair values, earnings or cash flows from the market risk sensitive instruments exceeded the value at risk amounts during the reporting period. n312

Registrants should provide a description of the model, assumptions and parameters which are necessary to understand these disclosures. n313

The confidence intervals selected should reflect reasonably possible near-term changes in market rates and prices. In this regard, absent economic justification for the selection of different confidence intervals, registrants should use intervals that are 95% or higher. n314

Registrants with multiple foreign currency exchange rate exposures should prepare foreign currency value at risk analysis disclosures that measure the aggregate sensitivity to changes in all foreign currency rate exposures, including the aggregate effects of changes in both transactional currency/functional currency exchange rate exposures and functional currency/reporting currency exchange rate exposures. n315

Model, assumptions and parameters that should be described include, but are not limited to, how loss is defined by the model (*e.g.*, loss in earnings, fair values or cash flows), the type of model used (*e.g.* variance/covariance, historical simulation or Monte Carlo simulation and a description as to how optionality is addressed by the model), the types of instruments covered by the model (*e.g.*, derivative financial instruments, other financial instruments, derivative commodity instruments, and whether other instruments are included voluntarily, such as certain commodity instruments and positions, cash flows from anticipated transactions and financial instruments excluded from the definition of "other financial instruments," and other relevant information about the model's assumptions and parameters (*e.g.*, holding periods, confidence intervals and, when appropriate, the methods used for aggregating value at risk amounts across market risk exposure categories, such as by assuming perfect positive correlation, independence or actual observed correlation). n316

Registrants that voluntarily include other market risk sensitive instruments, positions and transactions within their quantitative disclosures about market risk under the sensitivity analysis or value at risk disclosure alternatives are not required to provide separate market risk disclosures for any voluntarily selected instruments, positions or transactions. Instead, registrants seeking the sensitivity analysis and value at risk disclosure alternatives are permitted to present comprehensive market risk disclosures, which reflect the combined market risk exposures inherent in both the required and any voluntarily selected instruments, positions or transactions. Registrants that choose the tabular presentation disclosure alternative should present voluntarily selected instruments, positions or transactions in a manner consistent with the requirements in Item 305(a) for market risk sensitive instruments. n317

A materiality assessment should be made for each market risk exposure category within the trading and other than trading portfolios. Registrants should evaluate both:

- The materiality of the fair values of derivative financial instruments, other financial instruments and

derivative commodity instruments outstanding as of the end of the latest fiscal year n318; and

- The materiality of potential, near-term losses in future earnings, fair values and/or cash flows from reasonably possible near-term changes in market rates or prices. n319

If either of these items are material, the registrant should disclose quantitative and qualitative information about market risk, if such market risk for the particular market risk exposure category is material. n320

Registrants should discuss material limitations that cause this information not to fully reflect the net market risk exposures of the entity. This discussion should include summarized descriptions of instruments, positions and transactions omitted from the quantitative market risk disclosure information or the features of instruments, positions and transactions that are included, but not fully reflected in the quantitative market risk disclosure information. n321 Limitations that should be considered include, but are not limited to:

- The exclusion of certain market risk sensitive instruments, positions and transactions from the disclosures required under Item 305(a)(1) (*e.g.*, derivative commodity instruments not permitted by contract or business custom to be settled in cash or with another financial instrument, commodity positions, cash flows from anticipated transactions and financial instruments excluded from the definition of "other financial instruments." Failure to include such instruments, positions and transactions in preparing the disclosures under Item 305(a)(1) may be a limitation because the resulting disclosures may not fully reflect the net market risk of a registrant; and
- The ability of disclosures required under Item 305(a)(1) to reflect fully the market risk that may be inherent in instruments with leverage, option or prepayment features (*e.g.*, options, including written options, structured notes, collateralized mortgage obligations, leveraged swaps and options embedded in swaps). n322

Registrants should present summarized market risk information for the preceding fiscal year. In addition, registrants should discuss the reasons for material quantitative changes in market risk exposures between the current and preceding fiscal years. This information is not required if disclosure is not required for the current fiscal year, and is also not required for the first fiscal year in which a registrant must present Item 305 information. n323

If registrants change disclosure alternatives or key model characteristics, assumptions and parameters used in providing quantitative information about market risk (*e.g.* changing from tabular presentation to value at risk, changing the scope of instruments included in the model or changing the definition of loss from fair values to earnings), and if the effects of any such change is material, the registrant should:

- Explain the reasons for the change; and
- Either provide summarized comparable information, under the new disclosure method, for the preceding year or, in addition to providing disclosure for the current year under the new method, provide disclosures for the current year and preceding year under the method used in the preceding year. n324

[B] Qualitative Information About Market Risk. Item 305(b), "Qualitative information about market risk," requires the registrant to describe, to the extent material:

- (1) the registrant's primary market risk exposures; n325
- (2) how those exposures are managed. Such descriptions shall include, but not be limited to, a discussion of the objectives, general strategies and instruments, if any, used to manage those exposures; and

(3) changes in either the registrant's primary market risk exposures or how those exposures are managed, when compared to what was in effect during the most recently completed fiscal year and what is known or expected to be in effect in future reporting periods. n326

Qualitative information about market risk should be presented separately for market risk sensitive instruments entered into for trading purpose and those entered into for purposes other than trading. n327

[C] Interim Periods. Item 305(c), "Interim periods," provides that if interim period financial statements are included or are required to be included by Article 3 of Regulation S-X, discussion should be provided so as to enable the reader to assess the sources and effects of material changes in information that would be provided under Item 305 of Regulation S-K from the end of the preceding fiscal year to the date of the most recent interim balance sheet. n328

[D] Safe Harbor. Item 305(d), "Safe harbor," provides that the statutory safe harbor provided under the Securities Act for forward-looking information applies to certain information provided under Item 305, n329 provided that the disclosure is made by:

- (1) an issuer;
- (2) a person acting on behalf of the issuer;
- (3) an outside reviewer retained by the issuer making a statement on behalf of the issuer; or
- (4) an underwriter,

with respect to information provided by the issuer or information derived from information provided by the issuer. n330

[xi] Directors, Executive Officers, Promoters and Control Persons.

The information concerning the identities, family relationships, business experience and involvement in legal proceedings of the registrant's directors, executive officers and certain significant employees is governed by Item 401 of Regulation S-K.

From the standpoint of the prospective investor, this section of the prospectus may be of importance because in many instances the investor may base his or her judgment on whether to purchase upon the character and reputation of those persons associated with the registrant in policy-making capacities. Thus, the listing of a person as a director who has never acted in that capacity or who has resigned from a previous directorship, n331 overstating a director's qualifications as an expert, n332 or exaggerating a director's success in past operations, n333 are false or misleading practices. Similarly, it is misleading to create the impression in the prospectus that a group of well-known and highly successful persons is giving its time and effort to building up the registrant's business when in fact the names of such persons are being used merely as "window dressing." n334 In the same vein, failure to disclose relevant criminal records constitutes a material omission. n335

[A] Identification of Directors. Item 401(a), "Identification of directors," requires the registrant to list the names and ages of all directors of the registrant, and all persons nominated or chosen to become directors n336 and to disclose as to each such person:

- (1) all positions and offices held with the registrant;
- (2) the term of office as director and any periods during which the person served as such; and

(3) any arrangement or understanding between the director and any other persons, including the name of such other persons, pursuant to which the director was or is to be selected as a director or nominee. n337

[B] Identification of Executive Officers. Item 401(b), "Identification of executive officers," requires the registrant to disclose the same information concerning its executive officers n338 as is required concerning its directors. n339

[C] Identification of Certain Significant Employees. Item 401(c), "Identification of certain significant employees," requires that if the registrant employs persons such as production managers, sales managers or research scientists who are not executive officers but who are expected to make significant contributions to the business of the registrant, those persons must be identified and their backgrounds disclosed to the same extent as for executive officers. This information, however, is not required if the registrant, immediately prior to the filing of the Form S-1 was:

(1) subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act; or

(2) an insurance company whose securities are exempt from the reporting requirements of Section 13(a) of the Exchange Act by Section 12(g)(2)(G). n340

[D] Family Relationships. Item 401(d), "Family relationships," requires the registrant to state the nature of any family relationship n341 between any director, executive officer or person nominated or chosen by the registrant to become a director or executive officer.

[E] Business Experience. New rules affecting the required disclosure under Item 401(e) are effective February 28, 2010. n342 Item 401(e), "Business experience," requires a brief account of the business experience during the past five years of each person identified by the registrant as a director, executive officer or chosen or nominated to become a director or executive officer and each significant employee, including principal occupations and employment, the name and principal business of the organization in which the occupation or employment was carried on and whether the corporation or organization in which the person was previously employed was a parent, subsidiary or other affiliate of the registrant. n343 In addition, for each director or person nominated or chosen to become a director, there must be a brief discussion of the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director for the registrant at the time that the disclosure is made, in light of the registrant's business and In addition, for each director or person nominated or chosen to become a director, there must be a brief discussion of the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director for the registrant at the time that the disclosure is made, in light of the registrant's business and structure. n344 Directorships held by each director or person nominated or chosen to become a director in a company:

(1) with a class of securities registered under Section 12 of the Exchange Act,

(2) subject to the reporting requirements of Section 15(d) of the Exchange Act, or

(3) registered as an investment company under the Investment Company Act of 1940,

must be indicated, and the company in which the directorship was held stated. n345 If any person identified by the registrant as an executive officer or significant employee has been employed by the registrant or any of the registrant's subsidiaries for less than five years, the registrant must also include a brief explanation of the nature of the responsibility undertaken by the person in principal occupations and employment in the past five years. n346

[F] Involvement in Certain Legal Proceedings. New rules affecting the required disclosure under Item 401(f) are effective February 28, 2010. n347 Item 401(f), "Involvement in certain legal proceedings," requires the registrant to describe any of the following legal proceedings that occurred during the preceding five years n348 and that are material n349 to an evaluation of the ability or integrity of a person who is a director, director nominee or executive officer of

the registrant:

(1) a petition under federal bankruptcy or state insolvency laws n350 that was filed by or against, or the appointment of a receiver or similar officer by a court for, the business or property of

(a) the person,

(b) any partnership in which the person was a general partner at, or within two years before, the time of the filing, or

(c) any corporation or business association of which the person was an executive officer at, or within two years before, the time of the filing; n351

(2) a criminal proceeding in which the person was convicted, or a pending criminal proceeding of which the person is a named subject, excluding traffic violations and other minor offenses; n352

(3) an order, judgment or decree, not subsequently reversed, suspended or vacated, of a court of competent jurisdiction, of which the person was the subject, permanently or temporarily enjoining the person from, or otherwise limiting, the following activities

(a) acting as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator, floor broker, leverage transaction merchant, any other person regulated by the Commodity Futures Trading Commission or an associated person of any of the foregoing, or an investment adviser, underwriter, broker or dealer in securities, or as an affiliated person, director or employee of any investment company, bank, savings and loan association or insurance company, or engaging in or continuing any conduct or practice in connection with the activity,

(b) engaging in any type of business practice or

(c) engaging in any activity in connection with the purchase or sale of any security or commodity or in connection with any violation of federal or state securities law or federal commodities law; n353

(4) an order, judgment or decree, not subsequently reversed, suspended or vacated, of any federal or state authority, of which the person was the subject, barring, suspending or otherwise limiting for more than sixty days the right of the person to engage in any activity described in paragraph 3(a) above, or to be associated with persons engaged in such activity; n354

(5) a finding by a court of competent jurisdiction in a civil action or by the Commission that the person violated any federal or state securities law, and the judgment in the civil action or the finding by the Commission was not subsequently reversed, suspended or vacated; n355

(6) a finding by a court of competent jurisdiction in a civil action or by the Commodities Futures Trading Commission that the person violated any federal commodities law, and the judgment in the civil action or the finding by the CFTC was not subsequently reversed, suspended or vacated; n356

(7) a Federal or State judicial or administrative order, judgment, decree or finding, not subsequently reversed, suspended or vacated, relating to an alleged violation of

(a) any Federal or State securities or commodities law or regulation,

(b) any law or regulation respecting financial institutions or insurance companies including, but not limited to, a temporary or permanent injunction, order of disgorgement or restitution, civil money penalty or temporary or permanent cease-and-desist order or removal or prohibition order,

(c) any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity, or n357

(8) a sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization (as defined in Section 3(a)(26) of the Exchange Act), any registered entity (as defined in Section 1(a)(29) of the Commodity Exchange Act) or any equivalent exchange, association, entity or organization that has disciplinary authority over its members or persons associated with a member. n358

The registrant may also explain any mitigating circumstances associated with the legal proceedings. n359

[G] Promoters and Control Persons. Item 401(g), "Promoters and control persons," requires that registrants not subject to the periodic reporting requirements of the Exchange Act for the twelve months preceding a filing of the registration statements must make the disclosures called for by Item 401(f) as to material events within the preceding five years involving (1) any control person, and (2) if the registrant was organized within the preceding five years, any promoter. n360

[H] Audit Committee Financial Expert. Item 401(h), "Audit committee financial expert," calls for disclosure that the board of directors of the registrant has determined that the registrant either (A) has at least one audit committee financial expert serving on its audit committee or (B) does not have an audit committee financial expert serving on its audit committee. The registrant must then disclose the name of the audit committee financial expert and whether that person is independent. n361 If the registrant does not have an audit committee financial expert, it must explain why.

A person with the following attributes qualifies as an audit committee financial expert:

- (1) an understanding of generally accepted accounting principles and financial statements;
- (2) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- (3) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- (4) an understanding of internal control over financial reporting; and
- (5) an understanding of audit committee functions.

These attributes must have been acquired through (i) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions, (ii) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions, (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of

financial statements or (iv) other relevant experience (which shall be briefly described).

A person who is determined to be an audit committee financial expert will not be deemed an expert for the purposes of section 11 of the Securities Act as a result of being designated or identified as an audit committee financial expert pursuant to Item 401, nor does it impose on that person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on a member of the audit committee and board of directors in the absence of the designation or identification. The duties, obligations or liability of any other member of the audit committee or board of directors are not affected by designating a person an audit committee financial expert.

[xii] Executive Compensation.

Item 402 of Regulation S-K, "Executive Compensation," requires disclosure of the compensation of officers and directors in clear concise and understandable terms. n362

The framework of Item 402 generally divides the executive compensation discussion into five categories:

- Compensation discussion and analysis of material factors underlying compensation policies and decisions reflected in the data presented in the tables required by Item 402; n363
- Compensation with respect to the last fiscal year (and the two preceding fiscal years), as reflected in a summary compensation table that presents compensation paid currently or deferred (including options, restricted stock and similar grants) and compensation consisting of current earnings or awards that are part of a plan, and as supplemented by a table providing backup information for certain data in the summary compensation table;
- Holdings of equity-related interests that relate to compensation or are potential sources of future gains, with a focus on compensation-related equity interests that were awarded in prior years and are "at risk," whether or not these interests are in-the-money, as well as recent realization on these interests, such as through vesting or restricted stock or the exercise of options and similar instruments;
- Retirement and other post-employment compensation, including retirement and deferred compensation plans, other retirement benefits and other post-employment benefits, such as those payable in the event of a change in control; and
- Director compensation, as reflected in a summary table.

[A] General. Paragraph (a) of Item 402 contains general provisions stating that Item 402 requires clear, concise and understandable disclosure of all plan n364 and non-plan compensation awarded to, earned by, or paid to the "named executive officers" and directors of the registrant by any person for all services rendered in all capacities to the registrant and its subsidiaries. n365 The "named executive officers" as to whom disclosure under Item 402 is required are:

- (1) all individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year (the "PEO"), regardless of compensation level;
- (2) all individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year (the "PFO"), regardless of compensation level;
- (3) the registrant's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year; and

(4) up to two additional individuals for whom disclosure would have been provided pursuant to paragraph (3) above, except that the individual was not serving as an executive officer n366 of the registrant at the end of the last completed fiscal year. n367

If the named executive of the registrant served in such capacity during any part of a fiscal year with respect to which information is required, Item 402(a)(4) provides that such information should be provided as to all of his or her compensation for the full fiscal year.

The general provisions of Item 402 also provide that any table or column called for by Item 402 may be omitted if there has been no compensation awarded to, earned by or paid to any of the named executives or directors required to be reported in that table or column in any fiscal year covered by that table.

[B] Compensation Discussion and Analysis. Item 402(b), "Compensation discussion and analysis," requires an overview of the material factors underlying compensation policies and decisions regarding the named executive officers. n368 The Compensation Discussion and Analysis should address the information contained in the tables required by Item 402. n369

Item 402(b)(1) requires the registrant to discuss the compensation awarded to, earned by, or paid to the named executive officers. The discussion must explain all material elements of the compensation, and must describe the following:

- the objectives of the registrant's compensation programs;
- what the compensation program is designed to reward;
- each element of compensation;
- why the registrant chooses to pay each element;
- how the registrant determines the amount (and, where applicable, the formula) for each element to pay; and
- how each compensation element and the registrant's decisions regarding that element fit into the registrant's overall compensation objectives and affect decisions regarding other elements. n370

Examples of the material information to be disclosed as part of the Compensation Discussion and Analysis may include: n371

- (1) the policies for allocating between long-term and currently paid out compensation;
- (2) the policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- (3) for long-term compensation, the basis for allocating compensation to each different form of award (such as relationship of the award to the achievement of the registrant's long-term goals, management's exposure to downside equity performance risk, correlation between cost to registrant and expected benefits to the registrant);
- (4) how the determination is made as to when awards are granted, including awards of equity-based compensation such as options;

- (5) what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- (6) how specific forms of compensation are structured and implemented to reflect these items of the registrant's performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goals or to reduce or increase the size of any award or payout), identifying any particular exercise of discretion, and stating whether it applied to one or more named executive officers or to all compensation subject to the relevant performance goals;
- (7) how specific forms of compensation are structured and implemented to reflect the named executive officer's individual performance and/or individual contribution to these items of the registrant's performance, describing the elements of individual performance and/or contribution that are taken into account;
- (8) registrant policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of a payment;
- (9) the factors considered in decisions to increase or decrease compensation materially;
- (10) how compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (*e.g.*, how gains from prior option or stock awards are considered in setting retirement benefits);
- (11) with respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payments in connection with any termination or change-in-control, the basis for selecting particular events as triggering payment (*e.g.*, the rationale for providing a single trigger for payment in the event of a change-in-control);
- (12) the impact of the accounting and tax treatments of the particular form of compensation;
- (13) the registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging the economic risk of such ownership;
- (14) whether the registrant engaged in any benchmarking n372 of total compensation, or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- (15) the role of executive officers in determining executive compensation. n373

As part of the Compensation Discussion and Analysis, a registrant is not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the board of directors or compensation committee. n374 Likewise, the registrant need not disclose any other factors or criteria involving confidential trade secrets or confidential commercial or financial information where such disclosure would result in competitive harm for the registrant. n375 If the registrant does disclose target levels and they are non-U.S. GAAP financial measures, such disclosure will not be subject to Regulation G and Item 10(e) of Regulation S-K. n376

[C] Summary Compensation Table. New rules affecting the required disclosure under Item 402(c) are effective

February 28, 2010. n377 Item 402(c), "Summary compensation table," requires the following information regarding compensation of the named executive officers for each of the registrant's last three completed fiscal years, n378 to be set forth in tabular form:

- (1) the name and principal position of the named executive officer (column (a));
- (2) the fiscal year covered (column (b));
- (3) the dollar value of base salary (cash and non-cash) earned by the named executive officer during the fiscal year covered (column (c)); n379
- (4) the dollar value of bonus (cash and non-cash) earned by the named executive officer during the fiscal year covered (column (d)); n380
- (5) for awards of stock, n381 the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (e));
- (6) for awards of options, n382 with or without tandem SARs, including awards that have subsequently been transferred, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (f)); n383
- (7) the dollar value of all earnings for services performed during the fiscal year pursuant to awards under non-equity incentive plans, n384 and all earnings on any outstanding awards (column (g)); n385
- (8) the sum of the following amounts (column (h)): n386
 - (A) the aggregate change in the actuarial present value of the named executive officer's accumulated benefit under all defined benefit and actuarial pension plans (including supplemental plans) from the pension plan measurement date used for financial statement reporting purposes with respect to the registrant's audited financial statements for the prior completed fiscal year to the pension plan measurement date used for financial statement reporting purposes with respect to the registrant's audited financial statements for the covered fiscal year; n387 and
 - (B) above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified, including such earnings on nonqualified defined contribution plans; n388
- (9) all other compensation for the covered fiscal year that the registrant could not properly report in any other column of the Summary Compensation Table (column (i)). n389 Such compensation must include, but is not limited to:
 - (A) perquisites and other personal benefits or property, unless the aggregate amount of such compensation is less than \$10,000; n390
 - (B) all "gross-ups" or other amounts reimbursed during the fiscal year for the payment of taxes; n391
 - (C) the compensation cost, if any (computed in accordance with FAS 123R), for any security of the registrant or its subsidiaries purchased from the registrant or its

subsidiaries (through deferral of salary or bonus, or otherwise) at a discount from the market price of such security at the date of purchase, unless that discount is available generally, either to all security holders or to all salaried employees of the registrant;

(D) the amount paid or accrued n392 to any named executive officer pursuant to a plan or arrangement in connection with:

(i) any termination, including without limitation through retirement, resignation, severance or constructive termination (including a change in responsibilities) of such executive officer's employment with the registrant and its subsidiaries; or

(ii) a change in control of the registrant;

(E) registrant contributions or other allocations to vested and unvested defined contribution plans;

(F) the dollar value of any life insurance premiums paid by, or on behalf of, the registrant during the covered fiscal year for the benefit of a named executive officer; and

(G) the dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date n393 fair value required to be reported for the stock or option award in column (e) or (f) and

(10) the dollar value of total compensation for the covered fiscal year (column (j)). With respect to each named executive officer, disclose the sum of all amounts reported in columns (c) through (i). n394

All compensation should be disclosed in U.S. dollars and rounded to the nearest dollar. Where a named executive officer received compensation paid in a different currency, a footnote must be provided to identify such currency and describe the rate and methodology used to convert such payment amounts into dollars. n395 Finally, if a named executive officer is also a director who receives compensation for his or her services as a director, such compensation should be reflected in the Summary Compensation Table and a footnote should be included to identify and itemize such compensation and amounts. n396

[D] Grants of Plan-Based Awards Table. New rules affecting the required disclosure under 402(d) are effective February 28, 2010. n397 Item 402(d), "Grants of plan-based awards table," requires the following information concerning each grant of an award made to a named executive officer in the last completed fiscal year under any plan, including awards that subsequently have been transferred, in tabular format:

(1) the name of the named executive officer (column (a));

(2) the grant date for equity-based awards reported in the table (column (b)); n398

(3) the dollar value of the estimated future payout upon satisfaction of the conditions in question under non-equity incentive plan awards granted in the fiscal year, or the applicable range of estimated payouts denominated in dollars (threshold, target and maximum amount n399) (columns (c) through (e)); n400

(4) the number of shares of stock, or the number of shares underlying options to be paid out or vested upon satisfaction of the conditions in question under equity incentive plan awards granted in the fiscal year, or the applicable range of estimated payouts denominated in the number of shares of stock, or the number of shares underlying options under the award (threshold, target and maximum amount) (columns (f) through (h));

- (5) the number of shares of stock granted in the fiscal year that are not required to be disclosed in columns (f) through (h) (column (i));
- (6) the number of securities underlying options granted in the fiscal year that are not required to be disclosed in columns (f) through (h) (column (j));
- (7) the per-share exercise or base price of the options granted in the fiscal year (column (k)); n401 and
- (8) the grant date fair value of each equity award computed in accordance with FAS 123R (column (l)).
n402

For each grant of an award made to a named executive officer during the fiscal year, disclosure on a separate line must be provided in the Grants of Plan-Based Awards Table. n403 If grants of awards were made to a named executive officer during the fiscal year under more than one plan, the registrant should identify the particular plan under which each such grant was made. n404 A tandem grant of two instruments, only one of which is granted under an incentive plan, need be reported only in column (i) or (j), as applicable. n405 For instance, an option granted in tandem with a performance share would be reported only as an option grant in column (j), with the tandem feature noted either by a footnote or accompanying textual narrative.

If the named executive officer paid any consideration for the award, the dollar amount of such payment should be disclosed in a footnote to the appropriate column. n406 Options, SARs and similar option-like instruments granted in connection with a repricing transaction or other material modification must be reported in the Grants of Plan-Based Awards Table. n407 For any equity awards that are subject to performance conditions, report in column (l) the value at the grant date based upon the probable outcome of such conditions. n408 However, the disclosure required by the table does not apply to any repricing that occurs through a preexisting formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an antidilution provision in a plan or award, or a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs. n409

[E] Narrative Disclosure to Summary Compensation Table and Grants of Plan-Based Awards Table. Item 402(e), "Narrative disclosure to summary compensation table and grants of plan-based awards table," requires the registrant to provide a narrative description of any material factors necessary to understand the information disclosed in the tables required by Item 402(c) and Item 402(d). n410 Such factors may include:

- (1) the material terms of each named executive officer's employment agreement or arrangement, whether written or unwritten;
- (2) if at any time during the last fiscal year, any outstanding option or other equity-based award was repriced or otherwise materially modified, n411 a description of each such repricing or other material modification; n412
- (3) the material terms of any award reported in the Grants of Plan-Based Awards Table under Item 402(d), including a general description of the formula or criteria to be applied in determining the amounts payable, and the vesting schedule. n413 The registrant should also describe any performance-based conditions, n414 and any other material conditions, that are applicable to the award; and
- (4) an explanation of the amount of salary and bonus in proportion to total compensation.

[F] Outstanding Equity Awards at Fiscal Year-End Table. Item 402(f), "Outstanding equity awards at fiscal

year-end table," requires disclosure of information concerning unexercised options, stock that has not yet vested and equity incentive plan awards for each named executive officer outstanding as of the end of the registrant's last completed fiscal year. The Outstanding Equity Awards at Fiscal Year-End Table (the "Outstanding Equity Awards Table") must include:

- (1) the name of the named executive officer (column (a));
- (2) on an award-by-award basis, the number of securities underlying unexercised options, including awards that have been transferred other than for value, that are exercisable and that are not reported in column (d) of the Outstanding Equity Awards Table (column (b));
- (3) on an award-by-award basis, the number of securities underlying unexercised options, including awards that have been transferred other than for value, that are unexercisable and that are not reported in column (d) of the Outstanding Equity Awards Table (column (c));
- (4) on an award-by-award basis, the total number of shares underlying unexercised options awarded under any equity incentive plan that have not been earned (column (d));
- (5) for each instrument reported in columns (b), (c) and (d) of the Outstanding Equity Awards Table, as applicable, the exercise or base price (column (e));
- (6) for each instrument reported in columns (b), (c) and (d) of the Outstanding Equity Awards Table, as applicable, the expiration date (column (f));
- (7) the total number of shares of stock that have not vested and that are not reported in column (i) of the Outstanding Equity Awards Table (column (g));
- (8) the aggregate market value of shares of stock that have not vested and that are not reported in column (j) of the Outstanding Equity Awards Table (column (h));
- (9) the total number of shares of stock, units or other rights awarded under any equity incentive plan that have not vested and that have not been earned, and, if applicable, the number of shares underlying any such unit or right (column (i)); and
- (10) the aggregate market or payout value of shares of stock, units or other rights awarded under any equity incentive plan that have not vested and that have not been earned (column (j)). n415

If any award has been transferred (other than for value), a footnote should be included identifying and disclosing the nature of such transfer. n416 The registrant should also disclose the vesting dates of options, shares of stock and equity incentive plan awards held at fiscal year-end in a footnote to the applicable column. n417 When preparing the Outstanding Equity Awards Table, where the expiration date and the exercise and/or base price of the instruments are identical, multiple awards may be aggregated. n418 Options or stock awarded under an equity incentive plan should be reported in columns (d) or (i) and (j), respectively, until the relevant performance condition has been satisfied. n419 Once the relevant performance condition has been satisfied, even if the option or stock award is subject to forfeiture conditions, (1) options should be reported in column (b) or (c), as appropriate, until they are exercised or expire, and (2) stock should be reported in columns (g) and (h) until it vests. n420

[G] Option Exercises and Stock Vested Table. Item 402(g), "Option exercises and stock vested table," requires the registrant to provide the information concerning each exercise of stock options, SARs and similar instruments, as well as each vesting of stock, including restricted stock, restricted stock units and similar instruments, during the last

completed fiscal year for each of the named executive officers on an aggregated basis. The information should be presented in a table, which must include:

- (1) the name of the executive officer (column (a));
- (2) the number of securities for which the options were exercised (column (b));
- (3) the aggregate dollar value realized upon exercise of options, or upon the transfer of an award for value (column (c)); n421
- (4) the number of shares of stock that have vested (column (d)); and
- (5) the aggregate dollar value realized upon vesting of stock, or upon the transfer of an award for value (column (e)). n422

[H] Pension Benefits. Item 402(h), "Pension benefits," requires the registrant to disclose information with respect to each plan that provides for payments or other benefits at, following, or in connection with retirement. n423 Such information should be presented in a table, with a separate row for each plan in which the named executive officer participates, n424 followed by a brief narrative description necessary to understand each plan covered in the table. n425 The table must include the following information:

- (1) the name of the executive officer (column (a));
- (2) the name of the plan (column (b));
- (3) the number of years of service credited to the named executive officer under the plan, computed as of the same pension plan measurement date used for financial statement reporting purposes with respect to the registrant's audited financial statements for the last completed fiscal year (column (c)); n426
- (4) the actuarial present value of the named executive officer's accumulated benefit under the plan, computed as of the same pension plan measurement date used for financial statement reporting purposes with respect to the registrant's audited financial statements for the last completed fiscal year (column (d)); n427 and
- (5) the dollar amount of any payments and benefits paid to the named executive officer during the registrant's last completed fiscal year (column (e)).

Following the Pension Benefits Table, the registrant must provide a succinct narrative description of material factors necessary to understand each pension benefits plan disclosed. n428 Examples of such factors may include:

- (1) the material terms and conditions of payments and benefits available under the plan, including the plan's normal retirement payment and benefit formula and eligibility standards, and the effect of the form of benefit elected on the amount of annual benefits; n429
- (2) if any named executive officer is currently eligible for early retirement under any plan, the registrant should identify that named executive officer and the plan, and describe the plan's early retirement payment and benefit formula and eligibility standards; n430
- (3) the specific elements of compensation (*e.g.*, salary, bonus, etc.) included in applying the payment and benefit formula, identifying each such element;

(4) with respect to named executive officers' participation in multiple plans, the different purposes for each plan; and

(5) the registrant's policies with regard to such matters as granting extra years of credited service.

[I] Nonqualified Defined Contribution and Other Nonqualified Deferred Compensation Plans. Item 402(i), "Nonqualified defined contribution and other nonqualified deferred compensation plans," requires the registrant to provide information in a table regarding each defined contribution plan or other plan that provides for the deferral of compensation on a basis that is not tax-qualified. The table must be followed by a brief narrative description of any material factors necessary to understand each plan disclosed. n431 The Nonqualified Deferred Compensation Table must include the following:

(1) the name of the executive officer (column (a));

(2) the dollar amount of aggregate executive contributions during the registrant's last fiscal year (column (b));

(3) the dollar amount of aggregate registrant contributions during the registrant's last fiscal year (column (c));

(4) the dollar amount of aggregate interest or other earnings accrued during the registrant's last fiscal year (column (d));

(5) the aggregate dollar amount of all withdrawals by and distributions to the executive during the registrant's last fiscal year (column (e)); and

(6) the dollar amount of total balance of the executive's account as of the end of the registrant's last fiscal year (column (f)). n432

Following the tabular disclosure, the registrant must provide a succinct narrative description of any material factors necessary to understand each plan disclosed in the Nonqualified Deferred Compensation Table. n433 Examples of such factors may include:

(1) the types of compensation permitted to be deferred, and any limitations (by percentage of compensation or otherwise) on the extent to which deferral is permitted;

(2) the measures for calculating interest or other plan earnings (including whether the measures are selected by the executive or the registrant and the frequency and manner in which selections may be changed), quantifying interest rates and other earnings measures applicable during the registrant's last fiscal year; and

(3) material terms with respect to payouts, withdrawals and other distributions. n434

[J] Potential Payments Upon Termination or Change-in-Control. Item 402(j), "Potential payments upon termination or change-in-control," requires narrative disclosure regarding each contract, agreement, plan or arrangement, whether written or unwritten, that provides for payments to a named executive officer at, following, or in connection with any termination n435 or a change in control of the registrant or a change in the named executive officer's responsibilities. n436 With respect to each named executive officer, the registrant must:

- (1) describe and explain the specific circumstances that would trigger payments or the provision of other benefits, including perquisites and health care benefits; n437
- (2) describe and quantify the estimated payments and benefits that would be provided in each covered circumstance, whether they would or could be lump sum, or annual, disclosing the duration, and by whom they would be provided;
- (3) describe and explain how the appropriate payment and benefit levels are determined under the various circumstances that trigger payments or provision of benefits;
- (4) describe and explain any material conditions or obligations applicable to the receipt of payments or benefits; n438 and
- (5) describe any other material factors regarding each such contract, agreement, plan or arrangement.

The registrant should provide quantitative disclosure under Item 402(j), assuming that the triggering event took place on the last business day of the registrant's last completed fiscal year, and that the price per share of the registrant's securities is the closing market price as of that date. n439 In the event that uncertainties exist as to the provision of payments and benefits or the amounts involved, the registrant must make a reasonable estimate (or a reasonable estimated range of amounts) applicable to the payment or benefit and disclose the material assumptions underlying such estimates. n440 The registrant need not provide disclosure on contracts, agreements, plans or arrangements to the extent they are generally available to all salaried employees and do not discriminate in scope, terms or operation in favor of executive officers. n441

[K] Compensation of Directors. New rules affecting the required disclosure under 402(k) are effective February 28, 2010. n442 Item 402(k), "Compensation of directors," requires disclosure concerning the compensation of directors in the registrant's last completed fiscal year in tabular format, followed by a narrative description of material factors necessary to understand the compensation disclosed in the table. Two or more directors may be grouped in a single row in the table if all elements of their compensation are identical. n443 The Director Compensation Table must include:

- (1) the name of each director (column (a)); n444
- (2) the aggregate dollar amount of all fees earned or paid in cash for services as a director, including annual retainer fees, committee and/or chairmanship fees, and meeting fees (column (b));
- (3) for awards of stock, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (c));
- (4) for awards of stock options, with or without tandem SARs, including awards that have been subsequently been transferred, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (d)); n445
- (5) the dollar value of all earnings for services performed during the fiscal year pursuant to non-equity incentive plans, and all earnings on any outstanding awards (column (e));
- (6) the sum of (column f):
 - (A) the aggregate change in the actuarial present value of the director's accumulated benefit under all defined benefit and actuarial pension plans (including supplemental plans) from (x) the pension plan measurement date used for financial statement reporting

1-7 Federal Securities Act of 1933 § 7.03

purposes with respect to the registrant's audited financial statements for the prior completed fiscal year to (y) the pension plan measurement date used for financial statement reporting purposes with respect to the registrant's audited financial statements for the covered fiscal year; and

(B) above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified, including such earnings on nonqualified defined contribution plans;

(7) all other compensation, regardless of the amount, for the covered fiscal year that the registrant could not properly report in any other column of the Director Compensation Table (column (g)). Such compensation must include, but is not limited to:

(A) perquisites and other personal benefits, or property, unless the aggregate amount of such compensation is less than \$10,000; n446

(B) all "gross-ups" or other amounts reimbursed during the fiscal year for the payment of taxes; n447

(C) the compensation cost (computed in accordance with FAS 123R), if any, for any security of the registrant or its subsidiaries purchased from the registrant or its subsidiaries (through deferral of salary or bonus, or otherwise) at a discount from the market price of such security at the date of purchase, unless that discount is available generally, either to all security holders or to all salaried employees of the registrant;

(D) the amount paid or accrued to any director pursuant to a plan or arrangement in connection with:

(i) the resignation, retirement or any other termination of such director; or

(ii) a change in control of the registrant;

(E) contributions or other allocations by the registrant to vested and unvested defined contribution plans;

(F) consulting fees earned from, or paid or payable by, the registrant and/or its subsidiaries (including joint ventures);

(G) the annual costs of payments and promises of payments pursuant to director legacy programs and similar charitable award programs; n448

(H) the dollar value of any life insurance premiums paid by, or on behalf of, the registrant during the covered fiscal year for the benefit of a director; and

(I) the dollar value of any dividends or other earnings paid on stock or option awards, when such amounts were not factored into the grant date fair value for the stock or option award; and

(8) the dollar value of total compensation for the covered fiscal year (column (h)). With respect to each director, disclose the sum of all amounts reported in columns (b) through (g). n449

Following the Director Compensation Table, the registrant must provide a narrative description of any material factors necessary to understand the director compensation disclosed in the table. n450 Such factors may include:

(1) a description of standard compensation arrangements, such as fees for retainer, committee service, service as chairman of the board or a committee and meeting attendance; and

(2) whether any director has a different compensation arrangement, identifying that director and describing the terms of that arrangement. n451

When disclosing the director compensation information required under Item 402(k), the registrant must also follow certain guidelines and instructions provided with respect to the Summary Compensation Table under Item 402(c). n452

[L] Smaller Reporting Companies. Item 402(l) provides that a registrant that qualifies as a "smaller reporting company" n453 may provide scaled disclosure with respect to executive compensation as set forth in paragraphs (m) through (r) of Item 402 of Regulation S-K. Consequently, smaller reporting companies may forgo the disclosure required by paragraphs (a) through (k) of Item 402. Under the scaled disclosure, in contrast with larger companies, smaller reporting companies will:

- provide executive compensation disclosure for only three named executive officers (specifically including the PEO, but not the PFO), rather than the five required of larger companies;
- provide the Summary Compensation Table disclosure for only two years, rather than the three years required of larger companies;
- not be required to provide a Compensation Discussion and Analysis;
- provide only three of the seven tables required of larger companies; n454
- provide alternative narrative disclosures; and
- not be required to include footnote disclosure of grant date fair value of equity awards in the Director Compensation Table. n455

[M] Smaller Reporting Companies--General. Item 402(m) contains general provisions stating that smaller reporting companies must provide clear, concise and understandable disclosure of all plan n456 and non-plan compensation awarded to, earned by, or paid to the "named executive officers" and directors of the registrant by any person for all services rendered in all capacities to the registrant and its subsidiaries. n457 The "named executive officers" of the smaller reporting company as to whom disclosure is required are:

- (1) all individuals serving as the smaller reporting company's principal executive officer or acting in a similar capacity during the last completed fiscal year ("PEO"), regardless of compensation level;
- (2) the smaller reporting company's two most highly compensated executive officers other than the PEO who were serving as executive officers at the end of the last completed fiscal year; and
- (3) up to two additional individuals for whom disclosure would have been provided pursuant to paragraph (2) above, except that the individual was not serving as an executive officer of the smaller reporting company at the end of the last completed fiscal year. n458

If the named executive served in such capacity during any part of the fiscal year with respect to which information is required, such information should be provided as to all of his or her compensation for the full fiscal year. n459 The general provisions of Item 402(m) also provide that any table or column called for by Item 402 may be omitted if there has been no compensation awarded to, earned by or paid to any of the named executive officers or directors required to

be reported in that table or column in any fiscal year covered by that table. n460

[N] Smaller Reporting Companies--Summary Compensation Table. New rules affecting the required disclosure under 402(n) are effective February 28, 2010. n461 Item 402(n), "Smaller reporting companies--Summary compensation table," requires the following information regarding compensation of the named executive officers for each of the smaller reporting company's last two completed fiscal years n462 to be set forth in tabular form:

- (1) the name and principal position of the named executive officer (column (a));
- (2) the fiscal year covered (column (b));
- (3) the dollar value of base salary (cash and non-cash) earned by the named executive officer during the fiscal year covered (column (c)); n463
- (4) the dollar value of bonus (cash and non-cash) earned by the named executive officer during the fiscal year covered (column (d)); n464
- (5) for awards of stock, n465 the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (e));
- (6) for awards of options, n466 with or without tandem SARs, including awards that subsequently have been transferred, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (f)); n467
- (7) the dollar value of all earnings for services performed during the fiscal year pursuant to awards under non-equity incentive plans, n468 and all earnings on any outstanding awards (column (g)); n469
- (8) above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified, including such earnings on nonqualified defined contribution plans (column (h)); n470
- (9) all other compensation for the covered fiscal year that the smaller reporting company could not properly report in any other column of the Summary Compensation Table (column (i)). n471 Such compensation must include, but is not limited to:
 - (A) perquisites and other personal benefits, or property, unless the aggregate amount of such compensation is less than \$10,000; n472
 - (B) all "gross-ups" or other amounts reimbursed during the fiscal year for the payment of taxes; n473
 - (C) the compensation cost, if any (computed in accordance with FAS 123R), for any security of the smaller reporting company or its subsidiaries purchased from the smaller reporting company or its subsidiaries (through deferral of salary or bonus, or otherwise) at a discount from the market price of such security at the date of purchase, unless that discount is available generally, either to all security holders or to all salaried employees of the smaller reporting company;
 - (D) the amount paid or accrued n474 to any named executive officer pursuant to a plan or arrangement in connection with:
 - (i) any termination, including without limitation through retirement, resignation,

severance or constructive termination (including a change in responsibilities) of such executive officer's employment with the smaller reporting company and its subsidiaries;
or

(ii) a change in control of the smaller reporting company;

(E) contributions or other allocations by the smaller reporting company to vested and unvested defined contribution plans;

(F) the dollar value of any life insurance premiums paid by, or on behalf of, the smaller reporting company during the covered fiscal year for the benefit of a named executive officer; and

(G) the dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported for the stock or option award in column (e) or (f); n475 and

(10) the dollar value of total compensation for the covered fiscal year (column (j)). With respect to each named executive officer, disclose the sum of all amounts reported in columns (c) through (i). n476

All compensation should be disclosed in U.S. dollars and rounded to the nearest dollar. Where a named executive officer received compensation paid in a different currency, a footnote must be provided to identify such currency and describe the rate and methodology used to convert such payment amounts into dollars. n477 Finally, if a named executive officer is also a director who receives compensation for his or her services as a director, such compensation should be reflected in the Summary Compensation Table and a footnote should be included to identify and itemize such compensation and amounts. n478

[O] Smaller Reporting Companies--Narrative Disclosure to Summary Compensation Table. Item 402(o) of Regulation S-K, "Smaller reporting companies--Narrative disclosure to summary compensation table," requires the smaller reporting company to provide a narrative description of any material factors necessary to understand the information disclosed in the Summary Compensation Table. n479 Examples of such factors may include:

(1) the material terms of each named executive officer's employment agreement or arrangement, whether written or unwritten;

(2) if at any time during the last fiscal year any outstanding option or other equity-based award was repriced or otherwise materially modified, n480 a description of each such repricing or other material modification; n481

(3) the waiver or modification of any specified performance target, goal or condition to payout with respect to any amount included in non-stock incentive plan compensation or payouts reported in column (g) to the Summary Compensation Table. The smaller reporting company must state whether the waiver or modification applied to one or more named executive officers or to all compensation subject to the target, goal or condition;

(4) the material terms of each grant, including but not limited to the date of exercisability, any conditions to exercisability, any tandem feature, any reload feature, any tax-reimbursement feature and any provision that could cause the exercise price to be lowered;

(5) the material terms of any non-equity incentive plan award made to a named executive officer during the last completed fiscal year; n482

(6) the method of calculating earnings on nonqualified deferred compensation plans including nonqualified defined contribution plans; and

(7) an identification of any material item included under column (i) (All Other Compensation) in the Summary Compensation Table. n483

[P] Smaller Reporting Companies--Outstanding Equity Awards at Fiscal Year-End Table. Item 402(p) of Regulation S-K, "Smaller reporting companies--Outstanding equity awards at fiscal year-end table," requires the smaller reporting company to provide information for each named executive officer, in tabular format, regarding unexercised options, stock that has not vested, and equity incentive plan awards outstanding as of the end of the smaller reporting company's last completed fiscal year. The Outstanding Equity Awards at Fiscal Year-End Table (the "Outstanding Equity Awards Table") must include:

(1) the name of the named executive officer (column (a));

(2) on an award-by-award basis, the number of securities underlying unexercised options, including awards that have been transferred other than for value, that are exercisable and that are not reported in column (d) of the Outstanding Equity Awards Table (column (b));

(3) on an award-by-award basis, the number of securities underlying unexercised options, including awards that have been transferred other than for value, that are unexercisable and that are not reported in column (d) of the Outstanding Equity Awards Table (column (c));

(4) on an award-by-award basis, the total number of shares underlying unexercised options awarded under any equity incentive plan that have not been earned (column (d));

(5) for each instrument reported in columns (b), (c) and (d) of the Outstanding Equity Awards Table, as applicable, the exercise or base price (column (e));

(6) for each instrument reported in columns (b), (c) and (d) of the Outstanding Equity Awards Table, as applicable, the expiration date (column (f));

(7) the total number of shares of stock that have not vested and that are not reported in column (i) of the Outstanding Equity Awards Table (column (g));

(8) the aggregate market value of shares of stock that have not vested and that are not reported in column (j) of the Outstanding Equity Awards Table (column (h));

(9) the total number of shares of stock, units or other rights awarded under any equity incentive plan that have not vested and that have not been earned, and, if applicable, the number of shares underlying any such unit or right (column (i)); and

(10) the aggregate market or payout value of shares of stock, units or other rights awarded under any equity incentive plan that have not vested and that have not been earned (column (j)). n484

If an award has been transferred other than for value, the smaller reporting company should identify and disclose the nature of such transfer in a footnote. n485 The smaller reporting company should also disclose the vesting dates of options, shares of stock and equity incentive plan awards held at fiscal year-end in a footnote to the applicable column. n486 When preparing the Outstanding Equity Awards Table, where the expiration date and the exercise and/or base

price of the instruments are identical, multiple awards may be aggregated. n487 Options or stock awarded under an equity incentive plan should be reported in columns (d) or (i) and (j), respectively, until the relevant performance condition has been satisfied. n488 Once the relevant performance condition has been satisfied, even if the option or stock award is subject to forfeiture conditions, (1) options should be reported in column (b) or (c), as appropriate, until they are exercised or expire, and (2) stock should be reported in columns (g) and (h) until it vests. n489

[Q] Smaller Reporting Companies--Additional Narrative Disclosure. Item 402(q), "Smaller reporting companies--Additional narrative disclosure," requires the smaller reporting company to provide a narrative description of the following items, to the extent material:

(1) The material terms of each plan that provides for the payment of retirement benefits, or benefits that will be paid primarily following retirement, including but not limited to:

- tax-qualified defined benefit plans;
- supplemental executive retirement plans;
- tax-qualified defined contribution plans; and
- nonqualified defined contribution plans. n490

(2) The material terms of each contract, agreement, plan or arrangement, whether written or unwritten, that provides for payments to a named executive officer at, following, or in connection with:

- the resignation, retirement or other termination of a named executive officer; or
- a change in control of the smaller reporting company or a change in the named executive officer's responsibilities following a change in control. n491

[R] Smaller Reporting Companies--Compensation of Directors. New rules affecting the required disclosure under 402(r) are effective February 28, 2010. n492 Item 402(r), "Smaller reporting companies--Compensation of directors," requires disclosure concerning the compensation of directors in the registrant's last completed fiscal year in tabular format, followed by a narrative description of material factors necessary to understand the compensation disclosed in the table. Two or more directors may be grouped in a single row in the table if all elements of their compensation are identical. n493 The Director Compensation Table must include:

(1) the name of each director (column (a)); n494

(2) the aggregate dollar amount of all fees earned or paid in cash for services as a director, including annual retainer fees, committee and/or chairmanship fees and meeting fees (column (b));

(3) for awards of stock, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (c));

(4) for awards of stock options, with or without tandem SARs, including awards that have subsequently been transferred, the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (column (d)); n495

(5) the dollar value of all earnings for services performed during the fiscal year pursuant to non-equity incentive plans, and all earnings on any outstanding awards (column (e));

(6) above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified, including such earnings on nonqualified defined contribution plans (column (f));

(7) all other material compensation for the covered fiscal year that the smaller reporting company could not properly report in any other column of the Director Compensation Table (column (g)). n496 Such compensation must include, but is not limited to:

(A) perquisites and other personal benefits, or property, unless the aggregate amount of such compensation is less than \$10,000;

(B) all "gross-ups" or other amounts reimbursed during the fiscal year for the payment of taxes;

(C) the compensation cost (computed in accordance with FAS 123R), if any, for any security of the smaller reporting company or its subsidiaries purchased from the smaller reporting company or its subsidiaries (through deferral of salary or bonus, or otherwise) at a discount from the market price of such security at the date of purchase, unless that discount is available generally, either to all security holders or to all salaried employees of the smaller reporting company;

(D) the amount paid or accrued to any director pursuant to a plan or arrangement in connection with:

(i) the resignation, retirement or any other termination of such director; or

(ii) a change in control of the smaller reporting company;

(E) contributions or other allocations by the smaller reporting company to vested and unvested defined contribution plans;

(F) consulting fees earned from, or paid or payable by the smaller reporting company and/or its subsidiaries (including joint ventures);

(G) the annual costs of payments and promises of payments pursuant to director legacy programs and similar charitable award programs; n497

(H) the dollar value of any life insurance premiums paid by, or on behalf of, the smaller reporting company during the covered fiscal year for the benefit of a director; and

(I) the dollar value of any dividends or other earnings paid on stock or option awards, when such amounts were not factored into the grant date fair value for the stock or option award; and

(8) the dollar value of total compensation for the covered fiscal year (column (h)). With respect to each director, disclose the sum of all amounts reported in columns (b) through (g). n498

Following the Director Compensation Table, the registrant must provide a narrative description of any material factors necessary to understand the director compensation disclosed in the table. n499 Such factors may include:

(1) a description of standard compensation arrangements, such as fees for retainer, committee service, service as chairman of the board or a committee and meeting attendance; and

(2) whether any director has a different compensation arrangement, identifying that director and describing the terms of that arrangement. n500

To the extent that risks arising from the registrant's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the registrant, the registrant must include a narrative description of its policies and practices of compensating employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives. n501 Situations that may trigger disclosure include compensation policies and practices:

- (1) at a business unit that carries a significant portion of the registrant's risk profile;
- (2) at a business unit with compensation structured significantly differently than other units within the registrant;
- (3) at a business unit where compensation expense is a significant percentage of the unit's revenues and
- (4) that vary significantly from the overall risk and reward structure of the registrant, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the registrant from the task extend over a significantly longer period of time. n502

When disclosing the director compensation information required under Item 402(r), the smaller reporting company must also follow certain guidelines and instructions provided with respect to the Summary Compensation Table under Item 402(n). n503

[xiii] Security Ownership of Certain Beneficial Owners and Management.

Certain information regarding the security ownership of certain beneficial owners and management is required by Item 403 of Regulation S-K.

Item 403 of Regulation S-K, "Security Ownership of Certain Beneficial Owners and Management," contains three parts: "Security ownership of certain beneficial owners," "Security ownership of management" and "Changes in control."

[A] Security Ownership of Certain Beneficial Owners. Item 403(a), "Security ownership of certain beneficial owners," requires the registrant to provide information, as of the most recent practicable date, n504 for any person (including two or more persons acting as a partnership, limited partnership, syndicate or other group for the purpose of acquiring, holding or disposing of securities of an issuer) known to the registrant to be the beneficial owner of more than five percent of any class of the registrant's voting securities, in substantially the following tabular form:

- (1) the title of the class of voting securities for which the information is being provided (column 1);
- (2) the name and address n505 of each person for whom information is required to be presented (column 2);
- (3) the amount and nature of beneficial ownership n506 of each person listed, including disclosure, by footnote or otherwise, of the amount known to the registrant to be shares for which each person has the right to acquire beneficial ownership and, by additional subcolumns or other appropriate explanation necessary to reflect amounts as to which each person has:
 - (a) sole voting power,

- (b) shared voting power,
- (c) sole investment power and
- (d) shared investment power (column 3); and

(4) the percentage of the class of voting securities owned by each person (column 4). n507

If any person named pursuant to Item 403(a) holds more than five percent of any class of the registrant's voting securities under a voting trust or similar agreement, the registrant must also state:

- (1) the title of the securities;
- (2) the amount of securities held or to be held pursuant to the agreement, if not clear from the table;
- (3) the duration of the agreement;
- (4) the names and addresses of the voting trustees; and
- (5) the voting rights and other powers of the voting trustees under the trust or agreement. n508

[B] Security Ownership of Management. Item 403(b), "Security ownership of management," requires the registrant to provide the tabular information required by Item 403(a) with the exception of addresses of the persons for whom information is presented, as to each class of the registrant or any of its parents or subsidiaries other than director's qualifying shares, beneficially owned by all:

- (1) directors and nominees, naming them;
- (2) each of the named executive officers (as defined in Item 402(a)); and
- (3) directors and officers as a group, without naming them.

[C] Changes in Control. Item 403(c), "Changes in control," requires the registrant to describe any arrangements known to it (including any pledge by any person of securities of the registrant or any of its parents), the operation of which may at a subsequent date result in a change in control of the registrant. n509

[xiv] Certain Relationships and Related Transactions and Corporate Governance.

The information regarding relationships and related transactions is governed by Item 404 of Regulation S-K. Item 11(n) of Form S-1 also requires the information required under Item 407(a) of Regulation S-K with respect to director independence. n510

Item 404 of Regulation S-K, "Transactions With Related Persons, Promoters and Certain Control Persons," contains four parts: "Transactions with related persons," "Review, approval or ratification of transactions with related persons," "Promoters and certain control persons" and "Smaller reporting companies." n511

[A] Transactions With Related Persons. Item 404(a), "Transactions with related persons," requires the registrant to describe any transactions n512 since the beginning of the registrant's last fiscal year or any currently proposed transactions, in which the amount involved exceeds \$120,000, to which the registrant or any of its subsidiaries was or is to be a party and in which any of the following "related persons" had or will have a direct or indirect n513 material

interest:

- (1) any director or executive officer of the registrant;
- (2) any nominee for election as director; n514
- (3) any security holder known to the registrant to own of record or beneficially more than five percent of any class of the registrant's voting securities; and
- (4) any member of the immediate family n515 of any of the foregoing persons.

The registrant is required to provide the following information concerning the related person specified above:

- (1) the name of the person;
- (2) the person's relationship with the registrant;
- (3) the nature of the person's interest in the transaction;
- (4) the amount of the transaction; n516 and
- (5) the amount of the person's interest in the transaction. n517

The registrant need not provide information concerning a transaction if:

- (1) the interest of the person arises solely from the ownership individually and in the aggregate of less than ten percent of any class of equity securities of another corporation furnishing the services to the registrant or its subsidiaries;
- (2) the rates or charges for the transaction are determined by competitive bids;
- (3) the transaction involves the rendering of services as a common or contract carrier or public utility at rates or charges fixed in conformity with law or governmental authority;
- (4) the transaction involves services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture or similar services;
- (5) the interest of the person arises solely from the ownership of the registrant's securities and the person receives no extra or special benefit not shared on a pro rata basis, n518
- (6) the interest arises solely from compensation paid with respect to an employment relationship transaction with an executive officer and:
 - (a) such compensation is reported pursuant to the executive compensation disclosure requirements of Item 402 of Regulation S-K; or
 - (b) the executive officer is not an "immediate family member" of any related person, and such compensation (i) would have been reported under Item 402 of Regulation S-K if such person was a "named executive officer" under Item 402(a)(3), and (ii) was approved or recommended to the board of directors of the registrant; n519 or

(7) the interest arises from compensation of a director, if such compensation is reported pursuant to the executive compensation disclosure requirements of Item 402(k) of Regulation S-K. n520

[B] Review, Approval or Ratification of Transactions with Related Person. Item 404(b), "Review, approval or ratification of transactions with related persons," requires the registrant to describe its policies and procedures for the review, approval or ratification of any transactions with related persons disclosed under Item 404(a). Such disclosure with respect to such policies and procedures should include:

- (1) the types of transactions that are covered;
- (2) the standards to be applied;
- (3) the persons or groups of persons on the board of directors or otherwise who are responsible for applying such policies and procedures; and
- (4) a statement of whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced. n521

The registrant need not provide disclosure regarding transactions that occurred prior to the time the related person became a "related person" under Item 404(a). n522 However, the registrant must identify any transactions with related persons disclosed under Item 404(a) where the policies and procedures did not require review, approval or ratification, or where such policies and procedures were not followed. n523

[C] Promoters and Certain Control Persons. Item 404(c), "Promoters and certain control persons," requires certain disclosure from registrants that (i) are filing a registration statement on Form S-1 and (ii) had a promoter at any time during the past five fiscal years. Registrants must disclose the following information with respect to promoters and control persons: n524

- (1) the names of those persons, the nature and amount of anything of value n525 to be received by each such person from the registrant and the nature of any consideration to be received by the registrant; and
- (2) the amount at which any assets were acquired (or will be acquired) by the registrant from any person, and the principle followed and the persons involved in determining such amount. n526

[D] Smaller Reporting Companies. Item 404(d) provides that a company that qualifies as a smaller reporting company need only provide scaled disclosure to comply with the requirements of Item 404. Disclosure is not required on the policies and procedures for the review, approval or ratification of transactions with related persons. Accordingly, smaller reporting companies need only provide the following information to comply with Item 404:

- (1) the disclosure of transactions with related persons required by Item 404(a), n527 but only with respect to such transactions where the amount involved exceeds the lesser of \$120,000 or one percent of the smaller reporting company's average total assets at year end for the last two completed fiscal years; n528
- (2) the disclosure with respect to promoters and certain control persons required by Item 404(c); and
- (3) a list of all parents of the smaller reporting company showing the basis of control and, as to each parent, the percentage of voting securities owned or other basis of control by its immediate parent, if any. n529

[E] Director Independence. Item 11(n) of Form S-1 also requires the disclosure required by Item 407(a) of Regulation S-K with respect to director independence. Item 407(a), "Director independence," requires the registrant to identify each director that is "independent" pursuant to the standards applicable to the registrant under Item 407(a)(1). n530 Additionally, the registrant must identify each director that is a member of the compensation, nominating or audit committee that is not independent under the applicable committee independence standards. n531 This information should be provided for any person who served as a director during any part of the last completed fiscal year. n532

In determining whether a director is independent (whether as a member of the board of directors or as a member of a committee of such board), a registrant filing a registration statement on Form S-1 should use the definitions of independence applicable to directors and committee members as provided by the national securities exchange or inter-dealer quotation system n533 where the registrant has applied for listing. n534 If the registrant has relied upon an available exemption to such independence standards, it must disclose the exemption relied upon and explain the basis for the conclusion that such exemption is applicable. n535

For each director that is identified as independent, the registrant must describe any transactions, relationships or arrangements that were not disclosed under Item 404(a) (regarding transactions with related persons). n536 The disclosure should fully describe in detail the nature of the transaction, relationship or arrangement. n537

[I] Item 11A. Material Changes. This item operates in conjunction with the incorporation of information by reference pursuant to General Instruction VII.

Item 11A requires that if an eligible registrant has elected to incorporate information by reference to periodic reports filed under the Exchange Act, the registrant must include in the prospectus a description of all material changes in its affairs which have occurred since the end of the latest fiscal year for which audited financial statements were included in the latest Form 10-K. This disclosure is not required, however, where such a description has been included in a Form 10-Q or Form 8-K filed under the Exchange Act.

[m] Item 12. Incorporation of Certain Information by Reference. This item governs the incorporation of information by reference to periodic reports filed under the Exchange Act.

Item 12 requires that if the registrant elects to incorporate information by reference pursuant to General Instruction VII, the following documents must be specifically incorporated by reference into the registration statement, by means of a statement to that effect in the prospectus:

- (1) the registrant's latest annual report on Form 10-K which contains financial statements for the registrant's latest fiscal year for which such annual report was required to have been filed; n538 and
- (2) all other reports filed under Section 13(a) or 15(d) of the Exchange Act or proxy or information statements filed under Section 14 of the Exchange Act since the end of the fiscal year covered by the annual report referred to above. n539

The registrant also must:

- (1) state that it will provide, to each person to whom a prospectus is delivered, a copy of any of the reports or documents that have been incorporated by reference in the prospectus but not delivered with the prospectus (a) upon written or oral request and (b) at no cost to the requester;
- (2) provide the name, address, telephone number and email address to which the request for these reports or documents must be made;

(3) provide its website address, including where to access incorporated reports and documents; n540

(4) identify the reports and other information that it files with the Commission

(5) state that the public may read and copy any materials it files with the Commission at the Commission's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549 and may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330; and

(6) if the registrant is an electronic filer, state that the Commission maintains an internet site that contains reports, proxy and information statements and other information regarding electronic filers and that the address of that site is www.sec.gov. n541

[n] Item 12A. Disclosure of Commission Position on Indemnification for Securities Act Liabilities. This item requires the registrant to furnish the information set forth in Item 510 of Regulation S-K.

Item 510 of Regulation S-K, "Disclosure of commission position on indemnification for Securities Act liabilities," requires that if:

(1) the undertaking required by Item 512(h) of Regulation S-K is not required to be included in the registration statement because acceleration of the effective date of the registration statement pursuant to Securities Act Rule 461 n542 is not requested; and

(2) waivers of indemnification against liability under the Securities Act have not been obtained from directors, officers and controlling persons of the registrant, who are eligible for such indemnification under an arrangement with the registrant,

then the registrant must include in the prospectus:

(1) a brief description of the indemnification provisions against liability under the Securities Act relating to directors, officers and controlling persons of the registrant (including any provision of the underwriting agreement which relates to indemnification of the underwriter or its controlling persons by the registrant against such liabilities where a director, officer, or controlling person of the registrant is such an underwriter or controlling person thereof or a member of any firm which is such an underwriter) and

(2) a statement that the registrant has been informed that, in the opinion of the Commission, the indemnification provisions are against public policy as expressed in the Securities Act and are therefore unenforceable.

The disclosure required by Item 510 is in addition to the disclosure concerning indemnification of directors and officers required by Item 702 of Regulation S-K. n543

[o] Summary Prospectus. Form S-1 provides for the use of a summary prospectus that must be filed as part of the registration statement. n544 The summary prospectus must include the following information in response to the following items of Form S-1 specifically applicable to the summary prospectus:

(1) Item 1, the aggregate offering price to the public, the aggregate underwriting discounts and commissions and the offering price per unit to the public; n545

- (2) Item 4, a brief statement of the principal purposes for which the proceeds are to be used; n546
- (3) Item 7, the amount of the offering, if any, to be made for the account of security holders; n547
- (4) Item 8, the name of the managing underwriter or underwriters and the nature of the underwriter's obligation to take the securities; if the securities are offered other than through underwriters, the manner of distribution; and, if the securities are offered other than for cash, the general purposes of the distribution, the basis upon which the securities are to be offered, the amount of compensation and other expenses of distribution and by whom they are to be borne; n548
- (5) Item 9, the dividend rights, voting rights, conversion rights, interest and maturity; n549 and
- (6) Item 11, the general character of the business done and intended to be done, the selected financial data pursuant to Item 301 of Regulation S-K, n550 and the nature and present status of any material pending legal proceedings. n551

A tabular presentation of notes payable, long-term debt, deferred credits, noncontrolling interests, if material, and the equity section of the balance sheet filed, as may be appropriate, must also be included. n552 All other information and documents required to be included in Form S-1 may be omitted from the summary prospectus. n553

If the securities being registered are to be offered in exchange for securities of any other issuer, the summary prospectus should also include the information required by Items 9 and 11 of Form S-1, n554 as specified in (5) and (6) above which would be required if the securities of the other issuer were registered on Form S-1. n555 The Commission may, upon the request of the registrant and where consistent with the protection of investors,

- (1) permit the omission of any information required to be included in the summary prospectus;
- (2) permit the furnishing of appropriate information of comparable character in substitution for the required summary prospectus information; or
- (3) require the inclusion of other information in addition to or in substitution for the required summary prospectus information in any case where that information is necessary or appropriate for the protection of investors. n556

[3] Information Included in the Registration Statement But Not Required in Prospectus.

Part II of Form S-1, containing Items 13 through 17, is not part of the prospectus but is part of the registration statement filed with the Commission and is, therefore, available for inspection during business hours at the office of the Commission in Washington, D.C. n557

[a] Item 13. Other Expenses of Issuance and Distribution. This item requires the registrant to furnish the information specified in Item 511 of Regulation S-K.

Item 511 of Regulation S-K, "Other expenses of issuance and distribution," calls for a reasonably itemized statement of all expenses of issuance and distribution of the securities to be registered, other than underwriting discounts and commissions. If any of the securities being registered are to be offered for the account of security holders, the portion of the expenses to be borne by the selling security holder should be indicated.

The registrant should include as separate items:

- (1) registration fees;
- (2) federal taxes;
- (3) state taxes and fees;
- (4) trustees' and transfer agents' fees;
- (5) costs of printing and engraving;
- (6) stock exchange or NASD fees;
- (7) legal, accounting and engineering fees; and
- (8) any premium paid by the registrant or selling security holder on any policy that insures or indemnifies directors or officers against any liabilities they may incur in connection with the registration, offering or sale of the securities. n558

The information called for by Item 511 of Regulation S-K may be given subject to future contingencies, and, if the amounts of any disclosure items are not known, estimates should be given and so identified. n559

[b] Item 14. Indemnification of Directors and Officers. This item requires the registrant to furnish the information specified in Item 702 of Regulation S-K.

Item 702 of Regulation S-K, "Indemnification of directors and officers," requires the registrant to state the general effect of any statute, charter provision, by-law, contract, or other arrangement under which any controlling person, n560 director or officer of the registrant is insured or indemnified in any manner n561 against any liability he or she may incur in that capacity.

[c] Item 15. Recent Sales of Unregistered Securities. This item requires the registrant to furnish the information specified in Item 701 of Regulation S-K.

Item 701 of Regulation S-K, "Recent sales of unregistered securities," requires the registrant to disclose all unregistered sales of securities of the registrant within the past three years, including sales of reacquired securities, new issues, securities issued in exchange for property, services or other securities and new securities resulting from the modification of outstanding securities.

The following information must be furnished for each sale:

- (1) the date of sale and the title and amount of securities sold; n562
- (2) the names of the principal underwriters, if any, or if the shares were not publicly offered, the names of the persons or class of persons to whom the securities were sold;
- (3) if the securities were sold for cash, the aggregate offering price and the aggregate underwriting discounts or commissions or if the securities were sold other than for cash, the nature of the transaction and the nature and aggregate amount of consideration received by the registrant; and
- (4) the section of the Securities Act or the rule of the Commission under which exemption from registration was claimed and a summary of the facts relied upon to make the exemption available. n563

[d] Item 16. Exhibits and Financial Statement Schedules.

This item requires the registrant to provide:

- (1) the exhibits required by Item 601 of Regulation S-K; and
- (2) the financial statements required by Regulation S-X and Item 11(e) of Form S-1.

[i] Exhibits. Item 601 of Regulation S-K, "Exhibits," provides an exhibit table listing the exhibits that must be filed. The filing of exhibits pursuant to Item 601 is subject to Rule 411(c) as to incorporation of exhibits by reference. n564 The registrant must also include an exhibit index immediately preceding the exhibits filed with the Form S-1. n565

The registrant need not refile an exhibit to a registration statement (other than an opinion or consent) filed in preliminary form regardless of any requirements of Commission rules or forms to the contrary, if the exhibit is amended only:

- (1) by inserting information on interest, dividend or conversion rates, redemption or conversion prices, purchase or offering prices, underwriters' or dealers' commission, names, addresses or participation of underwriters or similar matters, that appear elsewhere in an amendment to the registration statement or prospectus filed pursuant to Rule 424(b) under the Securities Act; or
- (2) by correcting typographical errors, inserting signatures or making other similar immaterial changes.

Any such incomplete exhibit may not, however, be incorporated by reference in any subsequent filing under any Act administered by the Commission. n566

The following exhibits are required to be filed with Form S-1: n567

- 1. (1) n568 underwriting agreement; n569
- 2. (2) plan of acquisition, reorganization, arrangement, liquidation² or succession; n570
- 3. (3) articles of incorporation and by-laws; n571
- 4. (4) instrument defining the rights of security holders, including indentures; n572
- 5. (5) opinion regarding legality; n573
- 6. (8) opinion regarding tax matters; n574
- 7. (9) voting trust agreement; n575
- 8. (10) material contracts; n576
- 9. (11) statement regarding the computation of per-share earnings; n577
- 10. (12) statements regarding computation of ratios; n578
- 11. (15) letter regarding unaudited interim financial information; n579

12. (16) letter regarding change in certifying accountant; n580

13. (21) subsidiaries of the registrant; n581

14. (23) consents of experts and counsel; n582

15. (24) power of attorney; n583

16. (25) statement of eligibility of trustee; n584

17. (26) invitations for competitive bids; n585

18. (99) additional exhibits; n586

19. (101) interactive data file.

In January 2009, the Commission adopted rules, currently effective until October 31, 2014, requiring registrants to provide financial statement information in a form that is intended to improve its usefulness to investors. Registrants will provide their financial statements to the Commission and on their corporate websites in Interactive Data Files. An Interactive Data File is machine-readable computer code that presents information in eXtensible Business Reporting Language (XBRL). n587

The Interactive Data File must be submitted to the Commission and posted on the registrant's corporate website, if any, as provided by Rule 405 of Regulation S-T if the registrant's registration statement under the Securities Act contains a price or price range and the registrant does not prepare its financial statements in accordance with Article 6 of Regulation S-X (*17 CFR 210.6-01 et. seq.*) and is described in paragraph (A), (B) or (C):

(A) A large accelerated filer that had an aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of more than \$5 billion as of the last business day of the second fiscal quarter of its most recently completed fiscal year that prepares its financial statements in accordance with generally accepted accounting principles as used in the United States and the filing contains financial statements of the registrant for a fiscal period that ends on or after June 15, 2009;

(B) A large accelerated filer not specified in paragraph (A) of this Item that prepares its financial statements in accordance with generally accepted accounting principles as used in the United States and the filing contains financial statements of the registrant for a fiscal period that ends on or after June 15, 2010 or

(C) A filer not specified in paragraph (A) or (B) that prepares its financial statements in accordance with either generally accepted accounting principles as used in the United States or International Financial Reporting Standards as issued by the International Accounting Standards Board, and the filing contains financial statements of the registrant for a fiscal period that ends on or after June 15, 2011. n588

An Interactive Data File may be submitted to the Commission in the manner provided by Rule 405 of Regulation S-T if the registrant prepares its financial statements in accordance with either U.S. GAAP as used in the United States or International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board, and not in accordance with Article 6 of Regulation S-X (*17 CFR 210.6-01 et. seq.*). n589

An Interactive Data File may not be submitted to the Commission if the registrant prepares its financial statements in

accordance with Article 6 of Regulation S-X (17 CFR 210.6-01 *et. seq.*). n590

[ii] Financial Statements. The registrant must furnish the financial statement schedules required by Regulation S-X and Item 11(e) of Regulation S-K. n591

[e] Item 17. Undertakings.

This item requires the registrant to furnish the undertakings specified by Item 512 of Regulation S-K. n592

[i] Rule 415 Offering. Item 512(a) of Regulation S-K, "Rule 415 offering," requires that the registrant undertake to file, during any period in which offers or sales of securities pursuant to Rule 415, *i.e.*, securities being offered on a delayed or continuous offering ("shelf" registration), are being made, a post-effective amendment to the registration statement:

- (1) to include any prospectus required by Section 10(a)(3) of the Securities Act;
- (2) to reflect in the prospectus any facts or events occurring after the effective date of the registration statement, or the most recent post-effective amendment of the registration statement, that, individually or in the aggregate, represent a fundamental change in the information in the registration statement; n593 and
- (3) to include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to that information in the registration statement. n594

If securities are being registered pursuant to Rule 415, the registrant must also undertake:

- (1) that, for the purpose of determining any liability under the Securities Act, each post-effective amendment will be deemed to be a new registration statement relating to the securities offered therein, and the offering of the securities at the time of the post-effective amendment will be deemed the initial bona fide offering of the securities; n595
- (2) to remove from registration by a post-effective amendment any securities remaining unsold at the termination of the offering; n596
- (3) if the registrant is a foreign private issuer, to file a post-effective amendment to the registration statement to include any financial statements required by 3-19 of Regulation S-X at the start of any delayed offering or throughout a continuous offering; and n597
- (4) that, for purposes of determining liability of the registrant under the Securities Act to any purchaser in the initial distribution of the securities, that in a primary offering of securities pursuant to the registration statement (regardless of the underwriting method used to sell the securities), if the securities are offered or sold by means of certain communications, the registrant is a seller to the purchaser and is considered to offer or sell the securities to the purchaser. n598

If the registrant is relying on Rule 430B n599 with regard to information that may be omitted from a base prospectus in a Rule 415 offering, the registrant must undertake that for purposes of determining liability under the Securities Act to any purchaser:

- (1) each prospectus filed pursuant to Rule 424(b)(3) will be deemed to be part of the registration statement as of the date the filed prospectus was deemed part of and included in the registration

statement; and

(2) each prospectus required to be filed pursuant to Rule 424(b)(2), (b)(5) or (b)(7) as part of a registration statement in reliance on Rule 430B, for the purpose of providing the information required by Section 10(a) of the Securities Act, will be deemed to be part of and included in the registration statement as of the date such form of prospectus is first used after effectiveness or the date of the first contract of sale of securities in the offering, n600 and for liability purposes of the issuer and any underwriter that date will be deemed to be a new effective date of the registration statement (provided that no statement made will supersede or modify any statement that was made in the registration statement in place immediately prior to the new effective date).

If the registrant is subject to Rule 430C, n601 the registrant must undertake that, for purposes of determining liability under the Securities Act, each prospectus filed pursuant to Rule 424(b), other than those filed as part of registration statements relying on Rule 430B or prospectuses filed in reliance on Rule 430A, will be deemed to be part of the registration statement as of the date it is first used after effectiveness (provided that no statement made will supersede or modify any statement that was made in the registration statement in place immediately prior to the new effective date). n602

[iii] Warrants and Rights Offerings. Item 512(c) of Regulation S-K, "Warrants and rights offerings," requires the registrant, if the securities are to be offered to existing security holders pursuant to warrants or rights, and any securities not taken by security holders are to be reoffered to the public, with appropriate modifications to suit the particular case, to undertake to supplement the prospectus after the expiration of the subscription period to set forth:

- (1) the results of the subscription offer;
- (2) the transactions by the underwriters during the subscription period;
- (3) the amount of unsubscribed securities to be purchased by the underwriters; and
- (4) the terms of any subsequent reoffering of the securities pursuant to the warrants or rights.

The registrant must also undertake that if any public offering by the underwriters is to be made on terms differing from conditions set forth on the cover page of the prospectus, the registrant will file a post-effective amendment setting forth the terms of the public offering.

[iii] Competitive Bids. Item 512(d) of Regulation S-K, "Competitive bids," requires the registrant, if the securities being registered are to be offered at competitive bidding, to undertake:

- (1) to use its best efforts to distribute prior to the opening of bids to prospective bidders, underwriters and dealers, a reasonable number of copies of a prospectus meeting the requirements of Section 10(a) and relating to the securities offered at competitive bidding, as are contained in the registration statement (together with any supplements thereto); and
- (2) to file an amendment to the registration statement reflecting the results of bidding, the terms of the reoffering and applicable related matters not later than the first use of a prospectus relating to the securities offered at competitive bidding that was authorized by the registrant after the opening of bids, unless no further public offering by the registrant and no reoffering by the purchasers are proposed to be made.

[iv] Equity Offerings of Nonreporting Registrants. Item 512(f) of Regulation S-K, "Equity offerings of

nonreporting registrants," provides that if equity securities of a nonreporting registrant are being registered for sale in an underwritten offering, the registrant must undertake to provide the underwriter at the time of closing specified in the underwriting agreement, certificates in those denominations and registered in those names as required by the underwriter to permit prompt delivery to each purchaser.

[v] Acceleration of Effective Date. Item 512(h) of Regulation S-K, "Request for acceleration of effective date or filing of registration statement becoming effective upon filing," provides that if an acceleration of the effective date of the registration statement is requested pursuant to Rule 461 n603 and:

- (1) any provision or arrangement exists for the registrant to indemnify any director, officer or controlling person of the registrant against liabilities arising under the Securities Act; or
- (2) the underwriting agreement requires the registrant to indemnify the underwriter or controlling persons of the underwriter against Securities Act liabilities, and a director, officer or controlling person of the registrant is an underwriter, a controlling person thereof or a member of a firm that is the underwriter; and
- (3) the benefits of indemnification are not waived by persons named in subparagraphs (1) and (2) above,

a statement must be included that in the opinion of the Commission the indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. Pursuant to the underwriting, if a claim for indemnification against Securities Act liabilities, other than the payment by the registrant of expenses incurred by a director, officer or controlling person of the registrant arising from the successful defense of any action, suit or proceeding, is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant must, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction, the question of whether the indemnification is against public policy as expressed in the Securities Act. The registrant would be governed by the final adjudication of the issue.

[vi] Rule 430A. Item 512(i) of Regulation S-K provides that the registrant must undertake in any registration statement permitted by Rule 430A that for purposes of determining Securities Act liability:

- (1) the information omitted from the form of prospectus filed as part of the registration statement in reliance upon Rule 430A and contained in a prospectus filed pursuant to Rule 424 (b)(1) or (4) or Rule 497(h) shall be deemed to be part of the registration statement at the time it was declared effective; and
- (2) each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

[vii] Qualification of Trust Indentures for Delayed Offerings. Item 512(j) of Regulation S-K, "Qualification of trust indentures under the Trust Indenture Act of 1939 for delayed offerings," requires that, if the registrant intends to rely on Section 305(b)(2) of the Trust Indenture Act of 1939 for determining the eligibility of the trustee under indentures for securities to be issued, offered or sold on a delayed basis by or on behalf of the registrant, the registrant must undertake to file an application for the purpose of determining the eligibility of the trustee to act under section 310(a) of the Trust Indenture Act in accordance with the rules and regulations prescribed under Section 305(b)(2) thereof.

[f] Signatures. The registration statement must be signed by the registrant, its principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, and by at least a majority of its board of directors or persons performing similar functions. If the registrant is a foreign person, the registration statement must also be signed by its duly authorized representative in the United States. In the case of a registrant that is a limited

partnership, the registration statement must be signed by a majority of the board of directors of any corporate general partner signing the registration statement. n604

FOOTNOTES:

(n1)Footnote 1. The Commission proposed replacing Form S-1 with Form A in its "Aircraft Carrier" release. Sec. Act Rel. No. 33-7606 (1998). *See § 7.01 supra* for a general discussion of "Aircraft Carrier." In the 2004 Proposals, the Commission proposed amending Form S-1 and Form F-1 to expand the use of incorporation by reference to allow the inclusion of information from previously filed Exchange Act reports and documents.

(n2)Footnote 2. Although Form S-1 may be used for registration of an exchange offer of securities, the Commission has adopted Form S-4 for the registration of securities issued in certain business combination transactions; including exchange offers. Form S-4 is discussed in § 7.06[1] *infra*. The forms under the Securities Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section D (Matthew Bender).

(n3)Footnote 3. General Instruction I, Form S-1.

(n4)Footnote 4. *See § 7.05 infra*.

(n5)Footnote 5. Regulation S-K is discussed in § 7.02[3][a] *supra*, and is reprinted in the Securities Primary Law Sourcebook, Volume D, Section K (Matthew Bender).

(n6)Footnote 6. General Instruction VII, Form S-1. This was previously the case for Form S-2, which was eliminated by the 2005 Rules. For specific eligibility requirements, see the text of General Instruction VII. Note that a registrant may satisfy this requirement by including, on the website maintained by or for the registrant, hyperlinks directly to the registrant's reports or other materials filed on EDGAR or the registrant's EDGAR filing page; however, linking to the Commission's EDGAR system generally, or to a page where an investor would be required to select the registrant or input the registrant's name, does not satisfy this requirement. Question 113.04, Questions and Answers of General Applicability, Securities Act Forms.

(n7)Footnote 7. Rule 408. The rules under the Securities Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

(n8)Footnote 8. Rule 409.

(n9)Footnote 9. General Instruction II(A), Form S-1.

For discussion of Regulation C, *see § 7.02[3][b] supra*.

(n10)Footnote 10. General Instruction II(B), Form S-1.

(n11)Footnote 11. The use of a particular name by a registrant may be misleading if that name is so similar to one

already associated with another enterprise as to cause confusion in the public mind. *Gold Hunter Extension, Inc.*, 3 SEC 891, 892 (1938) (use of name of "Gold Hunter Extension, Inc.," on facing page held likely to lead to confusion between registrant's properties and better known "Gold Hunter Mine" nearby). *See also National Educators Mut. Ass'n, Inc.*, 1 SEC 208, 212-213 (1935) (use of the name "National Educators Mutual Association, Inc.," held misleading in that it tended to create in the minds of the public the erroneous impression that the registrant was connected with the National Education Association).

See also Communications Satellite Corp. v. Comcet, Inc., 429 F.2d 1245, 1249 (1970) .

The facing page of the prospectus of U.S. Land Development Corporation [Registration No. 2-14300, filed Aug. 18, 1958], for example, was amended prior to the effective date to include the qualifying statement immediately below the name of the company: "Not affiliated with the United States Government of any agency thereof."

Similarly, a name may be misleading if it tends to convey a false impression of the nature of the registrant's business. *In re National Education Mut. Ass'n. Inc.*, 1 S.E.C. 208 at 213 (inclusion of the word "mutual" in the name of a stock corporation organized solely for profit held misleading).

If confusion between the registrant and another well known company could result due to registrant's name, or if registrant's name indicates a line of business in which registrant is not engaged or is only peripherally engaged, and the situation is not one in which the registrant has changed the general character of its business gradually over a period of years and the investing public is generally aware of that change and of the nature of the registrant's current business, then the registrant may have to include a statement to prevent confusion or to remove any misleading inference. Item 501(b)(1), Regulation S-K. If such a statement is not sufficient to avoid the confusion, the registrant may have to change its name. *Id.*

(n12)Footnote 12. Item 501(a), Regulation S-K.

(n13)Footnote 13. Rule 100(a)(5).

Item 3 of Schedule A requires "the location of the issuer's principal business office, and if the issuer is a foreign or territorial person, the name and address of its agent in the United States authorized to receive notice." Schedule A under the 1933 Act is reprinted in the Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

(n14)Footnote 14. Rule 478.

(n15)Footnote 15. Delayed or continuous offerings pursuant to Rule 415 are discussed in §§ 7A.05 and 7A.06 *infra* .

(n16)Footnote 16. The registrant must check the appropriate box on the facing page. The definitions of "large accelerated filer" and "accelerated filer" are set forth in Rule 12b-2 under the Exchange Act. A company that qualifies as a smaller reporting company based on the eligibility test in Item 10(f) of Regulation S-K is required to check the "smaller reporting company" box whether or not it chooses to rely on the scaled disclosure standards of the amended Regulation S-K requirements. *See* Sec. Act Rel. No. 33-8876; § 7.05 *infra* (discussing the qualifications of a smaller reporting company).

(n17)Footnote 17. If the filing fee is calculated based on the maximum aggregate offering price pursuant to Rule 457(o), only the title of the class of securities to be registered, the proposed maximum aggregate offering price for that class of securities and the amount of registration fee need to appear in the table. Any difference between the dollar amount of securities registered for such offerings and the dollar amount of securities sold may be carried forward on a future registration statement pursuant to Rule 429.

(n18)Footnote 18. Fee Rate Advisory # 4 for Fiscal Year 2010.

Rule 457(f) provides the method of computation of the registration fee where securities are to be offered in exchange for other securities (except where such exchange results from the exercise of a conversation privilege) or in a reclassification or recapitalization that involves the substitution of a security for another security, a merger, a consolidation, or a similar plan of acquisition.

Rule 457(g) provides the calculation of the registration fee where securities are to be offered pursuant to warrants or other rights to purchase those securities and the holders of the warrants or rights may be deemed to be underwriters. For discussion of calculation of the registration fee, *See § 7A.04[3] infra*.

(n19)Footnote 19. Rule 457(a).

(n20)Footnote 20. Rule 457(a).

(n21)Footnote 21. Rule 457(a).

(n22)Footnote 22. The subsequent registration statement must be filed by the same registrant (including a successor within the meaning of Rule 405), a majority-owned subsidiary of that registrant, or a parent that owns more than 50 percent of the registrant's outstanding voting securities, and it must be filed within five years of the filing date of the earlier registration statement. In addition, a note must be added to the "Calculation of Registration Fee" table in the subsequent registration statement stating the dollar amount of the filing fee previously paid, the file number of the earlier registration statement, the name of the registrant and the initial filing date of the earlier registration statement. Rule 457(p).

(n23)Footnote 23. Section 6(c). Fees paid to the U.S. Treasury-designated lockbox must be paid in accordance with the instructions in 17 CFR § 202.3a.

(n24)Footnote 24. Rule 456.

(n25)Footnote 25. Rule 421(a).

(n26)Footnote 26. Rule 404(c).

(n27)Footnote 27. Rule 421(a).

(n28)Footnote 28. Rule 421(c).

(n29)Footnote 29. *Id.*

(n30)Footnote 30. Item 1, Form S-1.

(n31)Footnote 31. *See § 7.02[2] infra*.

(n32)Footnote 32. Item 501(a), Regulation S-K, "Delaying amendments," sets forth requirements for amendments that delay the effective date of registration statements.

For discussion of the other information required on the facing page of Form S-1, *see § 7.03[1] supra*.

(n33)Footnote 33. Item 501(b), Regulation S-K.

(n34)Footnote 34. In the case of a foreign private registrant, an English translation of the registrant's name must also be set forth on the outside front cover page of the prospectus. Item 501(b)(1), Regulation S-K.

For discussion of the steps a registrant must take in the event of the likelihood of confusion between the registrant's name or line of business, and the name or line of business of another company, *see* § 7.03[1] at n.12 *supra*.

(n35)Footnote 35. Item 501(b)(2), Regulation S-K.

(n36)Footnote 36. Item 501(b)(2), Regulation S-K.

(n37)Footnote 37. Item 501(b)(5), Regulation S-K.

(n38)Footnote 38. Item 501(b)(6), Regulation S-K.

(n39)Footnote 39. Item 501(b)(7), Regulation S-K.

(n40)Footnote 40. Item 501(b)(4), Regulation S-K.

(n41)Footnote 41. Item 501(b)(3), Regulation S-K.

(n42)Footnote 42. Instruction 2, Item 501(b)(3), Regulation S-K.

(n43)Footnote 43. Item 16 of Schedule A also provides that a variation in price may be proposed prior to the public offering date, but that the Commission must be notified immediately.

(n44)Footnote 44. In this connection, Item 17 of Schedule A requires a statement of all commissions or discounts paid or to be paid, directly or indirectly, by the issuer to the underwriters in respect of the sale of the security to be offered. Commissions include all cash, securities, contracts or anything else of value, paid, to be set aside, disposed of, or understandings with or for the benefit of any other persons in which any underwriter is interested, made in connection with the sale of such security. A commission paid or to be paid in connection with the sale of such security by a person in which the issuer has an interest or which is controlled or directed by, or under common control with, the issuer shall be deemed to have been paid by the issuer. Where any such commission is paid, the amount of such commission paid to each underwriter shall be stated.

(n45)Footnote 45. Item 501(b)(8), Regulation S-K.

The terms of any over-allotment option (also known as a "green shoe" option) should be described in response to Item 8 of Form S-1, "Plan of Distribution," (*see* § 7.03[2][h] *infra*) rather than on the cover page. Sec. Act Rel. No. 33-7497 (1998).

(n46)Footnote 46. Item 501(b)(9), Regulation S-K.

(n47)Footnote 47. Item 501(b)(10), Regulation S-K.

A preliminary prospectus should include a legend containing the following or other clear, plain language:

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Id.

(n48)Footnote 48. *See* § 7.02[2] *infra*.

(n49)Footnote 49. The information called for by paragraph (a) of Item 502 may be set forth on the outside back cover page instead of the inside front cover page of the prospectus, but it must be included on the inside front cover page if the prospectus is being delivered electronically.

(n50)Footnote 50. Item 502(b) allows the registrant to use the following or other plain English:

Dealer Prospectus Delivery Obligation: Until (insert date), all dealers that effect transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers' obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

The statement need not be included if, pursuant to Rule 174, dealers are not required to deliver a prospectus, or if the exemption provided by Section 4(3) is not available because of the provisions of Section 24(d) of the Investment Company Act of 1940. (Section 24(d) makes Section 4(3) inapplicable to any transaction in a security issued by a face-amount certificate company or in a redeemable security issued by an open-end management company or unit investment trust if any other security of the same class is currently being offered or sold by the issuer or by or through an underwriter in a distribution not exempt from Section 5.)

Section 4(3) and Rule 174, are discussed in § 4.06 *supra*.

If the expiration date for delivering the prospectus is not known on the effective date of the registration statement, the date must be included in the prospectus, copies of which are required to be filed with the Commission pursuant to Rule 424(b). Rule 424(b) is discussed in § 7A.06 *infra*.

(n51)Footnote 51. See § 7.02[2] *infra*.

(n52)Footnote 52. Item 503(a), Regulation S-K.

(n53)Footnote 53. Instruction, Item 503(a), Regulation S-K.

(n54)Footnote 54. In 2010, the Commission issued guidance directing filers to consider addressing possible domestic and international climate change regulation, as well as the potential business impact of climate change, under Item 503(c). Sec. Act. Rel. Nos. 33-9106, 34-61469 (Feb. 2, 2010). For a further discussion of risk factors see Division of Corporation Finance: Updated Staff Legal Bulletin No. 7, "Plain English Disclosure," Risk Factor Guidance, June 7, 1999.

(n55)Footnote 55. The phrase "common equity" means any class of common stock or an equivalent interest, including but not limited to a unit of beneficial interest in a trust or a limited partnership interest. Rule 405.

(n56)Footnote 56. Provisions regarding disclosure of the ratio of earnings to fixed charges are located in the registration statement and prospectus provisions section of Regulation S-K because the ratio only is required in certain Securities Act filings. Sec. Act Rel. No. 33-6383, n.46 (1982).

(n57)Footnote 57. The term "earnings" is the amount resulting from adding and subtracting the following items.

Add the following:

- Pretax income from continuing operations before adjustment for income or loss from "equity investees" (investments accounted for using the equity method of accounting);

- Fixed charges;
- Amortization of capitalized interest;
- Distributed income of equity investees; and
- The registrant's share of pre-tax losses of equity investees for which charges arising from guarantees are included in fixed charges. From the total of the added items, subtract the following:
- Interest capitalized;
- "Preference security dividend" requirements of consolidated subsidiaries; and
- The noncontrolling interest in pre-tax income of subsidiaries that have not incurred fixed charges.

Rate regulated public utilities should not add amortization of capitalized interest in determining earnings, nor reduce fixed charges by any allowance for funds used during construction.

The term "preference security dividend" is the amount of pre-tax earnings that is required to pay the dividends on outstanding preference securities. The dividend requirement must be computed as the amount of the dividend divided by (1 minus the effective income tax rate applicable to continuing operations). Instruction 1(B)-(C), Item 503(d), Regulation S-K.

(n58)Footnote 58.

The term "fixed charges" means the sum of the following:

- Interest expensed and capitalized;
- Amortized premiums, discounts and capitalized expenses related to indebtedness;
- An estimate of the interest within rental expense; and
- Preference security dividend requirements of consolidated subsidiaries. Instruction 1(A), Item 503(d), Regulation S-K.

(n59)Footnote 59. The combined ratio may not be meaningful to a potential debtholder since the preferred stockholder has a subordinate claim on the registrant's earnings. Sec. Act Rel. No. 33-6383, ASR 306 Fed. Sec. L. Rep. (CCH) P 72,328 No. 956 (1982).

If either ratio computation indicates a less than one-to-one coverage, the registrant should disclose the dollar amount of the coverage deficiency. Instruction 2(A), Item 503(d), Regulation S-K.

(n60)Footnote 60. Item 503(d), Regulation S-K.

(n61)Footnote 61. Instruction 2(B), Item 503(d), Regulation S-K.

(n62)Footnote 62. *Id.* If the registrant is a foreign private issuer, the ratio must be computed on the basis of the

registrant's primary financial statements and, if materially different, their reconciliations to U.S. generally accepted accounting principles. Instruction 2(C), Item 503(d), Regulation S-K.

(n63)Footnote 63. Instruction 2(D), Item 503(d), Regulation S-K.

(n64)Footnote 64. Instruction 3, Item 503(d), Regulation S-K. *See* Item 601(b)(12), Regulation S-K.

(n65)Footnote 65. Item 503(e), Regulation S-K; *see also* § 7.05 *infra*.

(n66)Footnote 66. Instruction 3, Item 504, Regulation S-K. In addition, Item 13 of Schedule A calls for "specific purposes in detail and the approximate amounts to be devoted to such purposes, so far as determinable ... and if the funds are to be raised in part from other sources, the amounts thereof and the sources thereof"

(n67)Footnote 67. Instruction 7, Item 504, Regulation S-K.

(n68)Footnote 68. Instruction 1, Item 504, Regulation S-K.

(n69)Footnote 69. *Id.* Item 501 of Regulation S-K is discussed in § 7.03[2][a] *supra*.

(n70)Footnote 70. Instruction 2, Item 504, Regulation S-K.

A discussion of the registrant's financial condition and results of operations must be included in the response to Item 11 of Form S-1, *see* § 7.03[2][k][viii] *infra*.

(n71)Footnote 71. Instruction 5, Item 504, Regulation S-K.

An "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified. Rule 405. "Control" means the possession, direct or indirect, 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. Rule 405.

(n72)Footnote 72. Instruction 6, Item 504, Regulation S-K.

Instruction 6 to Item 504 is a codification of former disclosure practices and the Commission's policy on disclosure where a registrant indicates that the proceeds may be used to acquire one or more businesses. Instruction 6 is not intended to introduce a new obligation to disclose intended acquisition targets. Sec. Act. Rel. No. 33-6332, Fed. Sec. L. Rep. (CCH) No. 926, Part II.

(n73)Footnote 73. Instruction 6, Item 504, Regulation S-K.

(n74)Footnote 74. Instruction 4, Item 504, Regulation S-K.

(n75)Footnote 75. *Lewis Am. Airways, Inc.*, 1 SEC 330, 344 (1936) . *See also Mon-O-Co Oil Corp.*, 38 SEC 833, 839-40 (1959) .

(n76)Footnote 76. The requirements of Item 201(a) of Regulation S-K are required to be disclosed in response to Item 11 of Form S-1, discussed in § 7.03[2][k][iv] *infra*.

(n77)Footnote 77. Item 505(b), Regulation S-K.

(n78)Footnote 78. Item 506 disclosure is limited to instances in which purchasers of the registrant's common

equity may be subject to material dilution of their equity interests, either immediately or in the future, as a result of a material amount of outstanding options, rights or convertible securities. Item 506 distinguishes between previously nonreporting registrants and reporting registrants and requires less disclosure in the case of reporting registrants. Item 506 minimizes those circumstances under which dilution is required to be disclosed by more seasoned companies whose securities are selling on the basis of earnings, and where dilution of book value is generally not material to the investor. The Commission considers this minimization appropriate because the more detailed transactional information required of nonreporting registrants is otherwise generally included in (the Exchange Act) reports and proxy and information statements required to be filed by reporting companies. See Act Rel. No. 33-6332, Fed. Sec. L. Rep. (CCH) No. 926, Part II (1981).

(n79)Footnote 79. Item 506(a)-(c), Regulation S-K.

(n80)Footnote 80. As used in Item 507, the term "security holder" means beneficial holders, not nominee holders or other such holders of record. Question 140.01, Questions and Answers of General Applicability, Securities Act Forms.

When identifying an entity as a security holder, the registrant must identify in the registration statement the person or persons who have voting or investment control over the registrant's securities that the entity owns. Use Rule 13d-3 by analogy to make the determination. Question 140.02, Questions and Answers of General Applicability, Securities Act Forms.

(n81)Footnote 81. "The term 'predecessor' means a person the major portion of business and assets of which another person acquired in a single succession, or in a series of related successions in each of which the acquiring person acquired the major portion of the business and assets of the acquired person." Rule 405.

"The term 'succession' means the direct acquisition of the assets comprising a going business, whether by merger, consolidation, purchase, or other direct transfer. The term does not include the acquisition of control of a business unless followed by the direct acquisition of its assets." Rule 405.

(n82)Footnote 82. See § 7.03[2][d] *supra* for the definition of "affiliate."

(n83)Footnote 83. "The term 'principal underwriter' means an underwriter in privity of contract with the issuer of the securities as to which he is underwriter, the term 'issuer' having the meaning given in Sections 2(4) and 2(11) of the Act." Rule 405. For a detailed discussion of the meaning of the term "underwriter," see § 4.02[2] *supra*.

The term "managing underwriter" generally means an underwriter (or underwriters) who, by contract or otherwise,

- (1) deals with the registrant;
- (2) organizes the selling effort;
- (3) receives some benefit directly or indirectly in which all other underwriters similarly situated do not share in proportion to their respective interests in the underwriting; or
- (4) represents any other underwriters in such matters as maintaining the records of the distributions, arranging the allotments of securities offered, or arranging for appropriate stabilization activities, if any.

(n84)Footnote 84. "The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."

Rule 405.

(n85)Footnote 85. Instruction, Item 508(a), Regulation S-K.

Use of the words "take down" is misleading when the underwriting is on a "best efforts basis." *Livingston Mining Co.*, 2 SEC 141, 149 (1937) . Disclosure of a best efforts arrangement might be worded as follows:

There is no firm commitment for the purchase of any of the securities comprising the public offering, and therefore, no representation is made that the Company will receive the proceeds of the sale of the entire offering.

If the underwriting arrangements are an "all or none" or "part or none" basis, the following type of wording would be appropriate:

The Company has entered into an escrow agreement with the Underwriter which provides that proceeds from the sale of the Company's stock shall be paid over to _____ Bank, named as escrow agent by the Company and the Underwriter. As soon as the bank has received full payment for _____% of the shares offered, i.e., \$_____, in payment for _____ shares sold, it shall in its capacity of Registrar and Transfer Agent record and issue the shares in the names in which the stock certificates are to be issued and disburse to the Company and the Underwriter the net amounts due under the terms of the Underwriting Agreement, namely, \$_____ to the Company, \$_____ to the Underwriter. If, upon expiration of the Underwriting Agreement, _____% of the Company's securities have not been sold, then the escrow agent shall refund amounts paid, including the Underwriter's commission, to purchasers.

With respect to liability for failure to accurately describe the method of underwriting ("all or none") as violating the antifraud provisions of 1933 Act, see *A.J. White & Co. v. SEC*, 556 F.2d 619, 622, (1st Cir.), cert. denied, 434 U.S. 969 (1977) .

(n86)Footnote 86. Instruction, Item 508(a), Regulation S-K.

(n87)Footnote 87. "The term 'control' (including the terms 'controlling,' 'controlled by,' and 'under common control with') means the possession, direct or indirect, 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."

Rule 405.

For a further discussion of "control," see § 4.02 *supra*.

(n88)Footnote 88. "The phrase 'dividend or interest reinvestment plan' means a plan which is offered solely to the existing security holders of the registrant, which allows those security holders to reinvest dividends or interest paid to them on securities issued by the registrant, and that also may allow additional cash amounts to be contributed by the participants in the plan, provided the securities to be registered are newly issued, or are purchased for the account of plan participants at prices not in excess of current market prices at the time of purchases or at prices not in excess of an amount determined in accordance with a pricing formula specified in the plan and based upon average or current market prices at the time of purchase."

Rule 405.

(n89)Footnote 89. Item 508(c)(3), Regulation S-K. This requirement comes into play in the case of exchange offers and similar situations where the proceeds do not consist of cash.

(n90)Footnote 90. For discussion of Instruction 5 to Item 504 of Regulation S-K, *see* § 7.03[2][d] *supra*.

(n91)Footnote 91. The term "commissions" is defined in Item 17 of Schedule A.

(n92)Footnote 92. The NASD is currently known as the Financial Industry Regulatory Authority ("FINRA"). Because Regulation S-K still refers to the organization as the NASD, the references herein will also remain the same.

(n93)Footnote 93. Instruction 1, Item 508(e), Regulation S-K.

(n94)Footnote 94. Instruction 2, Item 508(e), Regulation S-K.

Item 511 of Regulation S-K requires the registrant to furnish a reasonably itemized statement of all expenses in connection with the issuance and distribution of the securities to be registered, other than underwriting discounts and commissions. If any of the securities to be registered are to be offered for the account of security holders, the registrant should indicate the portion of such expenses to be borne by such security holder.

(n95)Footnote 95. Instruction 3, Item 508(e), Regulation S-K.

While Item 508(e) does not require disclosure of material currency conversion profits (see former Securities Act Guide 14 [deleted as unnecessary] concerning underwriter's compensation from conversion of funds into foreign currency), if the conversion profits are intended to constitute, or are negotiated as a part of the underwriter's compensation, the conversion profits may, in certain circumstances, be deemed by the NASD to be "other items of value accruing to the underwriter" and would, therefore, be disclosable. Sec. Act Rel. No. 33-6332, Fed. Sec. L. Rep. (CCH) No. 926, Part II (1981).

Certain disclosures should be made in the prospectus if a material amount of options has been or is to be issued to promoters, underwriters, officers or directors. These additional disclosures ordinarily include the following: that for the life of the options the option holders are given at nominal cost the opportunity to profit from a rise in the market price of the capital stock of the issuer with a resulting dilution in the interest of security holders; that for the life of the options the issuer might be deprived of favorable opportunities to procure additional equity capital, if it should be needed for the purpose of the business; and that the holders of such options might be expected to exercise them at a time when the issuer would, in all likelihood, be able to obtain equity capital, if it needed capital then, by sale of a new offering on terms more favorable than those provided for by the options.

Additionally, options and stock to be issued by the issuer or some other person which are issued to underwriters in connection with a registered public offering are required to be registered along with the securities to be offered to the public, even if such options have been acquired for investment. The same procedure should be followed with respect to stock sold to underwriters in connection with an underwriting, and an appropriate undertaking included in the registration statement, as follows:

The registrant undertakes with respect to ... shares issued (or to be issued) to underwriters, that (1) any prospectus revised to show the terms of offering of such shares (other than a transaction on a national securities exchange), and (2) any prospectus revised to comply with the requirements of Section 10(a)(3) of the Securities Act will be filed as a post-effective amendment to the registration statement prior to any offering thereof; and that the effective date of each such amendment shall be deemed the effective date of the registration statement with respect to securities sold after such amendment shall have become effective.

(n96)Footnote 96. Item 508(h), Regulation S-K.

A commission paid or to be paid in connection with the sale of such security by a person in which the issuer has an interest or which is controlled or directed by, or under common control with, the issuer, is deemed to have been paid by the issuer and must be reported. Item 17, Schedule A.

(n97)Footnote 97. The term "promoter" includes:

(1) any person who, acting alone or in conjunction with one or more other persons, directly or indirectly, takes initiative in founding and organizing the business or enterprise of an issuer; or

(2) any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration for services or property, or both services and property, at least ten percent of any class of securities of the issuer or at least ten percent of the proceeds from the sale of any class of the issuer's securities.

Rule 405.

A person who receives those securities or proceeds either solely as underwriting commissions or solely in consideration of property is not deemed a promoter within the meaning of Rule 405 if that person does not otherwise take part in the founding and organizing of the enterprise. *Id.*

All persons coming within the definition of promoter as described above may be referred to as "founders" or "organizers" or by any other appropriate term provided that such term is reasonably descriptive of those persons' activities for the issuer. *Id.*

(n98)Footnote 98. The term "associate," when used to indicate a relationship with any person, means:

(1) a corporation or organization (other than the registrant or a majority-owned subsidiary of the registrant) of which that person is an officer or partner or is, directly or indirectly, the beneficial owner of ten percent or more of any class of equity securities;

(2) any trust or other estate in which that person has a substantial beneficial interest or as to which that person serves as trustee or in a similar capacity; and

(3) any relative or spouse of that person, or any relative of that spouse, who has the same home as the person or who is a director or officer of the registrant or any of its parents or subsidiaries.

Rule 405.

(n99)Footnote 99. Item 508(j), Regulation S-K.

(n100)Footnote 100. Item 202(a), Regulation S-K.

(n101)Footnote 101. Instruction 1(A), Item 202, Regulation S-K.

(n102)Footnote 102. A complete legal description of the securities need not be given and the description should not be technical nor consist of verbatim excerpts of the governing instruments. Rather, what is called for is a brief summary of the provisions that are pertinent from an investment standpoint.

There is no doubt that in many instances prospectuses have been so long and cumbersome as partially to destroy their usefulness. The technical description of securities has often contributed to this undue length. Sec. Act Rel. No. 33-1503 (1937). *See also* Sec. Act Rel. No.33-1580 (1937).

(n103)Footnote 103. If convertible securities or stock purchase warrants are being registered and are subject to redemption or call, the description of the conversion terms of the securities or material terms of the warrants should disclose:

- (1) whether the right to convert or purchase the securities will be forfeited unless the right is exercised before the date specified in a notice of redemption or call;
- (2) the expiration or termination date of the warrants;
- (3) the kinds, frequency and timing of notice of the redemption or call, including the cities or newspapers in which notice will be published and whether the securities provide for a class of newspapers or group of cities in which the publication may be made at the discretion of the registrant; and
- (4) in the case of bearer securities, that investors are responsible for making arrangements to prevent loss of the right to convert or purchase in the event of redemption or call (*e.g.*, by reading newspapers in which the notice of redemption or call may be published).

Instruction 4(A)-(D), Item 202, Regulation S-K.

(n104)Footnote 104. The term "voting securities" means securities, the holders of which are presently entitled to vote for the election of directors. Rule 405.

(n105)Footnote 105. Item 202(a)(1)(i)-(xi), Regulation S-K.

(n106)Footnote 106. Item 202(a)(2), Regulation S-K.

(n107)Footnote 107. Item 202(a)(3), Regulation S-K.

(n108)Footnote 108. Item 202(a)(4), Regulation S-K.

(n109)Footnote 109. Item 202(a)(5), Regulation S-K.

(n110)Footnote 110. Sec. Act Rel. No. 33-6332, Fed. Sec. L. Rep. (CCH) No. 926, Part II (1981).

(n111)Footnote 111. In *Oil Ridge Oil & Refining Co.*, 1 S.E.C. 225 (1935) , the registrant had represented that the stock offered embodied a "bond feature" and was a "protective plan." The use of these terms was held to be misleading since there was no obligation to pay a fixed sum of money with stated interest. *Id. at 228*

In *National Educators Mut. Ass'n, Inc.*, 1 S.E.C. 208 (1935) , the face of the bond contained the figure \$1,000 prominently displayed and accompanied by the statement that the company "will pay the Sum of One Thousand Dollars"; but underneath, in much smaller type, a parenthetical statement appeared, as follows: "(Consisting of \$750 cash and \$250 stock)." This was held to be misleading. *Id. at 211* .

See also *Major Metals Corp.*, 2 S.E.C. 74, 78 (1937) (use of the term "bond" in describing securities representing unsecured claims against corporate assets); *West Park Apartments Corp.*, 3 S.E.C. 900, 907-08 (1938) (failure to disclose that indebtedness was noninterest bearing); *Chain Stores Depot Corp.*, 7 S.E.C. 1015, 1020 (1940) (misleading

use of the term "first mortgage").

For discussion of the description of debt securities, *see* § 7.03[2][i][ii] *infra*.

(n112)Footnote 112. For purposes of Item 202(b) of Regulation S-K, debt securities that differ from each other only in terms of interest rate or maturity should be deemed to be securities of the same class.

(n113)Footnote 113. For example, "maturing serially from 1955 to 1960."

(n114)Footnote 114. Instruction 1(B), Item 202, Regulation S-K.

(n115)Footnote 115. Where debt securities are designated as subordinated, in accordance with Instruction (1) to Item 202 of Regulation S-K, discussed in the text at n.114 *supra*, the registrant should state the aggregate amount of outstanding indebtedness as of the most recent practicable date that by the terms of those debt securities would be senior to the subordinated debt securities and describe briefly any limitation on the issuance of the additional senior indebtedness, or state that there is no limitation. Item 202(b)(3), Regulation S-K.

(n116)Footnote 116. In the case of secured debt, there should be stated:

- (1) whether the securities being registered are to be issued on the basis of unbounded bondable property, the deposit of cash or otherwise;
- (2) the approximate amount of unbounded bondable property available for use against the issuance of bonds, as of the most recent practicable date;
- (3) provisions permitting the withdrawal of cash deposited as a basis for the issuance of bonds; and
- (4) provisions permitting the release or substitution of assets securing the issue. Item 202(b)(5), Regulation S-K.

Provisions permitting the release of assets upon the deposit of equivalent funds or the pledge of equivalent property, the release of property no longer required in the business, obsolete property or property taken by eminent domain or the application of insurance funds and other similar provisions need not be described. Item 202(b)(5), Regulation S-K. *See also* Schedule A, Item 12.

(n117)Footnote 117. For discussion of Item 202(a)(4) of Regulation S-K, *see* text at n.106 *supra*.

(n118)Footnote 118. 26 U.S.C. § 1273. The term "original issue discount" means the excess (if any) of the stated redemption price at maturity, over the issue price. *Id.* § 1273(a)(1). If the original issue discount is less than one-fourth of 1 percent of the stated redemption price at maturity, multiplied by the number of complete years to maturity, then the issue discount is considered to be zero. *Id.* § 1273(a)(3). The term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time. *Id.* § 1273(a)(2).

The term "issue price," in the case of issues of bonds or other evidences of indebtedness registered with the Commission, means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. *Id.* § 1273(b)(1).

(n119)Footnote 119. Item 202(b)(1)-(10), Regulation S-K. Section 305(a)(2) of the Trust Indenture Act, 15 U.S.C. § 77aaa *et seq.*, shall not be deemed to require the inclusion in a registration statement or in a prospectus of any information not required by Item 202. Instruction 3, Item 202, Regulation S-K.

(n120)Footnote 120. Item 202(c)(1)-(5), Regulation S-K.

For a discussion of the nature of warrants and rights, *see* § 2.01[7] *supra*.

(n121)Footnote 121. *See, e.g.*, Rule 131 which requires registration of "industrial revenue bonds" where the bond obligation is by *private lessees* to pay rental on the bonds. In the case of any kind of security other than shares and debt, wherever the title of securities is required to be stated, the registrant should provide appropriate information comparable to that of shares and debt. Instruction 1(c), Item 202, Regulation S-K.

(n122)Footnote 122. *See* § 7.03[2][k][iv][A] *infra* for discussion of the disclosure requirements of Item 201(a) (Market information) of Regulation S-K.

(n123)Footnote 123. Instruction 2(A)-(D), Item 202, Regulation S-K.

(n124)Footnote 124. The description of the terms of deposit with respect to American Depositary Receipts called for by Item 202(f)(2) of Regulation S-K must include the provisions, if any, with respect to:

- (1) the amount of deposited securities represented by one unit of American Depositary Receipts;
- (2) the procedure for voting the deposited securities;
- (3) the collection and distribution of dividends;
- (4) the transmission of notices, reports, and proxy soliciting material;
- (5) the sale or exercise of rights;
- (6) the deposit or sale of securities resulting from dividends, splits, or plans of reorganization;
- (7) amendment, extension, or termination of the deposit;
- (8) rights of holders of receipts to inspect the transfer books of the depositary and the list of holders of receipts;
- (9) restrictions upon the right to deposit or withdraw the underlying securities; and
- (10) limitation upon the liability of the depositary.

(n125)Footnote 125. The response to Item 202(f) of Regulation S-K must include information with respect to fees and charges in connection with:

- (1) the deposit or substitution of the underlying securities;
- (2) receipt and distribution of dividends;
- (3) the sale or exercise of rights;
- (4) the withdrawal of the underlying security; and
- (5) the transferring, splitting, or grouping of receipts.

Information with respect to the right to collect the fees and charges against dividends received and deposited securities

must also be given. Instruction 5, Item 202, Regulation S-K.

(n126)Footnote 126. See n.127 *infra* for the definition of "expert."

(n127)Footnote 127. In 1970, the Commission authorized publication of Guide 56, which set forth the policy of its Division of Corporation Finance requiring disclosure of the interests of counsel who are named in the prospectus as having passed upon legal matters in connection with the registration or offering of securities. Sec. Act Rel. No. 33-5094 Fed. Sec. L. Rep. (CCH) P 77,917 (1970). The substance of this Guide has been incorporated into Item 509 of Regulation S-K.

(n128)Footnote 128. Accountants reporting on financial statements presented or incorporated by reference in the registration statement should note Rule 2-01 of Regulation S-X (17 C.F.R. § 210.2-01) (Qualifications of Accountants), that discusses disqualifying interests. Instruction 2, Item 509, Regulation S-K.

(n129)Footnote 129. Instruction 1, Item 509, Regulation S-K.

For the purpose of Instruction 1 to Item 509, the term "expert" or "counsel" includes the firm, corporation, partnership or other entity that employs the expert or counsel, or of which the expert or counsel is a member, or of counsel. The terms also include all attorneys in the case of counsel and all nonclerical personnel in the case of named experts participating in the matter on behalf of the firm, corporation, partnership, or entity.

(n130)Footnote 130. See *Callahan Zinc-Lead Co.*, 5 SEC 1009 (1939) ; *Plymouth Consol. Gold Mines, Ltd.*, 1 SEC 139 (1935) ; *Southeastern Indus. Loan Co.*, Sec. Act Rel. No. 33-2726, Fed. Sec. L. Rep. (CCH) P 75,225 (1941); *Cornucopia Gold Mines*, 1 SEC 364 (1936) .

(n131)Footnote 131. For discussion of the reporting requirements under the Exchange Act, see Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02 (Matthew Bender).

(n132)Footnote 132. *Corporate Leaders Sec. Co.*, 2 SEC 667, 674 (1937) .

Item 8 of Schedule A requires a statement of "the general character of the business actually transacted or to be transacted by the issuer." Accordingly, the description should not relate to the powers and objects specified in the charter, but to the actual business done and intended to be done.

(n133)Footnote 133. *Southeastern Indus. Loan Co.*, Sec. Act Rel. No. 33-2726, Fed. Sec. L. Rep. (CCH) P 75,225 (1941); *Automatic Telephone Dialer, Inc.*, Sec. Act Rel. No. 33-2736 Fed. Sec. L. Rep. (CCH) P 75,231 (1941), 10 SEC 698, 700-701 (1941) .

(n134)Footnote 134. *Virginia City Gold Mining Co.*, 2 SEC 855, 857 (1937) ; *Crusader Aircraft Corp.*, 3 SEC 153, 155 (1938) (nondisclosure of registrant's lack of success in previous enterprises).

(n135)Footnote 135. *Lewis American Airways, Inc.*, 1 SEC 330, 343 (1936) .

(n136)Footnote 136. Instruction 3, Item 101, Regulation S-K.

(n137)Footnote 137. Sec. Act Rel. No. 33-7620 (1999).

(n138)Footnote 138. Item 101(h), Regulation S-K. For a full description of the scaled disclosure available to smaller reporting companies, see § 7.05 *infra*.

(n139)Footnote 139. A "subsidiary" of a specified person is an affiliate controlled by that person directly, or indirectly through one or more intermediaries. Rule 405.

(n140)Footnote 140. For the definition of "predecessor," *see* § 7.03[2][g] *supra*.

(n141)Footnote 141. The phrase "significant subsidiary" means a subsidiary, including subsidiaries of the subsidiary, which meets any of the following conditions:

- (1) the investments of the registrant and its other subsidiaries in, and advances to the subsidiary exceed ten percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year. For a proposed combination between entities under common control, this condition is also met when the number of common shares exchanged by the registrant exceeds ten percent of its total common shares outstanding at the date the combination is initiated.);
- (2) the registrant's and its other subsidiaries' proportionate share of the total assets (after intercompany eliminations) of the subsidiary exceeds ten percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or
- (3) the equity of the registrant and its other subsidiaries in the income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principle of the subsidiary exceeds ten percent of the income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year.

Rule 405.

For purposes of making the prescribed income test, the following guidelines should be applied:

- (1) when a loss exclusive of amounts attributable to any noncontrolling interests is incurred by either the parent and its subsidiaries consolidated or the tested subsidiary exclusive of amounts attributable to any noncontrolling interests, but not both, the equity in the income or loss of the tested subsidiary should be excluded from the income of the registrant and its subsidiaries consolidated for purposes of the computation;
- (2) if income of the registrant and its subsidiaries consolidated exclusive of amounts attributable to any noncontrolling interests for the most recent fiscal year is at least ten percent lower than the average of the income for the last five fiscal years, that average income should be substituted for purposes of the computation. Any loss years should be omitted for purposes of computing average income.

Id.

(n142)Footnote 142. Item 101(a)(1), Regulation S-K.

(n143)Footnote 143. If the registration statement is filed prior to the end of the registrant's second fiscal quarter, the registrant should describe its plan of operation for the remainder of the fiscal year. If the registration statement is filed subsequent to the end of the registrant's second fiscal quarter, the registrant should describe its plan of operation for the remainder of the fiscal year and for the first six months of the next fiscal year. If the information on future plan of operation is not available, the reasons for it not being available should be stated. Item 101(a)(2).

(n144)Footnote 144. The requirement that intersegment sales or transfers be separately stated reflects a similar requirement by Statement of Financial Accounting Standard No. 14, "Financial Reporting for Segments of a Business Enterprise." *See* Sec. Act Rel. No. 33-6332, Fed. Sec. L. Rep. (CCH) No. 926 (1981).

(n145)Footnote 145. Item 101(b)(1), Regulation S-K.

(n146)Footnote 146. Item 101(b)(1), Regulation S-K.

(n147)Footnote 147. Item 101(b)(2), Regulation S-K.

(n148)Footnote 148. Nonpublic corporate information, the disclosure of which would adversely affect the registrant's competitive position, need not be disclosed. Item 101(c)(1)(ii), Regulation S-K.

Rule 418(a)(5) permits the Commission or its staff, where appropriate, to request supplemental information on new products or new industry segments that require the investment of a material amount of the assets of the registrant or that is otherwise material. This information includes copies of any studies prepared for the registrant by outside persons or any internal studies or reports that were material to the decision to develop the product or to do business in the new segment.

(n149)Footnote 149. The registrant should disclose, for example, that the registrant is required to carry significant amounts of inventory to meet rapid delivery requirements of customers or to assure itself of a continuous allotment of goods from suppliers, that the registrant provides the right to return merchandise, or that the registrant has provided extended payment terms to customers. Item 101(c)(1)(vi), Regulation S-K.

(n150)Footnote 150. The name of any customer and its relationship, if any, with the registrant or its subsidiaries should be disclosed if the aggregate amount of sales to the customer by one or more industry segments equals 10% or more of the registrant's consolidated revenues and the loss of that customer would have a material adverse effect on the registrant and its subsidiaries taken as a whole.

The names of other customers may be included, unless the effect of including the names would be misleading. Item 101(c)(1)(vii), Regulation S-K. A group of customers that are affiliates of each other or that are under common control, should be regarded as a single customer. *Id.*

If no substantial part of the registrant's business stems from a single customer or a few customers, a simple statement to that effect is in order. However, special problems may arise in this area. For example, suppose that the company is expanding, but at the present time lacks adequate facilities to serve a large number of customers simultaneously. One such situation was treated as follows in this portion of the prospectus:

The Company has had some customers which each year have accounted for between 30% and 42% of its sales. For the last fiscal year divisions of General Foods Corporation, constituting the Company's largest single customer during the last fiscal year, accounted for approximately 42% of the Company's sales. This is due to the fact that the Company has lacked adequate capital, facilities and personnel to service more than a limited number of customers at one time. It is the intention of the Company to expand its business to service a greater number of customers at one time. See 'Application of Proceeds.'

(n151)Footnote 151. Government orders that are firm but not yet funded and government contracts awarded but not yet signed may be included as firm orders, provided an appropriate explanation of the nature and amount of the orders is given. The portion of orders already included in sales or operating revenues on the basis of percentage of completion or program accounting should be excluded. Item 101(c)(1)(viii), Regulation S-K.

Language such as the following relating to backlog is suggested:

The amount of the Company's backlog as of February 7, 19____ was approximately \$1,413,000 compared to approximately \$1,127,000 as of February 7, 19____. It is management's estimate that

approximately 75% of the current backlog will be filled during the current fiscal year.

(n152)Footnote 152. The description of competitive conditions should include, where material, the identity of the particular markets in which the registrant competes, an estimate of the number of competitors, and the registrant's competitive position, if known or reasonably available to the registrant. Separate consideration should be given to each of the principal products or services, or classes of products or services of the segment, if any. Generally, the names of competitors need not be disclosed, and should not be disclosed if the disclosure would be misleading. If, however, the registrant knows or has reason to know that one or a small number of competitors is dominant in the industry, these competitors should be identified. Item 101(c)(x), Regulation S-K.

In the past, many prospectuses contained phrases in general terms that all but precluded an intelligent appraisal of the issuer's real position in the industry. The Commission first proposed in former Guide 5 the requirement that issuers "would have to include, where available, more meaningful information measuring the performance of companies in the same line of business." Sec. Act Rel. No. 33-5276, Fed. Sec. L. Rep. (CCH) No. 434, Special Edition (1972). Guide 5 stated that stock phrases or "boiler plate" relating to subjects such as the company's chances of success or competition often do not provide meaningful disclosure. See Act Rel. No. 5396, Fed. Sec. L. Rep. (CCH) P 79,384 (1973). Former Guide 5 read in part, "Stock phrases such as 'A substantial number of companies that are engaged in the same business as the registrant have greater financial resources, experience and are better known to the public than registrant,' may not provide meaningful disclosure unless accompanied by a brief explanation of the basis for such statements or the effect such conditions may have on the registrant."

The principal methods of competition (*e.g.*, price, service, warranty or product performance) should be identified and the positive and negative factors pertaining to the competitive position of the registrant, to the extent that they exist, should be explained if known or reasonably available to the registrant. Item 101(c)(1)(x), Regulation S-K.

Where the issuer has special knowledge of forthcoming events that will affect the industry or the issuer's position in the industry, a more definitive disclosure must be made. One Branch Chief in the Division of Corporation Finance gave this example: An issuer who manufactures Citizen's Band radios as its principal product learns through reliable industry channels that General Motors is seriously considering entering the C-B manufacturing business; the portent is something more than mere speculation and should be discussed under the "Competition" section. For a variety of reasons the issuer may be reluctant to make the effort of researching such information as the size of the industry, the major companies in that industry, the issuer's relative position, and any announcements or developments materially affecting the industry for inclusion in the prospectus. In this connection, counsel might suggest that the issuer examine current trade journals and materials available from such bodies as trade associations and governmental agencies.

Statements on the conservative side are in order in this section, for, generally speaking, the competition in nearly all industries is keen. Failure to disclose acute competition may form the basis of a stop order, *see, e.g., American Kid Co., 1 SEC 694, 699-700 (1936)* (registrant's statement that glazed kid industry is not affected by problems which confront independent tanner of cowhides, sheep leathers, and calfskins held misleading).

(n153)Footnote 153. The registrant should disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material. Item 101(c)(1)(xii), Regulation S-K. In 2010, the Commission issued guidance directing filers to consider addressing possible domestic and international climate change regulation, as well as the potential business impact of climate change, under Item 503(c). Sec. Act. Rel. Nos. 33-9106, 34-61469 (Feb. 2, 2010).

(n154)Footnote 154. *See* SEC Staff Accounting Bulletin No. 99 (August 12, 1999) for the staff's view that exclusive reliance on quantitative measures to assess materiality in financial statements is inappropriate.

(n155)Footnote 155. Item 101(d)(1), Regulation S-K.

(n156)Footnote 156. Item 101(d)(2), Regulation S-K.

(n157)Footnote 157. *See § 7.03[2][k][i][B] supra.*

(n158)Footnote 158. Item 101(d)(3), Regulation S-K. The registrant may discuss the questions of risks and segment dependency regarding foreign operations in connection with its discussion of disclosable industry segments pursuant to Item 101(c) of Regulation S-K if it is more practicable to do so.

(n159)Footnote 159. Item 101(d)(4), Regulation S-K.

(n160)Footnote 160. Instruction 2, Item 101, Regulation S-K.

(n161)Footnote 161. If such company hasn't been in business for three years, it should give the relevant information related to any predecessors of the company. Item 101(h), Regulation S-K.

(n162)Footnote 162. Item 101(h)(1)-(4), Regulation S-K.

(n163)Footnote 163. Item 101(h)(5), Regulation S-K.

(n164)Footnote 164. Item 101(h)(5), Regulation S-K.

(n165)Footnote 165. Item 101(h)(6), Regulation S-K; *see also § 7.03[2][k][G] supra.*

(n166)Footnote 166. The registrant should disclose information that will reasonably inform investors as to the suitability, adequacy, productive capacity, and extent of utilization of the facilities by the registrant. Instruction 1, Item 102, Regulation S-K.

In determining whether properties should be described, the registrant should be described, the registrant should consider the quantitative and qualitative factors listed in Instruction 1 to Item 101 of Regulation S-K, discussed in § 7.03[2][k][i][C] *supra*. Instruction 2, Item 102, Regulation S-K. Detailed description of the physical characteristics of individual properties or legal descriptions by metes and bounds are not required and should not be given. Instruction 1, Item 102, Regulation S-K.

(n167)Footnote 167. Instruction 3, Item 102, Regulation S-K.

(n168)Footnote 168. Instruction 3(A) and (B), Item 102, Regulation S-K.

(n169)Footnote 169. Instruction 5, Item 102, Regulation S-K

(n170)Footnote 170. *See Instructions 7-9, Item 102, Regulation S-K.*

(n171)Footnote 171. Instruction 4, Items 102, 1201(a), Regulation S-K. The new amendments modernize oil and gas disclosure requirements to reflect the significant changes in the industry and markets since the last regulations revisions in 1982.

(n172)Footnote 172. Item 1201(a), Regulation S-K.

(n173)Footnote 173. Items 1202(a)(1), (4), Regulation S-K.

(n174)Footnote 174. Item 1202(a)(2), Regulation S-K. A registrant need not provide disclosure of reserves in a country containing 15% or more of the registrant's proved reserves if doing so would violate the country's prohibition on the disclosure of reserves. Instruction 4, Item 1202(a)(2), Regulation S-K. "By geographic area" means by individual country, by groups of countries within a continent, or by continent, as appropriate for meaningful disclosure under the

circumstances. Item 1201(d), Regulation S-K. If an oil-barrel-equivalent basis is used, the basis for such equivalency must also be disclosed. Instruction 3, Item 1202(a)(2), Regulation S-K. Reported total reserves shall be a simple arithmetic sum of each reserve category. Item 1202(a)(3), Regulation S-K.

(n175)Footnote 175. Item 1202(a)(2)(i)-(iii), Regulation S-K. At year end, material changes in proved undeveloped reserves, including conversion or investments and progress towards conversion into proved developed reserves or reasons why material amounts of such reserves remain undeveloped five years of more after disclosure as proved undeveloped reserves, must be disclosed.

Item 1203, Regulation S-K. Question 105.01, Compliance and Disclosure Interpretation (C&DIs), Oil and Gas Rules.

(n176)Footnote 176. Item 1202(a)(2)(iv)-(vii), Regulation S-K. "Probable reserves" are those additional reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered. "Possible reserves" include those additional reserves that are less certain to be recovered than probable reserves. Article 4-10(a)(18),(19), Regulation S-X. An issuer can assign probable or possible reserves in an area in which it does not or cannot assign proved reserves, but should only do so in exceptional circumstances; for example, where the issuer awaits regulatory approval or production responses. Volumes that are not economically producible are not reserves of any classification and should not be disclosed. Question 117.02, C&DIs, Oil and Gas Rules.

(n177)Footnote 177. Item 1202(a)(5), Regulation S-K.

(n178)Footnote 178. Item 1202(a)(6), Regulation S-K. The particular properties do not need to be identified. *Id.*

(n179)Footnote 179. Item 1202(a)(7), Regulation S-K.

(n180)Footnote 180. Item 1202(a)(8), Regulation S-K.

(n181)Footnote 181. *Id.* "Reserves audit" means the process of reviewing certain of the pertinent facts interpreted and assumptions underlying a reserves estimate prepared by another party and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data relied upon, the depth and thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities. Item 1202(a)(9), Regulation S-K.

(n182)Footnote 182. Item 1202(b), Regulation S-K. The information specified may be presented in tabular format. *Id.*

(n183)Footnote 183. Instruction, Item 1202, Regulation S-K.

(n184)Footnote 184. Item 1204(a), Regulation S-K.

Generally, "net production" should include only production that is owned by the registrant and produced to its interest, less royalties and production due others; however, in special situations (*e.g.*, foreign production) net production before any royalties may be provided. If "net before royalty" production figures are furnished, the change from the usage of "net production" should be noted. Instruction 1, Item 1204(b), Regulation S-K.

Production of natural gas should include only marketable production of natural gas on an "as sold" basis, including dry, residue, wet, and synthetic gas, depending on whether liquids have been extracted before the registrant transfers title; flared gas, injected gas, and gas consumed in operations should not be included, and recovered gas-lift gas and reproduced gas should not be included until sold. Instruction 2, Item 1204(b), Regulation S-K.

(n185)Footnote 185. *Id.*

(n186)Footnote 186. Item 1204(b), Regulation S-K.

If any product, such as bitumen, is sold or custody is transferred prior to conversion to synthetic oil or gas, the product's production, transfer prices, and production costs should be disclosed separately from all other products. Instruction 3, Item 1204(b), Regulation S-K. The transfer price of oil and gas (natural and synthetic) and the average production cost, not including ad valorem and severance taxes, per unit of production, should be determined in accordance with SFAS 69. Instructions 4 and 5, Item 1204(b), Regulation S-K.

Units of production should be expressed in common units with oil, gas, and other products converted to a common unit of measure on the basis used in computing amortization. Instruction 5, Item 1204(b), Regulation S-K.

(n187)Footnote 187. Item 1205(a), Regulation S-K. A "dry well" is an exploratory, development, or extension well that proves to be incapable of producing either oil or gas in sufficient quantities to justify installation of permanent equipment for production as an oil or gas well; whereas a "productive well" is an exploratory, development, or extension well that is not a dry well. The "number of wells drilled" refers to the number of wells completed at any time during the fiscal year, regardless of when drilling was initiated. Item 1205(b), Regulation S-K.

(n188)Footnote 188. Item 1205(c), Regulation S-K.

(n189)Footnote 189. Item 1206(a), Regulation S-K. Include only those wells in the process of being drilled at the "as of" date and express them in terms of both gross and net wells; do not include wells that the registrant plans to drill, but has not commenced drilling unless there are factors that make such information material. Item 1206(c), (d), Regulation S-K.

(n190)Footnote 190. Item 1206(b), Regulation S-K.

(n191)Footnote 191. Item 1207(a), Regulation S-K. The information must be disclosed in a form understandable to investors and include, as based on the particular faces and circumstances: (i) disclosure by geographic area; (ii) significant supplies dedicated to the registrant; (iii) any significant reserves or supplies subject to priorities or curtailments which may affect quantities delivered to certain classes of customers, such as customers receiving services under low priority and interruptible contracts; (iv) any priority allocations or price limitations imposed by Federal or State regulatory agencies, as well as other factors beyond the registrant's control that may affect the registrant's ability to meet its contractual obligations (the registrant need not provide detailed discussions of price regulation); (v) any other factors beyond the registrant's control, such as other party control over drilling new wells, competition, and the availability of foreign reserves and supplies and (vi) any impact on the registrant's earnings and financing needs resulting from an inability to meet short-term or long-term contractual obligations. Item 1207(b). See Items 303 and 1209 of Regulation S-K (§§ 229.303 and 229.1209).

"Available reserves" are estimates of the amounts of oil and gas the registrant can produce from current proved developed reserves using presently installed equipment under existing economic and operating conditions and an estimate of amounts that others can deliver to the registrant under long-term contracts or agreements on a per-day, per-month, or per-year basis. Item 1207(d), Regulation S-K.

(n192)Footnote 192. 1207(c), Regulation S-K.

(n193)Footnote 193. "Net developed acreage" means acreage assignable to productive wells. Item 1208(a), Regulation S-K. A "gross" well or acre means a well or acre in which the registrant owns a working interest. The number of gross wells is the total number of wells in which the registrant owns a working interest. One or more completions in the same bore hole count as one well. The number of wells with multiple completions should be discussed in a footnote. If one of the multiple completions in a well is an oil completion, the well should be classified as an oil well. Item 1208(c)(1), Regulation S-K.

A "net" well or acre is deemed to exist when the sum of fractional ownership working interests in gross wells or acres equals one. The number of net wells or acres is the sum of the fractional working interests owned in gross wells or acres expressed as whole numbers and fractions of whole numbers. Item 1208(c)(2), Regulation S-K.

"Productive" wells include producing wells and wells mechanically capable of production. Item 1208(c)(3), Regulation S-K.

(n194)Footnote 194. Item 1208(b), Regulation S-K. "Undeveloped acreage" means those leased acres on which wells have not been drilled or completed to a point that would permit the production of economic quantities of oil or gas regardless of whether such acreage contains proved reserves. Undeveloped acreage is not un-drilled acreage held by production under the terms of the lease. Item 1208(c)(4), Regulation S-K.

(n195)Footnote 195. The definition of materiality is discussed in § 7.03[2][h][i] *supra*.

(n196)Footnote 196. The amounts of damage actions or claims, exclusive of interest and costs, not exceeding ten percent of the current assets of the registrant and its subsidiaries on a consolidated basis need not be described, unless the same issues are in large degree involved in other proceedings pending or known to be contemplated. In such a case, the amount involved in such other proceedings should be included in computing the required percentage of the current assets. Instruction 2, Item 103, Regulation S-K.

(n197)Footnote 197. Instruction 1, Item 103, Regulation S-K.

Notwithstanding Instructions 1 and 2 to Item 103 of Regulation S-K, any material bankruptcy, receivership, or similar proceeding involving the registrant or any of its significant subsidiaries must be described. Instruction 3, Item 103, Regulation S-K.

(n198)Footnote 198. Instruction 4, Item 103, Regulation S-K.

(n199)Footnote 199. Instruction 5(A)-(C), Item 103, Regulation S-K. In 2010, the Commission issued guidance directing filers to consider addressing possible domestic and international change regulation, as well as the potential business impact of climate change, under Item 503(c). Sec. Act. Rel. Nos. 33-9106, 34-61469 (Feb. 2, 2010).

Instruction 5(C) to Item 103 does not require that the potential fines in similar proceedings be aggregated to determine whether the \$100,000 threshold has been met. Since Instruction 5(C) concerns proceedings involving potential monetary sanctions, permits proceedings and requests for waivers and variances need not be disclosed.

For an interpretive release on the Commission's views regarding the scope of the definition of the term "proceeding," see Sec. Act Rel. No. 33-6130, Fed. Sec. L. Rep. (CCH) P 23,507B (1979).

Since its inception, the Commission has considered one of its basic tasks to be to require public disclosure of all *financial* information having a material bearing on an investor's decision to buy or sell securities. In the 1970's, however, there was increased public concentration on environmental and social matters. It was only natural, then, that the question would arise whether the Commission should broaden its disclosure requirements to include such matters in registration statements, reports, and other documents filed or furnished to investors pursuant to the federal securities laws. A 1971 release constituted the first official Commission statement dealing with these matters. See Sec. Act Rel. No. 33-5170, Fed. Sec. L. Rep. (CCH) P 78,150 (1971).

In proposing amendments to former Item 5 of Regulation S-K (current Item 103 of Regulation S-K), the Commission issued its views as to the quality and utility of disclosure of environmental proceedings reflecting its experience in administering its prior disclosure policies. Sec. Act Rel. No. 33-6315, Fed. Sec. L. Rep. (CCH) P 82,867 (1981).

(n200)Footnote 200. *Charles A. Howard*, 1 SEC 6, 9 (1934) .

(n201)Footnote 201. *Oklahoma-Texas Trust v. SEC*, 100 F.2d 888 (10th Cir., 1939) ; *Potrero Sugar Co.*, 5 SEC 982 (1939) .

(n202)Footnote 202. Instruction 9, Item 201(d), Regulation S-K. Essentially, the new disclosure relates to compensation plans (including individual compensation arrangements) under which equity securities are authorized for issuance. For purposes of Item 201(d), Regulation S-K, an "individual compensation arrangement" includes, but is not limited to, the following: a written compensation contract within the meaning of "employee benefit plan" under § 230.405 and a plan (whether or not set forth in any formal document) applicable to one person as provided under Item 402(a)(6)(ii) of Regulation S-K. *See* Instruction 2, Item 201(d), Regulation S-K.

Item 201 requires the registrant to disclose the following information in tabular format for both equity compensation plans previously approved by security holders and those not previously approved by security holders: (i) the number of securities to be issued upon the exercise of outstanding options, warrants and rights (column (a)); (ii) the weighted-average exercise price of the outstanding options, warrants and rights (column (b)); and (iii) the number of remaining securities available for issuance under the plans, other than those securities to be issued upon the exercise of the outstanding options, warrants and rights offered (column (c)). To the extent that the number disclosed in column (c) includes securities available for issuance under any compensation plan or individual compensation arrangement other than upon the exercise of an option, warrant or right, then the registrant should disclose, in a footnote to the table, the number of securities and type of plan separately for each such plan. *See* Instruction 6, Item 201(d), Regulation S-K.

If an equity compensation plan contains a formula for calculating the number of securities available for issuance under the plan, including without limitation, a formula that automatically increases the number of securities available for issuance by a percentage of the number of outstanding securities of the registrant, the registrant must disclose a description of this formula in a footnote to the table. *See* Instruction 8, Item 201(d), Regulation S-K.

The registrant must disclose the information for each category of equity compensation plan described. *See* Item 201(d)(1)-(2), Regulation S-K. The registrant must provide this disclosure with respect to any compensation plan and individual compensation arrangement of the registrant (or parent, subsidiary or affiliate of the registrant) under which equity securities of the registrant are authorized for issuance to employees or non-employees (such as directors, consultants, advisors, vendors, customers, suppliers or lenders) in exchange for consideration in the form of goods or services as described in Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, or any successor standard. However, the registrant does not have to provide any disclosure with respect to: (a) any plan, contract or arrangement for the issuance of warrants or rights to all security holders of the registrant as such on a pro rata basis (such as a stock rights offering) or (b) any employee benefit plan that is intended to meet the qualification requirements of § 401(a) of the Internal Revenue Code (26 U.S.C. 401(a)). *See* Instruction 1, Item 201(d), Regulation S-K.

If more than one class of equity securities is being issued under the plan, then the plan information should be aggregated for each class of securities. *See* Instruction 3, Item 201(d), Regulation S-K. The registrant may, but is not required to, aggregate the following information with the disclosure required with respect to the plan information noted above: (i) individual compensation arrangements; and (ii) compensation plans assumed in connection with a merger, consolidation or other acquisition transaction pursuant to which the registrant may make subsequent grants or awards of its equity securities. However, with respect to any individual options, warrants or rights assumed in connection with a merger, consolidation or other acquisition transaction, the registrant must disclose in a footnote to the table, the number of securities to be issued upon the exercise of the outstanding options, warrants and rights as well as the weighted average exercise price of the outstanding options, warrants and rights. *See* Instructions 4-5, Item 201(d), Regulation S-K.

The registrant must also briefly describe, in narrative form, the material features of each compensation plan that was adopted without the approval of security holders. *See* Item 201(d)(3), Regulation S-K. However, if the financial statements contains the disclosure required in the preceding sentence, then the registrant may satisfy its requirements under Item 201 by providing a cross-reference to the financial statements. *See* Instruction 7, Item 201(d), Regulation S-K.

(n203)Footnote 203. Instruction 7, Item 201(e), Regulation S-K. The performance graph is only required in certain annual report filings under the Exchange Act and therefore is not discussed in detail herein. *Id.* The performance graph provides information on the yearly percentage change in a registrant's cumulative total shareholder return on a class of common stock registered under Section 12 of the Exchange Act. Item 201(e)(1), Regulation S-K. A registrant that qualifies as a smaller reporting company is not required to provide the performance graph. Instruction 6, Item 201(e), Regulation S-K. Incidentally, prior to the enactment of the 2006 Executive Compensation Rules, the performance graph was required as part of the executive compensation disclosure under Item 402 of Regulation S-K. However, the Commission intended the disclosure under the Compensation Discussion and Analysis of Item 402(b) to encourage broader discussion than just the relationship of executive compensation to the performance of the company's stock price. Accordingly, the Commission removed the performance graph from the disclosure requirements under the executive compensation section and moved such requirement to Item 201(e). *See* Sec. Act Rel. No. 33-8732..

(n204)Footnote 204. Where there is no established public trading market for a class of common equity securities, the registrant should so state. The existence of limited or sporadic quotations should not of itself be deemed to constitute an "established public trading market." Item 201(a)(1)(i), Regulation S-K.

In the case of foreign registrants, there should also be disclosed, in addition to the name of the principal United States market, the identity of the principal established foreign public trading market, if any, for each class of the registrant's common equity securities. *Id.*

If the common equity of a registrant is listed for trading on more than one registered securities exchange, the registrant should identify each exchange. Instruction 1, Item 201, Regulation S-K.

(n205)Footnote 205. *See* Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 2.04[2][d] (Matthew Bender) for discussion of the consolidated reporting system. *See also* Sec. Exch. Act Rel. No. 34-15250, 1978 SEC LEXIS 488 (October 20, 1978)

(n206)Footnote 206. Item 201(a)(1)(ii), Regulation S-K.

If the common equity securities of a registrant are listed for trading on more than one registered securities exchange, the registrant should only report one set of price quotations. Where the prices are not reported in the consolidated transaction reporting system, the registrant should report prices on the most significant (in terms of volume) securities exchange for those shares. Instruction 1, Item 201, Regulation S-K.

(n207)Footnote 207. *See* Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 2.01[2] (Matthew Bender) for discussion of trading in the over-the-counter market.

(n208)Footnote 208. Item 201(a)(iii), Regulation S-K.

The registrant should indicate where applicable, that the over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions. *Id.* Where there is no established public trading market, reference to quotations should be qualified by appropriate explanation. *Id.*

(n209)Footnote 209. Item 201(a)(1)(iv), Regulation S-K. The market prices required by Item 201(a)(1)(iv) should be stated in the currency in which they are quoted with a translation of those prices into United States currency at the

exchange rate in effect on the date the disclosed price was reported on the foreign exchange. If the primary United States market for the registrant's common equity securities trades using American Depositary Receipts, the United States prices disclosed should be on that basis. *Id.*

(n210)Footnote 210. Item 201(a)(1)(v), Regulation S-K.

(n211)Footnote 211. Instruction 2, Item 201, Regulation S-K.

(n212)Footnote 212. *See* § 6.05 *supra* for discussion of the requirements of Securities Act Rule 144.

(n213)Footnote 213. Item 201(a)(2)(i)-(iii), Regulation S-K.

Market information for a registrant's noncommon equity is required under Item 202(e) of Regulation S-K, discussed in § 7.03[2][i][v] *supra*.

(n214)Footnote 214. Item 201(b)(1), Regulation S-K. If the registrant is a foreign private issuer whose common equity is wholly or partially in bearer form, the registrant should provide as much information as possible with respect to security holdings in the United States. If the securities being registered trade in the United States in the form of American Depositary Receipts or similar certificates, the registrant should so indicate together with the name of the depository and the number of shares or other units of the underlying security representing the trading units in such receipts. Instruction 5, Item 201, Regulation S-K.

(n215)Footnote 215. Item 201(b)(2)(i)-(iii), Regulation S-K. The registrants' present commitments to the more than five percent beneficial owners, directors, director-nominees and officers as to the issuance of shares of any class of its common equity securities should be disclosed. *Id.*

In computing the approximate number of holders of the registrants' common equity securities, the registrant may rely upon the number of record holders, or may consider individual participation in security position listings pursuant to Rule 17Ad-8 of the Exchange Act (Securities position listings). The method of computation that is chosen should be indicated. Instruction 3, Item 201, Regulation S-K.

Item 201(b) of Regulation S-K reflects the provision for disclosure of stockholder information under former Item 9 of Regulation S-K except that Item 201(b)(2) requires disclosure of the effect of an acquisition, business combination, or other reorganization on the status of current holdings of the registrants' common equity securities and on the registrants' ability to issue shares of common equity securities.

(n216)Footnote 216. Item 201(c)(1), Regulation S-K.

(n217)Footnote 217. For discussion of the disclosure requirements of Item 303 of Regulation S-K, "Management's discussion and analysis of financial condition and results of operations," *see* § 7.03[2][k][viii] *infra*.

(n218)Footnote 218. Item 201(c)(1), Regulation S-K.

(n219)Footnote 219. Item 201(c)(2), Regulation S-K.

(n220)Footnote 220. Instruction 4(A), (B), Item 201, Regulation S-K. In addition, the registrant should briefly describe the applicable provisions of any reciprocal tax treaty between the foreign country in which the registrant is organized and the United States regarding withholding. If no such treaty exists, the registrant should so state. Instruction 4(B), Item 201, Regulation S-K.

(n221)Footnote 221. The Commission established a centralized set of instructions as to financial statements in Article 3 of Regulation S-X entitled "General Instructions as to Financial Statements," *see* Sec. Act Rel. No. 33-6234,

Fed. Sec. L. Rep. (CCH) P 72,303 (1980).

For discussion of Regulation S-X, *see* Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4A.02[2][a] (Matthew Bender).

(n222)Footnote 222. *See* § 7.03[3][d] *infra* for discussion of the disclosure requirements of Item 16 of Form S-1 concerning exhibits and financial statements.

(n223)Footnote 223. Item 11(e), Form S-1.

(n224)Footnote 224. Instruction 7, Item 201(e), Regulation S-K.

(n225)Footnote 225. Item 301(c), Regulation S-K.

(n226)Footnote 226. Item 301(a), (b), Regulation S-K. The purpose of the selected financial data is to supply in a convenient and readable format selected financial data that highlight certain significant trends in the registrant's financial condition and results of operations. Instruction 1, Item 301, Regulation S-K.

(n227)Footnote 227. Instruction 2, Item 301, Regulation S-K.

The items required to be included in the table of financial data are subject to variation in order to conform to the nature of the registrant's business. In addition, the registrant may include within the financial data table additional items that it believes would enhance an understanding of, and would highlight other trends in, its financial condition and results of operations. *Id.*

(n228)Footnote 228. *Id.*

All references to the registrant in the table of selected financial data and in Item 301 of Regulation S-K mean the registrant and its consolidated subsidiaries. Instruction 3, Item 301, Regulation S-K.

(n229)Footnote 229. Instruction 4, Item 301, Regulation S-K.

Rule 472(c) governs amendments of financial statements.

(n230)Footnote 230. *See* Instruction 5, Item 301, Regulation S-K. A foreign private issuer must present the selected financial data in the same currency as its financial statements. The registrant may present the selected financial data on the basis of the accounting principles used in its primary financial statements but in such case must present the data also on the basis of any reconciliation of such data to United States generally accepted accounting principles and Regulation S-X made pursuant to Rule 4-01 of Regulation S-X. *See* Instruction 6, Item 301, Regulation S-K.

For purposes of Item 301 of Regulation S-K, the rate of exchange means the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York. The average rate means the average of the exchange rates on the last day of each month during a year. *See* Instruction 7, Item 301, Regulation S-K.

(n231)Footnote 231. Item 302(c), Regulation S-K.

(n232)Footnote 232. Gross profit is net sales minus costs and expenses directly associated with, or allocated to, products sold or services rendered. Item 302(a)(1), Regulation S-K.

(n233)Footnote 233. Item 302(a)(1), Regulation S-K. If the data given pursuant to Item 302(a)(1) vary from the amounts previously reported on the Exchange Act' Form 10-Q or Form 10-QSB, discussed in Federal Securities

Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02[2] (Matthew Bender), filed for any quarter, as would be the case when a pooling of interests occurs or where an error is corrected, the registrant should reconcile the amounts given in response to Item 302(a)(1) of Regulation S-K with those previously reported on the Exchange Act' Form 10-Q or Form 10-QSB, giving the reason for the difference. Item 302(a)(2), Regulation S-K.

(n234)Footnote 234. Item 302(a)(1), Regulation S-K.

(n235)Footnote 235. Item 302(a)(3), Regulation S-K. If the financial statements to which the information furnished in response to Item 302(a) relates are reported upon by an accountant, appropriate professional standards and procedures as specified in the Statements of Auditing Standards issued by the Auditing Standards Board of the American Institute of Certified Public Accountants should be followed by the reporting accountant with regard to the selected quarterly financial data required by Item 302(a). Item 302(a)(4), Regulation S-K.

(n236)Footnote 236. *See* Item 302(a)(5), Regulation S-K. Section 12(b) of the Exchange Act requires registration with the Commission of any security listed for trading on a national securities exchange. Section 12(g) of the Exchange Act requires registration with the Commission of any equity security traded in the over-the-counter market if the issuer has total assets in excess of \$10 million that are held of record by 500 or more persons.

(n237)Footnote 237. Item 302(b), Regulation S-K.

SFAS No. 69 disclosures that relate to annual periods shall be presented for each annual period for which an income statement is required. SFAS No. 69 disclosures required as of the end of an annual period shall be presented as of the date of each audited balance sheet required. SFAS No. 69 disclosures required as of the beginning of an annual period shall be presented as of the beginning of each annual period for which an income statement is required. *See* Instruction 1, Item 302, Regulation S-K.

This paragraph, together with Rule 4-10 of Regulation S-X, prescribes financial reporting standards for the preparation of accounts by persons engaged, in whole or in part, in the production of crude oil or natural gas in the United States, pursuant to Section 503 of the Energy Policy and Conservation Act of 1975 ("EPCA") and Section 11(c) of the Energy Supply and Environmental Coordination Act of 1974 ("ESECA") as amended by Section 506 of EPCA. The application of the paragraph to those oil and gas producing operations of companies regulated for ratemaking purposes on an individual company cost-of-service basis may, however, give appropriate recognition to differences arising because of the effect of the ratemaking process. *See* Instruction 2, Item 302, Regulation S-K.

Any person exempted by the Department of Energy from any record-keeping or reporting requirements pursuant to Section 11(c) of ESECA, as amended, is similarly exempted from the related provisions of this paragraph in the preparation of accounts pursuant to EPCA. This exemption does not affect the applicability of this paragraph to filings pursuant to the federal securities laws. *See* Instruction 3, Item 302, Regulation S-K.

(n238)Footnote 238. The Commission has issued several interpretive releases regarding the disclosure required by Item 303 of Regulation S-K. *See, e.g.,* Sec. Act Rel. Nos. 33-8350 (Dec. 19, 2003) , 33-8182 (Jan. 28, 2003), 33-8056 (Jan. 22, 2002), 33-7558 (July 29, 1998), and 33-6835 (May 18, 1989). The flexible nature of Item 303 requires disclosures that keep pace with the evolving nature of business trends. For example, in 2010, the Commission issued guidance directing filers to consider addressing possible domestic and international climate change regulation, as well as the potential business impact of climate change, under Item 303. Sec. Act. Rel. Nos. 33-9106, 34-61469 (Feb. 2, 2010).

(n239)Footnote 239. Instruction 1, Item 303(a), Regulation S-K. All references to the registrant in the discussion mean the registrant and its subsidiaries on a consolidated basis. Instruction 10, Item 303(a), Regulation S-K.

(n240)Footnote 240. Instruction 2, Item 303(a), Regulation S-K.

(n241)Footnote 241. Instruction 3, Item 303(a), Regulation S-K.

(n242)Footnote 242. Item 303(a), Regulation S-K.

(n243)Footnote 243. Instruction 1, Item 303(a), Regulation S-K.

If, however, trend information is relevant, the registrant may be required to refer to the five-year selected financial data presented pursuant to Item 301 of Regulation S-K, discussed in § 7.03[2][k][vi] *supra*.

The causes for any material changes from year to year in any line items of the consolidated financial statements should be described to the extent necessary to an understanding of the registrant's businesses as a whole. If the causes for a change in one line item also relate to other line items, however, no repetition is required and a line-by-line analysis of the financial statements as a whole is not required. Registrants do not need to recite the amounts of changes from year to year which are readily computable from the financial statements, and the discussion should not merely repeat numerical data contained in the consolidated financial statements. Instruction 4, Item 303(a), Regulation S-K.

(n244)Footnote 244. Instruction 1, Item 303(a), Regulation S-K.

(n245)Footnote 245. "Liquidity" is defined for the purposes of Item 303 as the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's need for cash. Instruction 5, Item 303(a), Regulation S-K.

The discussion of liquidity may be combined with that of capital resources whenever the two topics are interrelated. Item 303(a), Regulation S-K.

(n246)Footnote 246. Item 303(a)(1), Regulation S-K.

(n247)Footnote 247. Instruction 5, Item 303(a), Regulation S-K.

(n248)Footnote 248. *Id.*

(n249)Footnote 249. Item 303(a)(1), Regulation S-K.

(n250)Footnote 250. *Id.*

If the financial statements are required to disclose restrictions on the ability of subsidiaries, consolidated or unconsolidated, to transfer cash dividends, loans or advances to the registrant pursuant to Rule 4-08(e)(3) under Regulation S-X, the registrant must also discuss the nature and extent of the restrictions and the effect the restrictions have and are expected to have on the ability of the parent company to meet its cash obligations. Instruction 6, Item 303(a), Regulation S-K.

(n251)Footnote 251. The discussion of capital resources may be combined with that of liquidity whenever the two topics are interrelated. Item 303(a), Regulation S-K.

(n252)Footnote 252. Item 303(a)(2)(i), Regulation S-K.

(n253)Footnote 253. Item 303(a)(2)(ii), Regulation S-K.

(n254)Footnote 254. *Id.*

(n255)Footnote 255. Item 303(a)(3), Regulation S-K.

Registrants are only required to discuss the effects of inflation and other changes in prices when considered material. The discussion may be made in any appropriate manner. All that is required is a brief textual presentation of

management's views. Specific numerical data need not be presented except as required by Rule 3-20(c) of Regulation S-X. However, registrants may elect to voluntarily disclose supplemental information on the effects of changing prices either as provided for in SFAS No. 89 or through other supplemental disclosures. The Commission encourages experimentation with such disclosures in order to provide meaningful presentation in financial statements of the impact of price changes. Instruction 8 to Item 303(a) of Regulation S-K.

Registrants that elect to disclose supplementary information on the effects of changing prices as specified by SFAS No. 89, "Financial Reporting and Changing Prices," may combine those explanations with the discussion and analysis required by Item 302(a) of Regulation S-K, or may supply such information separately with appropriate cross reference. Instruction 9, Item 303(a), Regulation S-K.

(n256)Footnote 256. See Rule 175 under the Securities Act, Rule 3b-6 under the Exchange Act and Sec. Act Rel. No. 6084. Instruction 7, Item 303(a), Regulation S-K.

(n257)Footnote 257. Item 303(a), Regulation S-K.

Foreign private registrants also shall discuss briefly any pertinent governmental economic, fiscal, monetary, or political policies or factors that have materially affected or could materially affect, directly or indirectly, their operations or investments by United States nationals. See Instruction 11, Item 303(a), Regulation S-K.

Foreign private issuers must also focus on the primary financial statements presented in the registration statement or report. There shall be a reference to the reconciliation to U.S. GAAP, and a discussion of any aspects of the difference between foreign and U.S. GAAP, not discussed in the reconciliation, that the registrant believes is necessary for an understanding of the financial statements as a whole. See Instruction 12, Item 303(a), Regulation S-K.

(n258)Footnote 258. The term "off-balance sheet arrangement" is defined as any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party and under which the registrant has:

- (a) any obligation under a guarantee contract that has any of the characteristics identified in paragraph 3 of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (November 2002);
- (b) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support for such assets;
- (c) any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the registrant's own stock and classified in stockholders' equity in the registrant's statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (June 1998); or
- (d) any obligation, including a contingent obligation, arising out of a variable interest (as referenced in FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (January 2003), as may be modified or supplemented) in an unconsolidated entity that is held by, and is material to, the registrant, where such entity provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant.

Item 303(a)(4)(ii). For purposes of Item 303(a)(4), contingent liabilities arising out of litigation, arbitration or regulatory actions are not considered to be off-balance sheet arrangements. Instruction 3, Item 303(a)(4), Regulation

S-K.

(n259)Footnote 259. The registrant should aggregate off-balance sheet arrangements in groups or categories that provide material information in an efficient and understandable manner and should avoid repetition and disclosure of immaterial information. The registrant must analyze in the aggregate effects that are common to or similar between a number of off-balance sheet arrangements, to the extent the aggregation increases understanding. To the extent material, distinctions in arrangements and their effects must be discussed, but the discussion should avoid repetition and disclosure of immaterial information. Instruction 2, Item 303(a)(4), Regulation S-K.

(n260)Footnote 260. Instruction 1, Item 303(a)(4), Regulation S-K. Generally, the disclosure should cover the most recent fiscal year. However, where discussion is necessary to an understanding of the disclosure, such discussion should address changes from the previous year. Instruction 4, Item 303(a)(4), Regulation S-K.

(n261)Footnote 261. Instruction 5, Item 303(a)(4), Regulation S-K.

(n262)Footnote 262. Item 303(a)(5).

(n263)Footnote 263. Item 303(d), Regulation S-K.

(n264)Footnote 264. In preparing the interim period discussion, the registrant may presume that users of the interim period financial information have access to the discussion of full fiscal year financial information required by Item 303(a) of Regulation S-K for the preceding fiscal year, discussed in § 7.03[3][k][viii][A] *supra*. Instruction 2, Item 330(b), Regulation S-K. If interim financial statements are presented together with financial statements for full fiscal years, the required discussions of those financial statements under Item 303 of Regulation S-K may be combined. Instruction 1, Item 303(b), Regulation S-K.

(n265)Footnote 265. Instruction 5, Item 303(b), Regulation S-K.

(n266)Footnote 266. Item 303(b)(1), Regulation S-K.

(n267)Footnote 267. *Id.*

Discussion of material changes in financial condition may be combined if required from both the end and the corresponding interim date of the preceding fiscal year. *Id.* The discussion should not merely repeat numerical data contained in the financial statements. Instruction 3, Item 303(b), Regulation S-K.

(n268)Footnote 268. Instruction 4, Item 303(b), Regulation S-K.

(n269)Footnote 269. Item 303(b)(2), Regulation S-K.

(n270)Footnote 270. *Id.*

(n271)Footnote 271. *Id.* See Sec. Act Rel. No. 33-6835 (May 18, 1989) and *In re Caterpillar Inc.*, Exch. Act Rel. 333-0532 (March 31, 1992).

(n272)Footnote 272. Item 303(c), Regulation S-K. For purposes of Item 303(c), all information required in Item 303(a)(4) and 303(a)(5) is deemed to be a forward-looking statement as defined in the statutory safe harbors, except for historical facts. If the requirements of Item 303(a)(4) are met, the meaningful cautionary statements element of the statutory safe harbors is satisfied. Item 303(c)(2), Regulation S-K.

(n273)Footnote 273. Instruction 6, Item 303(b), Regulation S-K.

The Commission has undertaken enforcement activities against registrants who do not comply with the disclosure

requirements of Item 303 of S-K. *See, e.g.,* In the Matter of Caterpillar, Inc., Exch. Act Rel. No. 34-30532 (March 31, 1992). In *Caterpillar*, the Commission pursued an administrative proceeding to enforce deficiencies in Caterpillar's disclosure in public filings required under the Exchange Act of known uncertainties under Item 303 of Regulation S-K. *Id.* The action was settled by Caterpillar and the Commission ordered Caterpillar to cease and desist from committing or causing any violation or future violation of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated under the Exchange Act and ordered Caterpillar to implement and maintain procedures to ensure compliance with Item 303 of Regulation S-K.

(n274)Footnote 274. Item 304(a)(1)(i)-(iv), Regulation S-K. In the event that there has been a disagreement of the kind referred to in paragraph (4), the registrant must:

- (1) describe each such disagreement;
- (2) state whether any audit or similar committee of the board of directors, or the board of directors, discussed the subject matter of any of such disagreements with the former accountant; and
- (3) state whether the registrant has authorized the former accountant to respond fully to the inquiries of the successor accountant concerning the subject matter of any of such disagreements and, if not, the nature of and reason for any limitation on such authorization. Item 304(a)(1)(iv). Regulation S-K.

Disagreements required to be reported in response to Item 304(a)(1)(iv) of Regulation S-K include both those resolved to the former accountant's satisfaction and those not so resolved and mean those that occur at the decision-making level, i.e. between personnel of the registrant responsible for presentation of the financial statements and personnel of the accounting firm responsible for rendering the report. *Id.*

The term "disagreement" as used in Item 304 of Regulation S-K is to be interpreted broadly so as to include any difference of opinion concerning any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to the satisfaction of the former accountant, would have caused such accountant to make reference to the subject matter of the disagreement in connection with the report. Accordingly, it is not necessary for there to have been an argument or formal disagreement; merely a difference of opinion requires disclosure. Instruction 4, Item 304, Regulation S-K. Disclosure is not required, however, of initial differences of opinion based on incomplete facts or preliminary information which were later resolved to the former accountant's satisfaction by obtaining additional relevant facts or information, provided that the registrant and the accountant did not continue to have a difference of opinion with respect to the matter resolved. *Id.* In determining whether any "disagreement" or "reportable event" (as those terms are used in Item 304(a)(1)(iv) and (v)) has occurred, an oral communication from the engagement partner or another person responsible for rendering the accounting firm's opinion (including their designee) will generally suffice as an indication that the accountant has advised the registrant of a "reportable event" or that there has been a "disagreement" at the "decision-making level" as those terms are used in Item 304. Instruction 5, Item 304, Regulation S-K.

(n275)Footnote 275. *See* n.251 *supra* for additional discussion of the use of the term "reportable event" in Item 304 of Regulation S-K.

(n276)Footnote 276. Item 304(a)(1)(v)(A)-(D), Regulation S-K.

(n277)Footnote 277. Item 304(a)(1)(v), Regulation S-K.

(n278)Footnote 278. Item 304(a)(2), Regulation S-K.

(n279)Footnote 279. Item 304(a)(2)(D), Regulation S-K.

(n280)Footnote 280. Item 304(a)(3), Regulation S-K.

The disclosure called for by Item 304(a) of Regulation S-K need not be provided if it has previously been reported in or filed with a statement under Section 12, a report under Section 13 or 15(d), or a definitive proxy or information statement under Section 14 of the Exchange Act, or a registration statement under the Securities Act. The disclosure must be provided, however, notwithstanding prior disclosure, if required pursuant to Item 9 of Schedule 14A. Instruction 1, Item 304, Regulation S-K.

When disclosure is required by Item 304(a) of Regulation S-K in an annual report to security holders pursuant to Rule 14a-3 or Rule 14c-3 or in a proxy or information statement filed pursuant to the requirements of Schedule 14A or 14C under the Exchange Act, then instead of the letters from the newly engaged accountant and the former accountant which are required by paragraphs (a)(2)(D) and (a)(3) of Item 304, the registrant shall furnish, prior to filing with or furnishing such material to the Commission, the disclosure required by Item 304(a) to any former accountant engaged by the registrant during the two preceding fiscal years and any subsequent interim period as well as to the newly engaged accountant. If any such accountant believes that the statements made by the registrant in response to the provisions of Item 304(a) are incorrect or incomplete, it may present its views in a brief statement, ordinarily not expected to exceed 200 words, to be included in the annual report or proxy or information statement. The accountant's statement must be submitted to the registrant within ten business days of the date that the accountant receives the registrant's disclosure. Instruction 2, Item 304, Regulation S-K.

Unless the written views of the newly engaged accountant required to be filed as an exhibit by paragraph (a)(2)(B) of Item 304 have been previously filed with the Commission, the registrant shall file a Form 8-K concurrently with the annual report or proxy or information statement for the purpose of filing such written views as an exhibit to such Form 8-K. *Id.*

The information required by Item 304(a) need not be provided for a company being acquired by the registrant if such company is not subject to the filing requirements of either Section 13(a) or 15(d) of the Exchange Act, or which, because of Section 12(i) of the Exchange Act, has not filed an annual report to security holders pursuant to Rule 14a-3 or Rule 14c-3 for its latest fiscal year. Instruction 3, Item 304, Regulation S-K.

For a discussion of the periodic reporting requirements and the requirements relating to the filing of proxy and information statements, *see generally* Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, chs. 4 and 7 (Matthew Bender).

(n281)Footnote 281. Item 304(b), Regulation S-K. These disclosures need not be made if the method asserted by the former accountants ceases to be generally accepted because of authoritative standards or interpretations subsequently issued. *Id.* the disclosure called for by of Item 304(b) must be furnished, where required, notwithstanding any prior disclosure about accountant changes or disagreements. Instruction 1, Item 304, Regulation S-K.

(n282)Footnote 282. Small business issuers, as defined in Rule 405 under the Securities Act, need not provide the information required by Item 305, whether or not such issuers file on Forms SB-1 or SB-2. Item 305(e), Regulation S-K.

(n283)Footnote 283. Sec. Act Rel. No. 33-7386 (1997).

(n284)Footnote 284. General Instruction 1, Items 305(a) and 305(b), Regulation S-K.

(n285)Footnote 285. General Instruction 3A, Items 305(a) and 305(b), Regulation S-K.

(n286)Footnote 286. General Instruction 3B, Items 305(a) and 305(b), Regulation S-K. "Other financial instruments" includes, but is not limited to, trade accounts receivable, investments, loans, structured notes,

mortgage-backed securities, trade accounts payable, indexed debt instruments, interest-only and principal-only obligations, deposits and other debt obligations. "Other financial instruments" excludes employer and plan obligations for pension and other post-retirement benefits, substantively extinguished debt, insurance contracts, lease contracts, warranty obligations and rights, unconditional purchase obligations, investments accounted for under the equity method, noncontrolling interests in consolidated enterprises and equity instruments issued by the registrant and classified in stockholders' equity in the statement of financial position. For purposes of this item, trade accounts receivable and trade accounts payable need not be considered "other financial instruments" when their carrying amounts approximate fair value. General Instruction 3C, Items 305(a) and 305(b), Regulation S-K.

(n287)Footnote 287. General Instruction 3D, Items 305(a) and 305(b), Regulation S-K

(n288)Footnote 288. General Instruction 4(A), Items 305(a) and 305(b), Regulation S-K.

(n289)Footnote 289. "Anticipated transactions" means transactions (other than transactions involving existing assets or liabilities or transactions necessitated by existing firm commitments) an enterprise expects, but is not obligated, to carry out in the normal course of business. General Instruction 7, Items 305(a) and 305(b), Regulation S-K.

(n290)Footnote 290. General Instruction 4(A), Items 305(a) and 305(b), Regulation S-K.

(n291)Footnote 291. General Instruction 4(C), Items 305(a) and 305(b), Regulation S-K.

(n292)Footnote 292. General Instruction 6, Items 305(a) and 305(b), Regulation S-K.

(n293)Footnote 293. "Trading purposes" has the same meaning as defined by generally accepted accounting principles. General Instruction 7, Items 305(a) and 305(b), Regulation S-K.

(n294)Footnote 294. Item 305(a)(1), Regulation S-K.

For each market risk exposure category within the trading and other than trading portfolios, registrants may report the average, high and low sensitivity analysis or value at risk amounts for the reporting period (at least four equal time periods), as an alternative to reporting year-end amounts. Registrants using this approach are encouraged, but not required, to provide quantitative amounts that reflect the aggregate market risk inherent in the trading and other than trading portfolios. Instruction 1, Item 305(a), Regulation S-K.

(n295)Footnote 295. Item 305(a)(1), Regulation S-K.

(n296)Footnote 296. Item 305(a)(1)(i)(A)(1), Regulation S-K.

The Appendix, Item 305 contains a suggested format for presentation of this information. Item 305(a)(1)(i)(A)(4), Regulation S-K.

(n297)Footnote 297. Examples of contract terms sufficient to determine future cash flows from market risk sensitive instruments include, but are not limited to:

- (1) Debt instruments--principal amounts and weighted average effective interest rates;
- (2) Forwards and futures--contract amounts and weighted average settlement prices;
- (3) Options--contract amounts and weighted average strike prices;
- (4) Swaps--notional amounts, weighted average pay rates or prices and weighted average receive rates and prices; and

(5) Complex instruments--likely to be a combination of above contract terms.

Instruction 2(A), Item 305(a), Regulation S-K.

(n298)Footnote 298. Item 305(a)(1)(i)(1)-(2), Regulation S-K.

(n299)Footnote 299. Item 305(a)(1)(i)(3), Regulation S-K.

(n300)Footnote 300. Instruction 2(B), Item 305(a), Regulation S-K.

(n301)Footnote 301. Instruction 2(C), Item 305(a), Regulation S-K.

(n302)Footnote 302. Instruction 2(D), Item 305(a), Regulation S-K.

(n303)Footnote 303. Instruction 2(E), Item 305(a), Regulation S-K.

(n304)Footnote 304. Instruction 2(F), Item 305(a), Regulation S-K.

(n305)Footnote 305. Item 305(a)(1)(ii)(A).

(n306)Footnote 306. Item 305(a)(1)(ii)(A)-(B), Regulation S-K.

(n307)Footnote 307. Instruction 3(A)-(C), Item 305(a), Regulation S-K.

(n308)Footnote 308. Instruction 3(D), Item 305(a), Regulation S-K.

(n309)Footnote 309. Instruction 3(E), Item 305(a), Regulation S-K.

(n310)Footnote 310. Instruction 3(F), Item 305(a), Regulation S-K.

(n311)Footnote 311. Item 305(a)(1)(iii)(A).

(n312)Footnote 312. Item 305(a)(1)(iii)(B)(1), Regulation S-K.

This information is not required for the first fiscal year end in which a registrant must present Item 305 information. Item 305(a)(1)(iii)(B)(2), Regulation S-K.

(n313)Footnote 313. Item 305(a)(1)(iii)(C), Regulation S-K.

(n314)Footnote 314. Instruction 4(A), Item 305(a), Regulation S-K.

The term "near-term" means a period of time going forward up to one year from the date of the financial statements. Instruction 4(C), Item 305(a), Regulation S-K.

(n315)Footnote 315. Instruction 4(D), Item 305(a), Regulation S-K.

(n316)Footnote 316. Instruction 4(E), Item 305(a), Regulation S-K.

(n317)Footnote 317. General Instruction 4(B), Items 305(a) and 305(b), Regulation S-K.

(n318)Footnote 318. Registrants generally should not net fair values, except to the extent allowed under generally accepted accounting principles. General Instruction 5(C), Items 305(a) and 305(b), Regulation S-K.

(n319)Footnote 319. Registrants should consider, among other things, the magnitude of past market movements, reasonably possible, near-term market movements and potential losses that may arise from leverage, option and multiplier features. The term "near-term" means a period of time going forward up to one year from the date of the financial statements. The term "reasonably possible" has the same meaning as defined by generally accepted accounting principles. General Instruction 5(D)-(F), Items 305(a) and 305(b), Regulation S-K.

(n320)Footnote 320. General Instruction 5(A)-(B), Items 305(a) and 305(b), Regulation S-K.

(n321)Footnote 321. Item 305(a)(2), Regulation S-K.

(n322)Footnote 322. Instruction 5, Item 305(a), Regulation S-K.

(n323)Footnote 323. Item 305(a)(3), Regulation S-K.

(n324)Footnote 324. Item 305(a)(4), Regulation S-K.

(n325)Footnote 325. "Primary risk exposures" means:

(1) The following categories of market risk: interest rate risk, foreign currency exchange risk, commodity price risk and other relevant market rate or price risks (e.g., equity price risk); and

(2) Within each of these categories, the particular markets that present the primary risk of loss to the registrant.

Instruction 1, Item 305(b), Regulation S-K.

(n326)Footnote 326. Item 305(b)(1), Regulation S-K.

(n327)Footnote 327. Item 305(b)(2), Regulation S-K.

For purposes of disclosure under Item 305(b), registrants should describe primary market risk exposures that exist as of the end of the latest fiscal year, and how those exposures are managed. Instruction 2, Item 305(b), Regulation S-K.

(n328)Footnote 328. Information required under Item 305(c) is not required until after the first fiscal year end in which Item 305 is applicable. Instruction 1, Item 305(c), Regulation S-K.

(n329)Footnote 329. In particular, the safe harbor applies to items provided pursuant to paragraphs (a), (b)(1)(i), (b)(1)(iii) and (c) of Item 305, except for historical facts such as the terms of particular contracts and the number of market risk sensitive instruments held during or at the end of the reporting period. Item 305(d)(2)(i), Regulation S-K.

(n330)Footnote 330. Item 305(d)(1), Regulation S-K.

The "meaningful cautionary statements" prong of the statutory safe harbor will be satisfied if a registrant satisfies all requirements of Item 305(a), calling for quantitative disclosure of market risk. Item 305(d)(2)(ii), Regulation S-K.

(n331)Footnote 331. *Salesology, Inc.*, 38 SEC 812, 813-814 (1959) .

(n332)Footnote 332. *Profile Mines, Inc.*, 38 SEC 533, 537 (1958) ; *New England Uranium Oil Co.*, 38 SEC 782, 785 (1958) .

(n333)Footnote 333. *American Credit Corp.*, 1 SEC 230, 232 (1935) .

(n334)Footnote 334. *National Invested Sav. Corp., 1 SEC 825, 829-830 (1936)* .

(n335)Footnote 335. Gold Crown Mining Corp., Sec. Act Rel. No. 33-4177, 1960 SEC LEXIS 15 (January 19, 1960) (criminal conviction involving sale of securities); Tucker Corp., Sec. Act Rel. No. 33-3236 Fed. Sec. L. Rep. (CCH) P75,802 (1947).

(n336)Footnote 336. The registrant may not list any person chosen to become a director who has not consented to act as a director. Instruction 2, Item 401(a), Regulation S-K.

(n337)Footnote 337. Item 401(a), Regulation S-K. The registrant is not required to include arrangements or understandings with directors or officers of the registrant acting solely in their capacities as directors or officers. Instruction 1, Item 401(a), Regulation S-K.

(n338)Footnote 338. The term "executive officer" is defined in Rule 405 to mean:

(1) a president;

(2) a vice president in charge of a principal business unit, division, or function (e.g., sales, administration, finance);

(3) any officer performing a policy making function for the registrant. Rule 405 also provides that executive officers of subsidiaries may be deemed executive officers of the registrant if they perform policy-making functions for the registrant; or

(4) any other person who performs similar policy making functions for the registrant.

(n339)Footnote 339. For information required to be disclosed concerning the registrant's directors, *see* §§ 7.03[2][k][xi][A] *supra*.

(n340)Footnote 340. Section 12(g)(2)(G) of the Exchange Act exempts from Exchange Act of 1934 registration requirements securities of an insurance company if certain conditions have been met relating to regulation by the company's domiciliary state (*e.g.*, the filing of an annual statement with the Commissioner of Insurance of the domiciliary state).

(n341)Footnote 341. "Family relationship" is defined as any relationship by blood, marriage, or adoption not more remote than first cousin. Instruction, Item 401(d), Regulation S-K.

(n342)Footnote 342. But note, a reporting issuer with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the new rules until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such registrant filed before the 2010 Form 10-K is required to be filed would not be subject to the new rules. Question 3, Proxy Disclosure Enhancements Transition.

Note also, if a new registrant first files its registration statement on or after December 20, 2009, compliance with the Regulation S-K amendments is required in order for such registration statement to be declared effective on or after February 28, 2010. Question 4, Proxy Disclosure Enhancements Transition.

(n343)Footnote 343. Item 401(e)(1), Regulation S-K.

(n344)Footnote 344. Item 401(e)(1), Regulation S-K. If material, this disclosure should cover more than the past five years, including information about the person's particular areas of expertise or relevant qualifications.

(n345)Footnote 345. Item 401(e)(2), Regulation S-K.

(n346)Footnote 346. Item 401(e)(1), Regulation S-K.

The explanation required relates to level of professional competence and may include information as to the size of the operation supervised. *Id.*

(n347)Footnote 347. But note, a reporting issuer with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the new rules until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such registrant filed before the 2010 Form 10-K is required to be filed would not be subject to the new rules. Question 3, Proxy Disclosure Enhancements Transition.

Note also, if a new registrant first files its registration statement on or after December 20, 2009, compliance with the Regulation S-K amendments is required in order for such registration statement to be declared effective on or after February 28, 2010. Question 4, Proxy Disclosure Enhancements Transition.

(n348)Footnote 348. For purposes of determining this five-year period, the date of the reportable proceeding is deemed to be:

(1) for bankruptcy proceedings, the date

(a) of filing for uncontested petitions, or

(b) upon which approval of a contested petition became final; and

(2) for orders, judgments, or decrees, the date

(a) the final order, judgment or decree was entered or

(b) upon which any rights of appeal from preliminary orders, judgments, or decrees have lapsed.

Instruction 1, Item 401(f), Regulation S-K.

(n349)Footnote 349. If a registrant omits a proceeding as not material, it may furnish to the Commission at the time of filing supplemental information not part of the statement to which the omission relates, a description of the proceeding, and the reasons for the omission. Instruction 2, Item 401(f), Regulation S-K.

(n350)Footnote 350. Item 401(f)(1) is interpreted to require disclosure regarding comparable events in foreign countries (except in the unusual situation where it is not material). For example, disclosure should be provided when a director of a U.S. public company is also the CEO of a non-U.S. company and a receiver is appointed for the non-U.S. company. Question 116.04, Questions and Answers of General Applicability, Securities Act Forms.

(n351)Footnote 351. Item 401(f)(1), Regulation S-K.

(n352)Footnote 352. Item 401(f)(2), Regulation S-K.

(n353)Footnote 353. Item 401(f)(3), Regulation S-K.

(n354)Footnote 354. Item 401(f)(4), Regulation S-K.

(n355)Footnote 355. Item 401(f)(5), Regulation S-K.

(n356)Footnote 356. Item 401(f)(6), Regulation S-K.

(n357)Footnote 357. Item 401(f)(7), Regulation S-K. This paragraph does not apply to any settlement of a civil proceeding among private litigants. Instruction 5, Item 401(f), Regulation S-K.

(n358)Footnote 358. Item 401(f)(8), Regulation S-K.

(n359)Footnote 359. Instruction 3, Item 401(f), Regulation S-K.

(n360)Footnote 360. These requirements do not apply however, to any of the registrant's subsidiaries that itself was a reporting company for the twelve months preceding the registrant's filing. Instruction 2, Item 401(g), Regulation S-K.

(n361)Footnote 361. "Independent" has the same meaning as in Item 7(d)(3)(iv) of Schedule 14A under the Exchange Act. If the registrant has more than one audit committee financial expert serving on its audit committee, the registrant has the option of disclosing the names of those additional persons. If it does, the registrant must indicate whether they are independent. Instructions, Item 401(h)(1), Regulation S-K.

(n362)Footnote 362. Effective November 7, 2006, the Commission significantly amended Item 402 in an effort to provide investors with a clearer and more complete picture of compensation earned by a company's principal executive officer, principal financial officer and highest paid executive officers and members of its board of directors (the "2006 Executive Compensation Rules"). See Sec. Act Rel. No. 33-8732. In addition, the 2006 Executive Compensation Rules are intended to provide better information about key financial relationships among companies and their executive officers, directors, significant shareholders and their respective immediate family members. The disclosure is generally required to be presented in plain English. Smaller reporting companies may provide the scaled executive compensation disclosure as provided in paragraphs (l) through (r) of Item 402. See § 7.03[2][k][xii][L] *infra*.

(n363)Footnote 363. The compensation discussion and analysis is considered "filed" with the Commission and will therefore be subject to Regulations 14A and 14C under the Exchange Act and to potential liability under Section 18 of the Exchange Act. 15 U.S.C. 78r. In addition, to the extent that the compensation discussion and analysis or any other disclosure regarding executive compensation is included or incorporated by reference into a periodic report, the disclosure will be subject to the certifications that CEOs and CFOs are required to make under the Sarbanes-Oxley Act of 2002.

(n364)Footnote 364. The term "plan" includes, but is not limited to, any plan, contract, authorization or arrangement, whether or not set forth in any formal documents, pursuant to which the following may be received: cash, stock, restricted stock or restricted stock units, phantom stock, stock options, stock appreciation rights ("SARs"), stock options in tandem with SARs, warrants, convertible securities, performance units and performance shares, and similar instruments. A plan may be applicable to one person. Registrants may omit information regarding group life, health, hospitalization, medical reimbursement or relocation plans that do not discriminate in scope, terms or operation, in favor of executive officers or directors of the registrant and that are available generally to all salaried employees. Item 402(a)(6)(ii), Regulation S-K.

(n365)Footnote 365. Unless specifically excluded from disclosure by Item 402, all such compensation shall be reported pursuant to this item, even if also called for by another requirement, including transactions between the registrant and a third party where the primary purpose of the transaction is to furnish compensation to any named executive officer or director. In addition, no item reported as compensation for one fiscal year need be reported as compensation for a subsequent fiscal year. Item 402(a)(2), Regulation S-K.

A foreign private issuer will be deemed to comply with Item 402 if it provides the information required by Items 6.B and 6.E.2 of Form 20-F, with more detailed information provided if otherwise made publicly available. Item 402(a)(1),

Regulation S-K.

A registrant's reimbursement to an officer of legal expenses with respect to a lawsuit in which the officer was named as a defendant in her capacity as an officer is not disclosable pursuant to Item 402 of Regulation S-K. 217.10, Interpretive Responses Regarding Particular Situations.

(n366)Footnote 366. The term "executive officer" includes the registrant's president, any vice president in charge of a principal business unit, division or function, any other officer who performs a policy-making function or any other person who performs similar policy-making functions. Executive officers of subsidiaries may be deemed executive officers of the parent company if they perform such policy-making functions. *See* Rule 405. Therefore, a "named executive officer" for compensation disclosure purposes may be an executive officer of a subsidiary or an employee of a subsidiary who performs such policy-making functions for the company.

(n367)Footnote 367. Item 402(a)(3), Regulation S-K. The determination as to which executive officers are most highly compensated shall be made by reference to total compensation for the last completed fiscal year as required to be disclosed under column (j) of the Summary Compensation Table pursuant to Item 402(c), reduced by the amount disclosed under column (h) of such Summary Compensation Table. However, no disclosure need be provided for any executive officer, other than the PEO and PFO, whose total compensation does not exceed \$100,000. Instruction 1 to Item 402(a)(3), Regulation S-K.

It may be appropriate in certain circumstances for a registrant to include an executive officer of a subsidiary in the disclosure required by Item 402. Instruction 2, Item 402(a)(3). *See also* Exchange Act Rule 3b-7. It may be appropriate in limited circumstances for a registrant not to include in the disclosure required by Item 402 an individual (other than its PEO or PFO) who is one of the registrant's most highly compensated executive officers due to the payment of amounts of cash compensation relating to overseas assignments attributed predominantly to such assignments. Instruction 3, Item 402(a)(3), Regulation S-K.

(n368)Footnote 368. Instruction 1, Item 402(b), Regulation S-K.

(n369)Footnote 369. Instruction 2, Item 402(b), Regulation S-K. The overview should also cover actions regarding executive compensation that were taken after the end of the registrant's last fiscal year. Actions that should be addressed may include, for instance, the adoption or implementation of new or modified programs and policies or specific decisions that were made that could affect a fair understanding of the named executive officer's compensation for the last fiscal year. In order to give context to the disclosure provided, it may be necessary to discuss prior years. Instruction 2, Item 402(b), Regulation S-K.

(n370)Footnote 370. Item 402(b)(1), Regulation S-K. The overview should focus on the most important factors relevant to the analysis of the registrant's material compensation policies. The discussion should reflect the individual circumstances of the registrant and should avoid boilerplate language and repetition of the more detailed information set forth in the tables and related narrative disclosures required by Item 402. Instruction 3, Item 402(b), Regulation S-K.

(n371)Footnote 371. Item 402(b)(2), Regulation S-K. The information disclosed will vary depending on the facts and circumstances of the registrant.

(n372)Footnote 372. Benchmarking generally entails using compensation data about other companies as a reference point on which--either wholly or in part--to base, justify or provide a framework for a compensation decision. It would not include a situation in which a company reviews or considers a broad-based third-party survey for a more general purpose, such as to obtain a general understanding of current compensation practices. Question 118.05, Questions and Answers of General Applicability, Securities Act Forms.

(n373)Footnote 373. Item 402(b)(2), Regulation S-K.

(n374)Footnote 374. Instruction 4, Item 402(b), Regulation S-K.

(n375)Footnote 375. Instruction 4, Item 402(b), Regulation S-K. The standard to use when determining whether disclosure would cause competitive harm is the same standard that would apply when the registrant requests confidential treatment pursuant to Rule 406 of the Securities Act and Rule 12b-2 of the Exchange Act. A registrant is not required to seek confidential treatment if it determines that the disclosure would cause competitive harm in reliance on Instruction 4; however, in such case, the registrant must discuss how difficult it will be for the executive or how likely it will be for the registrant to achieve the undisclosed target level or other factors. Instruction 4, Item 402(b), Regulation S-K.

(n376)Footnote 376. Instruction 5, Item 402(b), Regulation S-K. However, disclosure must be provided as to how the number is calculated from the registrant's audited financial statements. Instruction 4, Item 402(b), Regulation S-K.

(n377)Footnote 377. But note, a reporting issuer with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the new rules until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such registrant filed before the 2010 Form 10-K is required to be filed would not be subject to the new rules. Question 3, Proxy Disclosure Enhancements Transition.

Note also, if a new registrant first files its registration statement on or after December 20, 2009, compliance with the Regulation S-K amendments is required in order for such registration statement to be declared effective on or after February 28, 2010. Question 4, Proxy Disclosure Enhancements Transition.

(n378)Footnote 378. Information with respect to fiscal years prior to the last completed fiscal year is not required if the registrant was not a reporting company pursuant to Section 13(a) or 15(d) of the Exchange Act at any time during the year, unless such information was previously required in response to a filing requirement of the Commission. Instruction 1, Item 402(c), Regulation S-K.

Compensation information generally needs to be disclosed only for the fiscal year(s) the person was a named executive officer; however, where a person was a named executive officer in years 1 and 3, compensation information for all three fiscal years must be disclosed. Questions 119.01 and 119.18, Questions and Answers of General Applicability, Securities Act Forms.

(n379)Footnote 379. Any amounts deferred, whether pursuant to a plan established under *Section 401(k) of the Internal Revenue Code* (26 U.S.C. 401(k)), or otherwise, are required to be included in the salary or bonus column, as appropriate, for the fiscal year in which they are earned. Instruction 4, Item 402(c), Regulation S-K.

(n380)Footnote 380. If the amount of salary or bonus earned in a given fiscal year is not calculable through the latest practicable date, a footnote must be included disclosing that fact and providing the date on which the amount of salary or bonus is expected to be determined, and such amount must then be disclosed in a filing under Item 5.02(f) of Form 8-K. Instruction 1, Item 402(c)(2)(iii) and (iv), Regulation S-K. The salary column (column (c)) or bonus column (column (d)) need not include any amount of salary or bonus forgone at the election of a named executive officer under which stock, equity-based or other forms of non-cash compensation instead have been received. Instruction 2, Item 402(c)(2)(iii) and (iv), Regulation S-K. However, the receipt of any such form of non-cash compensation must be disclosed in a footnote added to the salary or bonus column and, where applicable, referring to the Grants of Plan-Based Awards Table (required by paragraph (d) of Item 402) where the stock, option or non-equity incentive plan award elected by the named executive officer is reported. Instruction 4, Item 402(c), Regulation S-K.

(n381)Footnote 381. The term "stock" means instruments such as common stock, restricted stock, restricted stock units, phantom stock, phantom stock units, common stock equivalent units or any similar instruments that do not have option-like features. Item 402(a)(6)(i), Regulation S-K.

(n382)Footnote 382. The term "option" means instruments such as stock options, stock appreciation rights and similar instruments with option-like features. The term "stock appreciation rights" ("SARs") refers to SARs payable in cash or stock, including SARs payable in cash or stock at the election of the registrant or a named executive officer. The term "equity" is used to refer generally to stock and/or options. Item 402(a)(6)(i), Regulation S-K.

(n383)Footnote 383. For awards reported in columns (e) and (f), include a footnote disclosing all assumptions made in the valuation by reference to a discussion of those assumptions in the registrant's financial statements, footnotes to the financial statements or discussion in the Management's Discussion and Analysis. The sections so referenced are deemed part of the disclosure provided pursuant to Item 402. Instruction 1, Item 402(c)(2)(v) and (vi), Regulation S-K.

If at any time during the last completed fiscal year, the registrant has adjusted or amended the exercise price of options or SARs previously awarded to a named executive officer, whether through amendment, cancellation or replacement grants or any other means, or otherwise has materially modified such awards, the registrant shall include, as awards required to be reported in column (f), the incremental fair value, computed as of the repricing or modification date in accordance with FASB ASC Topic 718, with respect to that repriced or modified award. Instruction 2, Item 402(c)(2)(v) and (vi), Regulation S-K.

For any awards that are subject to performance conditions, report the value at the grant date based upon the probable outcome of such conditions. This amount should be consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under FASB ASC Topic 718, excluding the effect of estimated forfeitures. In a footnote to the table, disclose the value of the award at the grant date assuming that the highest level of performance conditions will be achieved in an amount less than the maximum was included in the table. Instruction 3, Item 402(c)(2)(v) and (vi), Regulation S-K.

(n384)Footnote 384. The term "incentive plan" means any plan providing compensation intended to serve as incentive for performance to occur over a specified period, whether such performance is measured by reference to financial performance of the registrant or an affiliate, the registrant's stock price, or any other performance measure. Item 402(a)(6)(iii), Regulation S-K. An "equity incentive plan" is an incentive plan or portion of an incentive plan under which awards are granted that fall within the scope of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, as modified or supplemented ("FAS 123R"). A "non-equity incentive plan" is an incentive plan or portion of an incentive plan that is not an equity incentive plan. The term "incentive plan award" means an award provided under an incentive plan. Item 402(a)(6)(iii), Regulation S-K.

(n385)Footnote 385. If the relevant performance measure is satisfied during the fiscal year (including for a single year in a plan with a multi-year performance measure), the earnings are reportable for that fiscal year, even if not payable until a later date, and are not reportable again in the fiscal year when amounts are paid to the named executive officer. Instruction 1, Item 402(c)(2)(vii), Regulation S-K. All earnings on non-equity incentive plan compensation must be identified and quantified in a footnote to column (g), whether the earnings were paid during the fiscal year, payable during the period but deferred at the election of the named executive officer, or payable by their terms at a later date. Instruction 2, Item 402(c)(2)(vii), Regulation S-K.

(n386)Footnote 386. The registrant should identify and quantify in a footnote the separate amounts attributable to each of paragraphs (A) and (B) of column (h). Instruction 3, Item 402(c)(2)(viii), Regulation S-K.

(n387)Footnote 387. The disclosure required under column (h)(A) applies to each plan that provides for the payment of retirement benefits, or benefits that will be paid primarily following retirement, including but not limited to tax-qualified defined benefit plans and supplemental executive retirement plans, but excluding tax-qualified defined contribution plans and nonqualified defined contribution plans. Instruction 1, Item 402(c)(2)(viii), Regulation S-K. For purposes of this disclosure, the registrant should use the same amounts required to be disclosed pursuant to Item 402(h)(2)(iv) (disclosure of Pension Benefits) for the covered fiscal year and the amounts that were or would have been required to be reported for the executive officer pursuant to Item 402(h)(2)(iv) for the prior completed fiscal year.

Where such amount under this paragraph (A) is negative, it should not be reflected in the sum of column (h), but rather disclosed in a footnote. Instruction 3, Item 402(c)(2)(viii), Regulation S-K.

(n388)Footnote 388. For disclosure under column (h)(B), interest on deferred compensation is above-market only if the rate of interest exceeds 120% of the applicable federal long-term rate, with compounding (as prescribed under *Section 1274(d) of the Internal Revenue Code*, (26 U.S.C. 1274(d))) at the rate that corresponds most closely to the rate under the registrant's plan at the time the interest rate or formula is set. Instruction 2, Item 402(c)(2)(viii), Regulation S-K. In the event of a discretionary reset of the interest rate, the requisite calculation must be made on the basis of the interest rate at the time of such reset, rather than when originally established. Only the above-market portion of the interest must be included. If the applicable interest rates vary depending upon conditions such as a minimum period of continued service, the reported amount should be calculated assuming satisfaction of all conditions to receiving interest at the highest rate. Dividends (and dividend equivalents) on deferred compensation denominated in the registrant's stock ("deferred stock") are preferential only if earned at a rate higher than dividends on the registrant's common stock, and only the preferential portion of the dividends or equivalents must be included. The registrant may provide footnote or narrative disclosure to explain the criteria for determining any portion considered to be above-market. Instruction 2, Item 402(c)(2)(viii), Regulation S-K.

(n389)Footnote 389. Each compensation item that is not properly reportable in columns (c)-(h), regardless of the amount, must be included in column (i). Item 402(c)(2)(ix), Regulation S-K. Benefits paid pursuant to defined benefit and actuarial plans are not reportable as All Other Compensation in column (i) unless accelerated pursuant to a change in control; information concerning these plans is reportable pursuant to column (h) of the Summary Compensation Table (Item 402(c)(2)(viii)(A)) and Item 402(h). Instruction 2, Item 402(c)(2)(ix), Regulation S-K.

(n390)Footnote 390. If the total value of all perquisites and personal benefits is \$10,000 or more for any named executive officer, then each perquisite or personal benefit, regardless of its amount, must be identified by type. Instruction 4, Item 402(c)(2)(ix), Regulation S-K. If perquisites and personal benefits are required to be reported, then each perquisite or personal benefit that exceeds the greater of \$25,000 or 10% of the total amount of perquisites and personal benefits for that officer must be quantified and disclosed in a footnote. The requirements for identification and quantification apply only to compensation for the last fiscal year. Perquisites and other personal benefits should be valued on the basis of the aggregate incremental cost to the registrant. With respect to the perquisite or other personal benefit for which footnote quantification is required, the registrant should describe its methodology for computing the aggregate incremental cost in the footnote. Instruction 4, Item 402(c)(2)(ix), Regulation S-K.

Any item reported for a named executive officer pursuant to column (i) that is not a perquisite or personal benefit and whose value exceeds \$10,000 must be identified and quantified in a footnote to column (i). This requirement applies only to compensation for the last fiscal year. Instruction 3, Item 402(c)(2)(ix), Regulation S-K.

(n391)Footnote 391. Reimbursements of taxes owed with respect to perquisites or other personal benefits must be included in column (i) and are subject to separate quantification and identification as tax reimbursements even if the associated perquisites or other personal benefits are not required to be included because the total amount of all perquisites or personal benefits for a named executive officer is less than \$10,000 or are required to be identified but are not required to be separately quantified. Instruction 4, Item 402(c)(2)(ix), Regulation S-K.

(n392)Footnote 392. For purposes of column (i), an accrued amount is an amount for which payment has become due. Instruction 5, Item 402(c)(2)(ix), Regulation S-K.

(n393)Footnote 393. The terms "date of grant" or "grant date" refer to the grant date determined for purposes of financial statement reporting under FAS 123R. Item 402(a)(6)(iv), Regulation S-K.

(n394)Footnote 394. See Item 402(c)(i)-(ix), Regulation S-K.

(n395)Footnote 395. Instruction 2, Item 402(c), Regulation S-K.

(n396)Footnote 396. For such disclosure, the registrant should utilize the categories in the Director Compensation Table required under Item 402(k) of Regulation S-K. Instruction 3, Item 402(c), Regulation S-K.

(n397)Footnote 397. But note, a reporting issuer with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the new rules until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such registrant filed before the 2010 Form 10-K is required to be filed would not be subject to the new rules. Question 3, Proxy Disclosure Enhancements Transition.

Note also, if a new registrant first files its registration statement on or after December 20, 2009, compliance with the Regulation S-K amendments is required in order for such registration statement to be declared effective on or after February 28, 2010. Question 4, Proxy Disclosure Enhancements Transition.

(n398)Footnote 398. If such grant date is different than the date on which the compensation committee (or a committee of the board of directors performing a similar function or the full board of directors) takes action or is deemed to take action to grant such awards, a separate, adjoining column must be added between columns (b) and (c) showing such date. Item 402(d)(2)(ii), Regulation S-K.

(n399)Footnote 399. As used in Item 402(d), the term "threshold" refers to the minimum amount payable for a certain level of performance under the plan. Instruction 2, Item 402(d), Regulation S-K. The term "target" refers to the amount payable if the specified performance targets are reached. The term "maximum" refers to the maximum payout possible under the plan. If the award provides only for a single estimated payout, that amount must be reported as the target. When calculating the target, registrants must provide a representative amount based on the previous fiscal year's performance if the target amount is not determinable. Instruction 2, Item 402(d), Regulation S-K.

(n400)Footnote 400. If non-equity incentive plan awards are denominated in units or other rights, a separate, adjoining column between columns (b) and (c) must be added quantifying the units or other rights awarded. Instruction 6, Item 402(d), Regulation S-K.

(n401)Footnote 401. If such exercise or base price is less than the closing market price of the underlying security on the date of the grant, a separate, adjoining column showing the closing market price on the date of the grant shall be added after column (k). Item 402(d)(2)(vii), Regulation S-K. In determining if the exercise or base price of an option is less than the closing market price of the underlying security on the date of the grant, the registrant may use either the closing market price (*i.e.*, the price at which the registrant's security was last sold in the principal United States market for such security), or if no market exists, any other formula prescribed for the security. Instruction 3, Item 402(d), Regulation S-K; *see also* Item 402(a)(6)(v). Whenever the exercise or base price reported in column (k) is not the closing market price, the registrant should describe the methodology for determining the exercise or base price either by a footnote or accompanying textual narrative. Instruction 3, Item 402(d), Regulation S-K.

(n402)Footnote 402. If at any time during the last completed fiscal year, the registrant has adjusted or amended the exercise or base price of options, SARs or similar option-like instruments previously awarded to a named executive officer, whether through amendment, cancellation or replacement grants, or any other means ("repriced"), or otherwise has materially modified such awards, the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R, with respect to that repriced or modified award, shall be reported. Item 402(d)(2)(viii), Regulation S-K.

(n403)Footnote 403. Instruction 1, Item 402(d), Regulation S-K.

(n404)Footnote 404. Instruction 1, Item 402(d), Regulation S-K.

(n405)Footnote 405. Instruction 4, Item 402(d), Regulation S-K.

(n406)Footnote 406. Instruction 5, Item 402(d), Regulation S-K.

(n407)Footnote 407. Instruction 7, Item 402(d), Regulation S-K.

(n408)Footnote 408. Instruction 8, Item 402(d), Regulation S-K. This amount should be consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under FASB ASC Topic 718, excluding the effect of estimated forfeitures.

(n409)Footnote 409. Instruction 1, Item 402(d), Regulation S-K.

(n410)Footnote 410. Item 402(e)(1), Regulation S-K.

(n411)Footnote 411. For example, modification by extension of exercise periods, the change of vesting or forfeiture conditions, the change or elimination of applicable performance criteria, or the change of the bases upon which returns are determined. Item 402(e)(1)(ii), Regulation S-K.

(n412)Footnote 412. Such disclosure requirement does not apply to any repricing that occurs through a preexisting formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an antidilution provision in a plan or award, or a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs. Instruction 1, Item 402(e)(1), Regulation S-K.

(n413)Footnote 413. For example, the registrant should state where applicable that dividends will be paid on stock, and if so, the applicable dividend rate and whether that rate is preferential. Item 402(e)(1)(iii), Regulation S-K.

(n414)Footnote 414. For purposes of the Grants of Plan-Based Awards Table required under Item 402(d) and the narrative disclosure required by Item 402(e), performance-based conditions include both performance conditions and market conditions, as those terms are defined in FAS 123R.

(n415)Footnote 415. The "market value" of stock reported under column (h) and of equity incentive plan awards of stock reported under column (j) is computed by multiplying the closing market price of the registrant's stock at the end of the last completed fiscal year by the number of shares or units of stock or the amount of equity incentive plan awards, respectively. Instruction 3, Item 402(f)(2), Regulation S-K. The number of shares or units reported in columns (d) or (i), and the payout value reported in column (j), must be based on achieving threshold performance goals, except that if the previous fiscal year's performance has exceeded the threshold, the disclosure should be based on the next higher performance measure (target or maximum) that exceeds the previous fiscal year's performance. If the award provides only for a single estimated payout, that amount should be reported. If the target amount is not determinable, registrants must provide a representative amount based on the previous fiscal year's performance. Instruction 3, Item 402(f)(2), Regulation S-K.

For this purpose, the "previous fiscal year" means the same year as the "last completed fiscal year." Question 120.04, Questions and Answers of General Applicability, Securities Act Forms.

(n416)Footnote 416. Instruction 1, Item 402(f)(2), Regulation S-K.

(n417)Footnote 417. Instruction 2, Item 402(f)(2), Regulation S-K.

(n418)Footnote 418. Instruction 4, Item 402(f)(2), Regulation S-K. A single award consisting of a combination of options, SARs and/or similar option-like instruments should be reported as separate awards with respect to each tranche with a different exercise and/or base price or expiration date.

(n419)Footnote 419. Instruction 5, Item 402(f)(2), Regulation S-K.

(n420)Footnote 420. Instruction 5, Item 402(f)(2), Regulation S-K.

(n421)Footnote 421. The dollar amount realized upon exercise is calculated by determining the difference between the market price of the underlying securities at exercise and the exercise or base price of the options. Instruction, Item 402(g)(2), Regulation S-K. The registrant should not include the value of any related payment or other consideration provided (or to be provided) by the registrant to or on behalf of a named executive officer, whether in payment of the exercise price or related taxes (any such payment or other consideration is required to be disclosed in column (i) of the Summary Compensation Table under Item 402(c)(2)(ix)).

(n422)Footnote 422. The aggregate dollar amount realized upon vesting is calculated by multiplying the number of shares of stock or units by the market value of the underlying shares on the vesting date. For any amount realized upon exercise or vesting for which receipt has been deferred, the registrant should provide a footnote quantifying the amount and disclosing the terms of the deferral. Instruction, Item 402(g)(2), Regulation S-K.

(n423)Footnote 423. See Item 402(h)(1), Regulation S-K. The required disclosure includes but is not limited to tax-qualified defined benefit plans and supplemental executive retirement plans, but excludes tax-qualified defined contribution plans and nonqualified defined contribution plans. Instruction 1, Item 402(h)(2), Regulation S-K. For purposes of allocating the current accrued benefit between tax-qualified defined benefit plans and related supplemental plans, the registrant should apply the limitations applicable to tax-qualified defined benefit plans established by the Internal Revenue Code and the regulations thereunder that applied as of the pension plan measurement date. Instruction 3, Item 402(h)(2), Regulation S-K.

(n424)Footnote 424. Instruction 1, Item 402(h)(2), Regulation S-K.

(n425)Footnote 425. Item 402(h)(3), Regulation S-K.

(n426)Footnote 426. If a named executive officer's number of years of credited service with respect to any plan is different from such officer's number of actual years of service with the registrant, a footnote should be provided quantifying the difference and any resulting benefit augmentation. Instruction 4, Item 402(h)(2), Regulation S-K; see also Item 402(h)(3)(v), Regulation S-K.

(n427)Footnote 427. In column (d), the registrant must use the same assumptions used for financial reporting purposes under generally accepted accounting principles, except that retirement age must be assumed to be the normal retirement age as defined in the plan, or if not so defined, the earliest time at which a participant may retire under the plan without any benefit reduction due to age. Instruction 2, Item 402(h)(2), Regulation S-K. Furthermore, in the accompanying textual narrative on pension benefits, the registrant must disclose the valuation method and all material assumptions applied in quantifying the present value of the current accrued benefit. A benefit specified in the plan document or the executive's contract itself is not an assumption. All or part of this disclosure may be satisfied by reference to a discussion of such assumptions in the registrant's financial statements and related footnotes, or discussion in the Management's Discussion and Analysis. Instruction 2, Item 402(h)(2), Regulation S-K.

(n428)Footnote 428. Item 402(h)(3), Regulation S-K.

(n429)Footnote 429. For this purpose, normal retirement means retirement at the normal retirement age as defined in the plan, or if not so defined, the earliest time at which a participant may retire under the plan without any benefit reduction due to age. Item 402(h)(3)(i), Regulation S-K.

(n430)Footnote 430. For this purpose, early retirement means retirement at the early retirement age as defined in the plan, or otherwise available to the executive under the plan. Item 402(h)(3)(ii), Regulation S-K.

(n431)Footnote 431. Item 402(i)(3), Regulation S-K.

(n432)Footnote 432. See Item 402(i)(2), Regulation S-K. A footnote should be provided quantifying the extent to which amounts reported in the contributions and earnings columns are reported as compensation for the last completed

fiscal year in the registrant's Summary Compensation Table. Additionally, the footnote should quantify the extent to which amounts reported in the aggregate balance at last fiscal year end (column (f)) previously were reported as compensation to the named executive officer in the registrant's Summary Compensation Table for previous years. Instruction, Item 402(i)(2), Regulation S-K.

(n433)Footnote 433. Item 402(i)(3), Regulation S-K.

(n434)Footnote 434. Item 402(i)(3)(i)-(iii), Regulation S-K.

(n435)Footnote 435. As used in Item 402(j), termination includes resignation, severance, retirement or a constructive termination of a named executive officer. Item 402(j), Regulation S-K.

(n436)Footnote 436. If the form and amount of any payment or benefit that would be provided in connection with any termination or change-in-control is fully disclosed under Item 402(h) or Item 402(i), reference may be made to such disclosure. Instruction 3, Item 402(j), Regulation S-K. However, to the extent that the form or amount of any such payment or benefit would be enhanced or its vesting or other provisions accelerated in connection with any triggering event, such enhancement or acceleration must be disclosed under Item 402(j). Instruction 3, Item 402(j), Regulation S-K.

(n437)Footnote 437. Perquisites and other personal benefits or property may be excluded if the aggregate amount of such compensation will be less than \$10,000. Instruction 2, Item 402(j), Regulation S-K. For purposes of quantifying health care benefits, the registrant must use the assumptions used for financial reporting purposes under generally accepted accounting principles. If a triggering event has actually occurred for a named executive officer and such individual was not serving as a named executive officer at the end of the last completed fiscal year, the disclosure for that named executive officer shall apply only to that triggering event. Instruction 4, Item 402(j), Regulation S-K.

(n438)Footnote 438. This includes non-compete, nonsolicitation, non-disparagement or confidentiality agreements, including the duration of such agreements and provisions regarding waiver of breach of such agreements. Item 402(j)(4), Regulation S-K.

(n439)Footnote 439. Instruction 1, Item 402(j), Regulation S-K. The term "closing market price" means the price at which the registrant's security was last sold in the principal United States market for such security as of the date for which the closing market price is determined. Item 402(a)(6)(v), Regulation S-K.

(n440)Footnote 440. Item 402(a)(6)(v), Regulation S-K. In such event, the disclosure would require forward-looking information as appropriate.

(n441)Footnote 441. Instruction 5, Item 402(j), Regulation S-K.

(n442)Footnote 442. But note, a reporting issuer with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the new rules until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such registrant filed before the 2010 Form 10-K is required to be filed would not be subject to the new rules. Question 3, Proxy Disclosure Enhancements Transition.

Note also, if a new registrant first files its registration statement on or after December 20, 2009, compliance with the Regulation S-K amendments is required in order for such registration statement to be declared effective on or after February 28, 2010. Question 4, Proxy Disclosure Enhancements Transition.

(n443)Footnote 443. Instruction, Item 402(k)(2), Regulation S-K.

(n444)Footnote 444. Each director must be included in the Director Compensation Table, unless such director is also a "named executive officer" under Item 402(a) and his or her compensation for service as a director is fully

reflected in the Summary Compensation Table under Item 402(c) and otherwise as required pursuant to paragraphs (d) through (j) of Item 402. Item 402(k)(2)(i), Regulation S-K.

(n445)Footnote 445. The following apply equally to Item 402(k): Instructions 2 and 4 to Item 402(c); Instructions to Item (c)(2)(iii), (iv), (v), (vi), (vii) and (viii) and Instructions 1 and 5 to Item 402 (c)(2)(ix). These Instructions apply to the columns in the Director Compensation Table that are analogous to the columns in the Summary Compensation Table to which they refer and to disclosures under paragraph (k) of this Item that correspond to analogous disclosures provided for in paragraph (c) of this Item to which they refer. Instruction to Item 402(k).

(n446)Footnote 446. However, if the total value of all perquisites and personal benefits is \$10,000 or more for any director, then each perquisite or personal benefit, regardless of its amount, must be identified by type. Instruction 3, Item 402(k)(2)(vii), Regulation S-K. Furthermore, if perquisites and personal benefits are required to be reported under column (g), then each perquisite or personal benefit that exceeds the greater of \$25,000 or 10 percent of the total amount of perquisites and personal benefits for that director must be quantified and disclosed in a footnote. Perquisites and other personal benefits shall be valued on the basis of the aggregate incremental cost to the registrant, and the required footnotes should describe the methodology for computing such cost. Instruction 3, Item 402(k)(2)(vii), Regulation S-K.

Any item of compensation that is not a perquisite or personal benefit and whose value exceeds \$10,000 must be identified and quantified in a footnote to column (g). Instruction 2, Item 402(k)(2)(vii), Regulation S-K.

(n447)Footnote 447. This includes reimbursements of taxes owed with respect to perquisites or other personal benefits, even if such benefits are not required to be included in column (g) because the total amount of such benefits for an individual director is less than \$10,000. Instruction 3, Item 402(k)(2)(vii), Regulation S-K.

(n448)Footnote 448. This includes programs under which the registrant agrees to make donations to a charitable institution in a director's name; for instance, upon the retirement of the director. Instruction 1, Item 402(k)(2)(vii), Regulation S-K. In such scenarios, a footnote should be added disclosing the total dollar amount payable and other material terms under the program. Instruction 1, Item 402(k)(2)(vii), Regulation S-K.

(n449)Footnote 449. See Item 402(k)(2)(i)-(viii), Regulation S-K.

(n450)Footnote 450. Item 402(k)(3), Regulation S-K.

(n451)Footnote 451. Item 402(k)(3), Regulation S-K.

(n452)Footnote 452. Such instructions applicable to the columns in the Director Compensation Table include: Instructions 2 and 4 of Item 402(c) concerning disclosure in U.S. dollars and disclosure of amounts deferred under 401(k) plans or otherwise; Instructions to Item 402(c)(2)(iii) and (iv) concerning calculation of amounts and forgone salary and bonus amounts; Instructions to Item 402(c)(2)(v) and (vi) concerning forfeitures related to service-based vesting conditions; Instructions to Item 402(c)(2)(vii) regarding awards under non-equity incentive plans; Instructions to Item 402(c)(2)(viii) regarding above-market or preferential earnings; and Instructions 1 and 5 of Item 402(c)(2)(ix) regarding other compensation. See Instruction, Item 402(k); see generally § 7.03[2][k][xii][C] *supra* (discussing the requirements for the Summary Compensation Table and related instructions under Item 402(c)).

(n453)Footnote 453. See § 7.05 *infra* for discussion on criteria necessary to qualify as a smaller reporting company.

(n454)Footnote 454. The three required tables are the Summary Compensation Table, the Outstanding Equity Awards at Fiscal Year End Table, and the Director Compensation Table. See Sec. Act Rel. No. 33-8876.

(n455)Footnote 455. See Sec. Act Rel. No. 33-8876.

(n456)Footnote 456. The term "plan" has the same meaning as that under Item 402(a). *See* § 7.03[2][k][xii][A] and accompanying footnotes.

(n457)Footnote 457. As with larger companies, unless specifically excluded from disclosure under Item 402, all such compensation must be reported, including transactions between the smaller reporting company and a third party where a purpose of the transaction is to furnish compensation to any such named executive officer or director. In addition, no item reported as compensation for one fiscal year need be reported as compensation for a subsequent fiscal year. Item 402(m)(1), Regulation S-K.

(n458)Footnote 458. The determination as to which executive officers are most highly compensated shall be made by reference to total compensation for the last completed fiscal year as required to be disclosed pursuant to column (j) of the Summary Compensation Table under Item 402(n), reduced by the amount disclosed under column (h) of such Summary Compensation Table. However, no disclosure need be provided for any executive officer, other than the PEO, whose total compensation does not exceed \$100,000. Instruction 1, Item 402(m)(2), Regulation S-K.

It may be appropriate for a smaller reporting company to include an executive officer of a subsidiary in the disclosure required by Item 402(m). Instruction 2, Item 402(m)(2), Regulation S-K; *see also* Exchange Act Rule 3b-7. It may be appropriate in limited circumstances for a smaller reporting company not to include in the disclosure required by Item 402 an individual who is one of the smaller reporting company's most highly compensated executive officers due to the payment of amounts of cash compensation related to overseas assignments attributed predominantly to such assignments. Instruction 3, Item 402(m)(2), Regulation S-K.

(n459)Footnote 459. Item 402(m)(3), Regulation S-K.

(n460)Footnote 460. Item 402(m)(4), Regulation S-K.

(n461)Footnote 461. But note, a reporting issuer with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the new rules until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such registrant filed before the 2010 Form 10-K is required to be filed would not be subject to the new rules. Question 3, Proxy Disclosure Enhancements Transition.

Note also, if a new registrant first files its registration statement on or after December 20, 2009, compliance with the Regulation S-K amendments is required in order for such registration statement to be declared effective on or after February 28, 2010. Question 4, Proxy Disclosure Enhancements Transition.

(n462)Footnote 462. Information with respect to the fiscal year prior to the last completed fiscal year is not required if the registrant was not a reporting company pursuant to Section 13(a) or 15(d) of the Exchange Act at any time during the year, unless such information was previously required in response to a filing requirement of the Commission. Instruction 1, Item 402(n), Regulation S-K.

(n463)Footnote 463. Any amounts deferred, whether pursuant to a plan established under *Section 401(k) of the Internal Revenue Code* (26 U.S.C. 401(k)), or otherwise, are required to be included in the salary or bonus column, as appropriate, for the fiscal year in which earned. Instruction 4, Item 402(n), Regulation S-K.

(n464)Footnote 464. If the amount of salary or bonus earned in a given fiscal year is not calculable through the latest practicable date, a footnote must be included disclosing that fact and providing the date that the amount of salary or bonus is expected to be determined, and such amount must then be disclosed in a filing under Item 5.02(f) of Form 8-K. Instruction 1, Item 402(n)(2)(iii) and (iv), Regulation S-K. The salary column (column (c)) or bonus column (column (d)) should include any amount of salary or bonus forgone at the election of a named executive officer under which stock, equity-based or other forms of non-cash compensation instead have been received. Instruction 2, Item 402(n)(2)(iii) and (iv), Regulation S-K. However, the receipt of any such form of non-cash compensation must be

disclosed in a footnote added to the salary or bonus column and, where applicable, referring to the narrative disclosure required by paragraph (o) of Item 402 where the stock, option or non-equity incentive plan award elected by the named executive officer is reported. Instruction 2, Item 402(n)(2)(iii) and (iv), Regulation S-K.

(n465)Footnote 465. The meaning of the term "stock" is discussed *supra* in § 7.03[2][k][xii][C](5) and the accompanying footnotes.

(n466)Footnote 466. The meaning of the terms "option," "SARs" and "equity" are discussed *supra* in § 7.03[2][k][xii][C](6) and the accompanying footnote.

(n467)Footnote 467. For awards reported in columns (e) and (f), the treatment is identical to that of larger companies. See § 7.03[2][k][xii][C](6) *supra* and accompanying footnote.

(n468)Footnote 468. The terms "incentive plan," "equity incentive plan," "non-equity incentive plan" and "incentive plan award" discussed *supra* in § 7.03[2][k][xii][C](7) and the accompanying footnotes.

(n469)Footnote 469. The directions for disclosure under column (g) are identical to those of larger companies. See § 7.03[2][k][xii][C](7) *supra* and accompanying footnotes.

(n470)Footnote 470. The directions as to disclosure of above-market or preferential earnings are identical to those applicable to larger companies. See § 7.03[2][k][xii][C](8)(B) and accompanying footnote.

(n471)Footnote 471. Each compensation item that is not properly reportable in columns (c)-(h), regardless of the amount, must be included in column (i). Item 402(n)(2)(ix), Regulation S-K. Benefits paid pursuant to defined benefit and actuarial plans are not reportable as All Other Compensation in column (i) unless accelerated pursuant to a change in control; information concerning these plans is reportable pursuant to the Additional Narrative Disclosure for smaller reporting companies required under Item 402(q)(1) of Regulation S-K. Instruction 2, Item 402(n)(2)(ix), Regulation S-K.

(n472)Footnote 472. Perquisites and other personal benefits should be valued on the basis of the aggregate incremental cost to the registrant. Instruction 4, Item 402(n)(2)(ix), Regulation S-K.

(n473)Footnote 473. Reimbursements of taxes owed with respect to perquisites or other personal benefits must be included in column (i) even if the associated perquisites or other personal benefits are not required to be included because the aggregate amount of such compensation is less than \$10,000. Instruction 3, Item 402(n)(2)(ix), Regulation S-K.

(n474)Footnote 474. For purposes of column (i), an accrued amount is an amount for which payment has become due. Instruction 5, Item 402(n)(2)(ix), Regulation S-K.

(n475)Footnote 475. Other non-equity incentive plan awards and earnings along with earnings paid on stock or options need not be disclosed under column (i), but must be reported, as applicable, under the Narrative Disclosure to Summary Compensation Table (Item 402(o)) and Outstanding Equity Awards at Fiscal Year-End Table (Item 402(p)). Instruction, Item 402(n)(2)(ix), Regulation S-K.

(n476)Footnote 476. See Item 402(n)(i)-(ix), Regulation S-K.

(n477)Footnote 477. Instruction 2, Item 402(n), Regulation S-K.

(n478)Footnote 478. Instruction 3, Item 402(n), Regulation S-K. For such disclosure, the smaller reporting company should utilize the categories in the Director Compensation Table required under Item 402(r) of Regulation S-K.

(n479)Footnote 479. Item 402(o), Regulation S-K.

(n480)Footnote 480. For example, modification by extension of exercise periods, the change of vesting or forfeiture conditions, the change or elimination of applicable performance criteria, or the change of the bases upon which returns are determined. Item 402(o)(2), Regulation S-K.

(n481)Footnote 481. Such disclosure requirement does not apply to any repricing that occurs through a preexisting formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an antidilution provision in a plan or award, or a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs. Instruction, Item 402(o), Regulation S-K.

(n482)Footnote 482. This would include a general description of the formula or criteria to be applied in determining the amounts payable and the vesting schedule. Item 402(o)(5), Regulation S-K.

(n483)Footnote 483. An item is not considered "material" if it does not exceed the greater of \$25,000 or 10% of all items included in the specified category in question under column (i) of the Summary Compensation Table. However, all items of compensation are required to be included in the Summary Compensation Table without regard to whether such items are required to be identified under Item 402(o). Item 402(o)(7), Regulation S-K.

(n484)Footnote 484. The directions for column (j) are identical to those applicable to larger companies. *See* § 7.03[2][k][xii][F](10) *supra* and accompanying footnote.

(n485)Footnote 485. Instruction 1, Item 402(p)(2), Regulation S-K.

(n486)Footnote 486. Instruction 2, Item 402(p)(2), Regulation S-K.

(n487)Footnote 487. A single award consisting of a combination of options, SARs and/or similar option-like instruments should be reported as separate awards with respect to each tranche with a different exercise and/or base price or expiration date. Instruction 4, Item 402(p)(2), Regulation S-K.

(n488)Footnote 488. Instruction 5, Item 402(p)(2), Regulation S-K.

(n489)Footnote 489. Instruction 5, Item 402(p)(2), Regulation S-K.

(n490)Footnote 490. Item 402(q)(1), Regulation S-K.

(n491)Footnote 491. Item 402(q)(2), Regulation S-K.

(n492)Footnote 492. But note, a reporting issuer with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the new rules until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such registrant filed before the 2010 Form 10-K is required to be filed would not be subject to the new rules. Question 3, Proxy Disclosure Enhancements Transition.

Note also, if a new registrant first files its registration statement on or after December 20, 2009, compliance with the Regulation S-K amendments is required in order for such registration statement to be declared effective on or after February 28, 2010. Question 4, Proxy Disclosure Enhancements Transition.

(n493)Footnote 493. Instruction, Item 402(r)(2), Regulation S-K.

(n494)Footnote 494. Each director must be included in the Director Compensation Table, unless such director is also a "named executive officer" under Item 402(m) and his or her compensation for service as a director is fully reflected in the Summary Compensation Table under Item 402(n) and otherwise as required pursuant to paragraphs (o) through (q) of Item 402. Item 402(r)(2)(i), Regulation S-K.

(n495)Footnote 495. For disclosures for each director under columns (c) and (d), the Instructions to paragraphs (n)(2)(iii) and (iv) of this Item apply. Instruction, Item 402(r), Regulation S-K.

(n496)Footnote 496. Each compensation item that is not properly reportable in columns (b) through (f), regardless of the amount, must be included in column (g) and must be identified and quantified in a footnote if it is deemed material. Item 402(r)(2)(vii), Regulation S-K. An item is not considered "material" if it does not exceed the greater of \$25,000 or 10% of all items included in the specified category in question under column (g) of the Director Compensation Table. Item 402(o)(7), Regulation S-K.

(n497)Footnote 497. This includes programs under which the registrant agrees to make donations to a charitable institution in a director's name; for instance, upon the retirement of the director. In such scenarios, a footnote should be added disclosing the total dollar amount payable and other material terms under the program. Instruction, Item 402(r)(2)(vii), Regulation S-K.

(n498)Footnote 498. See Item 402(r)(2)(i)-(viii), Regulation S-K.

(n499)Footnote 499. Item 402(r)(3), Regulation S-K.

(n500)Footnote 500. Item 402(r)(3), Regulation S-K.

(n501)Footnote 501. Item 402(s), Regulation S-K. The purpose of the disclosure is to provide investors material information concerning how the registrant compensates and incentivizes its employees that may create risks that are reasonably likely to have a material adverse effect on the registrant.

(n502)Footnote 502. Item 402(s), Regulation S-K. While the information to be disclosed will vary depending upon the nature of the registrant's business and the compensation approach, the following are examples of the issues that the registrant may need to address for the business units or employees discussed:

(1) the general philosophy of the registrant's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by employees on behalf of the registrant, and the manner of their implementation;

(2) the registrant's risk assessment or incentive considerations, if any, in structuring the compensation policies and practices or in awarding and paying compensation;

(3) how the registrant's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods;

(4) the registrant's policies regarding adjustments to its compensation policies and practice to address changes in its risk profile;

(5) material adjustments the registrant has made to its compensation policies and practices as a result of changes in its risk profile and

(6) the extent to which the registrant monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

(n503)Footnote 503. Such instructions applicable to the columns in the Director Compensation Table include: Instructions 2 and 4 of Item 402(n) concerning disclosure in U.S. dollars and disclosure of amounts deferred under 401(k) plans or otherwise; Instructions to Item 402(n)(2)(iii) and (iv) concerning calculation of amounts and forgone salary and bonus amounts; Instructions to Item 402(n)(2)(v) and (vi) concerning forfeitures related to service-based vesting conditions; Instructions to Item 402(n)(2)(vii) regarding awards under non-equity incentive plans; Instruction to Item 402(n)(2)(viii) regarding above-market or preferential earnings; Instructions to Item 402(n)(2)(ix) regarding other compensation and paragraph 402(o)(7) regarding materiality. *See* Instruction, Item 402(r); *see generally* § 7.03[2][xii][N] *supra* (discussing the requirements for a smaller reporting company's Summary Compensation Table and related instructions under Item 402(n)).

(n504)Footnote 504. For purposes of Item 403(a), the registrant may indicate the source and date of such information. Instruction 4, Item 403, Regulation S-K.

(n505)Footnote 505. This may be a business, mailing or residence address. Item 403(a), Regulation S-K.

(n506)Footnote 506. If more than one beneficial owner is known to the registrant to be listed for the same securities, appropriate disclosure should be made to avoid confusion. Instruction 5, Item 403, Regulation S-K. The registrant should not count shares more than once when computing pursuant to Item 403(b) the aggregate number of shares owned by directors and officers as a groups. Instruction 5, Item 403, Regulation S-K.

The beneficial ownership disclosure requirement of Section 13(d) of the Exchange Act and the rules adopted there-under are discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7A.02 (Matthew Bender).

(n507)Footnote 507. The percentages are to be calculated on the basis of the amount of outstanding securities, excluding securities held by or for the account of the registrant or its subsidiaries, plus securities deemed outstanding under Exchange Act Rule 13d-3(d)(1), *i.e.*, securities subject to options, warrants, rights, or conversion privileges that can be exercised or converted within 60 days. Instruction 1, Item 403, Regulation S-K. The registrant may omit precise ownership percentages when the percentage for a director or nominee for election as director, or all officers and directors as a group, represents less than one percent of the class of securities, provided that the registrant discloses by footnote or similar means that the ownership figure is less than one percent. Instruction 1, Item 403, Regulation S-K.

The registrant is deemed to know the contents of any statements filed with the Commission pursuant to Section 13(d) or 13(g) of the Exchange Act, which require persons who acquire more than five percent of a class of an issuer's equity securities to file reports with the Commission. The registrant may rely upon information in those statements unless the registrant knows or has reason to believe that the information is incomplete or inaccurate or that a statement or amendment should have been filed and was not. Instruction 3, Item 403, Regulation S-K.

(n508)Footnote 508. Instruction 7, Item 403, Regulation S-K.

(n509)Footnote 509. Item 403(c), however, does not require a description of ordinary default provisions contained in the charter, trust indentures, or other governing instruments relating to securities of the registrant. Instruction 6, Item 403(c), Regulation S-K.

(n510)Footnote 510. Item 407 of Regulation S-K was added as part of the Commission's 2006 Executive Compensation Rules affecting disclosure of executive compensation. *See* Sec. Act Rel. No. 33-8732. For a discussion of the 2006 Executive Compensation Rules, see § 7.03[2][xii] *supra*.

(n511)Footnote 511. The information called for by Item 404 should be given for both the periods specified in the Item and for the two fiscal years preceding the registrant's last fiscal year. Instruction 1, Item 404, Regulation S-K. A foreign private issue will be deemed to comply with Item 404 if it provides the information required by Item 7.B of Form 20-F, with more detailed information provided if otherwise made publicly available or required to be disclosed by the issuer's home jurisdiction or market in which its securities are listed or traded. Instruction 2, Item 404, Regulation S-K.

(n512)Footnote 512. The term "transaction" includes, but is not limited to, any financial transaction, arrangement or relationship (including indebtedness or guarantee of indebtedness) or any series of the same. Instruction 2, Item 404(a), Regulation S-K.

Items of indebtedness may be excluded and need not be disclosed if they are amounts due from the related person for (x) purchases of goods and services subject to usual terms, (y) ordinary business travel and expense payments, and (z) other transactions in the ordinary course of business. Instruction 4, Item 404(a), Regulation S-K. Moreover, if the lender is a bank, savings and loan association, or broker-dealer extending credit under Federal Reserve Regulation T and the loans are not disclosed as nonaccrual, past due, restructured or potential problems, the disclosure under Item 404(a) may consist of a statement that the loans to such persons: (x) were made in the ordinary course of business; (y) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the lender; and (z) did not involve more than the normal risk of collectibility or present other unfavorable features.

The term "persons not related to the lender" means persons with no relationship at all with the lender other than the lending relationship, such as regular customers. Employees are considered related to the lender by virtue of their employment relationship. Question 130.05, Questions and Answers of General Applicability, Securities Act Forms.

(n513)Footnote 513. A person who has a position or relationship with a firm, corporation, or other entity that engages in a transaction with the registrant or its subsidiaries may have an indirect interest in the transaction because of that position or relationship. That person, however, will not be deemed to have a *material* interest in the transaction if the interest arises only from:

(1)

(a) the person's position as a director of another corporation that is a party to the transaction;

(b) the direct or indirect ownership by that person and all other related persons specified in Instruction 1 of Item 404(a), in the aggregate, of less than a ten percent equity interest in another person, other than a partnership, that is a party to the transaction; or

(c) both the foregoing position and ownership; or

(2) the person's position as a limited partner in a partnership in which the person and all other related persons specified in Instruction 1 of Item 404(a) have an interest of less than ten percent, and the person is not a general partner of and does not hold another position in the partnership.

Instruction 6, Item 404(a), Regulation S-K.

(n514)Footnote 514. Information related to such nominee for director need only be included when presented in a proxy or information statement related to the election of such nominee. Instruction 1, Item 404(a), Regulation S-K. Therefore, disclosure related to such nominee need not be included in Form S-1.

(n515)Footnote 515. "Immediate family" includes a person's spouse, parents, stepparents, children, stepchildren siblings, mother-and father-in-law, son-and daughter-in-law, brother-and sister-in-law, and any other person (other than a tenant or employee) sharing the household of such person. Instruction 1, Item 404(a), Regulation S-K.

(n516)Footnote 516. The dollar value of the amount involved in the transaction in question must include:

(a) in the case of any lease or other transaction providing for periodic payments or installments, the aggregate amount of all periodic payments or installments due on or after the beginning of the registrant's last fiscal year, including any required or optional payments due during or at the conclusion of the lease or other transaction providing for periodic payments or installments; and

(b) in the case of indebtedness, the largest aggregate amount of all indebtedness outstanding at any time since the beginning of the registrant's last fiscal year and all amounts of interest payable on it during the last fiscal year.

Instruction 3, Item 404(a), Regulation S-K.

In the case of indebtedness, the registrant must also disclose the amount of indebtedness outstanding as of the latest practicable date, the amounts of principal and interest paid during the disclosure period, and the rate of interest payable on such indebtedness. Item 404(a)(5), Regulation S-K.

(n517)Footnote 517. The amount of the person's interest should be calculated without taking into consideration the amount of the profit or loss involved in the transaction. Item 404(a)(4), Regulation S-K.

(n518)Footnote 518. Instruction 7, Item 404(a), Regulation S-K.

(n519)Footnote 519. Instruction 5, Item 404(a), Regulation S-K.

(n520)Footnote 520. Instruction 5, Item 404(a), Regulation S-K.

(n521)Footnote 521. Item 404(b)(1), Regulation S-K.

(n522)Footnote 522. Instruction 1, Item 404(b), Regulation S-K.

(n523)Footnote 523. Item 404(b)(2), Regulation S-K.

(n524)Footnote 524. The "control person" refers to any person who acquired control of a registrant that is a shell company, or any person that is part of a group, consisting of two or more persons that agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of a registrant, that acquired control of a registrant that is a shell company. Item 404(c)(2), Regulation S-K. The term "shell company" means a company that has no or nominal operations and that has either (i) no or nominal assets, (ii) assets consisting solely of cash or cash equivalents, or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets. Rule 405.

(n525)Footnote 525. This includes money, property, contracts, options or rights of any kind. Item 404(c)(i), Regulation S-K.

(n526)Footnote 526. The registrant should also disclose the relationship to the registrant of such persons involved

in determining the amount of such assets. If the assets were acquired by the promoter within two years prior to their transfer to the registrant, the registrant must disclose the cost of such assets to the promoter. Item 404(c)(ii), Regulation S-K.

(n527)Footnote 527. A smaller reporting company needs to provide information on such transactions as of the beginning of its last fiscal year (or any currently proposed transaction), and, in addition, for the fiscal year preceding the company's last fiscal year. Instruction 2, Item 404(d), Regulation S-K.

(n528)Footnote 528. The smaller reporting company should include information for any material underwriting discounts and all commissions upon the sale of securities by the company where any "related person" under Item 404(a) was or is to be a principal underwriter or is a controlling person or member of a firm that was or is to be a principal underwriter. Instruction 1, Item 404(d), Regulation S-K.

(n529)Footnote 529. Item 404(d), Regulation S-K.

(n530)Footnote 530. Item 407(a), Regulation S-K.

(n531)Footnote 531. If the registrant does not have a separately designated audit, nominating or compensation committee, the registrant must disclose all the directors which are not independent under such committee independence standards. Item 407(a), Regulation S-K.

(n532)Footnote 532. Instruction 2, Item 407(a), Regulation S-K. However, if the registrant is not subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act, no information needs to be disclosed regarding any director who is no longer a director at the time of effectiveness of the registration statement.

(n533)Footnote 533. In order to satisfy the requirements of Item 407(a), the independence standards of such national securities exchange or inter-dealer quotation system must require that a majority of the board of directors be independent. Item 407(a)(iii), Regulation S-K.

(n534)Footnote 534. Item 407(a)(iii), Regulation S-K. If the registrant has not adopted the independence standards provided by the securities exchange or quotation system, it must disclose the independence standards it uses. Additionally, when using its own independence standards, the registrant must disclose whether such standards and definitions are available on its website. If information is not available on the registrant's website, it must include a copy of such standards and definitions in an appendix to its proxy statement or information statement that is provided to security holders at least once every three fiscal years. Item 407(a)(2), Regulation S-K.

(n535)Footnote 535. Instruction 1, Item 407(a), Regulation S-K.

(n536)Footnote 536. Item 407(a)(3), Regulation S-K.

(n537)Footnote 537. Item 407(a)(3), Regulation S-K.

(n538)Footnote 538. A Form S-1 may be post-effectively amended to incorporate by reference a new Form 10-K by the registrant, only if the post-effective amendment is filed after the new Form 10-K has been filed, and the registrant meets all other requirements for incorporation by reference. Question 113.08, Questions and Answers of General Applicability, Securities Act Forms.

(n539)Footnote 539. Item 12(a), Form S-1.

The conditions for incorporating by reference any required consents are set forth in Rule 439. Note to Item 12(a), Form S-1.

(n540)Footnote 540. Item 12(b), Form S-1.

If it sends to security holders any of the information that is incorporated by reference in the prospectus, the registrant must send along with it any exhibits that are specifically incorporated by reference in that information. Note to Item 12(b)(1), Form S-1.

(n541)Footnote 541. Item 12(b)(2), Form S-1.

If a registrant wants to incorporate by reference an Exchange Act report that the registrant files after the filing date of a Form S-1 or an amendment thereto but prior to effectiveness, the registrant must file a pre-effective amendment to include a specific reference to such report in the prospectus filed as part of the registration statement. Question 113.05, Questions and Answers of General Applicability, Securities Act Forms.

(n542)Footnote 542. Acceleration of the effective date of a registration statement is discussed in § 7A.06[7][a] *infra*.

(n543)Footnote 543. Item 510, Regulation S-K.

Item 702 of Regulation S-K is discussed in § 7.03[3][b] *infra*.

(n544)Footnote 544. For discussion of Rule 431 which contains the provisions for the preparation and filing of summary prospectuses, *see* § 7A.05[1][f] *infra*.

(n545)Footnote 545. Instruction 1(a), Instructions as to Summary Prospectuses, Form S-1. Item 1 of Form S-1 is discussed in § 7.03[2][a] *supra*.

(n546)Footnote 546. *Id.*, Instruction 1(b). Item 4 of Form S-1 is discussed in § 7.03[2][d] *supra*.

(n547)Footnote 547. *Id.*, Instruction 1(c). Item 7 of Form S-1 is discussed in § 7.03[2][g] *supra*.

(n548)Footnote 548. *Id.*, Instruction 1(d). Item 8 of Form S-1 is discussed in § 7.03[2][h] *supra*.

(n549)Footnote 549. *Id.*, Instruction 1(e). Item 9 of Form S-1 is discussed in § 7.03[2][i] *supra*.

(n550)Footnote 550. Selected financial data pursuant to Item 301 of Regulation S-K is discussed in § 7.03[2][k][vi] *supra*. Item 11 of Form S-1 is discussed in § 7.03[2][k] *supra*.

(n551)Footnote 551. Instruction 1(f), Instructions as to Summary Prospectuses, Form S-1.

(n552)Footnote 552. Instruction 1(g), Instructions as to Summary Prospectuses, Form S-1.

(n553)Footnote 553. The summary prospectus cannot contain a summary or condensation of any other required financial information except as set forth above. Instruction 2, Instructions as to Summary Prospectuses, Form S-1.

(n554)Footnote 554. Item 9 of Form S-1 is discussed in § 7.03[2][i] *supra*. Item 11 of Form S-1 is discussed in § 7.03[2][k] *supra*.

(n555)Footnote 555. Instruction 3, Instructions as to Summary Prospectuses, Form S-1.

(n556)Footnote 556. Instruction 4, Instructions as to Summary Prospectuses, Form S-1.

(n557)Footnote 557. Rule 120. Of course, registration statements filed electronically with the Commission via EDGAR are publicly available on the Commission's website at www.sec.gov.

(n558)Footnote 558. Instruction, Item 511, Regulation S-K.

The Instruction to Item 511 of Regulation S-K requires separate disclosure of insurance policy premiums only for policies covering the offering of securities to be registered. Current umbrella insurance policies that include federal securities law liability coverage and premium increases on current policy arising from the offering need not be disclosed. Sec. Act Rel. No. 33-6332, Fed. Sec. L. Rep. (CCH) No. 926, Part II (1981).

The blue sky laws of several states provide for a ceiling on expenses in connection with the offering of securities in their respective jurisdictions. Normally, the computation of the ceiling includes underwriting commissions and discounts and all other expenses in connection with the offering. Therefore, the statutes of the states in which the securities are to be offered should be checked carefully to ascertain whether the ceiling is exceeded.

(n559)Footnote 559. Instruction, Item 511, Regulation S-K.

(n560)Footnote 560. For definition of the term "controlling," *see* § 7.03[2][h][ii] *supra*.

(n561)Footnote 561. In addition to registrants, underwriters may indemnify directors and officers against liability arising under the Securities Act.

The Commission has taken the position that indemnification by registrants of directors, officers, or controlling persons against liabilities arising under the Securities Act is against public policy and unenforceable. *See* § 7.03[2][n] *supra*. The same position is taken in the event the registrant agrees to indemnify the underwriter or controlling persons of the underwriter where a director, officer, or controlling person of the registrant is such an underwriter or controlling person thereof or a member of any firm that is such an underwriter. *See* Item 510, Regulation S-K, discussed at § 7.03[2][n] *supra*.

(n562)Footnote 562. If the sales were made in a series of transactions, the information may be given by such totals and periods as will reasonably convey the information required. Instruction 2, Item 701, Regulation S-K.

Information need not be set forth as to notes, drafts, bills of exchange, or bankers' acceptances that mature not later than one year from the date of issuance. Instruction 1, Item 701, Regulation S-K.

(n563)Footnote 563. Item 701(a)-(d), Regulation S-K. Unless some exemption was available, the registrant is exposed to a contingent liability under Section 12, discussed in § 9.03 *infra*, and that must be disclosed.

(n564)Footnote 564. Rule 411(c) provides that any document, or part of any document, filed with the Commission may be incorporated by reference, subject to Item 10(d) of Regulation S-K as an exhibit to any registration statement. If any modification has occurred in the text of any document incorporated by reference since the filing of the document, the registrant must file a statement containing the text of the modification and the date of the modification with the reference.

Item 10(d) Regulation S-K, "Incorporation by Reference," allows a document to be incorporated by reference to the specific document and to the prior filing or submission in which such document was physically filed or submitted if the rules, regulations or instructions to the forms of the Commission permit incorporation by reference. Item 10(d) prohibits incorporation by reference to be made to any document that incorporates another document by reference if the pertinent portion of the document containing the information to be incorporated by reference includes an incorporation by reference to another document, except where a registrant is expressly required to incorporate such document by reference. Item 10(d) also prohibits any document on file with the Commission for more than five years to be incorporated by reference. The five year rule does not apply to:

- documents contained in registration statements, which may be incorporated by reference as long as

the registrant has a reporting requirement with the Commission; and

- documents that the registrant specifically identifies by physical location by Commission file number reference, provided that those materials have not been disposed of pursuant to the Commission's Records Control Schedule, 17 C.F.R. § 200.80f.

(n565)Footnote 565. If the registration statement is filed electronically and an exhibit is filed in paper pursuant to a hardship exemption, the letter "P" shall be placed next to the exhibit required by Item 601(a)(2). Whenever an electronic confirming copy of an exhibit is filed pursuant to a grant of a temporary hardship exemption, the exhibit index shall specify where the confirming electronic copy can be located and the designation "CE" (confirming electronic) must be placed next to the listed exhibit in the exhibit index. Instruction 4, Item 601, Regulation S-K. Item 601(a)(2), Regulation S-K.

(n566)Footnote 566. Instruction 1(A), (B), Item 601, Regulation S-K.

(n567)Footnote 567. Unless otherwise specifically noted, only copies rather than originals of each exhibit need be filed. Instruction 3, Item 601, Regulation S-K. Additionally, a smaller reporting company need not provide the disclosure required by Item 601(b)(12) regarding computation of certain ratios. Item 601(c), Regulation S-K.

(n568)Footnote 568. The number in parenthesis at the beginning of each exhibit refers to the appropriate subsection in Item 601(b) of Regulation S-K where a description of the exhibit can be found. Instruction 3 to the Exhibit Table, Item 601, Regulation S-K.

(n569)Footnote 569. The registrant must include a copy of each underwriting contract with a principal underwriter pursuant to which the securities being registered are to be distributed. If the terms of the underwriting contract have not been determined, the proposed form of the document should be furnished. The final form of the agreement may be filed as an exhibit to a report on Form 8-K which is incorporated by reference into a registration statement subsequent to its effectiveness. Item 601(b)(1), Regulation S-K.

(n570)Footnote 570. These documents include any material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation, or arrangement and any amendments thereto described in the registration statement. Schedules to these exhibits need not be filed, however, unless the schedules contain information that is material to an investment decision and that is not otherwise disclosed in the agreement or disclosure document. If any schedules are omitted, the plan filed must contain a list briefly identifying the contents of the omitted schedules, along with an agreement to furnish a supplementary copy of any omitted schedule to the Commission upon request. Item 601(b)(2), Regulation S-K.

(n571)Footnote 571. These documents include the registrant's articles of incorporation and bylaws, or instruments corresponding thereto as currently in effect, and any amendments thereto. If amendments to the articles or by-laws are filed, the registrant must also file a complete copy of the articles or by-laws as amended. Item 601(b)(3), Regulation S-K. If it is impracticable for the registrant to file a charter amendment authorizing new securities with the appropriate state authority prior to the effective date of the registration statement, the proposed form of the amendment to be filed with the state authority may be filed as an exhibit to the registration statement. If material changes are made in the charter after the copy is filed, the registrant must also file the changed copy. *Id.*

(n572)Footnote 572. These documents include all instruments defining the rights of holders of equity or debt securities being registered, including, where applicable, the relevant portion of the articles of incorporation or by-laws of the registrant, and all instruments defining the rights of holders of long-term debt of the registrant, its consolidated subsidiaries, and any unconsolidated subsidiaries for which financial statements are required to be filed. Item 601(b)(4), Regulation S-K. However, for those instruments defining the rights of holders of long-term debt, there need not be

filed:

- (1) any instrument representing a long-term debt not being registered if the total amount of securities authorized by the instrument does not exceed 10% of the total assets of the registrant and its subsidiaries on a consolidated basis and if the registrant has filed an agreement to furnish to the Commission a copy of the agreement upon request;
- (2) any instrument representing any class of securities if appropriate steps will be taken to assure the redemption or retirement of that class, prior to or upon delivery by the registrant of the securities being registered; or
- (3) copies of instruments evidencing scrip certificates for fractions of shares.

Item 601(b)(4)(iii)(A)-(C), Regulation S-K.

If any of the securities being registered are or will be issued under an indenture to be qualified under the Trust Indenture Act, the copy of the indenture filed as an exhibit should include or be accompanied by:

- (1) a reasonably itemized and informative table of contents; and
- (2) a cross-reference sheet showing the location in the indenture of the provisions inserted pursuant to Sections 310 through 318(a) inclusive of the Trust Indenture Act. Item 601(b)(4)(iv), Regulation S-K.

The registrant is not required to file any instrument which defines the rights of participants (not as security holders) pursuant to an employee benefit plan. Instruction 1, Item 601(b)(4), Regulation S-K.

If two or more indentures, contracts, franchises, or other documents required to be filed as exhibits are substantially identical in all material respects except as to parties thereto, the dates of execution, or other details, the registrant should file a copy of only one of the documents, with a schedule identifying the omitted documents and setting forth the material details in which the omitted documents differ from the document a copy of which was filed. Instruction 2, Item 601, Regulation S-K. The Commission may at any time require filing of copies of any document so omitted. *Id.*

(n573)Footnote 573. The registrant must file an opinion of counsel regarding the legality of securities being registered, indicating whether the securities will, when sold, be legally issued, fully paid, and nonassessable, and, if debt securities, whether they will be binding obligations of the registrant. Item 601(b)(5)(i), Regulation S-K. The signed opinion covering the specific securities sold in a particular offering must be filed as part of the registration statement or incorporated by reference into the registration statement no later than the closing date of the offering of such securities. Question 118.02, Questions and Answers of General Applicability, Securities Act Forms. The registrant must also file either an opinion of counsel or an Internal Revenue Service determination letter regarding the legality of securities issued pursuant to a plan subject to the Employment Retirement Income Security Act of 1974 ("ERISA") (29 U.S.C. § 1001 *et seq.*), both when the plan is originally adopted and when it is subsequently amended. Items 601(b)(5)(ii)(A)-(B) and 601(b)(5)(iii)(A)-(B), Regulation S-K.

(n574)Footnote 574. If Industry Guide 5, "Preparation of registration statements relating to interests in real estate limited partnerships," applies, the registrant must include an opinion of counsel, an opinion of an independent public or certified accountant, or an Internal Revenue Service ruling supporting the tax matters and the tax consequences to shareholders as described in the filing when those tax matters are material to the transaction for which the registration statement is being filed. Item 601(b)(8), Regulation S-K. Otherwise, an opinion of counsel as to tax matters must be filed only where the tax consequences under Guide 5 are material to an investor and a representation as to tax

consequences is set forth in the filing. *Id.* This requirement may be satisfied, however, by the inclusion of the full opinion in the registration statement. *Id.* The tax opinion may be conditioned or qualified if the conditions and qualifications are fully described in the filing. *Id.*

(n575)Footnote 575. These documents include any voting trust agreement and amendments thereto. Item 601(b)(9), Regulation S-K.

(n576)Footnote 576. The registrant must include every contract not made in the ordinary course of business that is:

- (1) material to the registrant; and
- (2) to be performed in whole or in part at or after the filing of the registration statement; or
- (3) entered into not more than two years before the filing of the registration statement.

The registrant, however, need file only those contracts to which it or its subsidiary is a party, or has succeeded to a party by assumption or assignment, or in which the registrant or its subsidiary has a beneficial interest. Item 601(b)(10)(i), Regulation S-K.

Except where immaterial in amount or significance, a contract made in the ordinary course of business need not be filed unless:

- (1) it is a contract to which directors, officers, promoters, voting trustees, security holders named in the registration statement or report, or underwriters are parties, except for contracts involving only the purchase or sale of current assets having a determinable market price, at that price;
- (2) it is a contract upon which the registrant's business is substantially dependent (*e.g.* continuing contracts to sell the major part of the registrant's products or services or to purchase the major part of the registrant's requirements of goods, services, or raw materials or any franchise, license or other agreement to use a patent, formula, trade secret, process, or trade name upon which the registrant's business depends to a material extent);
- (3) it is a contract calling for the acquisition or sale of any property, plant, or equipment for a consideration exceeding 15% of such fixed assets of the registrant on a consolidated basis; or
- (4) it is a material lease under which a part of the property described in the registration statement is held by the registrant. *Id.* Item 601(b)(10)(ii)(A)-(D), Regulation S-K.

Certain contracts in which any director or any of the five most highly compensated executive officers of the registrant participates will be deemed material and must be filed (if not set forth in a formal document, a written description is required to be filed) including any management contract or any remunerative plan, contract, or arrangement, including (but not limited to) plans relating to options, warrants or rights, pension, retirement or deferred compensation, or bonus, incentive, or profit sharing. Those contracts, plans, or arrangements in which any other executive officer of the registrant participates must also be filed unless immaterial in amount or significance.

Management contracts or compensatory plans, contracts or arrangements need not be filed, however, if they are:

- (1) ordinary purchase and sales agency agreements;

- (2) agreements with managers of stores in a chain or similar organization;
- (3) contracts providing for labor or salesperson's bonuses or payments to a class of security holders as such;
- (4) a compensatory plan, contract, or arrangement that pursuant to its terms is available to employees, officers, or directors generally and that in operation provides for the same method of allocation of benefits between management and nonmanagement participants; or
- (5) a compensatory plan, contract, or arrangement of a foreign private issuer that furnishes compensation information on an aggregate basis pursuant to General Instruction 1 to Item 402 of Regulation S-K, discussed in § 7.03[3][k][xii][A] *supra*, or by Item 11 of Form 20-F; or Items 601(b)(10) (iii)(A), 601(b)(10)(iii)(C)(1)-(5), Regulation S-K.

With the exception of management contracts, registrants need only file copies of the various remunerative plans and need not file each individual director's or executive officer's personal agreement under the plans unless there are particular provisions in such personal agreements whose disclosure as an exhibit necessary to an investor's understanding of that individual's compensation under the plan. Instruction, Item 601(b)(10)(iii), Regulation S-K.

(n577)Footnote 577. The registrant must include a statement showing in reasonable detail the computation of per-share earnings, unless that computation can be clearly determined from the material contained in the registration statement. Item 601(b)(11), Regulation S-K.

(n578)Footnote 578. A company that qualifies as a smaller reporting company need not provide such disclosure required by Item 601(b)(12). Item 601(c), Regulation S-K. All registrants, other than smaller reporting companies, must set forth in reasonable detail the computation of any ratio of earnings to fixed charges, ratio of earnings to combined fixed charges and preferred stock dividends, or other ratios that appear in the registration statement. Item 601(b)(12), Regulation S-K.

See Item 503(d) of Regulation S-K, "Ratio of earnings to fixed charges," discussed in § 7.03[2][c][iv] *supra*.

(n579)Footnote 579. The registrant must file, where applicable, a letter from an independent accountant that acknowledges the accountant's awareness of the use in the registration statement of a report on unaudited interim financial information that pursuant to Rule 436(c) is not considered a part of a registration statement prepared or certified by an accountant or a report prepared or certified by an accountant within the meaning of Sections 7 and 11 of the Securities Act. Item 601(b)(15), Regulation S-K. The letter may be filed with the registration statement, an amendment thereto or a report on Form 10-Q which is incorporated by reference into the registration statement. *Id.*

The phrase "report on unaudited interim financial information" means a report consisting of:

- (1) a statement that the review of interim financial information was made in accordance with established professional standards for such reviews;
- (2) an identification of the interim financial information reviewed;
- (3) a description of the procedures for a review of interim financial information;
- (4) a statement that a review of interim financial information is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is an

expression of opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed; and

(5) a statement whether the accountant is aware of any material modifications that should be made to conform the accompanying financial information with generally accepted accounting principles. Rule 436(d)(1)-(5).

(n580)Footnote 580. If required by Item 304 of Regulation S-K, the registrant must provide a letter from its former independent accountant of registrant regarding its concurrence or disagreement with the statements made by the registrant in the current report concerning the resignation or dismissal as the registrant's principal accountant. Item 601(b)(16), Regulation S-K. *See § 7.03[2][k][ix] supra.*

(n581)Footnote 581. A list of the registrant's subsidiaries, the state or other jurisdiction of incorporation or organization of each, and the names under which those subsidiaries do business, must be included. The names of particular subsidiaries may be omitted, however, if as of the end of the year covered by the report, the unnamed subsidiaries considered in the aggregate as a single subsidiary would not constitute a significant subsidiary, as defined in Rule 1-02(v) of Regulation S-X. The names of consolidated, wholly owned, multiple subsidiaries carrying on the same line of business, such as chain stores or small loan companies, may be omitted, provided the name of the immediate parent, the line of business, the number of omitted subsidiaries operating in the United States, and the number operating in foreign countries are given. This instruction shall not apply, however, to banks, insurance companies, savings and loan associations, or to any subsidiary subject to regulation by another federal agency. The registrant may incorporate by reference its list of subsidiaries from any document previously filed with the Commission that contains an accurate and complete list of the subsidiaries. Item 601(b)(21)(i), (ii), Regulation S-K.

(n582)Footnote 582. The registrant must file dated and manually signed copies of all written consents required to be filed under the Securities Act. Consents may be included in the report of the expert or opinion of counsel filed with the registration statement or in the registration statement itself, so long as a reference is made in the exhibit index to the report, the part of the document or registration statement or opinion containing the consent. Item 601(b)(23)(i), Regulation S-K.

(n583)Footnote 583. The registrant must file manually signed copies of powers of attorney if any name is signed to the registration statement pursuant to a power of attorney. If the power of attorney is contained elsewhere in the registration statement or a document filed therewith, the registrant should make a reference in the exhibit index to the part of the registration statement or document containing the power of attorney. In addition, if the name of any officer signing on behalf of the registrant is signed pursuant to a power of attorney, the registrant must also file certified copies of a resolution of the registrant's board of directors authorizing the signature. A power of attorney filed with the Commission may relate only to a specific filing or amendment thereto and may not confer general authority, provided, however, that a power of attorney relating to a registration statement under the Securities Act may also relate to any registration statement for the same offering that is to be effective pursuant to Rule 462(b) under the Securities Act. Item 601(b)(24), Regulation S-K.

(n584)Footnote 584. The registrant must file a statement of eligibility and qualification of each person designated a trustee under an indenture to be qualified under the Trust Indenture Act of 1939. The statement of eligibility must be separately bound from the other exhibits, unless the registration statement is submitted in electronic format, in which event the statement of eligibility should be submitted in the same electronic submission as the registration statement to which it relates or an amendment thereto. Electronic filers that rely on Section 305(b)(2) of the Trust Indenture Act for determining the eligibility of the trustee under indentures for securities to be issued, offered or sold on a delayed basis by or on behalf of the registrant shall file statements of eligibility separately in the manner prescribed by Rules 5b-1 through 5b-3 under the Trust Indenture Act (17 C.F.R. §§ 260.5b-1-260.5b-3) and by the EDGAR Filer Manual.

(n585)Footnote 585. The registrant must file any form of communication that is an invitation for competitive bidding being sent or given to any person, if the registration statement covers securities to be offered through competitive bidding. Item 601(b)(26), Regulation S-K.

(n586)Footnote 586. These documents include any document (except for an exhibit) or part of a document which is incorporated by reference in the filing that is not otherwise required to be filed by Item 601 of Regulation S-K. Regulation S-K or is not a Commission filed document incorporated by reference in a Securities Act registration statement. Item 601(b)(99)(ii), Regulation S-K. Any additional exhibits that the registrant may wish to file must be clearly marked to indicate the subject matter to which they refer. Item 601(b)(99)(i), Regulation S-K.

(n587)Footnote 587. Item 11, Regulation S-T.

(n588)Footnote 588. Item 601(101)(i), Regulation S-K.

(n589)Footnote 589. Item 601(101)(ii), Regulation S-K.

(n590)Footnote 590. Item 601(101)(iii), Regulation S-K.

(n591)Footnote 591. For a discussion of Item 11(e) of Regulation S-K, *see* § 7.03[2][k][v] *supra*.

(n592)Footnote 592. In addition to the undertakings discussed below, Item 512 of Regulation S-K sets forth other undertakings which are required in certain circumstances, among which are those required when a registration statement incorporates subsequent Exchange Act documents by reference (Item 512(b)) and those required in registration statements which specifically incorporate by reference (other than by indirect reference through a Form 10-K) all or any portion of an annual report to security holders meeting the requirements of Rule 14a-3 or Rule 14c-3 under the Exchange Act. Item 512(e), Regulation S-K.

(n593)Footnote 593. Any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement.

(n594)Footnote 594. Item 512(a)(1)(i)-(iii), Regulation S-K.

(n595)Footnote 595. Item 512(a)(2), Regulation S-K. This undertaking reflects the Commission's view of the law in this area as well as the longstanding staff practice of requiring the inclusion of this undertaking in a "shelf" registration statement. Sec. Act Rel. No. 33-6383, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n596)Footnote 596. Item 512(a)(3), Regulation S-K.

(n597)Footnote 597. Item 512(a)(4), Regulation S-K.

(n598)Footnote 598. Item 512(a)(6), Regulation S-K.

(n599)Footnote 599. Rule 430B was adopted as part of the 2005 Rules, and it describes which type of information may be omitted from a base prospectus in a Rule 415 offering and included instead in a prospectus supplement, Exchange Act reports incorporated by reference or a post-effective amendment.

(n600)Footnote 600. Relating to an offering made pursuant to Rule 415(a)(1)(i) (securities sold by persons other than the registrant, subsidiary of the registrant or person to which the registrant is a subsidiary), Rule 415(a)(1)(vii) (mortgage related securities) and Rule 415(a)(1)(x) (securities registered on Form S-3 or Form F-3 offered and sold on an immediate, continuous or delayed basis).

(n601)Footnote 601. Rule 430C was a new rule adopted as part of the 2005 Rules that has provisions similar to Rule 430B regarding the treatment of prospectus supplements and which applies to offerings not covered by Rule 430B and prospectuses not covered by Rule 430A.

(n602)Footnote 602. Item 512(a)(5), Regulation S-K.

(n603)Footnote 603. Rule 461 is discussed in § 7A.06[7][a] *infra*.

(n604)Footnote 604. Instruction 1, Signatures, Form S-1. The name of each person who signs the registration statement must be typed or printed beneath his signature. Any person who occupies more than one position must indicate the capacity or capacities in which he signs the registration statement. Attention of registrants is drawn to Rule 402 concerning manual signatures and to Item 601(b)(25) of Regulation S-K concerning signatures pursuant to powers of attorney. Instruction 2, Signatures, Form S-1.



85 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 § 7.04

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.04 Registration of Securities of Reporting Issuers--Form S-3

[1] Form S-3--Registration of Securities of Reporting Issuers Considered to be Widely Followed by Professional Securities Analysts

Form S-3 is available to corporate issuers that, because of the broad dissemination of corporate information, are widely followed by professional securities analysts. n1 Form S-3 is a reflection of the "efficient market theory." n2 The central thesis of the theory is that available information will percolate down to the marketplace and therefore, need not be reported in every registration statement. n3

Form S-3 relies on incorporation by reference of Exchange Act reports with disclosure in the prospectus being limited to information concerning the offering and material facts not previously disclosed. The documents required to be incorporated by reference are listed in Item 12(a) of Form S-3 *infra*. Subsequently filed Exchange Act reports prior to the termination of the offering must be incorporated by reference into Form S-3. n4

Form S-3 contains two parts: Part I (Items 1-13), concerning information required in the prospectus, and Part II (Item 14-17), concerning information not required to be presented in the prospectus. n5

[a] Eligibility Standards.

The eligibility requirements for use of Form S-3 fall into two categories: "registrant requirements" and "transaction requirements." A registrant must first meet the registrant requirements and then meet one of the transaction requirements before using Form S-3.

[i] Registrant Requirements.

[A] Domestic Corporations. All registrants must meet the following conditions before they may use Form S-3 to register securities offered in any transaction meeting the Form's transaction requirements:

- (1) the registrant must be a United States corporation having its principal business operation in the U.S. or its territories;

(2) the registrant must have a class of securities registered under Exchange Act Section 12(b), n6 a class of equity securities registered under Exchange Act Section 12(g), n7 or must file reports under Exchange Act Section 15(d); n8

(3)

(a) the registrant must have been subject to the requirements of the Securities Exchange Act Section 12 or 15(d) and have filed all material required to be filed under Exchange Act Section 13, n9 14, n10 or 15(d) n11 for at least 12 calendar months n12 immediately preceding the filing of the registration statement on Form S-3; n13 and

(b) the registrant must have timely filed all reports required to be filed during the 12 calendar months and any portion of a month immediately preceding the filing of the registration statement; if the registrant has used Rule 12(b)-25(b) concerning any Exchange Act report or portion of a report, n14 the report or portion thereof must have been actually filed within the time period prescribed by Rule 12b-25(b); and

(4) the registrant and its consolidated or unconsolidated subsidiaries n15 must have, since the end of the last fiscal year for which certified financial statements of the registrant and its consolidated subsidiaries were included in a filing under Exchange Act Section 13(a) or 14(d), not defaulted to any material extent (*i.e.*, the default in the aggregate is material to the financial position of the registrant and its consolidated and unconsolidated subsidiaries, taken as a whole):

(a) on any dividend or sinking fund installment on preferred stock; or

(b) on any installment on indebtedness for borrowed money or on any rental on one or more long term leases. n16

[B] Successors. A registrant that is a successor will be deemed to have met conditions (1) through (4) above if:

(1) (a) the registrant and its predecessor, taken together, meet the Form S-3 registrant eligibility requirements;

(b) the succession was primarily for the purposes of changing the state of incorporation of the predecessor or to form of holding company; and

(c) the assets and liabilities of the successor at the time of succession were substantially the same as the assets and liabilities of the predecessor; or

(2) all predecessors met the Form S-3 registrant eligibility requirements at the time of the succession and the registrant has continued to meet the requirements since the succession. n17

[C] Foreign Private Issuers. A foreign private issuer satisfying Form S-3 registrant eligibility requirements (A)(2), A(3) and A(4) above for domestic corporations will be deemed to have met the registrant conditions for the use of Form S-3 if the foreign private issuer files the same reports with the commission under Exchange Act Section 13(a) or 15(d) as a domestic corporate registrant does under requirement (A)(3) above. n18

[D] Electronic Filings. If a registrant is subject to the electronic filing requirements of Rule 101 of Regulation S-T, the registrant must have (a) filed with the Commission all required electronic filings, including confirming

electronic copies of documents submitted in paper pursuant to a temporary hardship exemption, and (b) submitted electronically to the Commission and posted on its corporate website, if any, all Interactive Data Files required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the twelve calendar months and any portion of a month immediately preceding the filing of the registration statement on this Form (or for such shorter period of time that registrant was required to submit and post such files). n19

[ii] Transaction Requirements.

If a registrant meets the registrant eligibility requirements, the registrant may use Form S-3 for an offering of securities satisfying any of the following transaction requirements:

[A] Primary and Secondary Offerings By Certain Registrants. A qualified registrant, *i.e.*, one that has met the registrant eligibility requirements, must have a minimum of \$75 million as the aggregate market value of voting and non-voting common equity held by nonaffiliates (the "float") if securities, including securities acquired by standby underwriters in connection with call or redemption by the registrant of warrants or a class of convertible securities, are being offered:

- (1) for cash by or on behalf of a registrant; or
 - (2) in the case of outstanding securities, for cash for the account of any person other than the registrant.
- n20

The "float" is computed by using:

- (1) the price at which the stock was last sold; or
- (2) the average of the bid and asked priced of the stock as of a date within sixty days prior to the date of filing the Form S-3.

For registrants that do not meet the \$75 million float requirement, see § 7.04[1][a][ii][F] *infra* for a discussion of limited primary offerings available under certain limited circumstances.

[B] Primary Offerings of Non-convertible Preferred Securities. A qualified registrant may register non-convertible securities to be offered for cash by or on behalf of the registrant of form S-3 provided the securities are investment grade securities. n21

[C] Transactions Involving Secondary Offerings. A qualified registrant may use Form S-3 for the registration of secondary offerings of securities (outstanding securities offered for the account of any person other than the issuer) if securities of the same class are listed and registered on an exchange or quoted on NASDAQ, n22 including securities acquired by standby underwriters in connection with the call or redemption by the registrant of warrants or a class of convertible securities. n23 In addition, an affiliate n24 may use Form S-3 to register securities for resale, when a Form S-8 prospectus is unavailable for reoffers or resales of securities acquired by affiliates pursuant to a Form S-8 offering of securities to employees pursuant to employee benefit plans, if the conditions specified in General Instruction C to Form S-8 are met. n25

[D] Rights Offerings, Dividend or Interest Reinvestment Plans and Conversions or Warrants. A qualified registrant may use Form S-3 to register securities to be offered:

- (1) upon the exercise of outstanding rights granted by the issuer to be offered on a pro rata basis to all security holders of the class of securities to which the rights attach;

(2) pursuant to a dividend or interest reinvestment plan; n26

(3) upon the conversion of outstanding convertible securities or the exercise of outstanding transferable warrants issued by the issuer or an affiliate. n27

The registrant must send to all plan participants or to all record holders of the rights, convertible securities or transferable warrants, documents containing information required by Exchange Act Rule 14a-3(b) n28 and Items 401 (Director, Executive Officers), 402 (Executive Compensation) and 403 (Security Ownership of Certain Beneficial Owners and Management) of Regulation S-K, n29 within the twelve months immediately preceding the filing of the registration statement. n30 The information required by Items 401, 402 and 403 of Regulation S-K need only be given to holders of rights exercisable for common stock, holders of securities convertible into common stock and participants in plans that may invest in common stock or in securities convertible into common or in warrants exercisable for common stock, respectively. n31

[E] Offerings of Investment Grade Asset-backed Securities. A qualified registrant may use Form S-3 to register asset-backed securities n32 to be offered for cash, provided the securities are investment grade securities. n33

[F] Limited Primary Offerings by Certain Other Registrants. Effective January 2008, the Commission adopted amendments to allow companies with less than \$75 million in public float to register primary offerings of their securities on Form S-3. n34 A qualified registrant may offer securities for cash provided it:

(1) has a class of common equity securities that is listed and registered on a national securities exchange; n35

(2) has not sold, including the current sale, more than the equivalent of one-third of its public float in primary offerings under General Instruction I.B.6 of Form S-3 over the previous 12 calendar months; n36 and

(3) is not a shell company and has not been a shell company for at least 12 calendar months before filing the registration statement. n37

Registrants who use this option to register securities on Form S-3 must set forth on the outside front cover of the prospectus:

(1) the calculation of its public float; and

(2) the amount of all securities offered pursuant to General Instruction I.B.6 during the prior 12 calendar month period that ends on, and includes, the date of the prospectus. n38

[iii] Majority-Owned Subsidiaries. A registrant that is a majority-owned subsidiary n39 may register a security offering on Form S-3 if:

(1) the registrant-subsiary itself meets the registrant requirements and the applicable transaction requirement; n40

(2) the parent of the registrant-subsiary meets the registrant requirements and the securities are investment grade n41 non-convertible debt or preferred stock to be offered in a primary offering for cash by or on behalf of the registrant;

(3) the parent meets both the registrant requirements and the applicable transaction requirement and

provides a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X, of the payment obligations of the securities being registered, and the securities being registered are non-convertible securities, other than common equity; n42

(4) the parent meets the registrant requirements and the applicable transaction requirement, and the securities of the registrant-subsidary being registered are full and unconditional guarantees, as defined in Rule 3-10 of Regulation S-X, of the payment obligations on the non-convertible securities of the parent being registered, other than common equity; or

(5) the parent meets the registrant requirements and the applicable transaction requirement, and the securities of the registrant-subsidary being registered are guarantees of the payment obligations on non-convertible securities, other than common equity, which are being registered by another majority-owned subsidiary of the parent and of which the parent provides a full and unconditional guarantee as defined in Rule 3-10 of Regulation S-X.

[iv] Automatic Shelf Offerings by Well-Known Seasoned Issuers. A registrant that is a well-known seasoned issuer (a "WKSI") n43 may use Form S-3 to register securities offerings. In addition, a WKSI may use a process known as "automatic shelf registration." n44 Automatic shelf registration statements become effective immediately upon filing and are deemed to be filed on the proper form. n45 An issuer offering securities pursuant to an automatic shelf registration statement can elect to defer payment of the fees until the time of the securities offering (known as "pay-as-you-go"), with no fees required at the time of the initial filing of the registration statement. n46 A WKSI may use Form S-3 according to the following:

(1) The securities to be offered must be:

(a) Securities offered in a shelf offering pursuant to Rule 415, Rule 430A or Rule 430B, if by:

(i) a WKSI by reason of having \$700 million of worldwide common equity market capitalization held by non-affiliates; or

(ii) a WKSI only by reason of having issued \$1 billion aggregate amount of non-convertible securities, other than common equity, in registered primary offerings for cash (not in registered exchange offers) during the past three years and that is eligible to register a primary offering of its securities on Form S-3;

(b) Non-convertible securities, other than common equity, if offered in a shelf offering pursuant to Rule 415, Rule 430A or Rule 430B by a WKSI only by having issued \$1 billion aggregate amount of non-convertible securities, other than common equity, in registered primary offerings for cash (not in registered exchange offers) during the past three years and that is *not* eligible to register a primary offering of its securities on Form S-3;

(c) Securities of majority-owned subsidiaries of the parent-registrant offered in a shelf offering pursuant to Rule 415, Rule 430A or Rule 430B, if the parent-registrant is a WKSI and the securities of the majority-owned subsidiary are:

(i) securities of a majority-owned subsidiary that is a WKSI at the time it becomes a registrant (but not if it is a WKSI by reason of its being a majority-owned subsidiary of a parent that is a WKSI and that has provided a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X, of the payment obligations of the subsidiary's securities, and the securities are non-convertible securities other than common equity);

(ii) securities of a majority-owned subsidiary that are non-convertible securities, other than common equity, of whose payment obligations the parent registrant has provided a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X;

(iii) securities of a majority-owned subsidiary that are a guarantee of:

(A) non-convertible securities, other than common equity, of the parent registrant;

(B) non-convertible securities, other than common equity, of another majority-owned subsidiary, of whose payment obligations the parent-registrant has provided a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X; or

(iv) securities of a majority-owned subsidiary that are investment grade non-convertible debt or preferred stock to be offered in a primary offering for cash by or on behalf of the majority-owned subsidiary.

(d) Securities of "selling security holders," provided that the registration statement and the prospectus are not required to separately identify the selling security holders or the securities to be sold by such persons until certain required filings are made. n47

(2) The registrant must pay the registration fee;

(3) If the registrant is a majority-owned subsidiary, it must be one that is required to file and has filed Exchange Act reports and either satisfies the requirements with regard to incorporation by reference or information about it is included in the registration statement (or a post-effective amendment to the registration statement);

(4) The registrant may register additional securities or classes of its or its majority-owned subsidiaries' securities on a post-effective amendment;

(5) An automatic shelf registration statement and post-effective amendment become effective immediately upon filing. All filings made on or in connection with automatic shelf registration statements on Form S-3 become effective immediately without Commission staff review.

[b] Dividend or Interest Reinvestment Plans: Filing and Effectiveness of Registration Statement; Requests for Confidential Treatment. Registration statements on Form S-3 relating solely to securities offered pursuant to dividend or interest reinvestment plans, and post-effective amendments to such registration statements, will become effective automatically upon the date of filing of the form.

For other types of securities, the Commission has not set a minimum time period between the filing and effectiveness of Form S-3 registration statements but will use its administrative discretion to grant requests for acceleration. n48

All filings made on or relating to Form S-3 become public upon filing with the Commission. Consequently, requests for confidential treatment made in accordance with Rule 406 must be processed with the Commission staff prior to the filing of Form S-3. n49

Three copies of the complete registration statement, including exhibits and all papers and documents filed as part of the registration statement required by Rule 402, and three complete, unmarked copies of every amendment, including exhibits and all other papers and documents filed as part of the amendment, required by Rule 472; must be filed with the Commission. n50 The number of additional copies referred to in Rule 402(b) may be reduced from ten to three and the number of additional copies referred to in Rule 472(a) may be reduced from eight to three, one of which must be

marked clearly and precisely to indicate changes. n51

[c] Facing Page. The facing page of Form S-3 calls for the same information as the facing page of Form S-1 except the registrant's primary standard industrial classification code number need not be stated on Form S-3. In addition, Form S-3 requires the registrant to indicate the following information set forth in check boxes:

- (1) whether the only securities being registered are being offered pursuant to dividend or interest reinvestment plans;
- (2) whether any of the securities being registered are to be offered on a delayed or continuous basis pursuant to Rule 415, other than securities offered pursuant to dividend or interest reinvestment plans;
- (3) whether the Form S-3 is filed to register additional securities for an offering, pursuant to Rule 462(b), and the registration statement number of the earlier effective registration statement for the offering;
- (4) whether the Form S-3 is filed to register additional securities for an offering, pursuant to Rule 462(c), and the registration statement number of the earlier effective registration statement for the offering;
- (5) whether the Form S-3 is an automatic shelf registration statement or a post-effective amendment thereto that will become effective upon filing pursuant to Rule 462(e); and
- (6) whether the Form S-3 is a post-effective amendment to an automatic shelf registration statement filed to register additional securities or additional classes of securities pursuant to Rule 413(b).

[d] Registration of Additional Securities and Additional Classes of Securities. A registrant can register additional securities for an offering on Form S-3 according to the following:

(1) *Registration of Additional Securities Pursuant to Rule 462(b).* A registrant can register additional securities for an offering through a registration statement under certain conditions set forth in Rule 462(b). That registration statement may consist only of the following: the facing page; a statement that the contents of the earlier registration statement, identified by file number, are incorporated by reference; required opinions and consents; the signature page; and any price-related information omitted from the earlier registration statement (in reliance on Rule 430A) that the registrant chooses to include in the new registration statement. The information contained in such a registration statement is deemed to be a part of the earlier registration statement as of the date of effectiveness of the later registration statement. Any opinion or consent required in the later registration statement may be incorporated by reference from the earlier registration statement with respect to the offering, if: (i) such opinion or consent expressly provides for such incorporation; and (ii) such opinion relates to securities registered pursuant to Rule 462(b). n52

(2) *Registration of Additional Securities or Classes of Securities or Additional Registrants After Effectiveness of Automatic Shelf Registration.* A registrant which qualifies as a WKSI may register additional securities or classes of securities by filing a post-effective amendment to the effective registration statement. n53 The post-effective amendment must consist of the facing page; the disclosure updating the registration statement to reflect the additional securities, additional classes of securities or additional registrants; any required opinions and consents; and the signature page. Required information, consents or opinions may be included in the prospectus and the registration statement through a post-effective amendment or may be provided through a document incorporated or deemed incorporated by reference into the registration statement (and the prospectus that is part of the registration statement). Alternatively, the information required to update the registration statement may be contained in a

prospectus filed pursuant to Rule 424(b), and it will be deemed part of the registration statement and prospectus. n54 The post-effective amendment is effective immediately. n55

[e] The Prospectus.

Part I of Form S-3 is the prospectus and contains Items 1 through 13. No table of contents or cross reference sheet need be included in the Form S-3 prospectus or registration statement. n56 In addition to the information expressly required to be included in the Form S-3, the registrant may provide any other information it deems appropriate. n57 As with disclosure in Form S-1, a registrant that qualifies as a smaller reporting company that is eligible to use Form S-3 need only provide the scaled disclosure items in Regulation S-K. n58

Since information about the registrant is incorporated by reference in Form S-3 from Exchange Act reports, the prospectus does not require presentation of any information about the registrant except when:

- (1) there has been a material change in the registrant's affairs not reported in an Exchange Act filing; or
- (2) the Exchange Act reports incorporated by reference do not reflect restated financial statements or other financial information. n59

Form S-3 cannot be used to register securities issued in an exchange offer for securities of another person; instead, Form S-4 must be used.

[i] Item 1. Forepart of the Registration Statement and Outside Front Cover Page of Prospectus. This item requires the same information required by Item 501 of Regulation S-K to be furnished in response to Item 1 of Form S-1.

Additionally, registrants who use General Instruction I.B.6 to register securities on Form S-3 must set forth on the outside front cover of the prospectus:

- (1) the calculation of its public float; and
- (2) the amount of all securities offered pursuant to General Instruction I.B.6 during the prior 12 calendar month period that ends on, and includes, the date of the prospectus. n60

[ii] Item 2. Inside Front and Outside Back Cover Pages of Prospectus. This item calls for the same information required by Item 502 of Regulation S-K to be furnished in response to Item 2 of Form S-1.

[iii] Items 3. Summary Information, 4. Use of Proceeds and 5. Determination of Offering Price. Items 3 (Summary Information, Risk Factors and Ratio of Earnings to Fixed Charges), 4 (Use of Proceeds) and 5 (Determination of Offering Price) of Form S-3 require identical information as Items 3, 4 and 5 of Form S-1. n61

[iv] Item 6. Dilution. Where common equity securities are being registered by a registrant that has had losses in each of its last three fiscal years and there is a material dilution of the purchasers' equity interest, this item requires the registrant to disclose the following information in accordance with Item 506 of Regulation S-K:

- (1) the net tangible book value per share before and after the distribution;
- (2) the amount of the increase in the net tangible book value per share attributable to the cash payments made by purchasers of shares being offered; and

(3) the amount of the immediate dilution from the public offering price that will be absorbed by the purchasers. n62

The requirement to discuss dilution where the registrant has not been subject to the Exchange Act reporting requirement contained in the first sentence of Item 506 of Regulation S-K, is not applicable to Form S-3. n63

[v] Item 7. Selling Security Holders. This item requires information about selling security holders that is identical to the information required by Item 507 of Regulation S-K to be given in response to Item 7 of Form S-1. n64

[vi] Item 8. Plan of Distribution. This item requires identical information required by Item 508 of Regulation S-K to be given in response to Item 8 of Form S-1 with two exceptions:

(1) The requirement for disclosure, required by Item 508(b) of Regulation S-K, of the new underwriter's experience and of their relationship with the registrant, promoters and their controlling persons where the securities being registered are securities of nonreporting registrants, does not apply to Form S-3; and n65

(2) The requirement for disclosure pursuant to Item 508(j) of Regulation S-K of any principal underwriter's intention to sell its discretionary accounts, applies only where the registrant has not been subject to the Exchange Act reporting requirements and does not apply to Form S-3. n66

[vii] Items 9. Description of Securities to be Registered and 10. Interests of Named Experts and Counsel.

Items 9 and 10 of Form S-3 require information that is identical to the information required by Items 9 and 10 of Form S-1, n67 except that in response to Item 9 of Form S-3, no description of the registrant's securities to be registered need be made pursuant to Item 202 of Regulation S-K if capital stock is being registered and securities of the same class are registered under Exchange Act Section 12. n68

[viii] Item 11. Material Changes. This item requires the registrant to describe material changes in the registrant's affairs since the end of the latest fiscal year for which certified financial statements were included in the latest annual report to security holders and that were not described in a filed report on Exchange Act Form 10-Q or Form 8-K. n69

The registrant must include the following in the prospectus if not incorporated by reference therein from Exchange Act reports as specified by Item 12(a) of Form S-3, n70 or in proxy or information statements n71 filed pursuant to Section 14 of the Exchange Act, or a prospectus previously filed under Rule 424(b) or (c) under the Securities Act, or where no prospectus was required to be filed pursuant to 424(b).

(1) information required by Rules 3-05, "Financial Statements of Businesses Acquired or to be Acquired," and Article 11, "Pro Forma Financial Information," of Regulation S-X where the registrant has effected or will effect a transaction for which the information is required;

(2) restated financial statements prepared according to Regulation S-X if there has been:

(a) a change in accounting principles or a correction of an error, and the change or correction requires a material retroactive restatement of financial statements; or

(b) a combination of entities under common control consummated subsequent to the most recent fiscal year and the transferred businesses considered in the aggregate meet the test of a significant subsidiary; n72 or

(3) any financial information required because of a material disposition of assets outside the normal course of business. n73

A registrant that qualifies as a smaller reporting company need only provide the financial information called for by Article 8 of Regulation S-X in lieu of the financial information called for by Item 11 of Form S-3. n74

[ix] Item 12. Incorporation of Certain Information by Reference. Item 12(a)(1) and Item 12(a)(2) of Form S-3 require the registrant to incorporate by reference, by a statement in the prospectus, the registrant's latest annual report to the Commission on Form 10-K that contains certified financial statements for the registrant's latest fiscal year for which a Form 10-K was required to have been filed and all periodic or quarterly reports filed since the end of that fiscal year. n75

Item 12(a)(3) of Form S-3 provides that, if capital stock is being registered and securities of the same class are registered under Section 12 of the Exchange Act, the registrant must incorporate into the prospectus the description of the class of securities contained in the registration statement filed under the Exchange Act including any amendment or reports filed that update the description. The documents incorporated by reference are incorporated by a statement to the effect in the prospectus listing all documents incorporated by reference. n76

The registrant must also state in the prospectus that all documents subsequently filed by the registrant pursuant to Sections 13(a), 13(c), 14 or 15(d), of the Exchange Act prior to the termination of the offering, shall be deemed incorporated by reference. n77

The registrant must state (i) that it will provide to each person, including any beneficial owner, to whom a prospectus is delivered, a copy of any or all of the information that has been incorporated by reference in the prospectus but not delivered with the prospectus; (ii) that it will provide this information upon written or oral request; (iii) that it will provide this information at no cost to the requester; and (iv) the name, address and telephone number to which the request for this information should be sent. n78

The registrant must identify the reports and other information that it files with the Commission and state that the public may read and copy any materials it files with the Commission at its Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The registrant must state that the public may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330. If the registrant is an electronic filer, it must state that the Commission maintains an Internet site that contains reports, proxy and information statements and other information regarding electronic filers (www.sec.gov). The registrant is encouraged to give its Internet address, if available. n79

Any of the information required by Item 3 through Item 11 of Form S-3 n80 may be included in the prospectus through documents filed under the Exchange Act that are incorporated or deemed incorporated by reference into the prospectus that is part of the registration statement. n81

[x] Item 13. Disclosure of Commission Position on Indemnification for Securities Act Liabilities. This item requires information identical to the information required by Item 12A of Form S-1. n82

[f] Information Included in the Registration Statement But Not Required in Prospectus.

Part II of Form S-3, concerning information not required to be presented in the prospectus contains Items 14 through 17.

[i] Items 14. Other Expenses of Issuance and Distribution; and 15 Indemnification of Directors and Officers. Items 14 and 15 of Form S-3 require information identical to the information required to be furnished by Items 13 and 14 of Form S-1. n83

[iii] Item 16. Exhibits. The following documents are required by Item 601 of Regulation S-K to be filed as exhibits to Form S-3:

1. (1) n84 underwriting agreement; n85

2. (2) plan of acquisition, reorganization, arrangement, liquidation or succession; n86
3. (4) instruments defining the rights of security holders, including indentures; n87
4. (5) opinion regarding legality; n88
5. (8) opinion regarding tax matters; n89
6. (12) statement regarding computation of ratios; n90
7. (15) letter regarding unaudited interim financial information; n91
8. (23) consents of experts and counsel; n92
9. (24) powers of attorney; n93
10. (25) statement of eligibility of trustee; n94
11. (26) invitations for competitive bids; n95 and
12. (99) additional exhibits. n96

[iii] Item 17. Undertakings.

[A] Rule 415 Offering. The same undertakings concerning securities being registered pursuant to Rule 415 for the registration of securities on a delayed or continuous basis ("shelf" registration, both "automatic" and "non-automatic") as called for by Item 512(a) of Regulation S-K to be furnished in Form S-1 must be furnished in Form S-3. The undertakings called for by Items 512(a)(1)(i), (ii) and (iii) of Regulation S-K are not required to be furnished in Form S-3 if the information that must be included in a post-effective amendment pursuant to those items is contained in reports filed with the Commission by the registrant under Section 13 or Section 15(d) of the Exchange Act (that are incorporated by reference in the registration statement), or is contained in a form of prospectus filed pursuant to Rule 424(b) (that is part of the registration statement). n97

[B] Filings Incorporating Subsequent Exchange Act Documents by Reference. Since Form S-3 incorporates by reference Exchange Act documents filed subsequent to the effective date of the registration statement, the registrant must undertake that, for purposes of determining Securities Act liability, each filing of an annual report under Section 13(a) or 15(d) of the Exchange Act and, where applicable, each filing of an employee benefit plan's annual report under Section 15(d) of the Exchange Act, that is incorporated by reference in the registration statement will be deemed to be a new registration statement relating to the securities offered in the statement, and the offering of the securities at that time will be deemed the initial bona fide offering of the securities. n98

[C] Warrants and Rights Offerings and Competitive Bids. The same undertaking concerning warrants and rights offerings and competitive bids as called for by Item 512(c) and (d) of Regulation S-K to be furnished in Form S-1 must be furnished in Form S-3. n99

[D] Incorporated Annual and Quarterly Reports. The undertaking required by Item 512(e) of Regulation S-K concerning incorporated annual and quarterly reports must be furnished in Form S-3.

Item 512(e) of Regulation S-K provides that if the registration statement specifically incorporates by reference (other than by indirect incorporation through an Exchange Act Form 10-K report) in the prospectus all or part of the annual

report to security holders meeting the Exchange Act Rule 14a-3 (information to be furnished security holders if proxies are solicited) or Rule 14c-3 (annual report to be furnished security holders when proxies are not solicited) requirements, the registrant must include an undertaking:

(1) to deliver or cause to be delivered with the prospectus, to each person to whom the prospectus is sent or given, the latest annual report to security holders incorporated by reference in the prospectus and furnished pursuant to and meeting the requirements of Rule 14a-3 or Rule 14c-3 under the Exchange Act requirements; and

(2) if interim financial information required by Article 3 or Regulation S-X is not set forth in the prospectus, to deliver, to deliver or cause to be delivered, to each person to whom the prospectus is sent or given, the latest quarterly report specifically incorporated by reference in the prospectus to provide the interim financial information.

[E] Acceleration of Effectiveness. The same information required by Item 512(h) of Regulation S-K, as required to be furnished in Form S-1 concerning the Commission's position on indemnification if an acceleration of the effective date of the registration statement pursuant to Rule 461 is requested is also required to be furnished in Form S-3. n100

[F] Rule 430A. The same undertaking called for by Item 512(i) of Regulation S-K concerning offerings using Rule 430A that must be furnished in Form S-1 must also be furnished in Form S-3. n101

[iv] Signatures. The signature requirements of Form S-3 are the same as the signature requirements of Form S-1 with two exceptions:

(1) Form S-3 also requires the registrant to certify that "it has reasonable grounds to believe" that it meets all the requirements for filing on Form S-3; and n102

(2) Form S-3 contains an Instruction 3 to the signature requirements, not found in Form S-1, that provides that where eligibility for the use of Form S-3 is based on the assignment of a security rating to an investment grade security, n103 the registrant may elect to sign the registration statement although the security rating has not been assigned by the filing date of the registration statement. In such a case, a statement will be required indicating that the registrant reasonably believes that the security rating requirement will be satisfied by the time of sale.

FOOTNOTES:

(n1)Footnote 1. The 2005 Rules amend the eligibility requirements for use of Form S-3 to allow for "Automatic Shelf Registration" for WKSIs and to expand the categories of majority-owned subsidiaries that will be eligible to register their non-convertible debt securities or guarantees.

(n2)Footnote 2. 14 Sec. Reg. & L. Rep. 396 (BNA 1982); Sec. Act Rel. No. 33-6383, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

The adoption of Form S-3 was announced in Sec. Act. Rel. 33-6383, C.C.H. Fed. Sec. L. Rep. P 72,328 (1982) effective for all documents filed on or after May 24, 1982.

(n3)Footnote 3. 14 Sec. Reg. & L. Rep. 396 (BNA 1982).

For discussion of the concept of "efficient security markets," see the Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong., 1st Sess., Committee Print 95-29, Vol. 1 pp. 644-647. (1977).

(n4)Footnote 4. Incorporation by reference of subsequently filed Exchange Act reports in accordance with Item 12(b) of Form S-3 is discussed in § 7.04[1][e][ix] *infra*.

(n5)Footnote 5. *See* § 7.01 *supra* for a general discussion of the "aircraft carrier."

(n6)Footnote 6. Section 12(b) of the Exchange Act requires the registration of an exchange listed security.

For discussion of Exchange Act Section 12(b), *see* Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.01[1] (Matthew Bender).

(n7)Footnote 7. Section 12(g) of the Exchange Act and Rule 12g-1 thereunder require registration of securities traded over-the-counter if the issuer has total assets exceeding \$10 million.

Exchange Act Section 12(g) is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.01[2] (Matthew Bender).

(n8)Footnote 8. Section 15(d) of the Exchange Act applies 1934 Act reporting requirements to issuers with securities registered under the 1933 Act. This requirement does not apply to registered offerings of investment grade asset-backed securities as defined in § 7.04[1][a][ii][E] *infra*. However, if the depositor or any affiliate of or issuing entity previously established by the depositor was at any time during the previous 12 calendar months and any portion of a month immediately preceding the filing of a registration statement on Form S-3 subject to filing requirements under Section 12 or 15(d) of the Exchange Act with respect to a class of asset-backed securities involving the same asset class, that depositor has filing obligations, pursuant to an amendment to General Instruction I(A)(4) in Sec. Act Rel. 33-8518. General Instruction I(A)(4), Form S-3.

Exchange Act Section 15(d) is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02[1] (Matthew Bender).

(n9)Footnote 9. Section 13 of the Exchange Act contains the reporting requirements for issuers registered under the 1934 Act.

Exchange Act Section 13 is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02 (Matthew Bender).

(n10)Footnote 10. Exchange Act Section 14 Governs proxies and tender offers.

Proxy regulations discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, ch. 7 (Matthew Bender), tender offers are discussed in § 7A.03.

(n11)Footnote 11. In determining eligibility for use of Form S-3, the requirement that the registrant has filed in a timely manner all reports required to be filed during the past twelve calendar months refers only to Section 13(a) or 15(d) reports and Section 14(a) and 14(c) materials. Question 115.04, Questions and Answers of General Applicability, Securities Act Forms.

(n12)Footnote 12. A calendar month begins on the first day of the month and ends on the last day of that month. Question 115.06, Questions and Answers of General Applicability, Securities Act Forms.

The twelve month period relates to the effective date of the registrant's Securities Act or Exchange Act registration statement that gave rise to the filing obligation. Question 115.14, Questions and Answers of General Applicability, Securities Act Forms.

(n13)Footnote 13. This requirement does not apply to registered offerings of investment grade asset-backed

securities as defined in § 7.04[1][a][ii][E] *infra* . General Instruction I(A)(4), Form S-3.

(n14)Footnote 14. Rule 12b-25 and related Form 12b-25 of the Exchange Act concerning notice to the Commission of the registrant's inability to timely file any required portion of an annual or quarterly report and how the report will be deemed filed on the due date prescribed for thereport (paragraph (b) of Rule 12b-25 is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.01 (Matthew Bender).

(n15)Footnote 15. The term "subsidiary" is defined § 7.03[c] *supra* .

(n16)Footnote 16. General Instruction I(A)(1)-(5) Form S-3.

(n17)Footnote 17. General Instruction I(A)(7), Form S-3.

(n18)Footnote 18. General Instruction I(A)(6), Form S-3.

Requirement A(3) is discussed in the text at ns. 9-12 *supra*.

(n19)Footnote 19. General Instruction I(A)(8), Form S-3.

(n20)Footnote 20. General Instruction I(B)(1), Form S-3.

The term "affiliate" of, or person "affiliated" with, a specified person, is a person that, directly or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified. Regulation C, Rule 405.

The "for cash" reference is intended only to make clear that Form S-3 is not available for exchange offers or other business combination transactions. Question 116.09, Questions and Answers of General Applicability, Securities Act Forms. For example, Form-3 may be used for a spin-off if a company is eligible to use the form for a primary offering even if no cash will be paid for the spun-off shares. Question 125.09, Questions and Answers of General Applicability, Securities Act Forms.

(n21)Footnote 21. General Instruction I(B)(2), Form S-3.

An investment grade security is defined as a non-convertible security that, at the time of sale, has been rated by at least one nationally recognized statistical rating organization in one of its generic rating categories that signifies investment grade. *Id.* The four highest rating categories (within which there may be gradations, such as pluses or minuses, to indicate relative standing) signify investment grade. *Id.*

The phrase "nationally recognized statistical rating organization" (NRSRO) has the same meaning as the definition given to the phrase in Exchange Act Rule 15c3-1(c)(2)(vi)(F).

Some commentators objected that the net capital rule does not contain any specific definition of a rating organization and that a rating organization that is not an NRSRO has insufficient guidance on how to qualify as an NRSRO. The Commission did not provide a definition for an NRSRO but determined that the Commission and its staff will accept the following entities as NRSROs for net capital rule purposes:

- (1) Standard & Poor's Corporation;
- (2) Moody's Investors Services, Inc.;
- (3) Fitch Investors Services, Inc.; and

(4) Duff and Phelps, Inc.

Sec. Act Rel. No. 33-6383 n.54, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

When two or more classes of securities being registered on Form S-3 pursuant to General Instruction I.B.1 or I.B.2 are to be offered on a delayed or continuous basis pursuant to Rule 415(a)(1)(x), Rule 457(o) under the Securities Act permits the registration fee to be calculated on the basis of the maximum offering price of all the securities listed in the "Calculation of Fee" table on the facing page of Form S-3. In this event, the Fee Table need specify only the classes being registered and the aggregate proceeds to be raised, but not the amount of each class to be registered, the proposed maximum offering price per unit, or the proposed maximum aggregate offering price. General Instruction II(D), Form S-3.

In July 2008 the SEC proposed amendments that would no longer make NRSRO ratings a transaction requirement to permit registrants to register primary offerings of non-convertible securities for cash. Instead, primary offerings of non-convertible securities would be eligible under Form S-3 only if the issuer has issued, as of a date 60 days prior to the filing of the registration statement, more than \$1 billion in non-convertible securities for cash, other than common equity, through registered primary offerings over the prior three years. Securities Ratings, Securities Act Release No. 8940, Securities Exchange Act Release No. 58071 (July 1, 2008)

(n22)Footnote 22. NASDAQ is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 2.01 (Matthew Bender).

(n23)Footnote 23. General Instruction I(B)(3), Form S-3.

Because of comments received on proposed Form S-3 concerning secondary offerings of securities, the Commission further analyzed the secondary offering transaction registered on former Form S-16 and concluded that most secondary offerings are more in the nature of ordinary market transaction than primary offerings by registrants and that Exchange Act reports provide reliable marketplace information needed regarding registrants. Thus, the Commission determined that where the registrant meets the exchange Act reporting and other registrant requirements, Form S-3 will be available for registering secondary offerings of securities listed an exchange or quoted on NASDAQ. Since this Commission determination reflects only a difference as to actual delivery of the securities being registered (the Exchange Act reports would be incorporated by reference into the registration statement), the selling security holder has the statutory responsibility for the accuracy of the entire registration statement. Sec. Act Rel. No. 33-6383 n.23, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n24)Footnote 24. The term "affiliate" is defined in § 7.03[3][a][ii][A] *supra* .

(n25)Footnote 25. General Instruction I(B)(3), Form S-3. Form S-3 is available to affiliates on the resale of securities they acquire under Form S-8.

General Instruction C of Form S-8, permits an affiliate of an issuer to resell securities acquired in a registered offering on Form S-8, pursuant to shelf registration Rule 415 and with a Form S-3 prospectus that is filed with the Form S-8 if:

(1) the registrant, at the time of filing the prospectus, satisfies the registrant requirement for use of Form S-3; or

(2) the amount of securities proposed to be reoffered or resold with the prospectus, by each affiliate of the registrant and any other person with whom the affiliate is acting in concert to sell the issuer's securities does not exceed, during any three-month period, the amount specified in Rule 144(e)

(discussed in § 4.02[1][c] *supra*), calculated as of the date of filing the prospectus.

(n26)Footnote 26. Dividend or interest reinvestment plans are discussed in § 7.04[1][b] *infra*.

(n27)Footnote 27. General Instruction I(B)(4), Form S-3.

(n28)Footnote 28. Exchange Act Rule 14a-3(b), requires that for any solicitation by management for an annual meeting at which directors are to be elected, the proxy statement furnished to security holders must be accompanied or preceded by an annual report to security holders containing the financial and other information specified in Rule 14a-3(b).

(n29)Footnote 29. Items 401, 402 and 403 of Regulation S-K are discussed in § 7.03[2][k][xi]-[xiii] *supra*.

(n30)Footnote 30. General Instruction I(B)(4)(6), Form S-3.

(n31)Footnote 31. *Id.*

(n32)Footnote 32. The term "asset-backed security" means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders. General Instruction I(B)(5), Form S-3.

(n33)Footnote 33. *Id.*

(n34)Footnote 34. *See* Sec. Act Rel. No. 33-8878. The amendments, added as new General Instruction I.B.6 to Form S-3, are intended to allow more companies to benefit from the greater flexibility and efficiency in accessing the public securities markets afforded by Form S-3. It is important to note that eligibility under General Instruction I.B.6 applies only to a registrant's ability to conduct a limited primary offering on Form S-3. Instruction 6 to General Instruction I(B)(6), Form S-3. That is, a registrant's eligibility to use Form S-3 under General Instruction I.B.6 does not mean that the registrant meets the requirements of Form S-3 for purposes of any other rule or regulation of the Commission, except for Rule 415(a)(1)(x) concerning shelf registration. Sec. Act Rel. No. 33-8878.

(n35)Footnote 35. General Instruction I(B)(6)(c), Form S-3. A "national securities exchange" is a securities exchange that has registered with the Commission under Section 6 of the Exchange Act. Instruction 8 to General Instruction I(B)(6), Form S-3.

(n36)Footnote 36. That is, the aggregate market value of securities sold by or on behalf of the registrant pursuant to General Instruction I.B.6 during the prior 12 months (including the current sale) may not equal more than one-third of its public float, *i.e.*, the aggregate market value of the registrant's outstanding voting and non-voting common equity held by non-affiliates of the registrant as determined by the price at which the common equity was last sold (or the average bid or asked prices) in the principal market for such common equity as of a date within 60 days prior to the date of sale. General Instruction I(B)(6)(a), Form S-3. When computing the aggregate market value of securities sold, the registrant should aggregate the proceeds of such sales. Instruction 2 to General Instruction I(B)(6)(b), Form S-3. However, in the case of the sale of derivative securities convertible into or exercisable for shares of common equity, the registrant should calculate the aggregate market value of any underlying equity shares instead of the market value of the derivative securities. The aggregate market value of the underlying equity should be calculated by multiplying (x) the maximum number of common equity shares into which the derivative securities are convertible, by (y) the per share market price at which the common equity was last sold (or the average bid and asked price), in each case in the principal market of such common equity as of a date within 60 days prior to the date of sale. If such derivative securities have been converted or exercised, multiply (x) the actual number of shares into which the securities were converted (or received upon exercise), by (y) the market price on the date of conversion/exercise. Instruction 2 to General Instruction

I(B)(6)(b), Form S-3

If the registrant's public float equals or exceeds \$75 million subsequent to the effective date of the registration statement, then the one-third limitation will not apply to additional sales made pursuant to the registration statement on or subsequent to such date. Instruction 3 to General Instruction I(B)(6), Form S-3. In that case, the registration statement will be considered filed pursuant to General Instruction I.B.1. *See also § 7.04[1][a][ii][A] infra.*

(n37)Footnote 37. General Instruction I(B)(6)(b), Form S-3. If the registrant was a shell company at any time previously, it must have filed current Form 10 information with the Commission at least 12 calendar months previously reflecting its status as a non-shell company. Form 10 information refers to information required by Form 10 or Form 20-F, as applicable to the registrant, to register under the Exchange Act each class of securities being registered on Form S-3. Instruction 4 to General Instruction I(B)(6), Form S-3.

(n38)Footnote 38. Instruction 7 to General Instruction I(B)(6), Form S-3.

(n39)Footnote 39. The term "majority-owned subsidiary" means a subsidiary where greater than 50% of the outstanding securities representing the right to vote for the election of directors at such subsidiary (other than as affected by events of default) is owned by the subsidiary's parent and/or one or more of the parent's other majority-owned subsidiaries. Rule 405.

(n40)Footnote 40. A spun-off subsidiary would need to independently meet all other requirements for WKSII status, but may rely on the parent's pre-spin-off reporting history for purposes of evaluating whether the subsidiary is a WKSII and eligible to file a Form S-3 for automatic shelf registration. Question 118.08, Questions and Answers of General Applicability, Securities Act Forms.

(n41)Footnote 41. "Investment grade security" is defined in § 7.04[1][a][ii][B] *supra*.

(n42)Footnote 42. General Instruction I(C)(1)-(5), Form S-3.

With regard to (3), (4) and (5) above, when the parent guarantees the securities, the parent-guarantor is the issuer of a separate security consisting of the guarantee that must be concurrently registered with, but may be registered on the same registration statement as, the guaranteed securities. Note, General Instruction I(C), Form S-3.

(n43)Footnote 43. The definition of a WKSII is set forth in Rule 405. A WKSII is defined as an issuer that:

- is required to file reports pursuant to Section 13(a) or Section 15(d) of the Exchange Act;
- meets the registrant requirements of Form S-3 or Form F-3;
- either (1) has at least \$700 million of worldwide common equity market capitalization held by non-affiliates or (2) has issued \$1 billion aggregate amount of non-convertible securities, other than common equity, in registered primary offerings for cash (not in registered exchange offers) during the past three years; and
- is not an "ineligible issuer."

Rule 405, Regulation C.

Ineligible issuers and offerings include the following:

1-7 Federal Securities Act of 1933 § 7.04

- reporting issuers that are not current in their Exchange Act reports;
- issuers that are (or were in the past three years) blank check issuers;
- issuers that are (or were in the past three years) shell companies;
- issuers that are (or were in the past three years) penny stock issuers;
- issuers that are limited partnerships offering and selling their securities other than in a firm commitment underwriting;
- issuers that have filed for bankruptcy or insolvency during the past three years;
- issuers that have been or are the subject of refusal or stop orders under the Securities Act during the past three years;
- issuers that have been found to have violated the federal securities laws, have been the subject of a judicial or administrative order prohibiting certain conduct or activities regarding the federal securities laws during the past three years, or have entered into a settlement ("settlement" includes settlements in which the issuer neither admits nor denies violating the federal securities laws) with any government agency involving violations of federal securities laws after the effective date of the rules;.
- offerings by registered investment companies or business development companies; and
- offerings that are exchange offers or business combination transactions that are subject to Regulation M-A.

Rule 405, Regulation C.

Paragraph (2) of the definition of WKSII in Rule 405 specifies the determination date as to whether an issuer is a WKSII. Generally, the determination date is the time of filing of the relevant registration statement and thereafter at the time of the annual update of that registration statement upon the filing of the issuer's annual report on Form 10-K or 20-F. Issuers' non-affiliate equity market capitalization and the aggregate amount of their non-convertible securities issuances are measured using the 60-day window period used in Form S-3 and F-3.

(n44)Footnote 44. An automatic shelf registration statement can be used for all primary and secondary offerings securities of eligible WKSIs, other than those in connection with mortgage related securities, business combination transactions or exchange offers.

(n45)Footnote 45. See General Instruction I(D)(5), Form S-3 and Rule 401(g). A previously effective Form S-3 that was not an automatic shelf registration when it became effective cannot be amended to become an automatic shelf registration statement. Instead the issuer must file a new registration statement. Question 118.05, Questions and Answers of General Applicability, Securities Act Forms.

(n46)Footnote 46. Rule 456(b). The initial registration statement must indicate that the issuer is relying on Rule 456(b) but does not need to include the number of shares or units of securities or the maximum aggregate offering price of any securities. At the time of the securities offering, the issuer must include on the cover page to a prospectus supplement an update to the fee table calculating and reflecting payment of the pay-as-you-go filing fee, which must be calculated based on the fee payment rate in effect on the date of the fee payment. Rule 457(r).

(n47)Footnote 47. Until a prospectus, prospectus supplement, posteffective amendment to the registration statement or Exchange Act report incorporated by reference, identifying the selling security holders and the amount of securities to be sold by each of them (and, if included in a periodic or current report, a prospectus or prospectus supplement) is filed, as required by Rule 430B, pursuant to Rule 424(b)(7). General Instruction I(D)(1)(d), Form S-3.

(n48)Footnote 48. Sec. Act. No. 33-6331, Fed. Sec. L. Rep. (CCH) No. 926, Extra Edition (1981).

(n49)Footnote 49. General Instruction III, Form S-3.

Rule 406(a) provides that the procedure set forth in Rule 406 "Contracts in General" for requests for confidential treatment of material contract provisions does not apply to requests made on or with filings on Form S-3 relating to a dividend or interest reinvestment plan.

(n50)Footnote 50. *Id.*

(n51)Footnote 51. *Id.*

When two or more classes of securities being registered on Form S-3 pursuant to General Instruction I.B.1 or I.B.2 are to be offered on a delayed or continuous basis pursuant to Rule 415(a)(1)(x), Rule 457(o) under the Securities Act permits the registration fee to be calculated on the basis of the maximum offering price of all the securities listed in the "Calculation of Fee" Table on the facing page of Form S-3. In this event, the Fee Table need specify only the classes being registered and the aggregate proceeds to be raised, but not the amount of each class to be registered, the proposed maximum offering price per unit, or the proposed maximum aggregate offering price. General Instruction II(D), Form S-3.

(n52)Footnote 52. General Instruction IV(A), Form S-3.

(n53)Footnote 53. Pursuant to Rule 413(b). Also, the WKSII may add majority-owned subsidiaries as additional registrants, whose securities are eligible to be sold as part of the automatic shelf registration statement, by filing a post-effective amendment identifying the additional registrants. Persons required to sign the registration statement (the registrant, the additional registrants and certain other persons) must sign the post-effective amendment. General Instruction IV(B), Form S-3.

(n54)Footnote 54. General Instruction IV(B), Form S-3.

(n55)Footnote 55. *See* Rule 462(e) and Rule 462(f), Regulation C.

(n56)Footnote 56. General Instruction II(B), Form S-3.

(n57)Footnote 57. *Id.*

(n58)Footnote 58. General Instruction II(C), Form S-3; *see also* § 7.05 *infra* (discussing elements needed to qualify as a smaller reporting company).

(n59)Footnote 59. Sec. Act Rel. No. 33-6383, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

For discussion of the problem of outdated financial statements on Exchange Act Form 10-K, *see* § 7.04[1][e][viii] *infra*.

(n60)Footnote 60. Instruction 7 to General Instruction I(B)(6), Form S-3; *see also* § 7.04[1][ii][F].

(n61)Footnote 61. The summary information, risk factors, and ratio of earnings to fixed charges required by Item 503 of Regulation S-K to be included in the prospectus in response to Item 3 of Form S-1 is discussed in § 7.03[2][c][i]

, [iii] and [iv] *supra*.

The information about use of proceeds required by Item 504 of Regulation S-K to be furnished in response to Item 4 of Form S-1 is discussed in § 7.03[2][d] *supra*.

The information about common equity, warrants, rights and convertible securities required by Item 505 of Regulation S-K to be described in response to Item 5 of Form S-1 is discussed in § 7.03[2][e] *supra*.

(n62)Footnote 62. Item 506, Regulation S-K.

(n63)Footnote 63. The information about dilution required by Item 506 of Regulation S-K to be furnished in response to Item 6 of Form S-1 is discussed in § 7.03[2][f] *supra*.

(n64)Footnote 64. The information about selling security holders required by Item 507 of Regulation S-K to be given in response to Item 7 of Form S-1 is discussed in § 7.03[2][g] *supra*.

(n65)Footnote 65. The requirement to furnish information about the underwriter's experience and relationship with the registrant, promoters, and their controlling persons pursuant to Item 508(b) of Regulation S-K where the securities being registered are securities of nonreporting registrants is discussed with Form S-1 in § 7.03 [2][h][ii] *supra* . Item 8 of Form S-1 is discussed in § 7.03[2][h][i] *supra*.

(n66)Footnote 66. Item 508(j) of Regulation S-K is discussed with Form S-1 in § 7.03[2][h][x] *supra* .

(n67)Footnote 67. Item 9 of Form S-1 is discussed in § 7.03[2][i] *supra*.

Item 10 of Form S-1 is discussed in § 7.03[2][j] *supra*.

(n68)Footnote 68. Sec. Act Rel No. 33-6838, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

In October 2009, the SEC proposed rule changes that would require a registrant on form S-3 to furnish the information required by proposed Item 202(g) of Regulation S-K relating to credit ratings, even if only stock is to be registered and securities of the same class are registered pursuant to Section 12 of the Exchange Act. Credit Ratings Disclosure, Securities Act Release No. 9070, Securities Exchange Act Release No. 60797 (Oct. 7, 2009).

(n69)Footnote 69. Item 11(a), Form S-3.

Exchange Act Form 10-Q is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02[2] (Matthew Bender).

Exchange Act Form 8-K is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4. § 4.02[3] (Matthew Bender).

(n70)Footnote 70. The reports required by Item 12(a) include the Form 10-K and all other reports filed pursuant to Section 13(a) or 15(d) of the Exchange Act since the end of the fiscal year covered by the Form 10-K.

Item 12(a) of Form S-3 is discussed in § 7.04[1][d][ix] *infra*.

(n71)Footnote 71. Rule 14c-3 is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06 (Matthew Bender); Rule 14a-3.

(n72)Footnote 72. For definition of "significant subsidiary," *see* § 7.03[2][k][i][A] *supra*.

(n73)Footnote 73. Item 11(b)(i)-(iv), Form S-3.

The additional financial information required by Item 11(b) need be presented in the prospectus only if not disclosed in reports on Exchange Act Forms 10-K, 8-K or 10-Q, in proxy statements, or in previous Securities Act prospectuses incorporated by reference into the registration statement. Sec. Act Rel. No. 33-6383, Fed. Sec. L. Rep. (CCH) P 72,328 (1982). Commentators expressed concern that outdated financial statements from the latest Exchange Act Form 10-K may be incorporated by reference when restated financial statements are included in the prospectus or are incorporated by reference because of an accounting change or pooling subsequent to the most recent fiscal year end. Additionally, concern was expressed that the Commission staff may require an accountant's consent for the outdated financial statements. In the Commission's view, Rule 412 will operate to make the restated financial statements supersede the Form 10-K financial statements and to render the superseded items not a part of the registration statement or the prospectus for purposes of the Securities Act. Therefore, no consent will be required for the superseded financial statements. *Id.*

Rule 412 provides that statements in a document incorporated by reference will be deemed to be modified or superseded for purposes of the registration statement or prospectus to the extent that a statement in a prospectus or a subsequently filed document that is incorporated by reference modifies or replaces the original statement. Rule 412(a). The modifying or superseding statement need not state that it has modified or superseded a prior statement. The marking of a modifying or superseding statement is not deemed to be an admission that the modified or superseded statement constituted a violation of the federal securities laws or the rules and regulations thereunder when made. Rule 412(b). Any statement modified or superseded under Rule 412 is not deemed in its original form to constitute a part of the registration statement or the prospectus for purposes of Rule 412(c).

(n74)Footnote 74. General Instruction II(C), Form S-3; *see also* § 7.05 *infra* (discussing elements needed to qualify as a smaller reporting company).

(n75)Footnote 75. Item 12(a)(1) and Item 12(a)(2), Form S-3.

If a written consent to the use of material in connection with a registration statement must be filed, the consent must be filed as an exhibit to the registration statement although the material is incorporated by reference in the registration statement. Where the filing of a written consent is required for information incorporated by reference in the registration statement to be filed after the effective date of the registration statement, the consent must be filed as an amendment to the registration statement not later than the date on which the information is filed with the Commission, unless express consent to incorporation by reference into the registration statement is included in the incorporated information when it is filed. Rule 439, Regulation C.

Any required consent may be incorporated by reference into a registration statement filed pursuant to Rule 462(b) or a post-effective amendment filed pursuant to Rule 462(e) from a previously filed registration statement relating to that offering, however, if the consent contained in the previously filed registration statement expressly provides for incorporation by reference. Rule 439(b), Regulation C.

(n76)Footnote 76. Item 12(a), Form S-3.

(n77)Footnote 77. Item 12(b), Form S-3.

Registrants' attention is directed to Rule 439, discussed in this § 7.04[1][e][ix] *supra* regarding consent to use of material incorporated by reference. Instruction, Item 12, Form S-3.

(n78)Footnote 78. Item 12(c)(1), Form S-3. If the registrant sends any of the information that is incorporated by reference in the prospectus to security holders, it must also send any exhibits that are specifically incorporated by reference in that information. Note to Item 12(c)(1), Form S-3.

(n79)Footnote 79. Item 12(c)(2), Form S-3. The registrant's attention is directed to Rule 439 under the Securities Act regarding consent to the use of material incorporated by reference. Instruction, Item 12, Form S-3.

(n80)Footnote 80. For a discussion of Item 3 through Item 11 of Form S-3, see § 7.04[1][e][iii]-[viii] *supra*.

(n81)Footnote 81. Item 12(d), Form S-3. This section was added by the 2005 Rules as part of the expansion of the use of incorporation by reference.

(n82)Footnote 82. Item 12A of Form S-1 is discussed in § 7.03[2][n] *supra*.

(n83)Footnote 83. Item 13 of Form S-1 is discussed in § 7.03[3[a] *supra*; Item 14 is discussed in § 7.03[3][b] *supra*.

(n84)Footnote 84. The number in parenthesis at the beginning of each exhibit refers to the appropriate subsection in Item 601(b) of Regulation S-K where a description of the exhibit can be found. Instruction 3 to Exhibit Table, Item 601, Regulation S-K.

(n85)Footnote 85. This document is identical to the underwriting contract required by Item 601(b)(1) of Regulation S-K to be filed with all underwritten offerings on Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n86)Footnote 86. These documents are identical to the material plans of acquisition, reorganization, arrangement, liquidation, or succession required by Item 601(b)(2) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n87)Footnote 87. These documents are identical to the instruments defining the rights of security holders, including indentures, required by Item 601(b)(4)(i), (ii) and (iv) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n88)Footnote 88. This document is identical to the opinion of counsel or an Internal Revenue Service determination letter regarding the legality of the securities being registered, required by Item 601(b)(5) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n89)Footnote 89. This document is identical to the opinion of counsel regarding tax matters required by Item 601(b)(8) of Regulations S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n90)Footnote 90. This document is identical to statement on computation of ratios required by Item 601(b)(12) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n91)Footnote 91. This document is identical to the letter from the independent accountant concerning the use in the registration statement of a report on unaudited financial information required by Item 601(b)(15) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n92)Footnote 92. These documents are identical to the consents of experts and counsel required by Item 601(b)(24)(i) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*. In addition, where the filing of a written consent is required as to material incorporated by reference in a previously filed registration statement under the Securities Act, the consent, dated and manually signed, may be filed as an exhibit to the material incorporated by reference. Item 601(b)(23)(ii), Regulation S-K.

(n93)Footnote 93. These documents are identical to the copies of powers of attorney and resolutions of the registrant's board of directors required by Item 601(b)(24) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n94)Footnote 94. This document is identical to the statement of eligibility and qualification of each person

designated as a trustee pursuant to the Trust Indenture Act of 1939 required by Item 601(b)(25) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n95)Footnote 95. These documents are identical to communications constituting an invitation for competitive bids required by Item 601(b)(26) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n96)Footnote 96. These documents are identical to the additional exhibits required by Item 601(b)(99) of Regulation S-K to be filed with Form S-1, discussed in § 7.03[3][d][i] *supra*.

(n97)Footnote 97. The information called for by Item 512(a) of Regulation S-K to be furnished in response to Item 17 of Form S-1 is discussed in § 7.03[3][e] *supra*.

(n98)Footnote 98. Item 512(b), Regulation S-K.

(n99)Footnote 99. The information called for by Item 512(c) and (d) of Regulation S-K that must be furnished in response to Item 17 of Form S-1 is discussed in § 7.03[3][e][ii] and [iii] *supra*.

(n100)Footnote 100. The statement of the Commission's position on indemnification if an acceleration of the effective date of the registration statement is requested, required by Item 512(h) of Regulation S-K to be given in response to Item 17 of Form S-1, is discussed in § 7.03[3][e][v] *supra*.

(n101)Footnote 101. The Rule 430A undertaking to be furnished in response to Item 17 of Form S-1 is discussed in § 7.03[3][e][vi] *supra*.

(n102)Footnote 102. Whether or not a registrant had "reasonable grounds to believe" sufficient to discharge its obligation under Section 11(b) of the Securities Act depends upon a number of factors including the type of issuer and security involved, and the office held by the officer making the certification. The registrant's reasonable reliance on officers and/or employees for the information in the registration statement is also considered. See Rule 176.

(n103)Footnote 103. "Investment grade security" is defined in § 7.04[1][a][ii][B] *supra*.



86 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 § 7.05

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.05 Registration of Securities of Smaller Reporting Companies

[1] New Category of "Smaller Reporting Companies"

Effective February 2008, the Commission adopted amendments that changed the registration mechanics for a company that qualifies as a "smaller reporting company" under Item 10(f) of Regulation S-K. The amendments generally consolidate now-eliminated Regulation S-B's disclosure requirements into Regulation S-K and financial statement requirements into Regulation S-X.

Smaller reporting companies can choose, on an item-by-item (or "a la carte") basis, to comply with either the scaled disclosure and financial reporting requirements made available in Regulation S-K for smaller reporting companies or the requirements for larger companies in Regulation S-K. n1 In addition, foreign companies may qualify as "smaller reporting companies" if they otherwise qualify and choose to file on domestic company forms and provide financial statements prepared in accordance with U.S. GAAP.

[2] Qualifications of a Smaller Reporting Company

To qualify as a "smaller reporting company," the issuer may not be an investment company an asset backed issuer or a majority-owned subsidiary of a parent that is not a smaller reporting company. n2 Additionally, to qualify, an issuer must have had:

- (1) a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter; n3 or
- (2) in the case of an initial registration statement under the Securities Act, a public float of less than \$75 million as of a date within 30 days of the date of the filing of the registration statement; n4 or
- (3) in the case of an issuer whose public float was zero (as calculated under (1) or (2) above), annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available. n5

The determination of whether or not an issuer is a smaller reporting company must be determined on an annual basis. n6 If making a determination based on an initial Securities Act registration statement under paragraph (2) above, (a) the registrant must reflect such determination in the registration statement and on the cover page of the filing, n7 and (b) a registrant that was not determined to be a smaller reporting company has the option to redetermine its status at the conclusion of the offering covered by the registration statement based on the actual offering price and number of shares sold. n8

[3] Scaled Disclosure Requirements Applicable to Smaller Reporting Companies under Regulation S-K

The following Items of Regulation S-K contain scaled disclosure requirements for registrants that qualify as a smaller reporting company: n9

[a] Item 101. Description of Business. Paragraph (h) of Item 101 of Regulation S-K sets forth alternative disclosure standards for smaller reporting companies. Generally, the different requirements involve providing a less detailed description of the registrant's business. For instance, smaller reporting companies need not provide financial information about segments. n10 In addition, smaller reporting companies need only disclose business development activities for the past three years, as opposed to the general requirement of five years. n11 For a full description of the scaled disclosure requirements of Item 101 of Regulation S-K, see § 7.03[2][k][i][G] *supra*.

[b] Item 201. Market Price of and Dividends on Registrant's Common Equity and Related Stockholder Matters. Instruction 6 to paragraph (e) of Item 201 of Regulation S-K provides that smaller reporting companies are not required to provide a performance graph. n12

[c] Item 301. Selected Financial Data. Paragraph (c) of Item 301 of Regulation S-K provides that smaller reporting companies need not present the selected financial data required under Item 301. n13

[d] Item 302. Supplementary Financial Information. Paragraph (c) of Item 302 of Regulation S-K provides that smaller reporting companies need not present the supplementary financial information required under Item 302. n14

[e] Item 303. Management's Discussion and Analysis of Financial Condition and Results of Operations. Paragraph (d) of Item 303 of Regulation S-K provides scaled disclosure for smaller reporting companies, including that smaller reporting companies:

(1) need only provide two years for analysis if the company is presenting only two years of financial statements, instead of the three years of analysis required of larger companies that must provide three years of financial statements; and

(2) are not required to provide tabular disclosure of contractual obligations. n15

[f] Item 305. Quantitative and Qualitative Disclosures About Market Risk. Paragraph (e) of Item 305 of Regulation S-K provides that smaller reporting companies need not disclose the information required by Item 305. n16

[g] Item 402. Executive Compensation. Paragraphs (l) through (r) set forth the alternative disclosure requirements for smaller reporting companies with respect to compensation of executives and directors. n17 Smaller reporting companies will:

(1) provide executive compensation disclosure for only three named executive officers, rather than the five required of larger companies;

(2) provide disclosure of only two years in the Summary Compensation Table, as opposed to the three years required of larger companies;

- (3) not need to provide a Compensation Discussion and Analysis;
- (4) provide only three of the seven tables required of larger companies--that is, the Summary Compensation Table, the Outstanding Equity Awards at Fiscal Year End Table and the Director Compensation Table;
- (5) provide alternative narrative disclosure; and
- (6) not be required to include footnote disclosure of the grant date fair value of equity awards in the Director Compensation Table.

For a complete discussion of the scaled executive compensation disclosure applicable to smaller reporting companies under Item 402, see § 7.03[2][k][xii] *supra*.

[h] Item 404. Transactions with Related Persons, Promoters and Certain Control Persons. Under paragraph (d) of Item 404, smaller reporting companies will:

- (1) not be required to disclose policies and procedures with respect to reviewing related person transactions;
- (2) be required to provide disclosure with respect to transactions where the amount exceeds the lesser of 1% of a smaller company's total assets or \$120,000;
- (3) be required to provide additional information regarding underwriting discounts and commissions, as well as information related to corporate parents; and
- (4) be required to provide disclosure regarding promoters and certain control persons.

For a full discussion of the scaled disclosure requirements of smaller reporting companies under Item 404 of Regulation S-K, see § 7.03[2][k][xiv][D] *supra*.

[i] Item 503. Prospectus Summary, Risk Factors and Ratio of Earnings to Fixed Charges. Pursuant to paragraph (e) of Item 503 of Regulation S-K, smaller reporting companies are not required to provide information regarding:

- (1) the ratio of earnings to fixed charges when a registrant issues debt; or
- (2) the ratio of combined fixed charges and preference dividends to earnings when a registrant issues preference equity securities. n18

[j] Item 504. Use of Proceeds. When determining whether financial statements of businesses proposed to be acquired must be included in the filings of smaller reporting companies, Article 8 of Regulation S-X, rather than the other articles of Regulation S-X, will govern. n19

[k] Item 601. Exhibits. Smaller reporting companies need not provide the disclosure required by Exhibit 12 (Statements re Computation of Ratios). n20

For the remaining items of Regulation S-K, smaller reporting companies must follow the same requirements as larger companies. n21

FOOTNOTES:

(n1)Footnote 1. Sec. Act Rel. No. 33-8876.

(n2)Footnote 2. Item 10(f)(1), Regulation S-K.

(n3)Footnote 3. Under this qualification, the public float is computed by multiplying (x) the aggregate worldwide number of shares of the registrant's voting and non-voting common equity held by non-affiliates, by (y) the price at which the common equity was last sold (or the average bid and asked price) in the principal market for the common equity. Item 101(f)(1), Regulation S-K.

(n4)Footnote 4. Under this qualification, the public float is computed by multiplying (x) (i) the aggregate worldwide number of such shares held by non-affiliates before registration plus (ii) the number of shares included in the registration statement, by (y) the estimated public offering price. Item 101(f)(1), Regulation S-K.

(n5)Footnote 5. Item 101(f)(1), Regulation S-K.

(n6)Footnote 6. Item 10(f)(2), Regulation S-K.

(n7)Footnote 7. Item 10(f)(2)(ii), Regulation S-K. Additionally, the issuer must reflect such determination in subsequent filings for the fiscal year in which the initial filing is made, whether or not it is a smaller reporting company at the time of the subsequent filing. Once an issuer fails to qualify as a smaller reporting company, it will remain unqualified unless it determines that its public float is less than \$50 million as of the last business day of its second fiscal quarter, provided it has public equity outstanding with a market price available. Item 10(f)(2)(iii), Regulation S-K. Otherwise, the issuer must have had annual revenues of less than \$40 million during its previous fiscal year. Item 10(f)(2)(ii), Regulation S-K.

(n8)Footnote 8. Item 10(f)(2)(ii), Regulation S-K.

(n9)Footnote 9. As noted in § 7.05[3][a] *supra*, smaller reporting companies may elect to comply with the scaled financial and non-financial disclosure on an item-by-item, or "a la carte," basis.

(n10)Footnote 10. See Item 101(h) Regulation S-K; *see also* Sec. Act Rel. No. 33-8876.

(n11)Footnote 11. See Item 101(h) Regulation S-K; *see also* Sec. Act Rel. No. 33-8876.

(n12)Footnote 12. See Instruction 6, Item 201(e), Regulation S-K; *see also* Sec. Act Rel. No. 33-8876.

(n13)Footnote 13. See Item 301(c), Regulation S-K; *see also* § 7.03[2][k][vi] *supra*.

(n14)Footnote 14. See Item 302(c), Regulation S-K; *see also* § 7.03[2][k][vii] *supra*.

(n15)Footnote 15. See Item 303(d), Regulation S-K; *see also* § 7.03[2][k][viii] *supra*.

(n16)Footnote 16. See Item 305(e), Regulation S-K; *see also* § 7.03[2][k][x] *supra*.

(n17)Footnote 17. *See* Item 402(l)-(r), Regulation S-K.

(n18)Footnote 18. *See* Item 503(e), Regulation S-K; *see also* § 7.03[2][d] *supra*.

(n19)Footnote 19. Instruction 6, Item 504, Regulation S-K; *see also* § 7.03[2][d] *supra*.

(n20)Footnote 20. Item 601(c), Regulation S-K; *see also* § 7.03[3][d] *supra*.

(n21)Footnote 21. *See* Sec. Act Rel. No. 33-8876. Also note that Item 407 of Regulation S-K contains scaled disclosure requirements applicable to filings made by smaller reporting companies under the Exchange Act. *See* Item 407(g), Regulation S-K.



87 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 § 7.06

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.06 Registration of Certain Business Combinations

[1] Form S-4 Registration of Securities Issued in Business Combination Transactions

Form S-4 is the form for the registration of securities in connection with certain business combinations. n1 The form may be used in:

- (1) transactions under Rule 145(a); n2
- (2) mergers in which the applicable state law would not require the solicitation of the votes or consents of all the security holders of the company being acquired; n3
- (3) exchange offers for securities of the issuer or another entity; n4
- (4) public reoffers or resales of any such securities acquired pursuant to Form S-4; n5 or
- (5) more than one of the above types of transactions registered on one registration statement. n6

Form S-4 extends to registration of securities issued in business combinations the principles of integrated disclosure previously adopted by the Commission for primary offerings. The manner of preparation of Form S-4 depends on whether the registrant is a Form S-1 or Form S-3 company. Whether information may be incorporated by reference or must be included in the prospectus depends on which form the company could use in making a primary offering of securities not involving a business combination.

If the registrant is subject to the Commission's proxy rules, those rules apply to Form S-4, except that the Form S-4 prospectus may serve as the proxy or information statement for the transaction and may contain information required by Form S-4 in lieu of that required by Exchange Act Schedules 14A and 14C. n7

Form S-4 contains two parts, Part I, Information Required in the Prospectus and Part II, Information Not Required in the Prospectus.

If the securities to be registered on the Form S-4 will be issued in a roll-up transaction the registrant must, in addition to the requirements of the Form, comply with the disclosure provisions of Section 900 of Regulation S-K. A roll-up transaction is defined as a transaction involving the combination or reorganization of one or more partnerships, directly or indirectly, in which some or all of the investors in any of such partnerships will receive new securities, or securities in another entity. n8

[a] Facing Page. The facing page of Form S-4 requires a statement of the approximate date of commencement of the proposed sale of the securities to the public, the registrant's exact name as set forth in its charter, state or other jurisdiction of incorporation or organization, primary industrial classification, code number, I.R.S. employer identification number and the address, including zip code and telephone number, including area code, of the registrant's principal executive offices. n9 The facing page must also state the name, address and telephone number of the registrant's agent for service of process. In addition, the facing sheet of Form S-4 requires the registrant to calculate, in tabular form, the registration fee, setting forth the title of each class of securities to be registered, amount to be registered, proposed maximum offering price per unit, proposed maximum aggregate offering price and amount of registration fee. n10

[b] The Prospectus.

Part I of Form S-4, "Information Required in the Prospectus," requires the registrant to furnish in response to 19 items disclosure about (1) the transaction (Items 1-9), (2) the registrant (Items 10-14), (3) the company being acquired (Items 15-17) and (4) voting and management (Items 18 and 19).

[i] Information About the Transaction.

Form S-4 requires information about the transaction to appear in the prospectus. This information may not be incorporated by reference. If the registration statement on Form S-4 relates to offerings of securities under Rule 415(a)(1)(viii) ("shelf registration"), required information about the transaction only need be furnished as of the initial effectiveness of the registration statement to the extent practicable. The required information about the specific transaction must be included in the prospectus by means of a post-effective amendment. Where the transaction would qualify for an exemption, absent other similar transactions, a prospectus supplement may be used to furnish information about the transaction. n11

[A] Item 1. Forepart of Registration Statement and Outside Front Cover Page of Prospectus. This item requires the registrant to include the information required by Item 501 of Regulation S-K in the forepart of the registration statement and on the outside front cover page of the prospectus. n12

[B] Item 2. Inside Front and Outside Back Cover Pages of Prospectus. This item requires the registrant to include the information specified in Item 502 of Regulation S-K on the inside front cover of the prospectus or, where permitted, on the outside back cover page. n13 In addition, the inside front cover page must contain a statement printed in bold face type, stating where applicable, that the prospectus incorporates documents by reference, that the documents are available on request and giving the name, address and telephone number of a person to whom a request for documents should be directed. The statement must set forth the date five business days prior to the date on which the final investment decision should be made, for making the request to ensure timely delivery of documents.

[C] Item 3. Risk Factors, Ratio of Earnings to Fixed Charges and Other Information. Item 3 requires the registrant to furnish in the forepart of the prospectus:

(1) a summary of the information required by Item 503 of Regulation S-K; n14

(2) the name, address and telephone number of the principal executive offices of the registrant and the

company being acquired; n15

(3) a brief description of the business conducted by the parties; n16

(4) a brief description of the transaction; n17

(5) with respect to the registrant and the company being acquired, a brief statement comparing the percentage of outstanding voting shares held by directors, executive officers and their affiliates, and the vote required for approval of the transaction; n18

(6) a statement as to whether any federal or state regulatory requirements must be complied with or approval must be obtained in connection with the transaction, and if so, the status of such compliance or approvals; n19

(7) a statement about whether or not dissenters' rights of appraisal exist; n20 and

(8) a brief statement about the tax consequences of the transaction. n21

Item 3 requires as well that the registrant furnish selected financial data pursuant to Item 301 of Regulation S-K for (1) the registrant, (2) the company being acquired and (3) if material, for the registrant, on a pro forma basis, giving effect to the transaction. n22

In addition, Item 3(f) of Form S-4 requires, in comparative columnar form, historical and pro forma per share data of the registrant and historical and equivalent pro forma per share data of the company being acquired regarding book value, cash dividends and income (loss) from continuing operations. n23

Item 3(g) requires the furnishing in comparative columnar form of the market value of securities of the company being acquired (on an historical and equivalent per share basis) and the registrant (on a historical basis) as of the date preceding public announcement of the transaction or, if no such public announcement was made, as of the day preceding the day agreement on the transaction was reached.

[D] Item 4. Terms of the Transaction. Under Item 4 of Form S-4 registrant must provide:

(1) a brief summary of the terms of the acquisition agreement; n24

(2) the reasons of the registrant and of the company being acquired for engaging in the transaction; n25

(3) the information required by Item 202 of Regulation S-K, i.e., a description of the registrant's securities; n26

(4) an explanation of any material differences between the rights of security holders of the company being acquired and the rights of holders of the securities being offered; n27

(5) a brief statement as to the accounting treatment of the transaction; and n28

(6) the federal income tax consequences of the transaction. n29

If the registrant or the company being acquired has obtained a report, opinion or appraisal relating to the transaction from an outside party and such report has been referred to in the prospectus, the registrant must provide the information required by Item 1015(b) of Regulation M-A. n30

Finally, Item 4 requires that the acquisition agreement be incorporated by reference in the prospectus by means of a statement to that effect. n31

[E] Item 5. Pro Forma Financial Information. Item 5 requires the registrant to furnish the pro forma financial information for the transaction required by Article 11 of Regulation S-X. n32 A smaller reporting company instead need only provide the information in Rule 8-05 of Regulation S-X.

[F] Item 6. Material Contracts with the Company Being Acquired. Item 6 calls for information relating to any past, present or proposed material contracts, arrangements, negotiations, transactions or similar contracts between the registrant or its affiliates and the company being acquired or its affiliates during periods for which financial statements are presented or incorporated by reference. n33 Item 6 is designed to elicit information about possible conflicts of interest and pre-takeover transactions such as purchases by the registrant of large blocks of securities of the company being acquired.

[G] Item 7. Additional Information Required for Reoffering by Persons and Parties Deemed to be Underwriters. Item 7 provides that if any of the securities being registered are to be reoffered to the public by an underwriter, the prospectus must include:

- (1) the information required by Item 507 of Regulation S-K; n34
- (2) information about the consummation of the transaction in which the securities were acquired; and
- (3) any material change in the registrant's affairs subsequent to the transaction. n35

[H] Item 8. Interests of Named Experts and Counsel. This item requires the registrant to furnish the information specified in Item 509 of Regulation S-K. n36

[I] Item 9. Disclosure of Commission Position on Indemnification for Securities Act Liabilities. Item 9 requires the registrant to furnish the information required by Item 510 of Regulation S-K. n37

[ii] Information About the Registrant.

Form S-4, in specifying the means of delivering information about the registrant, adopts the two-tier Forms S-1 and S-3 approach in effect for primary offerings. Thus, if a registrant is subject to either Section 13(a) or 15(d) of the Exchange Act, it must furnish the same information about itself in the Form S-4 prospectus as would be required by Form S-1 or S-3 n38 if it were making a primary offering of securities not involving a business combination. A registrant eligible to use S-3 is not required to furnish information at the most streamlined level available, but may elect instead to comply with the items of Form S-4 by providing greater prospectus presentation. A nonreporting company must present company information at the level prescribed by Form S-1. n39

Items 10 through 14 of Form S-4 prescribe the registrant-related information. For purposes of furnishing the registrant-related information, these items have been divided into three alternative categories and availability of each alternative depends upon whether the registrant uses S-1 or S-3 level of disclosure. Information about the registrant may be provided in accordance with Items 10 and 11 of Form S-4 if the registrant elects this alternative and meets prescribed requirements for use of Form S-3. n40

Items 12 and 13 of Form S-4 may be used at the election of any registrant meeting the requirements of Form S-3; n41 and Item 14 must be used by registrants not eligible to use Form S-3. n42

Special disclosure provisions apply to business combination transactions of a registrant which is a real estate entity

described in General Instruction A of Form S-11. n43 Such registrant must furnish information prescribed by Items 12 through 16 of Form S-11, including:

- (1) discussion of the registrant's policies regarding certain activities (Item 12);
- (2) discussion of certain investment policies (Item 13);
- (3) description of real estate (Item 14);
- (4) disclosure of certain operating data (Item 15); and
- (5) discussion of the tax treatment of the registrant and its security holders regarding certain distributions (Item 16). n44

[A] Item 10. Information With Respect to S-3 Registrants. A Form S-3 registrant electing to provide information under Item 10 of Form S-4 must furnish in the prospectus: (1) a description of material changes in its affairs since the end of the latest fiscal year for which audited financial statements appeared in its latest annual report to security holders (changes described in the registrant's reports on Form 10-Q or Form 8-K under the Exchange Act need not be included in the prospectus); n45 and (2) if not incorporated by reference from certain previously filed reports:

- (1) financial information required by Rule 3-05 and Article 11 of Regulation S-X with respect to transactions other than that pursuant to which the securities being registered are to be issued;
- (2) restated financial statements pursuant to Regulation S-X, if there has been a change in accounting principles or a material retroactive restatement as a result of an error;
- (3) restated financial statements prepared in accordance with Regulation S-X where a combination of entities under common control has been consummated since the end of the registrant's most recent fiscal year, and the transferred businesses, in the aggregate, are "significant" pursuant to Rule 11-01(b) of Regulation S-X; and
- (4) any financial information required as a result of a disposition of assets outside the normal course of business. n46

[B] Item 11. Incorporation of Certain Information by Reference. If the registrant meets Form S-3 requirements and elects to furnish information pursuant to Item 10 of Form S-4, it may incorporate certain information into the prospectus by reference by a statement to that effect listing all documents so incorporated. n47

Such Registrant may incorporate by reference its latest annual report on Form 10-K and Form 10-KSB which contains financial statements for the registrant's latest fiscal year for which it was required to file Form 10-K or Form 10-KSB, as the case may be, and all other reports filed under Section 13(a) or 15(d) of the Exchange Act since the end of the fiscal year to which that Form 10-K and Form 10-KSB applies.

If the registrant is registering capital stock of a class which is being registered under Section 12 of the Exchange Act and traded on a national securities exchange or quoted by NASDAQ, the registrant may incorporate a description of those securities from any Exchange Act registration statement filed. n48

The registrant must identify the reports and other information that it files with the Commission and state that the public may read and copy any material it files at the Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The registrant must state that the public may obtain information on the operation of the Public Reference

Room by calling the Commission at 1-800-SEC-0330. Electronic filers must state that the Commission maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the Commission (www.sec.gov). Registrants are encouraged to give their Internet address, if available. n49

[C] Item 12. Information with Respect to S-3 Registrants. Item 12 of Form S-4 requires a Form S-3 registrant which elects to comply with the item to provide the information required by either paragraph (a) or (b) of Item 12 of Form S-4. n50

Paragraph (a) of Item 12 requires a registrant who elects to deliver the prospectus together with its latest Form 10-K, Form 10-KSB, or its latest annual report to security holders:

(1) to indicate that the prospectus is accompanied by the registrant's latest Form 10-K or annual report to security holders; and

(2) to provide the financial and other information about the Registrant required by Part I of Form 10-Q under the Exchange Act n51 as of the end of the most recent fiscal quarter that ended after the end of the last fiscal year for which certified financial statements were included in the registrant's Form 10-K or report to security holders, and more than 45 days prior to the effective date of the Form S-4, or a more recent date. The financial information must be delivered either by including it in the prospectus, or by providing, without charge, to each person to whom a prospectus is delivered, a copy of the registrant's latest Form 10-Q or its latest quarterly report to security holders that contains the financial information required. n52

A registrant using Item 12(a) of Form S-4 must also provide the information required by Rule 3-05 and Article 11 of Regulation S-X with respect to transactions other than that pursuant to which the securities being registered are to be issued, if such information was not included in the registrant's latest Form 10-K or its latest annual report to security holders, and must describe any material changes in the registrant's affairs since the end of latest full year for which audited financial statements appeared in its latest Form 10-K or its latest annual report to security holders, and which were not described in a subsequent Form 10-Q or quarterly report delivered with the prospectus. n53

If a registrant elects to deliver the documents specified in Item 12(a) of Form S-4 with a preliminary prospectus, such documents are not required to be redelivered with the final prospectus. n54

Item 12(b) of Form S-4 requires a registrant electing not to deliver its latest Form 10-K, Form 10-KSB, or its latest annual report with the Form S-4 prospectus to provide:

(1) a brief description of the business conducted by the registrant and its subsidiaries during the most recent fiscal year as required by Exchange Act Rule 14a-3 to be included in an annual report to security holders, taking the account changes in its business that have occurred between the end of the latest fiscal year and the effective date of the registration statement;

(2) financial and other information required by Rule 14a-3(b)(1) under the Exchange Act; and

(3) certain financial statements prepared in accordance with Regulation S-X. n55

The registrant must also furnish the information required by:

(1) Item 101(b), (c)(1)(i) and (d) of Regulation S-K, "Industry segments, classes of similar products or services, foreign and domestic operations and export sales"; n56

(2) where common equity securities are being offered, Item 201 of Regulation S-K, "Market price of and dividends on the registrant's common equity and related stockholder matters"; n57

(3) Item 301 of Regulation S-K, "Selected financial data"; n58

(4) Item 302 of Regulation S-K, "Supplementary financial information"; n59

(5) Item 303 of Regulation S-K, "Management's discussion and analysis of financial condition and results of operations"; n60

(6) Item 304 of Regulation S-K, "Disagreements with accountants on accounting and financial disclosure"; n61 and

(7) Item 305 of Regulation S-K, "Quantitative and qualitative disclosures about market risk." n62

[D] Item 13. Incorporation of Certain Information by Reference. Item 13 of Form S-4 allows a Form S-3 registrant which elects to furnish information required by Item 12 of Form S-4 to incorporate the following information by reference in the prospectus:

(1) the registrant's latest annual report on Exchange Act Form 10-K and Form 10-KSB containing audited financial statements for the latest fiscal year for which the registrant was required to file a Form 10-K and Form 10-KSB;

(2) all other reports filed under Section 13(a) or 15(d) of the Exchange Act since the end of the fiscal year covered by the Form 10-K or Form 10-KSB;

(3) if the registrant elects to deliver its latest annual report to security holders pursuant to Item 12 of Form S-4, the information required by Items 101(b), (c)(1)(i) and (d), 301, 302, 303, 304 and 305 of Regulation S-K and, where common equity securities are being issued, Item 201 of Regulation S-K; and

(4) if the registrant elects to provide a copy of its latest quarterly report which was delivered to security holders, pursuant to Item 12(a)(2)(iii) of Form S-4, financial information equivalent to that required to be presented in Part I of Form 10-Q. n63

The registrant may, where appropriate, clearly indicate that certain portions of its annual or quarterly report to security holders, other than those portions required to be incorporated by reference, are not part of the registration statement. n64

Electronic filers electing to deliver and incorporate by reference all or any portion of the quarterly or annual report to security holders pursuant to Item 13 of Form S-4 must file such report or the portion thereof that is incorporated by reference as an exhibit in electronic format. n65

The registrant must identify the reports and other information that it files with the Commission and state that the public may read and copy any material it files at the Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The registrant must state that the public may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330. Electronic filers must state that the Commission maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the Commission (www.sec.gov). Registrants are encouraged to give their Internet address, if available. n66

[E] Item 14. Information with Respect to Registrants Other Than S-3 Registrants. Item 14 provides that a registrant which does not meet Form S-3 requirements or who elects to comply with Item 14 in lieu of Item 10 or 12 of Form S-4, must furnish the information required by:

- (1) Item 101 of Regulation S-K, "Description of business"; n67
- (2) Item 102 of Regulation S-K, "Description of property"; n68
- (3) Item 103 of Regulation S-K, "Legal proceedings"; n69 and
- (4) the same information required by paragraph (3) of Item 13 above. n70

In addition, the registrant must provide the financial statements required by Regulation S-X (with schedules filed pursuant to Item 21 of Form S-4), n71 and the financial information required by Rule 3-05 and Article 11 of Regulation S-X with respect to transactions other than those pursuant to which the securities being registered are to be issued. n72

[iii] Information About the Company Being Acquired.

Form S-4 generally provides for the same prospectus presentation about a reporting company being acquired that would be required by Form S-1 or S-3 were such company making a primary offering of securities not involving a business combination. Thus, registrants must furnish information about a reporting company being acquired as if that company were the registrant. n73 On the other hand, information about a non-reporting company being acquired must be reported at the Form S-1 level. For purposes of Form S-4, a company is considered "non-reporting" if, among other things, it is not subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act, or if because of Section 12(i) of the Exchange Act, n74 it has not furnished an annual report to security holders pursuant to Exchange Act Rule 14a-3 or 14c-3 for its latest fiscal year.

Information about the company being acquired (including by means of an exchange offer of securities of the registrant for securities of such company), must be provided in accordance with one of the following items of Form S-4:

- (1) Item 15 of Form S-4, if the company being acquired is eligible to use Form S-3, and the registrant elects to use Item 15 in providing information about that company; n75
- (2) Item 16, if information is being provided about a company being acquired that is eligible to use Form S-3; and n76
- (3) Item 17, if the company being acquired is not eligible to use Form S-3. n77

[A] Item 15. Information With Respect to S-3 Companies. Item 15 provides that if the company being acquired is eligible to use Form S-3 and there is an election to use Item 15, the registrant must furnish the same information about the company being acquired that would be required by Items 10 n78 and 11 n79 of Form S-4 if securities of that company were being registered.

[B] Item 16. Information With Respect to S-3 Companies. Under Item 16, if the company being acquired is eligible to use Form S-3 and there is an election to use Item 16, the registrant must furnish the same information about the company being acquired that would be required by Items 12 n80 and 13 n81 of Form S-4 if securities of that company were being registered. In addition, electronic filers electing to deliver and incorporate by reference all or any portion of the quarterly or annual report to security holders pursuant to Item 16 of Form S-4 must file such report or the portion thereof that is incorporated by reference as an exhibit in electronic format. n82

[C] Item 17. Information With Respect to Companies Other Than S-3 Companies. Item 17 allows the

registrant to elect to provide information required by paragraph (a) or (b) of the Item if the company being acquired is not eligible to use Form S-3 or if compliance with Item 17 is elected in lieu of Item 15 or 16 of Form S-4. Paragraph (a) of Item 17 provides that if a reporting company is being acquired or paragraph (a) is selected in lieu of paragraph (b) of Item 17, the registrant must provide the information that would be required by Item 14 of Form S-4 n83 if securities of that company were being registered, and only the schedules required by Rules 12-15 (summary of investments-other than investments in related parties), 12-28 (real estate and accumulated depreciation) and 12-29 (mortgage loans and real estate) of Regulation S-X for the company being acquired.

If the company being acquired is not a reporting company, or has not furnished an annual report to security holders for its latest fiscal year, the prospectus must include:

- (1) a brief description of the general nature and scope of its business;
- (2) the information specified by Items 201, 301, 302, 303, 304(b) and 305 of Regulation S-K;
- (3) three-year financial statements which would have been required to appear in an annual report to security holders under Exchange Act Rules 14a-3(b)(1) and (b)(2) n84 or Rules 14c-3(a)(1) and (a)(2); n85
- (4) quarterly financial and other information pursuant to Part I of Form 10-Q n86 for the most recent fiscal quarter; and
- (5) schedules required by Rules 12-15, 12-28 and 12-29 of Regulation S-X. n87

[iv] Voting and Management Information.

Form S-4 requires that all voting information be presented in the prospectus, while the amount of prospectus presentation for management information, like company information, depends on which form (S-1, S-2 or S-3) could be used in a primary offering not involving a business combination.

[A] Item 18. Information if Proxies, Consents or Authorizations are to be Solicited. Item 18 requires that if proxies, consents n88 or authorizations are being solicited, the registrant must furnish, except as provided in paragraph (b) of the item:

- (1) the information required by Items 1, 2, 3 and 4 of Exchange Act Schedule 14A; n89
- (2) with respect to both the registrant and the company being acquired, the information required by Items 5 n90 and 6 n91 of Exchange Act Schedule 14A; and
- (3) with respect to each person who will serve as a director or executive officer of the surviving or acquiring company, the information required by Items 401, n92 402 n93 and 404 n94 of Regulation S-K. n95

Item 18 also calls for the information required by Item 21 n96 of Schedule 14A.

Paragraph (b) of Item 18 of Form S-4 provides that if the registrant or the company being acquired is eligible to use Form S-3, the information required by Item 5 of Exchange Act Schedule 14A concerning voting securities and principal holders thereof and information concerning each person who will serve as a director or executive officer of the surviving or acquiring company may be incorporated by reference from the registrant's latest annual report on Form 10-K.

[B] Item 19. Information if Proxies, Consents or Authorizations Are Not to be Solicited or in an Exchange Offer. Item 19 provides that if the transaction is an exchange offer or if proxies, consents or authorizations are not being solicited, the registrant must furnish, except as provided in paragraph (c) of the item,

- (1) the information required by Item 2 of Exchange Act Schedule 14C n97 and Item 3 of Exchange Act Schedule 14A n98 be furnished with respect to the registrant;
- (2) the date, time and place of the meeting of the security holders unless such information is otherwise disclosed in material furnished to security holders with the prospectus;
- (3) with respect to both the registrant and the company being acquired, a brief description of any material interest, direct or indirect, by security holdings or otherwise, in the transaction by affiliates of the parties; n99 and
- (4) the same information required by Item 18 of Form S-4 with respect to each person who will serve as a director or an executive officer of the surviving or acquiring company.

As in Item 18 of Form S-4, Item 19 requires the furnishing of the information required by Item 6 and 21 of Schedule 14A with respect to both the registrant and the company being acquired.

Paragraph (c) of Item 19 of Form S-4 permits registrants eligible to use Form S-3 to incorporate by reference from their latest annual report on Form 10-K any information required by paragraphs (a)(5) and (a)(7) of Item 19.

[c] Information Included in the Registration Statement But Not Required in Prospectus.

Part II of Form S-4, "Information Not Required in Prospectus," contains the following three items.

[i] Item 20. Indemnification of Officers and Directors. Under Item 20, the registrant must furnish the information required by Item 702 of Regulation S-K n100 concerning the indemnification of directors and officers of the registrant.

[ii] Item 21. Exhibits and Financial Statements Schedules. Item 21 requires the registrant to furnish the exhibits required by Item 601 of Regulation S-K, n101 and the financial statement schedules required by Regulation S-X and Items 14(e), n102 17(a) n103 and 17(b)(9) n104 of Form S-4. Paragraph (c) of Item 21 provides that if the registrant furnished information pursuant to Item 4(b) of Form S-4, it must provide the reports, opinions or appraisals as exhibits hereto if they were not included in the prospectus.

[iii] Item 22. Undertakings. Under Item 22, the registrant must furnish the undertakings required by Item 512 of Regulation S-K. n105

In addition, the registrant must undertake to respond to requests for information incorporated by reference pursuant to Items 4, 10(b), 11 or 13 of Form S-4 within one business day, and to send the incorporated documents by first class mail or its equivalent. n106

The registrant must also undertake to provide, by means of a post-effective amendment, all information about the transaction and the company being acquired not included in Form S-4 registration statement when it became effective. n107

[d] Roll-Up Transactions.

If the securities to be registered on the Form S-4 will be issued in a roll-up transaction, then the registrant must also

comply with the disclosure provisions of Section 900 of Regulation S-K. n108 In general, Section 900 requires the registrant to include additional information concerning the roll-up transaction in the registration statement on Form S-4 and to prepare supplements for each entity included in the roll-up transaction. In addition, the prospectus must be distributed to security holders no later than the lesser of 60 calendar days prior to the date on which action in the roll-up transaction is to be taken or the maximum number of days permitted for giving notice under applicable state law. n109 Section 900 has fourteen items. Item 902 concerns the information that must be included in the separate supplements. The remaining thirteen items involve additional disclosure concerning the roll-up transaction that must be included in the registration statement on Form S-4.

[i] Item 902. Individual Partnership Supplements. If two or more entities are proposed to be included in the roll-up transaction, this item requires a separate supplement to the disclosure document for each entity n110 which must be filed as part of the registration statement and must be delivered with the prospectus to investors in the partnership covered by the supplement. n111 The supplement must contain the following information:

- (1) Statements in the forepart of the supplement to the effect that supplements have been prepared for each partnership; that the effects of the roll-up transaction may be different for investors in the various partnerships; and that a copy of any supplement will be transmitted promptly, without charge, upon written request by an investor. n112
- (2) A brief description of each material risk and effect of the roll-up transaction, including, but not limited to, federal income tax consequences for investors in the partnership, with cross references to the discussion of the risks, effects and tax consequences of the roll-up transaction required in the Form S-4 pursuant to Items 904 and 915 of Regulation S-K. This discussion must address the effect of the roll-up transaction on the partnership's financial condition and results of operations. n113
- (3) A statement concerning whether the general partner reasonably believes that the roll-up transaction is fair or unfair to investors in the partnership and a brief discussion of the bases for such belief, with appropriate cross reference to the discussion of the fairness of the roll-up transaction required in the Form S-4 by Item 910 of Regulation S-K. The registrant must also include a brief description of any material differences between the fairness analysis for the partnership described in the supplement and other partnerships. n114
- (4) A brief, narrative description of the method of calculating the value of the partnership and allocating interests in the successor to the partnership, and a table showing such calculation and allocation. The table must include the following information (or other information of a comparable character necessary to a thorough understanding of the calculation and allocation): n115
 - (a) the appraised value of each separately appraised significant asset held by the partnership, or if appraisals have not been obtained for each significant asset, the value assigned for purposes of the valuation of the partnership to each significant asset for which an appraisal has not been obtained; n116
 - (b) the dollar amount of any mortgages or other similar liabilities to which such asset is subject; n117
 - (c) cash and cash equivalent assets held by the partnership; n118
 - (d) other assets held by the partnership; n119
 - (e) other liabilities of the partnership; n120

(f) the value assigned to the partnership; n121

(g) the value assigned to the partnership per interest held by holders of interests in the partnership (on an equivalent interest basis, such as per \$1,000 original investment); n122

(h) the aggregate number of interests in the successor to be allocated to the partnership and the percentage of the total interests of the successor; n123

(i) the number of interests in the successor to be allocated to investors in the partnership for each interest held by such investors (on an equivalent interest basis, such as per \$1,000 original investment); n124 and

(j) the value assigned to the general partner's interest in the partnership, and the number of interests in the successor or otherwise as compensation for reimbursement for claims against or interests in the partnership, such as foregone fees, unearned fees and for fees to be earned on the sale or refinancing of an asset. n125

(5) The amounts of compensation paid, and cash distributions made, to the general partner and its affiliates by the partnership for the last three fiscal years and the most recently completed interim period and the amounts that would have been paid if the compensation and distribution structure to be in effect after the roll-up transaction had been in effect during such period. A description of any changes, and their effects on the compensation and distributions to be paid by the successor, if any proposed change in the business or operations of the successor after the roll-up transaction would materially change the compensation and distributions that would have been paid by the successor (for example if properties will be sold or purchased after the roll-up transaction and no properties were sold or purchased during the period covered by the table). n126

(6) Cash distributions made to investors during each of the last five fiscal years and most recently completed interim period, identifying any such distributions which represent a return of capital. n127

(7) An appropriate cross-reference to selected financial information concerning the partnership and the pro-forma financial statements included in the Form S-4 in response to Item 914(b)(2) of Regulation S-K. n128

[ii] Item 903. Summary. This item requires the registrant to provide a clear concise and comprehensible summary of the roll-up transaction in the forepart of the S-4. n129 This summary must include any material terms or consequences of the roll-up transaction necessary to an understanding of such transaction, including:

(1) Each material risk and effect on investors, including, but not limited to:

(a) changes in the business plan, voting rights, cash distribution policies, form of ownership interest or management compensation;

(b) any conflicts of interest of the general partner in connection with the roll-up transaction and in connection with the successor's future operations; and

(c) the likelihood that securities received by investors in the roll-up transaction will trade at prices substantially below the value assigned to such securities in the roll-up transaction and/or the value of the successor's assets. n130

- (2) The material terms of the roll-up transaction, including the valuation method used to allocate securities in the successor to investors in the partnerships. n131
- (3) Whether the general partner reasonably believes that the roll-up transaction is fair or unfair to investors in each partnership, including a brief discussion of the bases for such belief. n132
- (4) Any opinion from an outside party concerning the fairness of the roll-up transaction, including whether the opinion addresses the fairness of all possible combinations of partnerships or portions of partnerships and contacts with any outside party concerning fairness opinions, valuations or reports in connection with the roll-up transaction required to be disclosed pursuant to Item 911(a)(5) of Regulation S-K. n133
- (5) The background of and reasons for the roll-up transaction, as well as alternatives to the roll-up transaction described in response to Item 908(b) of Regulation S-K. n134
- (6) Rights of investors to exercise dissenters' or appraisal rights or similar rights and to obtain a list of investors in the partnership in which the investor holds an interest. n135
- (7) If any affiliates of the general partner or the sponsor may participate in the business of the successor or receive compensation from the successor, an organizational chart showing the relationships between the general partner, the sponsor and their affiliates. n136

[iii] Item 904. Risk Factors and Other Considerations. This item requires the registrant to include in the registration statement on Form S-4, immediately following the summary required by Item 903, information concerning the risks of the roll-up transaction. Item 904(a) requires a description, in reasonable detail, of each material risk and effect of the roll-up transaction, including, but not limited to:

- (1) the potential risks, adverse effects and benefits of the roll-up transaction for investors and for the general partner, including those which result from each matter described in response to Item 905 of Regulation S-K with appropriate cross reference to the comparative information required by Item 905;
- (2) the material risks arising from an investment in the successor; and
- (3) the likelihood that securities of the successor received by investors in the roll-up transaction will trade in the securities markets at a price substantially below the value assigned to such securities in the roll-up transaction and/or the value of the assets of the successor, and the effects on investors of such a trading market discount.

Item 904(b) requires the registrant to quantify each risk or effect to the extent practicable, including the amount of cost savings and a comparison of such amount to the costs of the roll-up transaction, if a cost savings resulting from combined administration is identified as a potential benefit of the roll-up transaction and if there may be a material conflict of interest of the sponsor or general partner arising from its receipt of payments or other consideration as a result of the roll-up transaction, the amount of such payments and other consideration to be obtained in the roll-up transaction and a comparison of such amounts to which the sponsor or general partner would be entitled without the roll-up transaction. n137

Finally, Item 904(c) requires the registrant to state whether any of the risks or effects identified in this section may be different for investors in any partnership and, if so, identify such partnerships and describe such differences.

[iv] Item 905. Comparative Information. This item requires a description of certain information which should be illustrated in tables or other readily understandable formats, set forth in appropriate separate sections of the Form S-4.

n138 The registrant must describe the following information:

(1) The voting and other rights of investors in the successor under the successor's governing instruments and under applicable law, comparing such rights to the voting and other rights of investors in each partnership subject to the transaction under the partnerships' governing instruments and under applicable law and describing the effects of any changes in such rights. n139

(2) The duties owed by the general partner of the successor to investors in the successor under the successor's governing instruments and under applicable law, comparing such duties to the duties owed by the general partner of each partnership to investors in the partnership under the partnership's governing instruments and under applicable law, with a description of the effects of any changes in such duties. n140

(3) Each item of compensation (including reimbursement of expenses) payable by the successor after the roll-up transactions to the general partner and its affiliates or to any affiliate of the successor and compare such compensation to the compensation currently payable to the general partner and its affiliates by each partnership with a description of the effects of the changes in compensation arrangements. n141

(4) Each instance in which cash or other distributions may be made by the successor to the general partner and its affiliates or to any affiliate of the successor, comparing such distributions to the distributions currently paid or payable to the general partner and its affiliates by each partnership, describing the effects of any changes in distribution arrangements and if distributions similar to those currently paid or payable by any partnership to the general partner or its affiliates will not be made by the successor, state whether or not other compensation arrangements with the successor, such as incentive fees payable upon sale of a property) will, in effect, replace such distributions. n142

(5) If any proposed changes in the business or operations of the successor after the roll-up transaction would change materially the compensation and distributions that would have been paid by the successor from that shown in the table required, a description of such changes and any effects on the compensation and distributions to be paid by the successor is required. n143

(6) The material conflicts that may arise between the interests of the sponsor or general partner and the interests of investors in the successor as a result of the compensation and distribution arrangements described in C and D above and describe any steps that will be taken to resolve such conflicts. n144

Item 905 (c) requires the registrant to describe any provisions in the governing instruments of the successor and any policies of the general partner of the successor relating to distributions to investors of cash from operations, proceeds from the sale, financing or refinancing of assets and any other distributions, compare such provisions and policies to those of each of the partnerships and describe the effects of any changes in such provisions or policies.

Item 905(d) requires the registrant to describe each material investment policy of the successor, including policies with respect to borrowings by the successor, comparing such investment policies to the investment policies of each of the partnerships and describing the effects of any changes in such policies. It also requires a description of any plans of the general partner, sponsor or of any person who will be an affiliate of the successor with respect to a sale of any material assets of the partnerships, a purchase of any material assets and borrowings.

The registrant must also describe any other similar terms or policies of the successor that are material to an investment

in the successor, comparing any such terms or policies to those of each of the partnerships and describing the effects of any changes in any such terms or policies in Item 905(e).

The registrant must also state whether or not specific assets have been identified for sale, financing, refinancing or purchase following the roll-up transaction. If specific assets have been identified, the registrant must describe the assets and the proposed transaction. n145

[v] Item 906. Allocation of Roll-Up Consideration. This item requires the registrant to provide information concerning the consideration received in the roll-up transaction. Item 906(a) requires the registrant to describe, in reasonable detail, the method used to allocate interests in the successor to investors in the partnerships and the reasons why such method was used.

Item 906(b) states that the registrant must provide a table showing the calculation of the valuation of each partnership and the allocation of interests in the successor to investors, including for each partnership:

- (1) the value assigned to each significant category of assets of the partnership and the total value assigned to the partnership;
- (2) the total value assigned to all partnerships;
- (3) the aggregate amount of interests in the successor to be allocated to each partnership and the percentage of the total amount of all such interests represented thereby; and
- (4) the amount of interests of the successor to be issued to investors per interest held in each partnership (on an equivalent interest basis, such as per \$1,000 invested). n146

If interests in the successor will be allocated to the general partner in exchange for its general partner interest or otherwise or if the general partner will receive other consideration in connection with the roll-up transaction, Item 906(c) requires the registrant to describe, in reasonable detail, the method used to allocate interests in the successor to the general partner or to determine the amount of consideration payable to the general partner, and the reasons such methods were used and identify the consideration paid by the general partner for interests in the partnerships that will be changed in the roll-up transaction.

[vi] Item 907. Background of the Roll-Up Transaction. This item requires the registrant to furnish a summary of the background of the transaction, including, but not limited to, a description of any contracts, negotiations or transactions concerning a merger, consolidation or combination of any of the partnerships, an acquisition of any of the partnerships of a material amount of any of their assets, a tender offer for or other acquisition of securities of any class issued by any of the partnerships, or a change in control of any of the partnerships. This summary must cover the period beginning with each partnership's second full fiscal year before the date of the filing of the roll-up transaction, include contracts, negotiations or transactions between the general partner or its affiliates and any person who would have a direct interest in any of the transactions referred to in the preceding sentence, and identify the person who initiated such contacts, negotiations or transactions. n147

Item 907(b) requires the registrant to briefly describe the background of each partnership, including, but not limited to the amount of capital raised from investors, the extent to which net proceeds from the original offering of interests have been invested, the extent to which funds have been invested as planned and the amount not yet invested, and the partnership's investment objectives and the extent to which the partnership has achieved its investment objectives. n148

Finally, Item 907(c) requires the registrant to discuss whether the general partner, including any affiliated person materially dependent upon the general partner's compensation arrangement with the partnership, or any partnership has

experienced any material adverse financial developments since the commencement of the most recently completed fiscal year or is likely to experience any material adverse financial developments, with a description of such developments and the effects of the transaction on such matters. n149

[vii] Item 908. Reasons for and Alternatives to the Roll-Up Transaction. This item requires the registrant to describe the reasons for the roll-up transaction n150 and whether the general partner recommends the roll-up transaction, with a brief description of the reasons for such recommendation. n151 If the general partner or sponsor considered alternatives to the roll-up transaction being proposed, Item 908(b) requires the registrant to describe such alternatives and states reasons for their rejection. n152

The registrant must also describe, in reasonable detail, the following potential alternatives:

- (1) continuing the partnerships in accordance with their existing business plans, including the effects of such continuation and the material risks and benefits that likely would arise in connection therewith, and, if applicable, the general partner's reasons for considering such alternative; n153 and
- (2) liquidating the partnerships, the procedures required to accomplish liquidation, the effects of liquidation, the material risks and benefits that likely would arise in connection with liquidation, and, if applicable, the general partner's reasons for not considering such alternative. n154

Items 908(c) and (d) require the registrant to state the reasons for the structure of the roll-up transaction, the reasons for undertaking such transaction at this time, whether the general partner initiated the roll-up transaction and, if not, whether the general partner participated in the structuring of the transaction.

[viii] Item 909. Conflicts of Interest. This item requires the registrant to provide information concerning any conflict of interest the general partner may have with the investors. Item 909(a) requires a brief description of the general partner's fiduciary duties to each partnership subject to the roll-up transaction and each actual or potential material conflict of interest between the general partner and the investors relating to the roll-up transaction.

The registrant must also state whether or not the general partner has retained an unaffiliated representative to act on behalf of investors for purposes of negotiating the terms of the roll-up transaction in response to Item 909(b). If such a representative has not been retained, the registrant must describe the reasons therefore and the risks arising from the absence of separate representation. n155

If an unaffiliated representative has been retained to represent investors, the registrant must:

- (1) identify such unaffiliated representative; n156
- (2) briefly describe the representative's qualifications, including a brief description of any other transaction similar to the roll-up transaction in which the representative has served in a similar capacity within the past five years; n157
- (3) describe the method of selection of such representative, including a statement as to whether or not any investors were consulted in the selection of the representative and, if so, the names of such investors; n158
- (4) describe the scope and terms of the engagement of the representative, including, but not limited to who is responsible for paying the representative's fees and whether such fees are contingent upon the outcome of the roll-up transaction; n159

(5) describe any material relationship which existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of such relationship between the representative or its affiliates and the general partner, sponsor, any affiliate of the general partner or sponsor, or any other person having a material interest in the roll-up transaction; n160

(6) describe in reasonable detail the actions taken by the representative on behalf of investors; n161 and

(7) describe the fiduciary duties or other legal obligations of the representative to investors in each of the partnerships. n162

[ix] Item 910. Fairness of the Transaction. This item requires the registrant to state whether the general partner reasonably believes that the roll-up transaction is fair or unfair to investors and the reasons for such belief, addressing the fairness of the roll-up transaction to investors in each of the partnerships and the transaction as a whole. If the roll-up transaction may be completed with a combination of partnerships consisting of less than all partnerships or with portions of partnerships, the belief stated as to the fairness or unfairness of the transaction must address each possible combination.

Item 910(b) requires the registrant to discuss, in reasonable detail, the material factors upon which such belief of fairness or unfairness is based and, to the extent practicable, the weight assigned to each such factor. n163 The discussion concerning fairness should specifically address material terms of the transaction including whether the consideration offered to investors constitutes fair value in relation to: the form and amount of consideration to be received by investors and the sponsor in the roll-up transaction; the methods used to determine such consideration; and the compensation to be paid to the sponsor in the future. n164

This discussion also must compare the value of the consideration to be received in the roll-up transaction to the value of the consideration that would be received pursuant to each of the alternatives to the roll-up transaction discussed in response to Item 908(b), and describe any material differences among the partnerships, such as different types of assets or different investment objectives, relating to the fairness of the transaction.

The factors that are important in determining the fairness of a roll-up transaction to investors and the weight which should be given to such factors in a particular context will vary. Such factors will usually include whether an unaffiliated representative has been retained to act on behalf of the investors and whether the consideration offered to investors constitutes fair value in relation to:

(1) current market prices, if any;

(2) historic market prices, if any;

(3) net book value;

(4) going concern value;

(5) liquidation value;

(6) purchases of limited partnership interests by the general partner or sponsor or their affiliates since the commencement of the partnership's second full fiscal year preceding the date of filing of the disclosure document for the roll-up transaction;

(7) any report, opinion or appraisal discussed in Item 911 of Regulation S-K; and

(8) offers n165 of which the general partner or sponsor is made aware during the preceding 18 months for a merger, consolidation or combination of any of the partnerships, an acquisition of any of the partnerships or a material amount of their assets, a tender offer for or other acquisition of securities of any class issued by any of the partnerships, or a change in control of any of the partnerships. n166

The registrant must also describe any factors known to the general partner that may materially affect the value of the consideration to be received by investors in the roll-up transaction, the values assigned to the partnerships for purposes of the comparisons to alternatives required by the preceding paragraph and the fairness of the transaction to investors in response to Item 910(d). Finally, the registrant must state whether the general partner's statements in response to the preceding two paragraphs are based, in whole or in part on any report, opinion or appraisal described in response to Item 911 and to describe any material uncertainties known to the general partner that relate to the conclusions in any such report, opinion or appraisal including, but not limited to, developments or trends that have affected or are reasonably likely to affect materially such conclusions. In responding to the requirements of this section, the registrant may not use conclusive statements or state that the general partner has no reasonable belief as to the fairness of the roll-up transaction to investors. n167

[x] Item 911. Reports, Opinions and Appraisals. This item requires the registrant to state whether or not the general partner or sponsor has received any report, opinion (other than an opinion of counsel) or appraisal which is material related to the roll-up transaction, n168 including, but not limited to, any such report, opinion or appraisal relating to the consideration or the fairness of the consideration to be offered to investors in connection with the roll-up transaction or the fairness of such transaction to the general partner or investors n169 and attach all such reports, opinions or appraisals to the registration statement. n170 With respect to each such report, opinion or appraisal, the registrant must:

- (1) identify such outside party, n171 briefly describing the qualifications of such outside party and the method of selecting such outside party;
- (2) describe any material relationship between the outside party or its affiliates and the general partner, the sponsor, the successor or any of their affiliates which existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of such relationship;
- (3) state, if such report, opinion or appraisal relates to the fairness of the consideration, whether the general partner, sponsor or affiliate determined the amount of consideration to be paid or whether the outside party recommended the amount of consideration to be paid;
- (4) furnish a summary concerning such report, opinion or appraisal which must include, but is not limited to, the procedures followed, the findings and recommendations, the bases for and methods of arriving at such findings and recommendations, instructions received from the general partner, sponsor or affiliate on the scope of the investigation and if applicable, state the reasons for placing any limitations on the scope of the investigation, such as access to its personnel, premises or relevant books and records, by the general partner, sponsor or affiliate; and
- (5) state whether any compensation paid to such an outside party is contingent on the approval or completion of the roll-up transaction and, if so, the reasons for compensating such parties on a contingent basis.

The registrant must also describe any contacts in connection with the roll-up transaction between the sponsor or the general partner and any outside party with respect to the preparation by such party of any opinion concerning the fairness of the roll-up transaction, a valuation of a partnership or its assets or any other report with respect to the roll-up

transaction, except that this description is not required of contacts with respect to reports, opinions or appraisals files as exhibits to the registration statement. The description of such contacts with any outside party must include the identity of each party, the nature of the contact, the actions taken by such party, any views, preliminary or final, expressed on the proposed subject matter of the report, opinion or appraisal and any reasons such party did not provide a report, opinion or appraisal. n172

The registrant is also required to make a statement in the prospectus to the effect that upon written request by an investor or his representative who has been designated as such in writing, a copy of any such report opinion or appraisal will be transmitted promptly, without charge, by the general partner or sponsor and include the name and address of the person to whom investors or their representative should make their request. n173 If any report, opinion or appraisal relates to the fairness of the roll-up transaction to investors in the partnerships, Item 911(b) requires the registrant to state whether or not the report, opinion or appraisal addresses the fairness of the roll-up transaction as a whole and to investors in each partnership, and all possible combinations of partnerships (including portions of partnerships if the transaction is structured to permit portions of partnerships to participate). If all possible combinations are not addressed, the registrant must identify the combinations that are addressed, identify the persons that determined which combinations would be addressed and state the reasons for the selection of the combinations and state that if the roll-up transaction is completed with a combination of partnerships not addressed, no report, opinion or appraisal concerning the fairness of the roll-up transaction will have been obtained. If the sponsor or the general partner has not obtained any opinion on the fairness of the proposed roll-up transaction to investors in each of the affected partnerships, state the sponsor's or general partner's reasons for concluding that such an opinion is not necessary in order to permit the limited partners of shareholders to make an informed decision on the proposed transaction. n174

If the report, opinion or appraisal consists of an appraisal of the assets of the partnerships, the registrant must provide a clear concise summary description of the appraisal n175 containing:

- (1) a description of the purposes for which the appraisals were obtained and their use in connection with the roll-up transaction;
- (2) a description of which assets are covered by the appraisals, stating the aggregate appraised value of the assets covered by the appraisals (including such value net of associated indebtedness) and stating whether any events have occurred or conditions have changed since the date of the appraisals that may have caused a material change in the value of the assets; and
- (3) an appendix to the prospectus containing one or more tables setting forth the appraised value of any separately appraised asset that is significant n176 to the partnership holding such asset, and if the appraiser considered different valuation approaches in preparing the appraisals of such significant assets, the value of each such asset under each valuation approach considered by the appraiser, identifying the valuation approach used by the appraiser in determining the appraised value and the reason such approach was chosen, setting forth all material assumptions used by the appraiser in appraising the significant assets and if the appraiser used different assumptions for any of such assets, the reasons the different assumptions were chosen. n177

[xi] Item 912. Source and Amount of Funds and Transaction Expenses. Item 912(a) requires the registrant to state the source and total amount of funds or other consideration to be used in the roll-up transaction. The registrant must also furnish a reasonably itemized statement of all expenses incurred or estimated to be incurred in connection with the roll-up transaction including, but not limited to, filing fees, legal, financial advisory, accounting and appraisal fees, solicitation expenses and printing costs and identify the persons responsible for paying any or all of such expenses, stating whether or not any partnership subject to the roll-up transaction will be directly or indirectly responsible for any or all of the expenses of the transaction, the amount and sources of capital used to finance such amount by each partnership.

If all or any part of the consideration to be used by the sponsor or successor in the roll-up transaction is expected to be, directly or indirectly, provided by any partnership, Item 912(c) requires the registrant to state the amount to be provided by each partnership and the sources of capital to finance such amount. If all or any part of the funds or other consideration is, or is expected to be, directly or indirectly, borrowed by the sponsor or successor for the purpose of the roll-up transaction, the registrant must provide a summary of each such loan agreement containing the identity of the parties, the term, the collateral, the stated and effective interest rates and other material terms or conditions and briefly describe any plans or arrangements to finance or repay such borrowing or if no plans or arrangements have been made, make a statement to that effect. n178

[xii] Item 913. Other Provisions of the Transaction. This item requires the registrant to state whether or not appraisal rights are provided under applicable state law, under the partnership's governing instruments or will be voluntarily accorded by the successor, the general partner or the sponsor (or any of their affiliates) in connection with the roll-up transaction and summarize such rights, if available. n179 If appraisal rights will not be available to investors who object to the transaction, the registrant must briefly outline the rights which may be available to such investors under such law. The registrant is also required to describe any provision that has been made to allow investors to obtain access to the books and records of the partnership or to obtain counsel or appraisal services at the expense of the successor, the general partner, the partnership, the sponsor (or any of their affiliates). n180 Finally, the registrant must discuss the investors' rights under federal and state law to obtain a partnership's list of investors. n181

[xiii] Item 914. Pro Forma Financial Statements; Selected Financial Data. In addition to the information required by Item 301 of Regulation S-K and Item 302 of Regulation S-K, Item 914(a) requires the registrant to provide, for each partnership proposed to be included in a roll-up transaction:

- (1) a ratio of earnings to fixed charges, cash and cash equivalents, total assets at book value, total assets at the value assigned for purposes of the roll-up transaction (if applicable), total liabilities, general and limited partners' equity, net increase (decrease) in cash and cash equivalents, net cash provided by operating activities, distributions; and
- (2) per unit data for net income (loss), book value, value assigned for purposes of the roll-up transaction (if applicable) and distributions (separately identifying distributions that represent a return of capital).

This information should be provided for the same periods for which Selected Financial Data and Supplementary Financial Data are required to be provided in the registration statement.

The registrant is also required to provide pro forma financial information (including oil and gas reserves and cash flow disclosure, if appropriate), assuming that all partnerships participate in the roll-up transaction and participation in a roll-up transaction of those partnerships that on a combined basis have the lowest combined net cash provided by operating activities for the last fiscal year of such partnerships, provided that participation by such partnerships satisfies any conditions to consummation of the roll-up transaction. If the combination of all partnerships proposed to be included in the roll-up transaction results in such lowest combined net cash provided by operating activities, the registrant must so note and is not required to provide separate pro forma financial statements.

If pro forma financial statements are required, they must disclose the effect of the roll-up transaction on the successor's:

- (1) balance sheet as of the later of the end of the most recent fiscal year or the latest interim period;
- (2) statement of income (with separate line items to reflect income (loss) excluding and including the roll-up expenses and payments), earnings per share amounts and ratio of earnings to fixed charges for the most recent fiscal year and the latest interim period;

(3) statement of cash flows for the most recent fiscal year and the latest interim period; and

(4) book value per share as of the later of the end of the most recent fiscal year and the latest interim period.

If the roll-up transaction is structured to permit participation by portions of partnerships, the registrant should give consideration to the effect of such participation in preparing the pro forma financial statements reflecting a partial roll-up. n182 The registrant may, however, omit any or all of the pro forma information that is not material for the exercise of prudent judgment in regard to the matter to be acted upon. n183

[xiv] Item 915. Federal Income Tax Consequences. The registrant is required to provide, under Item 915(a), a brief, clear and understandable summary of the material federal income tax consequences of the roll-up transaction and an investment in the successor. If a tax opinion has been provided, the registrant must briefly summarize the substance of such opinion, including an identification of the material consequences upon which counsel has not been asked, or is unable to opine. The registrant must also describe any differences if any of the material federal income tax consequences are not expected to be the same of investors in all partnerships.

Item 915(b) requires the registrant to state whether or not the opinion of counsel is included as an appendix to the prospectus. If the opinion is filed as an exhibit to the registration statement and not included as an appendix to the prospectus, the registrant must include a statement to the effect that, upon receipt of a written request by an investor or his representative who has been designated as such in writing, a copy of the opinion of counsel will be transmitted promptly, without charge, by the general partner or sponsor and include the name and address of the person to whom investors should make their request.

FOOTNOTES:

(n1)Footnote 1. Sec. Act Rel. No. 33-6578, Fed. Sec. L. Rep. (CCH) P 72,418 (1985). Form S-4 replaced Forms S-14 and S-15 for use in connection with certain business combinations.

In 1985 the Commission rescinded Form S-14 and adopted Form N-14 for registration of securities issued by management investment companies and business development companies in business combination transactions. Sec. Act Rel. No. 33-6611, Fed. Sec. L. Rep. (CCH) P 83,938 (1985).

In Sec. Act Rel. No. 33-6579, Fed. Sec. L. Rep. (CCH) P 72,419 (1985), the Commission adopted Form F-4 as the counterpart to Form S-4, for use by foreign issuers to register securities issued in certain business combinations.

The forms under the Securities Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section D (Matthew Bender).

(n2)Footnote 2. General Instruction A.1(1), Form S-4. The rules under the Securities Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

In Service Corporation International, 17 B.N.A. Sec. Reg. & L. Rep. 2167 (Div. Corp. Fin. 1985), the staff, in response to an issuer's request for guidance on the conversion from the use of Form S-1 for shelf registration to Form S-4, took the position that it will not object if a registrant that otherwise qualifies to use of Forms S-4 uses that form for shelf registration of transactions to acquire privately owned businesses even when the transactions differ in certain technical respects from Rules 145(a) transaction described in the General Instructions to the form.

(n3)Footnote 3. General Instruction A.1(2), Form S-4.

Among the mergers in which Form S-4 can be used are certain "short form mergers" under state laws (*e.g.* Delaware Corporation Law, § 253) pursuant to which a parent corporation can merge certain subsidiaries into the parent without any action by shareholders, or statutes similar to Delaware Corporation Law, § 258, which permit corporate action to be taken without a meeting, upon the written consent of the holders of outstanding stock having not less than the minimum number of votes necessary to authorize such action at a meeting. Sec. Act Rel. No. 33-6578 n.23, Fed. Sec. L. Rep. (CCH) P 72,418 (1985).

(n4)Footnote 4. General Instruction A.1(3), Form S-4.

Prior to the adoption of Form S-4, exchange offers could be registered only on Form S-1. In permitting exchange offers to be registered on Form S-4, thus narrowing the distinction between cash offers and exchange offers, the Commission followed Recommendation 11 of the Advisory Committee on Tender Offers Report and Recommendations (July 1983). That Committee was appointed to examine the tender offer process and to make recommendations on any legislative or regulatory changes it considered necessary or appropriate. *See* Sec. Exch. Act Rel. No. 34-19,528, Fed. Sec. L. Rep. (CCH) P 83,319 (1983).

(n5)Footnote 5. General Instruction A.1(4), Form S-4.

(n6)Footnote 6. General Instruction A.1(5), Form S-4.

(n7)Footnote 7. General Instruction E.1, Form S-4.

A Form S-4 prospectus used as a proxy or information statement is deemed to satisfy the informational and filing requirements of the Exchange Act proxy and information statement rules.

(n8)Footnote 8. The following transactions are not considered to be roll-up transactions: (a) the interests of all of the investors in each of the partnerships are repurchased, recalled or exchanged in accordance with the terms of a preexisting partnership agreement for securities in an operating company specifically identified at the time of formation of the original partnership; (b) the securities to be issued or exchanged in the transaction are not required to be and are not registered under the Securities Act; (c) only issuers that are not required to register or report under Section 12 of the Exchange Act, both before and after the transaction, are involved in the transaction; (d) the transaction involves the combination or reorganization of one or more partnerships in which a non-affiliated party succeeds to the interests of a general partner or sponsor, if (i) such action is approved by at least 66 2/3% of the outstanding units of each of the participating partnerships, and (ii) as a result of the transaction, the only compensation that the existing general partners will receive is compensation to which they are entitled as expressly provided for in the preexisting partnership agreements; (e) the securities offered to investors in the transaction are securities of another entity that are reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under Section 11A of the Exchange Act if (i) the other entity was formed, and the class of securities was reported and regularly traded (minimum closing price of \$2 or more for majority of the business days during the preceding three months and a six-month minimum average daily trading volume of 1,000 shares) not less than 12 months before the date on which soliciting material is mailed to investors, and (ii) the securities of that entity issued to investors in the transaction do not exceed 20% of the total outstanding securities of the entity, exclusive of any securities of such class held by or for the account of the entity or its subsidiary; (f) all of the investors' partnership securities are reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under Section 11A of the Exchange Act and such investors receive new securities or securities in another entity that are reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under Section 11A of the Exchange Act, except that securities listed on the American Stock Exchange's Emerging Company Marketplace are not included; (g) all investors are provided an option to receive or retain a security under substantially the same terms and conditions as the original issue; or (h) the Commission exempts the security, transaction or persons, in whole or in part from the definition of a roll-up transaction. Item 901(c), Regulation S-K.

(n9)Footnote 9. The registrant must also indicate on the facing sheet whether the securities being registered on Form S-4 are being offered in connection with a holding company and whether there is compliance with General Instruction G of Form S-4.

(n10)Footnote 10. When two or more classes of securities are registered on Form S-4 pursuant to General Instruction H, discussed in § 7.06[1][b][i] *infra*, Rule 457(o) permits the registration fee to be calculated on the basis of the maximum offering price of all the securities listed. In this event, the registrant need not specify by each class information as to the amount to be registered, proposed maximum offering price by unit, and proposed maximum aggregate offering price. General Instruction J, Form S-4.

(n11)Footnote 11. General Instruction H, Form S-4.

(n12)Footnote 12. Item 501 of Regulation S-K is discussed in § 7.03[2][a] *supra*.

(n13)Footnote 13. Item 502 of Regulation S-K is discussed in § 7.03[2][b] *supra*.

(n14)Footnote 14. Item 503 of Regulation S-K is discussed in § 7.03[2][c] *supra*.

(n15)Footnote 15. Item 3(a), Form S-4.

(n16)Footnote 16. Item 3(b), Form S-4.

(n17)Footnote 17. Item 3(c), Form S-4.

(n18)Footnote 18. Item 3(h), Form S-4.

(n19)Footnote 19. Item 3(i), Form S-4.

(n20)Footnote 20. Item 3(j), Form S-4. The statement must make a cross reference to the information provided pursuant to Items 18 or 19 of Form S-4, discussed in § 7.06[1][b][iv][A]-[B] *infra*.

(n21)Footnote 21. Item 3(k), Form S-4. In view of the complexity of the tax consequences of certain business combinations, registrants may, where appropriate, cross reference to information provided by Item 4 of Form S-4, discussed in § 7.06[1][b][i][D] *infra*, in lieu of providing tax information under Item 3. Sec. Act Rel. No. 33-6578 n.47, Fed. Sec. L. Rep. (CCH) P 72,418 (1985).

(n22)Footnote 22. Item 3(d) and (e), Form S-4. Item 301 of Regulation S-K is discussed in § 7.03[2][k][vi] *supra*. To the extent that information required under Item 3(d) is required in the prospectus under Items 12, 14, 16 or 17 of Form S-4, it need not be repeated in Item 3(d). To the extent the information is required to be presented in the prospectus pursuant to Items 12 or 14, it need not be repeated in Item 3(e).

(n23)Footnote 23. Item 3(f)(1)-(3), Form S-4. The data required must be presented for the periods corresponding to the periods for which financial information is submitted pursuant to Item 301 of Regulation S-K.

For a business combination the financial information required by paragraphs (e) (information required by Item 301 of Regulation S-K for the registrant on a pro forma basis, giving effect to the transaction) and (f) shall be presented only for the most recent fiscal year and interim period. For a business combination between entities under common control, the financial information required by paragraphs (e) and (f) (except for information with regard to book value) shall be presented for the most recent three fiscal years and interim period. Information with regard to book value shall be presented as of the end of the most recent fiscal year and interim period. Equivalent pro forma per share amounts are calculated by multiplying the pro forma income (loss) per share before non-recurring charges or credits directly attributable to the transaction, pro forma book value per share, and the pro forma dividends per share of the registrant by the exchange ratio so that the per share amounts are equated to the respective values for one share of the company being

acquired. Instruction to Items 3(e) and (f), Form S-4.

(n24)Footnote 24. Item 4(a)(1), Form S-4.

(n25)Footnote 25. Item 4(a)(2), Form S-4.

(n26)Footnote 26. Item 4(a)(3), Form S-4. Item 202 of Regulation S-K is discussed in § 7.03[2][i] *supra*.

The information required by Item 202 of Regulation S-K need not be provided by Form S-3 registrants registering capital stock, if the registrant would meet the requirements for use of Form S-3 and elects to furnish information pursuant to Item 10, discussed in § 7.06[1][b][ii][A] *infra*, capital stock is to be registered, securities of the registrant of the same class are registered under Section 12 of the Exchange Act and are either traded on a national securities exchange, or are securities for which bid and offer quotations are reported in an automated quotations system operated by a national securities association, i.e., the NASD.

Notwithstanding the foregoing, in October 2009, the SEC proposed rules that would require the registrant to furnish the information required by proposed Item 202(g) of Regulation S-K. Credit Ratings Disclosure, Securities Act Release No. 9070, Securities Exchange Act Release No. 60797 (Oct. 7, 2009).

(n27)Footnote 27. Item 4(a)(4), Form S-4.

(n28)Footnote 28. Item 4(a)(5), Form S-4. This item requires disclosure as to whether the acquisition will be accounted for as a purchase transaction or a pooling of interests transaction. Sec. Act Rel. No. 33-6578, C.C.H. Fed. Sec. L. Rep. (CCH) P 72,418 (1985).

(n29)Footnote 29. Item 4(a)(6), Form S-4.

(n30)Footnote 30. Item 4(b), Form S-4. Item 1015(b) of Regulation M-A governs disclosure with respect to reports, opinions and appraisals, and requires, generally, a summary of any such report, and disclosure of the persons responsible for the report, the procedures followed in preparing it, and any findings or recommendations contained in the report. See Item 1015(b), Regulation M-A.

Item 4(b) of Form S-4 does not require that such report be obtained or that there must be an affirmative statement as to whether one was obtained. The item applies only where a report has been obtained and references to it is made in the prospectus.

(n31)Footnote 31. Item 4(c), Form S-4.

(n32)Footnote 32. Any Article 11 of Regulation S-X information relating to other business combinations besides the transaction presented (rather than incorporated by reference) pursuant to other items of Form S-4, must be presented together with the information provided pursuant to Item 5, but a clear distinction must be made between the transaction that is the subject of Form S-4 and any other. Instruction 1, Item 5, Form S-4. If pro forma financial information with respect to all other transactions is incorporated by reference pursuant to Item 11 of Form S-4, discussed in § 7.06[1][b][ii][B] *infra* or Item 15 of Form S-4, discussed in § 7.06[1][b][iii][A] *infra*, only the pro forma results need be presented as part of the pro forma financial information required by Item 5. Instruction 2, Item 5, Form S-4.

(n33)Footnote 33. The contracts include those concerning a merger, consolidation or acquisition; tender offer or other acquisition of securities; election of directors; or sale or other transfer of a material amount of assets.

(n34)Footnote 34. Item 507 of Regulation S-K is discussed in § 7.03[2][g] *supra*.

(n35)Footnote 35. Item 7(a) and (b), Form S-4.

(n36)Footnote 36. Item 509 of Regulation S-K is discussed in § 7.03[2][j] *supra*.

(n37)Footnote 37. Item 510 of Regulation S-K is discussed in § 7.03[2][1] *supra*.

(n38)Footnote 38. Registrant-related information required by Form S-3 is discussed in § 7.04[1][a][i] *supra*.

(n39)Footnote 39. Registrant-related information required by Form S-1 is discussed in § 7.03[2][k] *supra*.

(n40)Footnote 40. The registrant may elect to provide information under Items 10 and 11 of Form S-4 if the registrant meets the requirements of General Instruction I.A of Form S-3, discussed in § 7.04[1][a][i][A] *supra*, and if one of the following tests is met:

(1) the registrant meets the aggregate market value requirement of General Instruction I.B.1 of Form S-3, discussed in § 7.04[2][a][ii][A] *supra*; or

(2) non-convertible debt or preferred securities are to be offered pursuant to Form S-4 and are "investment grade securities" as defined in General Instruction I.B.2 of Form S-3, discussed in § 7.04[1][a][ii][B] *supra*; or

(3) the registrant is a majority-owned subsidiary and one of the conditions of General Instruction I.C. of Form S-3, discussed in § 7.04[1][a][ii][C] *supra* is met.

General Instruction B.1(a), Form S-4.

(n41)Footnote 41. General Instruction B.1(b), Form S-4.

Eligibility standards for the use of Form S-3 are discussed in § 7.04[1][a] *supra*.

(n42)Footnote 42. General Instruction B.1(c), Form S-4.

Form S-3 registrants eligible to use the first and second alternatives are not required to furnish information at the most streamlined level available but may elect instead to furnish company information in accordance with Item 14 of Form S-4. *Id.*

(n43)Footnote 43. General Instruction A of Form S-11 provides that the form may be used to register securities issued by:

(1) a real estate investment trust, as defined by *Section 856 of the Internal Revenue Code*; or

(2) other issuers whose businesses are primarily that of acquiring and holding for investment real estate, interests in real estate or interests in other issuers whose businesses are primarily that of acquiring and holding real estate or interests in real estate for investment.

An issuer that is an investment company under the Investment Company Act of 1940, however, may under no circumstances use Form S-11.

(n44)Footnote 44. General Instruction B.2, Form S-4. The information prescribed by these Items of Form S-11 may be incorporated by reference into the prospectus if the documents incorporated by reference contain such information and the registrant qualifies for and elects to provide information pursuant to General Instructions B.1(a) or B.1(b) of Form S-4.

(n45)Footnote 45. Item 10(a), Form S-4.

(n46)Footnote 46. Item 10(b), Form S-4. Financial information specified by Item 10(b) may be eliminated from the prospectus if incorporated by reference from Exchange Act filings specified in Item 11 of Form S-4, discussed in § 7.06[1][b][ii][B] *infra*, from Form 8-K under the Exchange Act, discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02[3] (Matthew Bender), from a proxy or information statement filed pursuant to Section 14 of the Exchange Act, discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, §§ 7.03 and 7.06 (Matthew Bender), or from a prospectus pursuant to Rule 424 of the Securities Act, or, where no prospectus was required to be filed pursuant to Rule 424(b), the prospectus included in the registration statement at effectiveness.

(n47)Footnote 47. If the registrant is incorporating by reference information about the registrant or the company being acquired, the prospectus must be sent to the security holders no later than 20 business days prior to either (i) the date on which the meeting of security holders is held, or if no meeting is held, either 20 business days prior to the date of the vote, consent or authorization of security holders, or (ii) the date the transaction is consummated if votes, consents or authorizations are not used to effect the transaction. General Instruction A.2, Form S-4. The 20-day limitation does not replace other time requirements under Sections 13(e), 14(d) and 14(e) of the Exchange Act applicable to tender offers and "going private" transactions.

(n48)Footnote 48. Item 11(a)(3), Form S-4.

The registrant must state in the prospectus that all documents subsequently filed by the registrant under Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act prior to one of the following dates, will be incorporated by reference:

- (1) the date on which a security holders meeting is held;
- (2) if there is no meeting, the date the transaction is consummated;
- (3) in an exchange offer, the date that the offer is terminated; or
- (4) if securities are being reoffered or resold, the date the reoffering is terminated. Item 11(b)(1)-(4), Form S-4.

Rule 439 describes the consents necessary for the use of material incorporated by reference. Instruction, Item 11, Form S-4.

(n49)Footnote 49. Item 11(c)(1)-(2), Form S-4. The registrant's attention is directed to Rule 439 of the Securities Act regarding consent to the use of material incorporated by reference.

(n50)Footnote 50. Item 12(a) cannot be used by a registrant if the financial statements in its latest annual report to shareholders does not reflect:

- (1) financial statements prepared in accordance with Regulation S-X that have been materially restated as a result of a change in accounting principles or correction of an error;
- (2) one or more business combinations accounted for as a pooling of interests which have been consummated since the end of the registrant's most recent fiscal year, and which are considered "significant" under Rule 11-01(b) of Regulation S-X; or
- (3) the material disposition of assets outside the normal course of business.

Item 12(c), Form S-4.

(n51)Footnote 51. For a discussion of Form 10-Q, see Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02[2] (Matthew Bender).

(n52)Footnote 52. Item 12(a)(1) and (2)(i)-(iii), Form S-4.

(n53)Footnote 53. Item 12(a)(3) and (4), Form S-4.

(n54)Footnote 54. Instruction, Item 12(a), Form S-4.

(n55)Footnote 55. Registrants using Item 12(b) must furnish the following financial information:

(1) interim financial information required by Rule 10-01 of Regulation S-X for filings on Exchange Act Form 10-Q;

(2) financial information required by Rule 3-05 and Article 11 of Regulation S-X, with respect to transactions other than that pursuant to which the securities being registered are to be issued; and

(3) restated financial statements described in n.52 *supra*.

(n56)Footnote 56. Item 101 of Regulation S-K is discussed in § 7.03[2][k][i] *supra*.

(n57)Footnote 57. Item 201 of Regulation S-K is discussed in § 7.03[2][k][iv] *supra*.

(n58)Footnote 58. Item 301 of Regulation S-K is discussed in § 7.03[2][k][vi] *supra*.

(N59)Footnote 59. Item 302 of Regulation S-K is discussed in § 7.03[2][k][vii] *supra*.

(n60)Footnote 60. Item 303 of Regulation S-K is discussed in § 7.03[2][k][viii] *supra*.

(n61)Footnote 61. Item 304 of Regulation S-K is discussed in § 7.03[2][k][ix] *supra*.

(n62)Footnote 62. Item 305 of Regulation S-K is discussed in § 7.03[2][k][x] *supra*.

(n63)Footnote 63. Item 13(a)(1), (2), (3)(i)-(vii), and (4), Form S-4. The registrant's attention is directed to Rule 439, discussed with Form S-3 in § 7.04[1] *supra*, regarding consent to use of material incorporated by reference. Instruction, Item 13(a), Form S-4.

(n64)Footnote 64. Item 13(b), Form S-4.

(n65)Footnote 65. Item 13(c), Form S-4.

(n66)Footnote 66. Item 13(d)(1)-(2), Form S-4.

(n67)Footnote 67. Item 101 of Regulation S-K is discussed in § 7.03[2][k][i] *supra*.

(n68)Footnote 68. Item 102 of Regulation S-K is discussed in § 7.03[2][k][ii] *supra*.

(n69)Footnote 69. Item 103 of Regulation S-K is discussed in § 7.03[2][k][iii] *supra*.

(n70)Footnote 70. Item 14(d),(f)-(j); Form S-4.

(n71)Footnote 71. Item 21 of Form S-4 is discussed in § 7.06[1][c][ii] *infra*.

(n72)Footnote 72. Item 14(e), Form S-4.

(n73)Footnote 73. If the registration statement on Form S-4 relates to offerings of securities upon the exercise of outstanding options, warrants or rights under Rule 415(a)(1)(viii) ("shelf registration"), the required information about the company to be acquired only need be furnished as of the initial effectiveness of the registration statement to the extent practicable. The required information about the specific company to be acquired must be included in the prospectus by means of a post-effective amendment. When the transaction would qualify for an exemption from Section 5 of the Securities Act, absent the existence of other similar (prior or subsequent) transactions, a prospectus supplement may be used to furnish the information necessary in connection with the transaction. General Instruction H, Form S-4.

If a United States registrant is acquiring a foreign private issuer (eligible to use Form 20-F under the Exchange Act *i.e.*, a reporting company)), the registrant may use Form S-4 and may present information about the foreign private issuer on Form S-4. General Instruction, F, Form S-4.

(n74)Footnote 74. Exchange Act Section 12(i) deals with the enforcement of certain Exchange Act sections with respect to bank securities by the various regulatory agencies authorized to enforce banking regulations rather than by the Commission.

(n75)Footnote 75. General Instruction C.1(a), Form S-4.

(n76)Footnote 76. General Instruction C.1(b), Form S-4.

(n77)Footnote 77. General Instruction C.1(c), Form S-4.

The same Form S-11 information about real estate entities furnished with respect to the registrant must be furnished in connection with the company being acquired. General Instruction C.2, Form S-4.

(n78)Footnote 78. Item 10 of Form S-4 is discussed in § 7.06[1][b][ii][A] *supra*.

(n79)Footnote 79. Item 11 of Form S-4 is discussed in § 7.06[1][b][ii][B] *supra*.

(n80)Footnote 80. Item 12 of Form S-4 is discussed in § 7.06[1][b][ii][C] *supra*.

(n81)Footnote 81. Item 13 of Form S-4 is discussed in § 7.06[1][b][ii][D] *supra*.

(n82)Footnote 82. Item 914(c), Regulation S-K.

(n83)Footnote 83. For discussion of Item 14 of Form S-4, *see* § 7.05[1][b][ii][E] *supra*.

(n84)Footnote 84. Exchange Act Rule 14a-3(b) concerns the effect of proxy rules on reports to stockholders.

(n85)Footnote 85. Exchange Act Rule 14c-3, concerning annual report to shareholders, is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06 (Matthew Bender).

(n86)Footnote 86. Form 10-Q is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 4.02[2] (Matthew Bender).

(n87)Footnote 87. Item 17(b)(1)-(10), Form S-4.

Financial statements submitted under Item 17(b)(7) need only be audited to the extent practicable. The balance sheets for the fiscal year before the company's most recent full fiscal year and income statements for the two years preceding

the company's last full fiscal year need not be audited if they have not been previously audited. If Form S-4 is used for resales to the public by any person who is deemed to be an underwriter under Rule 145(c) regarding the securities being re-offered, the financial statements of such companies must be audited for the periods required to be presented pursuant to Rule 3-05.

If the financial statements are prepared on the basis of a comprehensive body of accounting principles other than U.S. GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board, a reconciliation to U.S. GAAP must be provided in accordance with Item 17 of Form 20-F unless a reconciliation is unavailable or not obtainable without unreasonable cost or expense. At a minimum, registrant must provide a narrative description of all material variations in accounting principles, practices and methods used in preparing the non-U.S. GAAP financial statements from those accepted in the U.S. when the financial statements are prepared on a basis other than U.S. GAAP. Instruction 2, Item 17, Form S-4.

(n88)Footnote 88. In a consent solicitation, the registrant is required to send the prospectus to security holders 20 business days in advance of the date on which the consents may be used to effect the transaction, rather than 20 days in advance of the date on which the requisite consents may be received by the soliciting party. This procedure considers the possibility of revocation of consents and establishes a fixed date for calculation of the 20 business day period in this context. Sec. Act Rel. No. 33-6578 n.61, Fed. Sec. L. Rep. (CCH) P 72,418 (1985).

(n89)Footnote 89. Schedule 14A governs the information required in a proxy statement. Item 1, revocability of proxies, Item 2, dissenters' rights of appraisal and Item 3, persons making the solicitation of Schedule 14A are discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06.

(n90)Footnote 90. Item 4 of Schedule 14A, interest of certain persons in matters to be acted upon, is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06 (Matthew Bender).

(n91)Footnote 91. Item 5 of Schedule 14A, voting securities and the principal holders thereof, is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06 (Matthew Bender).

(n92)Footnote 92. Item 401 of Regulation S-K is discussed in § 7.03[2][k][xi] *supra*.

(n93)Footnote 93. Item 402 of Regulation S-K is discussed in § 7.03[2][k][xii] *supra*.

(n94)Footnote 94. Item 404 of Regulation S-K is discussed in § 7.03[2][k][xiv] *supra*.

(n95)Footnote 95. Item 18(a)(1)-(4) and (7), Form S-4.

(n96)Footnote 96. Item 21 of Schedule 14A, vote required for approval, is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06 (Matthew Bender).

(n97)Footnote 97. Item 2 of Exchange Act Schedule 14C is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06[2](Matthew Bender). Item 3 of Exchange Act Schedule 14C, date, time and place of the meeting, is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06 (Matthew Bender).

(n98)Footnote 98. Item 2 of Exchange Act Schedule 14A, dissenters' rights of appraisal, is discussed in Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, § 7.06[1][a] (Matthew Bender).

(n99)Footnote 99. This description need not be furnished regarding any interest arising from the ownership of securities of the registrant where the security holder receives no extra or special benefit not shared on a pro rata basis by all other holders of the same class. Instruction, Item 19(a)(4), Form S-4.

- (n100)Footnote 100. Item 702 of Regulation S-K is discussed in § 7.03[3][b] *supra*.
- (n101)Footnote 101. Item 601 of Regulation S-K is discussed in § 7.03[3][d][i] *supra*.
- (n102)Footnote 102. Item 14(e) of Form S-4 is discussed in § 7.06[1][b][ii][E] *supra*.
- (n103)Footnote 103. Item 17(a) of Form S-4 is discussed in § 7.06[1][b][iii][C] *supra*.
- (n104)Footnote 104. Item 17(b) of Form S-4 is discussed in § 7.06[1][b][iii][C] *supra*.
- (n105)Footnote 105. Item 512 of Regulation S-K is discussed in § 7.03[3][e] *supra*.
- (n106)Footnote 106. Item 22(b), Form S-4.
- (n107)Footnote 107. Item 22(c), Form S-4.
- (n108)Footnote 108. General Instruction I, Form S-4.
- (n109)Footnote 109. General Instruction I(2), Form S-4.
- (n110)Footnote 110. Item 902(a), Regulation S-K.
- (n111)Footnote 111. Item 902(b), Regulation S-K.
- (n112)Footnote 112. This statement must include the name and address to whom investors should make their request. Item 902(b)(1), Regulation S-K.
- (n113)Footnote 113. Item 902(b)(2), Regulation S-K.
- (n114)Footnote 114. Item 902(b)(3), Regulation S-K.
- (n115)Footnote 115. Item 902(b)(4), Regulation S-K.
- (n116)Footnote 116. Item 902(b)(4)(i), Regulation S-K.
- (n117)Footnote 117. Item 902(b)(4)(ii), Regulation S-K.
- (n118)Footnote 118. Item 902(b)(4)(iii), Regulation S-K.
- (n119)Footnote 119. Item 902(b)(4)(iv), Regulation S-K.
- (n120)Footnote 120. Item 902(b)(4)(v), Regulation S-K.
- (n121)Footnote 121. Item 902(b)(4)(vi), Regulation S-K.
- (n122)Footnote 122. Item 902(b)(4)(vii), Regulation S-K.
- (n123)Footnote 123. Item 902(b)(4)(viii), Regulation S-K.
- (n124)Footnote 124. Item 902(b)(4)(ix), Regulation S-K.
- (n125)Footnote 125. Item 902(b)(4)(x), Regulation S-K.
- (n126)Footnote 126. Item 902(b)(5), Regulation S-K.

(n127)Footnote 127. Item 902(b)(6), Regulation S-K.

(n128)Footnote 128. Item 902(b)(7), Regulation S-K.

(n129)Footnote 129. Item 903(a), Regulation S-K.

(n130)Footnote 130. Item 903(b)(1), Regulation S-K. This information must be presented prominently in the forepart of the summary. Instruction to Item 903, Regulation S-K.

(n131)Footnote 131. Item 903(b)(2), Regulation S-K.

(n132)Footnote 132. Item 903(b)(3), Regulation S-K.

(n133)Footnote 133. Item 903(b)(4), Regulation S-K.

(n134)Footnote 134. Item 903(b)(5), Regulation S-K.

(n135)Footnote 135. Item 903(b)(6), Regulation S-K.

(n136)Footnote 136. Item 903(b)(6), Regulation S-K.

(n137)Footnote 137. Instruction to Item 904, Regulation S-K.

(n138)Footnote 138. Instruction 1 and 2 to Item 905, Regulation S-K.

(n139)Footnote 139. Item 905(a)(1), Regulation S-K.

(n140)Footnote 140. Item 905(a)(2), Regulation S-K.

(n141)Footnote 141. Item 905(b)(1), Regulation S-K.

(n142)Footnote 142. The changes in compensation and distribution required by this paragraph and paragraph C must be set forth in a table demonstrating such changes and setting forth, among other things: the actual amounts of compensation and distributions, separately identified, paid by the partnerships on a combined basis to the general partner and its affiliates for the partnerships' last three fiscal years and most recently ended interim periods, and the amounts of compensation and distributions that would have been paid if the compensation and distributions structure to be in effect after the roll-up transaction had been in effect during such period. Item 905(b)(3), Regulation S-K.

(n143)Footnote 143. Item 905(b)(4), Regulation S-K.

(n144)Footnote 144. Item 905(b)(5), Regulation S-K.

(n145)Footnote 145. Item 905(d)(3), Regulation S-K.

(n146)Footnote 146. If necessary, the registrant can substitute other information of a comparable character necessary to an understanding of the calculation and allocation. Item 906(b), Regulation S-K.

(n147)Footnote 147. Item 907(a)(2), Regulation S-K.

(n148)Footnote 148. Item 907(b), Regulation S-K.

(n149)Footnote 149. Item 907(c), Regulation S-K.

(n150)Footnote 150. Item 908(a), Regulation S-K.

(n151)Footnote 151. Item 908(e), Regulation S-K.

(n152)Footnote 152. Item 908(b), Regulation S-K.

(n153)Footnote 153. Item 908(b)(2), Regulation S-K.

(n154)Footnote 154. Item 908(b)(3), Regulation S-K.

(n155)Footnote 155. Item 909(b)(1), Regulation S-K.

(n156)Footnote 156. Item 909(b)(2)(i), Regulation S-K.

(n157)Footnote 157. Item 909(b)(2)(ii), Regulation S-K.

(n158)Footnote 158. Item 909(b)(2)(iii), Regulation S-K.

(n159)Footnote 159. Item 909(b)(2)(iv), Regulation S-K.

(n160)Footnote 160. Item 909(b)(2)(v), Regulation S-K.

(n161)Footnote 161. Item 909(b)(2)(vi), Regulation S-K.

(n162)Footnote 162. Item 909(b)(2)(vii), Regulation S-K.

(n163)Footnote 163. The registrant should consider presenting the comparative numerical data as to the value of the consideration being received by investors, liquidation value and other values in a tabular format. Financial and other information concerning the partnerships should be prepared based upon the most recent available information, such as, in the case of financial information, the periods covered by interim selected financial information included in the prospectus in accordance with Item 914. Instruction 5, Item 910, Regulation S-K.

(n164)Footnote 164. Instruction 3, Item 910, Regulation S-K.

(n165)Footnote 165. Item 910(c), Regulation S-K.

(n166)Footnote 166. Instruction 2, Item 910, Regulation S-K.

(n167)Footnote 167. Instructions 1 and 4, Item 910, Regulation S-K.

(n168)Footnote 168. Any such report, opinion or appraisal must be identified even if it was not relied upon, such as reports or opinions regarding alternatives to the roll-up transaction, whether or not such alternatives were rejected. Instruction 1, Item 911, Regulation S-K.

(n169)Footnote 169. Item 911(a)(1), Regulation S-K.

(n170)Footnote 170. Item 911(a)(4), Regulation S-K.

(n171)Footnote 171. This information should be given with respect to the firm which provides the report, opinion or appraisal rather than the employees of such firm who prepared it. Instruction 2, Item 911, Regulation S-K.

(n172)Footnote 172. Item 911(a)(5).

(n173)Footnote 173. Item 911(a)(3).

(n174)Footnote 174. Item 911(b), Regulation S-K.

(n175)Footnote 175. A summary prepared by the appraisers may not be included in lieu of a description of the appraisal. Instruction 3, Item 911, Regulation S-K.

(n176)Footnote 176. An asset is significant to a partnership if it represents more than 10% of the value of the partnership's assets as of the end of the most recently-completed fiscal year or recently completed interim period or if 10% or more of the partnership's cash flow or net income for the most recently-completed fiscal year or most recently-completed subsequent interim period was derived from such asset. Item 911(c)(5), Regulation S-K.

(n177)Footnote 177. Item 911(c)(4), Regulation S-K.

(n178)Footnote 178. If the source of all or any part of the funds to be used in the roll-up transaction is a loan made in the ordinary course of business by a bank as defined by Section 3(a)(6) of the Exchange Act and Section 13(d) or 14(d) is applicable to such transaction, the name of such bank will not be made available to the public if the person filing the statement so requests in writing and files such request, naming such bank with the Secretary of the Commission. Item 912(e), Regulation S-K.

(n179)Footnote 179. Item 913(a), Regulation S-K.

(n180)Footnote 180. Item 913(b), Regulation S-K.

(n181)Footnote 181. Item 913(c), Regulation S-K.

(n182)Footnote 182. Instruction 2, Item 914, Regulation S-K.

(n183)Footnote 183. Instruction 1, Item 914, Regulation S-K.



88 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7 Registration Forms

1-7 Federal Securities Act of 1933 § 7.07

AUTHOR: Cristopher Greer Melinda I. Wang Jeffery C. Fang Amanda M. Burke Andrew R. Meyerson

§ 7.07 Foreign Registration Forms

[1] Form F-1--Registration of Securities of Foreign Private Issuers For Whom No Other Form is Authorized

Form F-1 contains two parts: Part I (Items 1-5), concerning information required in the prospectus, and Part II (Items 6-9), concerning information not required to be presented in the prospectus.

[a] Eligibility Standards. Form F-1 must be used for registration of securities of all foreign issuers. n1 If the registrant is a majority-owned subsidiary which does not itself meet the conditions of these eligibility requirements, it will still be deemed to have met these conditions if its parent meets the conditions and if the parent fully guarantees the securities being registered as to principal and interest. n2 Form F-1 is not to be used for an offering of asset-backed securities. General Instruction I(A), Form F-1.

A reporting issuer that has filed at least one annual report and that is current in its reporting obligation under the Exchange Act may now incorporate such information by reference to previous reports filed under the Exchange Act, pursuant to amendments to Form F-1 adopted as part of the 2005 Rules. Successor registrants can incorporate by reference if their predecessors were eligible. The following issuers will not be able to incorporate by reference into a Form F-1: and

- 1) reporting issuers who are not current in their Exchange Act reports;
- 2) issuers who are, or were or any of whose predecessors were during the past three years:
 - blank check issuers;
 - shell companies (other than business combination related shell companies); or
 - issuers for offerings of penny stock.

In addition, to enhance the availability to investors of incorporated information, the ability to incorporate by reference is conditioned on the issuer making its incorporated Exchange Act reports and other materials readily accessible on a

website maintained by or for the issuer. n3

[b] Application of General Rules and Regulations. Effective as of November 4, 2002, all foreign private issuers and foreign governments are required to file registration statements electronically through EDGAR. By mandating the electronic filing of foreign issuers' securities, the Commission wants to realize the same investor benefits and efficiencies in information transmission, documentation, retrieval and analysis achieved by domestic issuers since the Commission mandated electronic filings for domestic issuers in 1993. n4 Accordingly, a foreign registrant must file the Form F-1 registration statement in electronic format via EDGAR in accordance with the rules set forth in Regulation S-T. However, those registrants that have obtained a hardship exception under Rule 201 or 202 of Regulation S-T may file the registration statement in paper. n5

The Form F-1 registration statement generally must be in the English language, as required by Rule 306 of Regulation S-T for electronic filings and Rule 403(c) of the Securities Act, generally. If the registration statement requires the inclusion of a document (as an exhibit or attachment) and that document is in a foreign language, then the registrant must provide instead either an English translation or an English summary in accordance with Rule 403(c) of the Securities Act for electronic and paper filings. The registrant may also submit a copy of the unabridged foreign language document in accordance with Rule 306(b) of Regulation S-T for electronic filings or Rule 403(c)(4) of the Securities Act for paper filings. n6

[c] Exchange Offers. If any of the securities being registered are to be offered in exchange for securities of any other issuer, the prospectus must also include the information which would be required by Item 4 of Form F-1 (Information with Respect to the Registrant and the Offering) if the securities of such other issuer were registered on Form F-1. If the other issuer is not eligible to use Form F-1, then the prospectus must include the information which would be required by Item 11 of Form S-1 (Information with Respect to the Registrant) if the securities of such other issuer were being registered on Form S-1. It must also include the information concerning the securities of the other issuer which would be called for by Item 10(A) of Form 20-F (Share Capital) and Item 10(B) of Form 20-F (Memorandum and Articles of Association) n7 or Item 12 of Form 20-F (Description of Securities Other Than Equity Securities), if such securities were being registered. n8

[d] Roll-up Transactions. If the securities being registered on Form F-1 will be issued in a roll-up transaction, the registrant should follow those requirements of S-4 that are applicable to roll-up transactions. n9

[e] Registration of Additional Securities. With respect to the registration of additional securities for an offering pursuant to Rule 462(b) under the Securities Act, the registrant may file a registration statement consisting only of the following: the facing page; a statement that the contents of the earlier registration statement, identified by file number, are incorporated by reference; required opinions and consents; the signature page; and any price-related information omitted from the earlier registration statement in reliance on Rule 430A under the Securities Act that the registrant chooses to include in the new registration statement. The information contained in a Rule 462(b) registration statement shall be deemed to be a part of the earlier registration statement as of the date of effectiveness of the Rule 462(b) registration statement. Any opinion or consent required in the Rule 462(b) registration statement may be incorporated by reference from the earlier registration statement with respect to the offering if: (i) such opinion or consent expressly provides for such incorporation; and (ii) such opinion relates to the securities registered pursuant to Rule 462(b). n10

[f] Facing Page. The facing page of Form F-1 calls for the same information as the facing page of Form S-1.

[g] The Prospectus.

Part I of Form F-1, concerning information required to be presented in the prospectus, contains Items 1-4.

[i] Items 1-3. Items 1-3 of Part I of Form F-1 require identical disclosure as Items 1-3 of Form S-1 except that as part of Item 1, the foreign private issuer must provide an English translation of its name on the outside front cover page

of the prospectus. n11

[ii] Item 4. Information with Respect to the Registrant and the Offering.

The registrant must furnish the following information:

- (1) information required by Part I of Form 20-F;
- (2) information required by Item 18 of Form 20-F, n12 as well as any information required by Rule 3-05 and Article 11 of Regulation S-X; and
- (3) information required by Item 16F of Form 20-F for the registrant's fiscal years ending on or after December 15, 2009.

Part I of Form 20-F requires a discussion of the following subject areas:

[A] Identity of Directors, Senior Management and Advisors. This item requires the registrant to identify, to the extent applicable, the representatives and other individuals involved in the registrant's listing or registration. The registrant must provide the: (a) names, business addresses and functions of its directors and senior management; (b) names and addresses of its principal bankers and legal advisers (to the extent that the registrant has a continuing relationship with such persons), the sponsor for listing (where required by the host country regulations) and the legal advisers to the issue; and (c) names and addresses of the registrant's auditors for the preceding three years (together with their membership in a professional body). n13

[B] Offer Statistics and Expected Timetable. This item requires the registrant to provide key information regarding the conduct of any offering and the identification of important dates relating to the offering. The registrant must provide the total expected amount of the issue, including the expected issue price or the method of determining the price, and the number of securities expected to be issued. The registrant must also state, for all offerings, and separately for each group of targeted potential investors, the following information, to the extent applicable to each offering procedure:

- (1) The time period during which the offer will be open and where and to whom the purchase or subscription applications must be addressed. The registrant must describe whether the purchase period may be extended or shortened and the duration of any possible extension or early closure or shortening of such purchase period. The registrant must describe the manner in which the extension or shortening of the period would be made public. If the exact dates are unknown when the document is first filed or distributed to the public, the registrant must describe the arrangements for announcing the final or definitive date or period.
- (2) The method and time limits for paying securities and, where the payment is partial, the manner and dates on which amounts are to be paid.
- (3) The method and time limits for the delivery of equity securities (including provisional certificates, if applicable) to subscribers or purchasers.
- (4) In the case of pre-emptive purchase rights, the procedure for the exercise of any right of pre-emption, the negotiability of subscription rights and the treatment of subscription rights not exercised. n14
- (5) A full description of the manner in which results of the distribution of securities are to be made public, and when appropriate, the manner for refunding excess amounts paid by applicants (including

whether interest will be paid). n15

[C] Key Information. This item requires the registrant to summarize key information about the registrant's financial condition, capitalization and risk factors. If the financial statements included in the document are restated to reflect material changes in the registrant's group structure or accounting policies, the selected financial data also must be restated.

(1) *Selected financial data.* The registrant must provide selected financial data for the five most recent financial years (or such shorter period that the registrant has been in operation), in the same currency as the financial statements. Selected financial data for either or both of the earliest two years of the five-year period may be omitted, however, if the registrant represents that such information cannot be provided, or cannot be provided on a restated basis, without unreasonable effort or expense. If interim period financial statements are included, the selected financial data should be updated for that interim period, which may be unaudited, provided that fact is stated. If selected financial data for interim periods is provided, comparative data from the same period in the prior financial year must also be provided, except if the registrant presents the year end balance sheet information.

The selected financial data must include items generally corresponding to the following, except that the specific line items presented should be expressed in the same manner as the corresponding line items in the registrant's financial statements. Such data must include, at a minimum: net sales or operating revenues; income (loss) from operations; income (loss) from continuing operations; net income (loss); net income (loss) from operations per share; income (loss) from continuing operations per share; total assets; net assets; capital stock (excluding long term debt and redeemable preferred stock); number of shares as adjusted to reflect changes in capital; dividends declared per share in both the currency of the financial statements and the host country currency, including the formula used for any adjustments to dividends declared; and diluted net income per share. Per share amounts must be determined in accordance with the body of accounting principles used in preparing the financial statements.

Where the financial statements provided in response to Item 8 (Financial Information) are prepared in a currency other than the currency of the host country, disclosure of the exchange rate between the financial reporting currency and the currency of the host country should be provided, using the exchange rate designated by the host country for this purpose, if any: (a) at the latest practicable date; (b) the high and low exchange rates for each month during the previous six months; and (c) for the five most recent financial years and any subsequent interim period for which financial statements are presented, the average rates for each period, calculated by using the average of the exchange rates on the last day of each month during the period. n16

(2) *Capitalization and indebtedness.* The registrant must provide a statement of capitalization and indebtedness, as of a date no earlier than 60 days prior to the date of the document. The statement must illustrate the registrant's capitalization on an actual basis and, if applicable, should be adjusted to reflect the sale of newly issued securities and the intended application of the net proceeds therefrom. The statement must distinguish between guaranteed and unguaranteed indebtedness as well as secured and unsecured indebtedness and must include indirect and contingent indebtedness. n17

(3) *Reasons for the offer and use of proceeds.* The registrant must disclose the estimated net amount of the proceeds broken down into each principal intended use thereof. If the anticipated proceeds will not be sufficient to fund all of the proposed purposes, the order of priority of such purposes should be given, as well as the amount and sources of other funds needed. If the registrant has no specific plans for the proceeds, it should discuss the principal reasons for the offering.

If the proceeds are being used directly or indirectly to acquire assets, other than in the ordinary course of business, the registrant must briefly describe the assets and their cost. If the assets will be acquired from affiliates of the registrant or their associates, the registrant must disclose the persons from whom they will be acquired and how the cost to the registrant will be determined. If the proceeds may or will be used to finance acquisitions of other businesses, the

registrant must give a brief description of such businesses and information on the status of the acquisitions. If any material part of the proceeds is to be used to discharge, reduce or retire indebtedness, the registrant must describe the interest rate and maturity of such indebtedness and, for indebtedness incurred within the past year, the uses to which the proceeds of such indebtedness were put. n18

(4) *Risk factors.* Under a section entitled "Risk Factors," the registrant must prominently disclose risk factors that are specific to it or its industry and which make an offering speculative or one of high risk. The risk factors should be concise and clearly explain how each risk affects the issuer or the securities. n19

Registrants are encouraged, but not required, to list the risk factors in the order of their priority to the registrant. Among other things, such factors may include: the nature of the business in which it is engaged or proposes to engage; factors relating to the countries in which it operates; the absence of profitable operations in recent periods; the financial position of the registrant; the possible absence of a liquid trading market for the registrant's securities; reliance on the expertise of management; potential dilution; unusual competitive conditions; pending expiration of material patents, trademarks or contracts; or dependence on a limited number of customers or suppliers. The Risk Factors section is intended to be a summary of more detailed discussions contained elsewhere in the document. n20

[D] Information on the Company. This item requires the registrant to provide information about its business operations, the products it makes or the services it provides and the factors that affect the business. It is also intended to provide information regarding the adequacy and suitability of the registrant's properties, plants and equipment, as well as its plans for future increases or decreases in such capacity.

(1) *History and development of the company.* The following information must be provided:

(a) The legal and commercial name of the registrant.

(b) The date of incorporation and the length of life of the registrant, except where indefinite.

(c) The domicile and legal form of the registrant, the legislation under which it operates, its country of incorporation and the address and telephone number of its registered office (or principal place of business if different from its registered office). The registrant must also provide the name and address of its agent, if any, in the host country.

(d) The important events in the development of the registrant's business, *e.g.*, information concerning the nature and results of any material reclassification, merger or consolidation of the registrant or any of its significant subsidiaries; acquisitions or dispositions of material assets other than in the ordinary course of business; any material changes in the mode of conducting the business; material changes in the types of products produced or services rendered; name changes; or the nature and results of any bankruptcy, receivership or similar proceedings with respect to the company or significant subsidiaries.

(e) A description, including the amount invested, of the registrant's principal capital expenditures and divestitures (including interests in other companies), since the beginning of the registrant's last three financial years to the date of the offering or listing document.

(f) Information concerning the principal capital expenditures and divestitures currently in progress, including the distribution of these investments geographically (home and abroad) and the method of financing (internal or external).

(g) An indication of any public takeover offers by third parties in respect of the registrant's shares or by the registrant in respect of other companies' shares which have occurred during the last and current

financial year. The price or exchange terms attaching to such offers and the outcome thereof are also to be stated. n21

(2) *Business overview.* The information required by this item may be presented on the same basis as that used to determine the registrant's business segments under the body of accounting principles used in preparing the financial statements. The following information shall be provided:

(a) A description of the nature of the registrant's operations and its principal activities, stating the main categories of products sold and/or services performed for each of the last three financial years. Indicate any significant new products and/or services that have been introduced and, to the extent the development of new products or services has been publicly disclosed, give the status of development.

(b) A description of the principal markets in which the registrant competes, including a breakdown of total revenues by category of activity and geographic market for each of the last three financial years.

(c) A description of the seasonality of the registrant's main business.

(d) A description of the sources and availability of raw materials, including a description of whether prices of principal raw materials are volatile.

(e) A description of the marketing channels used by the registrant, including an explanation of any special sales methods, such as installment sales.

(f) Summary information regarding the extent to which the registrant is dependent, if at all, on patents or licenses, industrial, commercial or financial contracts (including contracts with customers or suppliers) or new manufacturing processes, where such factors are material to the registrant's business or profitability.

(g) The basis for any statements made by the registrant regarding its competitive position.

(h) A description of the material effects of government regulations on the registrant's business, identifying the regulatory body. n22

The registrant must also provide information, comparable to that required under Item 101(a)(2) of Regulation S-K, regarding its plan of operations. n23

(3) *Organizational structure.* If the registrant is part of a group, it must include a brief description of the group and its position within the group. The registrant must provide a listing of its significant subsidiaries, including name, country of incorporation or residence, proportion of its ownership interest and, if different, the proportion of voting power it holds. n24

(4) *Property, plants and equipment.* The registrant must provide information regarding any material tangible fixed assets, including leased properties, and any major encumbrances thereon, including a description of the size and uses of the property, productive capacity and extent of utilization of the registrant's facilities, how the assets are held, the products produced and the location. It must also describe any environmental issues that may affect its utilization of the assets. With regard to any material plans to construct, expand or improve facilities, the registrant must provide a description of the nature of and reason for the plan, an estimate of the amount of expenditures (including the amount of expenditures already paid), a description of the method of financing the activity, the estimated dates of start and completion of the activity and the increase of production capacity anticipated after completion. n25

[E] Operating and Financial Review and Prospects. This item requires the registrant to provide management's explanation of factors that have affected the registrant's financial condition and results of operations for the historical

periods covered by the financial statements, and management's assessment of factors and trends which are anticipated to have a material effect on the registrant's financial condition and results of operations in future periods. The registrant must discuss its financial condition, changes in financial condition and results of operations for each year and interim period for which financial statements are required, including the causes of material changes from year to year in financial statement line items, to the extent necessary for an understanding of the business as a whole. Information provided also shall relate to all separate segments of the registrant. The registrant must also provide the information specified below as well as such other information necessary for an investor's understanding of the registrant's financial condition, changes in financial condition and results of operations. n26

(1) *Operating results.* The registrant must provide information regarding significant factors, including unusual or infrequent events or new developments, materially affecting its income from operations and indicate the extent to which such income was affected. The registrant must describe any other significant component of revenue or expenses necessary to understand its results of operations.

To the extent that the financial statements disclose material changes in net sales or revenues, it must provide a narrative discussion of the extent to which such changes are attributable to changes in prices or to changes in the volume or amount of products or services being sold or to the introduction of new products or services. If material, it must describe the impact of inflation. If the currency in which financial statements are presented is of a country that has experienced hyperinflation, the existence of such inflation, a five year history of the annual rate of inflation and a discussion of the impact of hyperinflation on the registrant's business should also be disclosed. n27 The registrant must provide information regarding the impact of foreign currency fluctuations, if material, and the extent to which foreign currency net investments are hedged by currency borrowings and other hedging instruments. It must provide information regarding any governmental, economic, fiscal, monetary or political policies or factors that have materially affected, or could materially affect, directly or indirectly, the registrant's operations or investments in the registrant by host country shareholders. n28

(2) *Liquidity and capital resources.* The registrant must provide the following information regarding both its short term and long term liquidity:

(a) A description of the registrant's internal and external sources of liquidity; a brief discussion of any material unused sources of liquidity; and an opinion statement as to whether the working capital is sufficient for the registrant's present requirements, or, if not, how the registrant proposes to provide the additional working capital needed.

(b) An evaluation of the sources and amounts of the registrant's cash flows, including the nature and extent of any legal or economic restrictions on the ability of subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances and the impact such restrictions have had or are expected to have on the registrant's ability to meet its cash obligations.

(c) Information on the level of borrowings at the end of the period under review, the seasonality of borrowing requirements and the maturity profile of borrowings and committed borrowing facilities, with a description of any restrictions on their use.

(d) Information regarding the type of financial instruments used and the maturity profile of debt, currency and interest rate structure. This discussion also should include funding and treasury policies and objectives in terms of the manner in which treasury activities are controlled, the currencies in which cash and cash equivalents are held, the extent to which borrowings are at fixed rates and the use of financial instruments for hedging purposes.

(e) Information regarding the registrant's material commitments for capital expenditures as of the end of the latest financial year and any subsequent interim period and an indication of the general

purpose of such commitments and the anticipated sources of funds needed to fulfill such commitments.
n29

(3) *Research and development, patents and licenses, etc.* Where significant, the registrant must provide a description of its research and development policies for the last three years, including the amount spent during each of the last three financial years on company-sponsored research and development activities. n30

(4) *Trend information.* The registrant should identify the most significant recent trends in production, sales and inventory, the state of the order book and costs and selling prices since the latest financial year. It should discuss, for at least the current financial year, any known trends, uncertainties, demands, commitments or events that are reasonably likely to have a material effect on its net sales or revenues, income from continuing operations, profitability, liquidity or capital resources or which would cause reported financial information not necessarily to be indicative of future operating results or financial condition.

[F] Directors, Senior Management and Employees. This item requires the registrant to provide information concerning its directors and managers that will allow investors to assess such individuals' experience, qualifications and levels of compensation, as well as their relationship with the registrant. Information concerning the registrant's employees is also required.

(1) *Directors and senior management.* The following information must be disclosed with respect to the registrant's directors and senior management and any employees upon whose work the company is dependent, such as scientists or designers:

(a) Name, business experience, functions and areas of experience.

(b) Principal business activities performed outside the registrant (including, in the case of directors, other principal directorships).

(c) Date of birth or age (if required to be reported in the home country or otherwise publicly disclosed).

(d) The nature of any family relationship between any of the persons named above.

(e) Any arrangement or understanding with major shareholders, customers, suppliers or others pursuant to which any person referred to above was selected as a director or member of senior management. n31

(2) *Compensation.* The registrant must provide the following information for the last full financial year for the directors and members of its administrative, supervisory or management bodies:

(a) The amount of compensation paid, and benefits in kind granted, to such persons by the registrant and its subsidiaries for services in all capacities to the registrant and its subsidiaries by any person. Disclosure of compensation is required on an individual basis unless individual disclosure is not required in the registrant's home country and is not otherwise publicly disclosed. This standard also covers contingent or deferred compensation accrued for the year, even if the compensation is payable at a later date. If any portion of the compensation was paid (a) pursuant to a bonus or profit-sharing plan, n32 the registrant must provide a brief description of the plan and the basis upon which such persons participate in the plan; or (b) in the form of stock options, the registrant must provide the title and amount of securities covered by the options, the exercise price, the purchase price (if any) and the expiration date of the options.

(b) The total amounts set aside or accrued by the registrant or its subsidiaries to provide pension, retirement or similar benefits. n33

(3) *Board practices.* The registrant must disclose the following information for its last completed financial year with respect to (unless otherwise specified) its directors and members of its administrative, supervisory or management bodies:

(a) The date of expiration of the current term of office, if applicable, and the period during which the person has served in that office.

(b) The details of directors' service contracts with the registrant or any of its subsidiaries providing for benefits upon termination of employment, or an appropriate negative statement.

(c) The details relating to the registrant's audit committee and remuneration committee, including the names of committee members and a summary of the terms of reference under which the committee operates. n34

(4) *Employees.* The registrant must provide either the number of employees at the end of the period or the average for the period for each of the past three financial years (and changes in such numbers, if material) and, if possible, a breakdown of persons employed by main category of activity and geographic location. It must disclose any significant change in the number of employees and any information regarding the relationship between management and labor unions. If the registrant employs a significant number of temporary employees, it must disclose the number of temporary employees, on an average, during the most recent financial year.

(5) *Share ownership.*

(a) With respect to the persons listed under "Directors and senior management" above, the registrant must provide information, as of the most recent practicable date, as to their share ownership and the options granted to them on the registrant's shares. The disclosure must include, on an individual basis, the number of shares and percent of shares outstanding of that class, and whether such persons have different voting rights. Information regarding options must include: the title and amount of securities called for by the options; the exercise price; the purchase price, if any, and the expiration date of the options. n35

(b) Describe any arrangements for involving the employees in the capital of the registrant, including any arrangement that involves the issue or grant of options, shares or securities of the registrant. n36

[G] Major Shareholders and Related Party Transactions. This item requires the registrant to provide information regarding the major shareholders and others that control or may control the registrant. It requires the registrant to provide information regarding transactions that it has entered into with affiliated persons and whether the terms of such transactions are fair to the registrant. This may require disclosure of related party transactions not required to be disclosed under the body of accounting principles used in preparing the financial statements. This item is not intended to address the thresholds at which shareholders are required, on a continuing basis, to disclose their beneficial ownership of securities.

(1) *Major shareholders.* To the extent that the information in this subsection is known to the registrant or can be ascertained from public filings, it should be provided as of the most recent practicable date, with references to the number of shares held (including shares beneficially owned).

(a) With respect to such major shareholders, n37 the registrant should:

(i) Provide their names, and the number of shares and the percentage of outstanding shares of each class owned by each of them as of the most recent practicable date, or an appropriate negative statement if there are no major shareholders;

(ii) Disclose any significant change in the percentage ownership held by any major shareholders during the past three years; and

(iii) Indicate whether the major shareholders have different voting rights, or provide an appropriate negative statement.

(b) The registrant must disclose information as to the portion of each class of securities held in the host country and the number of record holders in the host country.

(c) To the extent known to the registrant, it must state whether it is directly or indirectly owned or controlled by another corporation(s), by any foreign government or by any other natural or legal person(s) severally or jointly, and, if so, it must give the name(s) of such controlling corporation(s), governments or other person(s) and briefly describe the nature of such control, including the amount and proportion of capital held giving a right to vote.

(d) The registrant must describe any known arrangements, the operation of which may at a subsequent date result in a change of control. n38

(2) *Related party transactions.* The registrant must provide the information required below for the period since the beginning of its preceding three financial years up to the date of the document, with respect to transactions or loans between it and (a) enterprises that directly or indirectly through one or more intermediaries, control or are controlled by, or are under common control with, the registrant; (b) associates n39; (c) individuals owning, directly or indirectly, an interest in the voting power of the registrant that gives them significant influence over the registrant n40 and close members of any such individual's family n41; (d) key management personnel, that is, those persons having authority and responsibility for planning, directing and controlling the activities of the registrant, including directors and senior management and close members of such individual's families; and (e) enterprises in which a substantial interest in the voting power is owned, directly or indirectly, by any person described in (c) or (d) or over which such a person is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the registrant and enterprises that have a member of key management in common with the registrant.

(a) The nature and extent of any transactions or presently proposed transactions which are material to the registrant or the related party, or any transactions that are unusual in their nature or conditions, involving goods, services or tangible or intangible assets, to which the company or any of its parent or subsidiaries was a party.

(b) The amount of outstanding loans (including guarantees of any kind) made by the registrant or its parent or subsidiaries to or for the benefit of any of the persons listed above. The information given should include the largest amount outstanding during the period covered, the amount outstanding as of the latest practicable date, the nature of the loan and the transaction in which it was incurred and the interest rate on the loan. n42

(3) *Interests of experts and counsel.* If any of the named experts or counselors was employed on a contingent basis, owns an amount of shares in the registrant or its subsidiaries which is material to that person, or has a material, direct or indirect economic interest in the registrant or that depends on the success of the offering, provide a brief description of the nature and terms of such contingency or interest. n43

[H] Financial Information. The purpose of this item is to specify which financial statements must be included in

the document, as well as the period to be covered, the age of the financial statements and other information of a financial nature. n44

(1) *Consolidated statements and other financial information.* The document must contain consolidated financial statements, audited by an independent auditor and accompanied by an audit report, comprised of: (a) a balance sheet; (b) an income statement; (c) a statement showing either (i) changes in equity other than those arising from capital transactions with owners and distributions to owners or (ii) all changes in equity (including a subtotal of all non-owner items recognized directly in equity); n45 (d) a cash flow statement; (e) related notes and schedules required by the comprehensive body of accounting standards pursuant to which the financial statements are prepared; and (f) if not included in the primary financial statements, a note analyzing the changes in each caption of shareholders' equity presented in the balance sheet. n46

The document should include comparative financial statements that cover the latest three financial years, audited in accordance with a comprehensive body of auditing standards. n47

The audit report(s) must cover each of the periods for which these international disclosure standards require audited financial statements. If the auditors have refused to provide a report on the annual accounts or if the report(s) contain qualifications or disclaimers, such refusal or such qualifications or disclaimers shall be reproduced in full and the reasons given, so the host country securities regulator can determine whether or not to accept the financial statements. Include an indication of any other information in the document which has been audited by the auditors. n48

The last year of audited financial statements may not be older than 15 months at the time of the offering or listing; provided, however, that in the case of the registrant's initial public offering, the audited financial statements also shall be as of a date not older than 12 months at the time the document is filed. In such cases, the audited financial statements may cover a period of less than a full year. n49

If the document is dated more than nine months after the end of the last audited financial year, it should contain consolidated interim financial statements, which may be unaudited (in which case that fact should be stated), covering at least the first six months of the financial year. The interim financial statements should include a balance sheet, income statement, cash flow statement and a statement showing either (i) changes in equity other than those arising from capital transactions with owners and distributions to owners or (ii) all changes in equity (including a subtotal of all non-owner items recognized directly in equity). Each of these statements may be in condensed form as long as it contains the major line items from the latest audited financial statements and includes the major components of assets, liabilities and equity (in the case of the balance sheet); income and expenses (in the case of the income statement); and the major subtotals of cash flows (in the case of cash flow statements). The interim financial statements should include comparative statements for the same period in the prior financial year, except that the requirement for comparative balance sheet information may be satisfied by presenting the year end balance sheet. n50 If not included in the primary financial statements, a note should be provided analyzing the changes in each caption of shareholders' equity presented in the balance sheet. The interim financial statements should include selected note disclosures that will provide an explanation of events and changes that are significant to an understanding of the changes in financial position and performance of the enterprise since the last annual reporting date. n51 If, at the date of the document, the registrant has published interim financial information that covers a more current period than those otherwise required by this standard, the more current interim financial information must be included in the document. Companies are encouraged, but not required, to have any interim financial statements in the document reviewed by an independent auditor. If such a review has been performed and is referred to in the document, a copy of the auditor's interim review report must be provided in the document. n52

If the amount of export sales constitutes a significant portion of the company's total sales volume, the registrant must provide the total amount of export sales and the percent and amount of export sales in the total amount of sales volume. n53

The registrant must provide information on any legal or arbitration proceedings, including those relating to bankruptcy, receivership or similar proceedings and those involving any third party, which may have, or have had in the recent past, significant effects on the registrant's financial position or profitability. This includes governmental proceedings pending or known to be contemplated. n54

The registrant must describe its policy on dividend distributions. n55

(2) *Significant changes.* The registrant must disclose whether or not any significant change has occurred since the date of the annual financial statements, and/or since the date of the most recent interim financial statements, if any, included in the document.

[I] The Offer and Listing. This item requires the registrant to provide information regarding the offer or listing of securities, the plan for distribution of the securities and related matters.

(1) *Offer and listing details.*

(a) The registrant must indicate the expected price at which the securities will be offered or the method of determining the price and the amount of any expenses specifically charged to the subscriber or purchaser.

(b) If there is not an established market for the securities, the registrant must disclose information regarding the manner of determination of the offering price as well as of the exercise price of warrants and the conversion price of convertible securities, including who established the price or who is formally responsible for the determination of the price, the various factors considered in such determination and the parameters or elements used as a basis for establishing the price.

(c) If the registrant's shareholders have pre-emptive purchase rights and where the exercise of the right of pre-emption of shareholders is restricted or withdrawn, the registrant shall indicate the basis for the issue price if the issue is for cash, together with the reasons for such restriction or withdrawal and the beneficiaries of such restriction or withdrawal if intended to benefit specific persons.

(d) Information regarding the price history of the stock to be offered or listed must be disclosed as follows:

(i) the annual high and low market prices for the five most recent full financial years;

(ii) the high and low market prices for each full financial quarter for the two most recent full financial years and any subsequent period;

(iii) the high and low market prices for each month for the most recent six months; and

(iv) for pre-emptive issues, the market prices for the first trading day in the most recent six months, for the last trading day before the announcement of the offering and (if different) for the latest practicable date prior to publication of the document.

Information must be given with respect to the market price in the host market and the principal trading market outside the host market. If significant trading suspensions occurred in the prior three years, they shall be disclosed. If the securities are not regularly traded in an organized market, information must be given about any lack of liquidity.

(e) The registrant must state the type and class of the securities being offered or listed, whether the shares are registered shares or bearer shares, the number of shares to be issued and to be made available

to the market for each kind of share, the nominal par or equivalent value on a per share basis and, where applicable, a statement of the minimum offer price. Any coupons attached must be disclosed. The registrant must also disclose the arrangements for transfer and any restrictions on the free transferability of the shares.

(f) If the rights evidenced by the securities being offered or listed are or may be materially limited or qualified by the rights evidenced by any other class of securities or by the provisions of any contract or other documents, the registrant must include information regarding such limitation or qualification and its effect on the rights evidenced by the securities to be listed or offered.

(g) With respect to securities other than common or ordinary shares to be listed or offered, the registrant must outline briefly the rights evidenced thereby.

(i) If subscription warrants or rights are to be listed or offered, the registrant must state: the title and amount of securities called for; the amount of warrants or rights outstanding; provisions for changes to or adjustments in the exercise price; the period during which and the price at which the warrants or rights are exercisable; and any other material terms of such warrants or rights.

(ii) Where convertible securities or stock purchase warrants to be listed or offered are subject to redemption or call, the description of the conversion terms of the securities or material terms of the warrants shall include whether the right to convert or purchase the securities will be forfeited unless it is exercised before the date specified in the notice of redemption or call; the expiration or termination date of the warrants; the kind, frequency and timing of notice of the redemption or call, including where the notice will be published; and, in the case of bearer securities, that investors are responsible for making arrangements to prevent loss of the right to convert or purchase in the event of redemption or call. n56

(2) *Plan of distribution.* The registrant must:

(a) List the names and addresses of the entities underwriting or guaranteeing the offering. n57

(b) To the extent known, indicate whether major shareholders, directors or members of its management, supervisory or administrative bodies intend to subscribe in the offering, or whether any person intends to subscribe for more than 5% of the offering.

(c) Identify any group of targeted potential investors to whom the securities are offered. If the offering is being made simultaneously in the markets of two or more countries and if a tranche has been or is being reserved for certain of these, the registrant must indicate any such tranche.

(d) If securities are reserved for allocation to any group of targeted investors, including, for example, offerings to existing shareholders, directors, or employees and past employees of the company or its subsidiaries, provide details of these and any other preferential allocation arrangements.

(e) Indicate whether the amount of the offering could be increased, as by the exercise of an underwriter's over-allotment option or "green-shoe," and by how much.

(f) Indicate the amount, and outline briefly the plan of distribution, of any securities that are to be offered otherwise than through underwriters. If the securities are to be offered through the selling efforts of brokers or dealers, the registrant must describe the plan of distribution and the terms of any agreement or understanding with such entities. If known, the registrant must identify the broker(s) or dealer(s) that will participate in the offering and state the amount to be offered through each.

(g) If the securities are to be offered in connection with the writing of exchange-traded call options,

the registrant must describe briefly such transactions.

(h) If simultaneously or almost simultaneously with the creation of shares for which admission to official listing is being sought, shares of the same class are described for or placed privately or if shares of other classes are created for public or private placing, detail the nature of such operations and of the number and characteristics of the shares to which they relate.

(i) Unless otherwise described under Item 10(c) of Form 20-F (Material contracts), describe the features of the underwriting relationship together with the amount of securities being underwritten by each underwriter in privity of contract with the registrant or selling shareholders. The foregoing information should include a statement as to whether the underwriters are or will be committed to take and to pay for all of the securities if any are taken, or whether it is an agency or the type of "best efforts" arrangement under which the underwriters are required to take and to pay for only such securities as they may sell to the public.

(j) If any underwriter or other financial adviser has a material relationship with the registrant, it must describe the nature and terms of such relationship. n58

(3) *Markets.* The registrant must disclose all stock exchanges and other regulated markets on which the securities to be offered or listed are traded. When an application for admission to any exchange and/or regulated market is being or will be sought, this must be mentioned without creating the impression that the listing necessarily will be approved. If known, the dates on which the shares will be listed and dealt in should be given. n59

(4) *Selling shareholders.* The registrant must provide the following information:

(a) The name and address of the person or entity offering to sell the shares and the nature of any position, office or other material relationship that the selling shareholder has had within the past three years with the registrant or any of its predecessors or affiliates.

(b) The number and class of securities being offered by each of the selling shareholders and the percentage of the existing equity capital. The amount and percentage of the securities for each particular type of securities beneficially held by the selling shareholder before and immediately after the offering shall be specified. n60

(5) *Dilution.* The registrant must:

(a) Where there is a substantial disparity between the public offering price and the effective cash cost to directors or senior management, or affiliated persons, of equity securities acquired by them in transactions during the past five years, or which they have the right to acquire, include a comparison of the public contribution in the proposed public offering and the effective cash contributions of such persons.

(b) Disclose the amount and percentage of immediate dilution resulting from the offering, computed as the difference between the offering price per share and the net book value per share for the equivalent class of security, as of the latest balance sheet date.

(c) In the case of a subscription offering to existing shareholders, disclose the amount and percentage of immediate dilution if they do not subscribe to the new offering. n61

(6) *Expense on the issue.* The registrant must provide:

(a) The total amount of the discounts or commissions agreed upon by the underwriters, other

placement or selling agents and the registrant, as well as the percentage such commissions represent of the total amount of the offering and the amount of discounts or commissions per share.

(b) A reasonably itemized statement of the major categories of expenses incurred in connection with the issuance and distribution of the securities to be listed or offered and by whom the expenses are payable, if other than the registrant. If any of the securities are to be offered for the account of a selling shareholder, the registrant must indicate the portion of such expenses to be borne by such shareholder. The information may be given subject to future contingencies. If the amounts of any items are not known, estimates (identified as such) shall be given. n62

[J] Additional Information. This item is to provide information, most of which is of a statutory nature, that is not covered elsewhere in the document. In registration statements that relate to securities other than common equity, the registrant does not have to provide the information called for by Items 10(A) (Share Capital) and 10(F) (Statement by Experts). n63

(1) *Share capital.* The following information must be given as of the date of the most recent balance sheet included in the financial statements and as of the latest practicable date:

(a) The amount of issued capital and, for each class of share capital: (a) the number of shares authorized; (b) the number of shares issued and fully paid and issued but not fully paid; (c) the par value per share, or that the shares have no par value; and (d) a reconciliation of the number of shares outstanding at the beginning and end of the year. If more than 10% of capital has been paid for with assets other than cash within the past five years, that fact should be stated.

(b) If there are shares not representing capital, the number and main characteristics of such shares shall be stated.

(c) The number, book value and face value of shares in the registrant held by or on behalf of the registrant itself or by its subsidiaries.

(d) Where there is authorized but unissued capital or an undertaking to increase the capital, for example, in connection with warrants, convertible obligations or other outstanding equity-linked securities, or subscription rights granted, indicate: (i) the amount of outstanding equity-linked securities and of such authorized capital or capital increase and, where appropriate, the duration of the authorization; (ii) the categories of persons having preferential subscription rights for such additional portions of capital; and (iii) the terms, arrangements and procedures for the share issue corresponding to such portions.

(e) The persons to whom any capital of any member of the group is under option or agreed conditionally to be put under option, including the title and amount of securities covered by the options; the exercise price; the purchase price, if any; and the expiration date of the options, or an appropriate negative statement. Where options have been granted or agreed to be granted to all the holders of shares or debt securities, or of any class thereof, or to employees under an employees' share scheme, it will be sufficient, so far as the names are concerned, to record that fact without giving names.

(f) A history of share capital for the last three years identifying the events during such period which have changed the amount of the issued capital and/or the number and class of shares of which it composed, together with a description of changes in voting rights attached to the various classes of shares during that time. Details should be given of the price and terms of any issue including particulars of consideration where this was other than cash (including information regarding discounts, special terms or installment payments). If there are no such issues, an appropriate negative statement must be made.

The reason for any reduction of the amount of capital and the ratio of capital reductions also shall be given.

(g) An indication of the resolutions, authorizations and approvals by virtue of which the shares have been or will be created and/or issued, the nature of the issue and amount hereof and the number of shares which have been or will be created. n64

(2) *Memorandum and articles of association.* The registrant must:

(a) Indicate the registrar and the entry number therein, if applicable, and describe its objectives and purposes and where they can be found in the memorandum and articles.

(b) With respect to directors, provide a summary of any provisions of the registrant's articles of association or charter and bylaws with respect to: (i) a director's power to vote on a proposal, arrangement or contract in which the director is materially interested; (ii) the directors' power, in the absence of an independent quorum, to vote in connection with their compensation; (iii) borrowing powers exercisable by the directors and how such borrowing powers can be varied; (iv) retirement or non-retirement of directors under an age limit requirement; and (v) number of shares, if any, required for a director's qualification.

(c) Describe the rights, preferences and restrictions attaching to each class of the shares, including: (i) dividend rights, including the time limit after which dividend entitlement lapses and an indication of the party in whose favor this entitlement operates; (ii) voting rights, including whether directors stand for reelection at staggered intervals and the impact of that arrangement where cumulative voting is permitted or required; (iii) rights to share in the registrant's profits; (iv) rights to share in any surplus in the event of liquidation; (v) registrant provisions; (vi) sinking fund provisions; (vii) liability to further capital calls by the company; and (viii) any provision discriminating against any existing or prospective holder of such securities as a result of such shareholder owning a substantial number of shares.

(d) Describe what action is necessary to change the rights of holders of the stock, indicating where the conditions are more significant than is required by law.

(e) Describe the conditions governing the manner in which annual general meetings and extraordinary general meetings of shareholders are convoked, including the conditions of admission.

(f) Describe any limitations on the rights to own securities, including the rights of non-resident or foreign shareholders to hold or exercise voting rights on the securities imposed by foreign law or by the charter or other constituent document of the company, or state that there are no such limitations if that is the case.

(g) Describe briefly any provision of the registrant's articles of association, charter or bylaws that could have an effect of delaying, deferring or preventing a change in control of the registrant and that would operate only with respect to a merger, acquisition or corporate restructuring involving the registrant or its subsidiaries.

(h) Indicate the bylaws provisions, if any, governing the ownership threshold above which shareholder ownership must be disclosed.

(i) With respect to subsections (b) through (h) above, if the law applicable to the registrant in these areas is significantly different from that in the host country, the effect of the law in these areas should be explained.

(j) Describe the conditions imposed by the memorandum and articles of association governing changes in the capital, where such conditions are more stringent than is required by law. n65

(3) *Material contracts.* The registrant must provide a summary of each material contract, other than contracts entered into in the ordinary course of business, to which it or any member of the group is a party, for the two years immediately preceding publication of the document, including dates, parties, general nature of the contracts, terms and conditions and amount of any consideration passing to or from the registrant or any other member of the group. n66

(4) *Exchange controls.* The registrant must describe any governmental laws, decrees, regulations or other legislation of the registrant's home country which may affect:

(a) The import or export of capital, including the availability of cash and cash equivalents for use by the registrant's group.

(b) The remittance of dividends, interest or other payments to nonresident holders of the registrant's securities. n67

(5) *Taxation.* The registrant must provide information regarding taxes (including withholding provisions) to which shareholders in the host country may be subject. Information should be included as to whether the registrant assumes responsibility for the withholding of tax at the source and regarding applicable provisions of any reciprocal tax treaties between the home and host countries, or a statement, if applicable, that there are no such treaties. n68

(6) *Dividends and paying agents.* The registrant must disclose any dividend restrictions, the date on which the entitlement to dividends arises, if known, and any procedures for nonresident holders to claim dividends. The registrant must identify the financial organizations which, at the time of admission of shares to official listing, are the paying agents of the registrant in the countries where admission has taken place or is expected to take place. n69

(7) *Statement by experts.* Where a statement or report attributed to a person as an expert is included in the document, the registrant must provide such person's name, address and qualifications and a statement to the effect that such statement or report is included, in the form and context in which it is included, with the consent of that person, who has authorized the consents of that part of the document. n70

(8) *Documents on display.* The registrant must provide an indication of where the documents concerning the registrant which are referred to in the document may be inspected. Exhibits and documents on display generally should be translated into the language of the host country, or a summary thereof in the host country language should be provided. n71

[K] Quantitative and Qualitative Disclosures About Market Risk. This Item requires identical disclosure as Item 11(j) of Form S-1, namely Item 305 of Regulation S-K. n72

[L] Description of Securities Other than Equity Securities. n73 (1) *Debt securities.* If debt securities are being registered, the registrant must provide:

(a) Information about interest, conversions, maturity, redemption, amortization, sinking funds and retirement.

(b) The kind and priority of any lien securing the issue, as well as a brief identification of the principal properties subject to each lien.

(c) Information regarding subordination of the rights of holders of the securities to other security holders or creditors. If the securities are designated in their title as subordinated, the registrant must give

the aggregate amount of outstanding indebtedness as of the most recent practicable date that is senior to the subordinated debt and briefly describe any limitations on the issuance of additional senior indebtedness, or state that there is no limitation.

(d) Information about provisions restricting the declaration of dividends or requiring the creation or maintenance of any reserves or of any ratio of assets or requiring the maintenance of properties.

(e) Information about provisions permitting or restricting the issuance of additional securities, the withdrawal of cash deposited against the issuance of additional securities, the incurring of additional debt, the release or substitution of assets securing the issue, the modification of the terms of the security and similar provisions. The registrant does not need to describe provisions permitting the release of assets upon the deposit of equivalent funds or the pledge of equivalent property, the release of property no longer required in the business, obsolete property or property taken by eminent domain, the application of insurance monies and similar provisions.

(f) The general type of event that constitutes a default and whether or not the registrant is required to provide periodic evidence of the absence of a default or of compliance with the terms of the indenture.

(g) Information regarding moderation of the terms of the security or the rights of security holders.

(h) If the rights evidenced by the securities being registered are or may be materially limited or qualified by the rights of any other authorized class of securities, enough information about the other class of securities so investors will understand the rights evidenced by the securities being registered. The registrant does not need to provide information about the other class of securities if all of it will be retired, so long as it has taken appropriate steps to ensure that retirement will be completed on or before the time the securities being registered are delivered.

(i) The tax effects of any "original issue discount" as that term is defined in *Section 1232 of the Internal Revenue Code, 25 U.S.C. § 1232*, including cases where the debt security is being sold in a package with another security and the allocation of the offering price between the two securities may have the effect of offering the debt security at an original issue discount.

(j) The name and address of the trustee and the nature of any material relationship between the trustee and the registrant and any of its affiliates, the percentage of the class of securities that is needed to require the trustee to take action and what indemnification the trustee may require before proceeding to enforce the lien.

(k) The names and addresses of the paying agents.

(l) The currency or currencies in which the debt is payable. If the debt may be paid in two or more currencies, the registrant must state who has the option to determine the currency conversion and what the basis will be for that determination.

(m) Any law or decree determining the extent to which the securities may be serviced.

(n) The consequences of any failure to pay principal, interest or any sinking or amortization installment.

(o) If the securities are guaranteed, the name of the guarantor and a brief outline of the contract of guarantee. n74

(2) *Warrants and rights.* If the securities are being offered pursuant to warrants or rights, the registrant must state, in

addition to the description thereof, the amount of securities called for by the warrants or rights, the period during and the price at which the warrants or rights are exercisable, the amount of warrants or rights outstanding, the provisions for changes or adjustments in the exercise price and any other material terms of the warrants or rights. n75

(3) *Other securities.* If securities other than equity, debt, warrants or rights are being registered, a description of the rights evidenced by the securities must be provided. The description should be comparable in detail to the description that would be required for equity, debt, warrants or rights. n76

(a) *American depositary shares.* If securities represented by American depositary receipts are being registered, the registrant must provide the name of the depositary, the address of its principal executive office, the title of the American depositary receipts and a description of the deposited security. n77 The registrant must briefly describe the American depositary shares, including provisions, if any, regarding:

- (i) The amount of deposited securities represented by one unit of American depositary receipts;
- (ii) Any procedure for voting the deposited securities;
- (iii) The procedure for collecting and distributing dividends;
- (iv) The procedures for transmitting notices, reports and proxy soliciting material;
- (v) The sale or exercise of rights;
- (vi) The deposit or sale of securities resulting from dividends, splits or plans of reorganization;
- (vii) Amendment, extension or termination of deposit arrangements;
- (viii) The rights that holders of American depositary receipts have to inspect the books of the depositary and the list of receipt holders;
- (ix) Any restrictions on the right to transfer or withdraw the underlying securities; and
- (x) Any limitation on the depositary's liability.

(b) *Fees* The registrant should describe all fees and charges that a holder of American depositary receipts may have to pay, either directly or indirectly. It must indicate the type of service, the amount of the fees or charges and to whom the fees or charges are paid. In particular, information about any fees or charges in connection with (a) depositing or substituting the underlying shares, (b) receiving or distributing dividends, (c) selling or exercising rights, (d) withdrawing an underlying security and (e) transferring, splitting or grouping receipts should be provided. Information about the depositary's right, if any, to collect fees and charges by offsetting them against dividends received and deposited securities should also be provided. n78

Finally, if convertible securities or stock purchase warrants that are subject to redemption or call are being registered, the following information in description of the securities must be included: (a) whether holders will forfeit the right to convert or purchase the securities unless they exercise the right before the date specified in the notice of redemption or call; (b) the expiration or termination date of the warrants; (c) the kinds, frequency and timing of the redemption or call notice, including the cities or newspapers in which you will publish the notice; and (d) in the case of bearer sacrifices, that investors are responsible for making arrangements to avoid losing the right to convert or purchase if there is a redemption or call, such as by reading the newspapers in which you will publish the redemption or call notice. n79

[iii] Item 4A. Material Changes. This item operates in conjunction with the incorporation of information by

reference pursuant to General Instruction VI.

Item 4A requires that if an eligible registrant has elected to incorporate information by reference to periodic reports filed under the Exchange Act, the registrant must include in the prospectus a description of all material changes in its affairs which have occurred since the end of the latest fiscal year for which audited financial statements were included in the latest Form 10-K, Form 20-F or Form 40-F. n80 This disclosure is not required, however, where such a description has been included in a Form 10-Q or Form 8-K filed under the Exchange Act.

[iv] Item 5. Incorporation of Certain Information by Reference. This item governs the incorporation of information by reference to periodic reports filed under the Exchange Act, if the registrant elects to do so pursuant to General Instruction VI.

Item 5 requires that if the registrant elects to incorporate information by reference pursuant to General Instruction VI, the following documents must be specifically incorporated by reference into the registration statement, by means of a statement to that effect in the prospectus:

- (1) the registrant's latest annual report on Form 10-K, Form 20-F or Form 40-F which contains financial statements for the registrant's latest fiscal year for which such annual report was required to have been filed; and
- (2) all other reports filed on Form 10-Q or Form 8-K. Since the end of the fiscal year covered by the annual report referred to above. n81

The registrant also must:

- (1) state that it will provide, to each person to whom a prospectus is delivered, a copy of any of the reports or documents that have been incorporated by reference in the prospectus but not delivered with the prospectus (a) upon written or oral request and (b) at no cost to the requester;
- (2) provide the name, address, telephone number and email address to which the request for these reports or documents must be made;
- (3) provide its website address, including where to access incorporated reports and documents; n82
- (4) identify the reports and other information that it files with the Commission
- (5) state that the public may read and copy any materials it files with the Commission at the Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 and may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330; and
- (6) if the registrant is an electronic filer, state that the Commission maintains an internet site that contains reports, proxy and information statements and other information regarding electronic filers and that the address of that site is www.sec.gov. n83

[v] Item 5. Disclosure of Commission Position on Indemnification for Securities Act Liabilities. This item requires the registrant to furnish information identical to that required by Item 12A of Form S-1. n84

[h] Instructions as to Summary Prospectuses. The Instructions as to Summary Prospectuses to Form F-1 are the same as those of Form S-1, n85 except:

(1) Instruction 1(b) of the Instructions as to Summary Prospectuses of Form F-1 requires a statement concerning the enforceability of civil liabilities against foreign persons in answer to Item 2 of Form F-1;

(2) Instruction 1(c)(iv) of the Instructions as to Summary Prospectuses of Form F-1 further requires a brief statement of exchange controls, tax treatises and limitations on ownership or voting; and

(3) Instruction 3 of the Instructions as to Summary Prospectuses of Form F-1 states that where the securities being registered are to be offered in an exchange for securities of any other issuer, the summary prospectus must contain the identical information required under Instruction 3 of the Instructions as to Summary Prospectuses of Form S-1 if the securities were registered on Form F-1 or Form S-1 according to General Instruction III of Form S-1.

[i] Information Included in the Registration Statement but Not Required in the Prospectus.

Part II of Form F-1, concerning information not required to be in the prospectus, contains Items 6-9.

[i] Items 6-9. Items 6-9 of Part II of Form F-1 require the same disclosure as Items 14-17 of Form S-1 n86 except for the following:

(1) Item 8 of Form F-1 does not require the registrant to file as an exhibit an instrument defining the rights of holders of long-term debt of the registrant and its consolidated subsidiaries or for its unconsolidated subsidiaries for which financial statements are required to be filed;

(2) Item 8 of Form F-1 does not require the registrant to file a letter from the registrant's former independent accountant regarding its concurrence or disagreement with the statements made by the registrant in the current report with respect to the resignation or dismissal of to the registrant's principal accountant;

(3) Item 8 of Form F-1 requires the registrant to furnish the financial statement schedules required by Item 4(b) of Form F-1 in addition to those required by Regulation S-X; and

(4) Item 9 of Form F-1 requires the registrant, if the securities are being registered pursuant to Rule 415 under the Securities Act, to file a post-effective amendment to the registration statement to include any financial statements required by Item 8(A) of Form 20-F (Consolidated Statements and Other Financial Information) at the start of any delayed offering or throughout a continuous offering. However, financial statements and information otherwise required by Section 10(a)(3) of the Securities Act do not have to be furnished, provided that the registrant includes in the prospectus by means of a post-effective amendment, financial statements required by Item 8(A) of Form 20-F (Consolidated Statements and Other Financial Information) and any other information necessary to ensure that all other information in the prospectus is at least as current as the date of those financial statements.

[j] Signatures. The signature requirement is identical to that of Form S-1, n87 except that the registration statement must be signed by the registrant's authorized representative in the United States. n88

[2] Form F-3--Registration of Securities of Reporting Issuers Widely Followed by Professional Securities Analysts.

[a] Eligibility Requirements.

This instruction sets forth registrant requirements and transaction requirements for the use of Form F-3. n89 Any foreign private issuer which meets both of these requirements may use this form for the registration of securities under

the Securities Act.

[i] Registrant Requirements. n90 All registrants must meet the following conditions in order to use Form F-3 for registration:

- (1) The registrant must (i) have a class of securities registered under Section 12(b) of the Exchange Act or (ii) have a class of equity securities registered pursuant to Section 12(g) of the Exchange Act or (iii) be required to file reports under Section 15(d) of the Exchange Act and have filed annual reports on Form 20-F, Form 10-K or Form 40-F under the Exchange Act. n91
- (2) The registrant has been subject to the requirements of Section 12 or 15(d) of the Exchange Act and has filed all required information pursuant to Section 13, 14 or 15(d) for at least the 36 calendar months immediately preceding the filing, has filed in a timely manner all required reports during the 12 calendar months immediately preceding the filing and, if the registrant had used Rule 12b-25 under the Exchange Act with respect to any report during the last twelve months, that report has actually been filed within the time period prescribed. n92
- (3) The registrant and its consolidated or unconsolidated subsidiaries have not defaulted, to any material extent, since the end of the last fiscal year for which certified financial statements of the registrant and its consolidated subsidiaries were included in an Exchange Act report. n93
- (4) If the registrant is a successor, the successor will be deemed to have met the Form S-2 eligibility test set forth in paragraphs (1) through (3) above if:
 - (a) its predecessor and it, taken together, meet the conditions for Form S-2 eligibility, provided that the succession was primarily for changing the state of incorporation of the predecessor or forming a holding company, and that the assets and liabilities of the successor at the time of the succession were substantially the same as the predecessor's assets and liabilities, or
 - (b) all predecessors met the conditions at the time of the succession and the registrant has continued to do so since the succession.
- (5) If a registrant is a majority-owned subsidiary, security offerings may be registered on Form F-3 if:
 - (a) the registrant-subsiary itself meets the Registrant Requirements and the applicable Transaction Requirements;
 - (b) the parent of the registrant-subsiary meets the Registrant Requirements and the conditions of Transaction Requirement 2(b) are met; or
 - (c) the parent of the registrant-subsiary meets the Registrant Requirements and the applicable Transaction Requirements and provides a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X, of the payment obligations of the securities being registered, and the securities being registered are non-convertible securities, other than common equity;
 - (d) the parent meets the registrant requirements and the applicable transaction requirement, and the securities of the registrant-subsiary being registered are full and unconditional guarantees, as defined in Rule 3-10 of Regulation S-X, of the payment

obligations on the non-convertible securities of the parent being registered, other than common equity; or

(e) the parent meets the registrant requirements and the applicable transaction requirement, and the securities of the registrant-subsiary being registered are guarantees of the payment obligations on non-convertible securities, other than common equity, which are being registered by another majority-owned subsidiary of the parent and of which the parent provides a full and unconditional guarantee as defined in Rule 3-10 of Regulation S-X.

(6) If the registrant is subject to the electronic filing requirements of Rule 101 of Regulation S-T, the registrant must have (a) filed with the Commission all required electronic filings, including confirming electronic copies of documents submitted in paper pursuant to a temporary hardship exemption, and (b) Submitted electronically to the Commission and posted on its corporate website, if any, all Interactive Data Files required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the twelve calendar months and any portion of a month immediately preceding the filing of the registration statement on this Form (or for such shorter period of time that the registrant was required to submit and post such files). n94

[ii] Transaction Requirements. n95 Security offerings meeting any of the following conditions and made by registrants that meet the Registrant Requirements above may be registered on Form F-3:

(1) securities to be offered for cash by or on behalf of the registrant provided that the worldwide aggregate market value n96 of the voting and non-voting common equity held by non-affiliates of the registrant is the equivalent of \$75 million or more and the financial statements included in the registration statement on Form F-3 comply with Item 18 of Form 20-F; n97

(2) non-convertible securities to be offered for cash if such securities are investment grade securities; n98

(3) the Transaction Requirement contained in paragraph (B)(3) of the General Instructions to Form F-3 is similar to that of Transaction Requirement (3) of Form S-3, n99 except that Form F-3 does not require that the securities be listed on a national securities exchange; and n100

(4) the Transaction Requirement contained in paragraph (B)(4) of the General Instructions to Form F-3 is identical to that of Transaction Requirement (4) of Form S-3, n101 except that the requirement of the issuer sending the information required by Rule 14a-3(b) of the Exchange Act and Items 401, 402 and 403 of Regulation S-K to record holders is not required in Form F-3. It also permits financial statements registered pursuant to Transaction Requirement (4) of It also permits financial statements registered pursuant to Transaction Requirement (4) of Form F-3 to comply with Items 17 and 18 of Form 20-F for a registrant's fiscal years ending before December 15, 2011; but for registrant's fiscal years ending on or after December 15, 2011, the financial statements included on Form F-3 under Transaction Requirement (4) must comply with Item 18 of Form 20-F. Moreover, it prohibits the registration of securities to be offered or sold in a standby underwriting in the United States or similar arrangement pursuant to Transaction Requirement (4) of Form F-3.

(5) the Transaction Requirement contained in paragraph (B)(5) of the General Instructions to Form S-3 is identical that of Transaction Requirement (6) of Form S-3. n102

[b] Automatic Shelf Offerings by Well-Known Seasoned Issuers. A registrant that is a well-known seasoned issuer ("WKSI") n103 may use From F-3 to register security offerings, n104 known as "automatic shelf registration."

n105 A WSKI may use Form F-3 according to the following:

(1) The securities to be offered must be:

(a) securities offered in a shelf offering pursuant to Rule 415, Rule 430A or Rule 430B, if by:

(i) a WSKI by reason of having \$700 million of worldwide common equity market capitalization held by non-affiliates; or

(ii) a WSKI only by reason of having issued \$1 billion aggregate amount of non-convertible securities, other than common equity, in registered primary offerings for cash (not in registered exchange offers) during the past three years and that is eligible to register a primary offering of its securities on Form S-3;

(b) Non-convertible securities, other than common equity, if offered in a shelf offering pursuant to Rule 415, Rule 430A or Rule 430B by a WSKI only by having issued \$1 billion aggregate amount of non-convertible securities, other than common equity, in registered primary offerings for cash (not in registered exchange offers) during the past three years and that is *not* eligible to register a primary offering of its securities on Form S-3;

(c) Securities of majority-owned subsidiaries of the parent-registrant offered in a shelf offering pursuant to Rule 415, Rule 430A or Rule 430B, if the parent-registrant is a WSKI and the securities of the majority-owned subsidiary are:

(i) securities of a majority-owned subsidiary that is a WSKI at the time it becomes a registrant (but not if it is a WSKI by reason of its being a majority-owned subsidiary of a parent that is a WSKI and that has provided a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X, of the payment obligations of the subsidiary's securities, and the securities are non-convertible securities other than common equity);

(ii) securities of a majority-owned subsidiary that are non-convertible securities, other than common equity, of whose payment obligations the parent registrant has provided a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X;

(iii) securities of a majority-owned subsidiary that are a guarantee of:

(A) non-convertible securities, other than common equity, of the parent registrant;

(B) non-convertible securities, other than common equity, of another majority-owned subsidiary, of whose payment obligations the parent-registrant has provided a full and unconditional guarantee, as defined in Rule 3-10 of Regulation S-X; or

(iv) securities of a majority-owned subsidiary that are investment grade non-convertible debt or preferred stock to be offered in a primary offering for cash by or on behalf of the majority-owned subsidiary.

(d) Securities of "selling security holders," provided that the registration statement and the prospectus are not required to separately identify the selling security holders or the securities to be sold by such persons until certain required filings are made. n106

(2) The registrant must pay the registration fee;

(3) If the registrant is a majority-owned subsidiary, it must be one that is required to file and has filed Exchange Act reports and either satisfies the requirements with regard to incorporation by reference or information about it is included in the registration statement (or a post-effective amendment to the registration statement);

(4) The registrant may register additional securities or classes of its or its majority-owned subsidiaries' securities on a post-effective amendment;

(5) An automatic shelf registration statement and post-effective amendment become effective immediately upon filing. All filings made on or in connection with automatic shelf registration statements on Form S-3 become effective immediately without Commission staff review.

[c] Application of General Rules and Regulations. Effective as of November 4, 2002, registrants must file the registration form on Form F-3 electronically via EDGAR in accordance with those instructions discussed in General Instruction II of Form F-1. n107

[d] Dividend or Interest Reinvestment Plans. This information is similar to that required by Form S-3. n108

[e] Registration of Additional Securities. A registrant can register additional securities for an offering on Form F-3 according to the following:

(1) *Registration of Additional Securities Pursuant to Rule 462(b).* A registrant can register additional securities for an offering through a registration statement under certain conditions set forth in Rule 462(b). In that situation, the registrant may file a registration statement consisting only of the facing page; a statement that the contents of the earlier registration statement, identified by file number, are incorporated by reference; required opinions and consents; the signature page; and any price-related information omitted from the earlier registration statement (in reliance on Rule 430A) that the registrant chooses to include in the new registration statement. The information contained in such a registration statement is deemed to be a part of the earlier registration statement as of the date of effectiveness of the later registration statement. Any opinion or consent required in the later registration statement may be incorporated by reference from the earlier registration statement with respect to the offering, if: (i) such opinion or consent expressly provides for such incorporation; and (ii) such opinion relates to securities registered pursuant to Rule 462(b). n109

(2) *Registration of Additional Securities or Classes of Securities or Additional Registrants After Effectiveness in Automatic Shelf Registration.* A registrant who qualifies as a WSKI may register additional securities or classes of securities by filing a post-effective amendment to the effective registration statement. n110 The post-effective amendment must consist of the facing page; the disclosure updating the registration statement to reflect the additional securities, additional classes of securities or additional registrants; any required opinions and consents; and the signature page. Required information, consents or opinions may be included in the prospectus and the registration statement through a post-effective amendment or may be provided through a document incorporated or deemed incorporated by reference into the registration statement (and the prospectus that is part of the registration statement). Alternatively, the information required to update the registration statement may be contained in a prospectus filed pursuant to Rule 424(b), and it will be deemed part of the registration statement and prospectus. n111 The post-effective amendment is effective immediately. n112

[f] Facing Page. The facing page of Form F-3 requires the same information as the facing page of Form S-3, except that the facing page of Form F-3 also requires a translation of the registrant's name into English. n113

[g] The Prospectus.

Part I of Form F-3, concerning information required to be presented in the prospectus, contains Items 1-7.

[i] Items 1-3. Items 1-3 of Part I of Form F-2 require identical disclosure as Items 1-3 of Form F-1.

[ii] Item 4. Information About the Offering. The registrant is required only to furnish the same information from Part I of Form 20-F as required by Item 4(a) of Form F-1:

(1) Item 2 (Offer Statistics and Exposed Timetable); n114 Item 3(B) (Capitalization and Indebtedness); n115

(2) Item 3(C) (Reasons for the Offer and Use of Proceeds); n116 Item 7(C) (Interests of Experts and Counsel); n117

(3) Item 9 (The Offer and Listing); n118

(4) Item 10 (Additional Information); n119 and Item 12 (Description of Securities Other Than Equity Securities). n120

The registrant does not have to repeat in the prospectus any information called for by these items if the same information is contained in a report being incorporated by reference into the registration statement. n121

[iii] Item 5. Material Changes. The registrant must describe any and all material changes in the registrant's affairs that have occurred since the end of the latest fiscal year for which certified financial statements are included in the Form F-3 in accordance with Item 6 and that have not been described in a report on Form 6-K, Form 10-Q or Form 8-K filed under the Exchange Act and incorporated by reference pursuant to Item 6. n122

The registrant must include in the prospectus, if not included in documents incorporated by reference or a prospectus previously filed pursuant to Rule 424(b) or (c) under the Securities Act or, where no prospectus was required to be filed pursuant to Rule 424(b), the prospectus included in the registration statement at effectiveness, or a Form 6-K filed during either of the two preceding years: (i) information required by Rule 3-05 and Article 11 of Regulation S-X where the registrant has effected or is about to effect a transaction for which such information is required; (ii) restated financial statements if there has been a change in accounting principles or a correction of an error where such change or correction requires a material retroactive restatement of financial statements; (iii) restated financial statements where one or more business combinations of entities under common control have been consummated subsequent to the most recent fiscal year and the acquired business, considered in the aggregate, are significant under Rule 11-01(b); or (iv) any financial information required because of a material disposition of assets outside the normal course of business.

If the financial statements included in this registration statement in accordance with Item 6 are not sufficiently current to comply with the requirements of Item 8(A) of Form 20-F, financial statements necessary to comply with that Item shall be presented directly in the prospectus, through incorporation by reference of a Form 6-K identified in the prospectus as containing such financial statements, or through incorporation by reference of an amended Form 20-F, Form 40-F or Form 10-K, in which case the prospectus shall disclose that the Form 20-F, Form 40-F or Form 10-K has been so amended. n123

[iv] Item 6. Incorporation of Certain Information by Reference. The registrant must when registering securities pursuant to Form F-3, incorporate by reference its latest filed Form 20-F, Form 40-F or Form 10-K and any report on Form 10-Q or Form 8-K filed since the end of the fiscal year covered by such annual report. The prospectus must state that the Form 20-F, Form 40-F or Form 10-K is amended if the registrant's latest filing on Form 20-F, Form 40-F or Form 10-K is amended to include the information specified in Item 18 of Form 20-F. n124 If capital stock is to be registered and securities of the same class are registered under Section 12 of the Exchange Act, the description of the

class of securities which is contained in a registration statement filed under the Exchange Act must also be incorporated by reference. n125

An Interactive Data File is required for a periodic report on Form 10-Q, Form 20-F or Form 40-F; a registration statement under the Securities Act, if the registration statement contains a price or price range and a Form 8-K where the Form 8-K contains audited annual financial statements that are a revised version of financial statements previously filed with the Commission and have been revised pursuant to applicable accounting standards to reflect the effects of certain subsequent events, including a discontinued operation, a change in reportable segments or a change in accounting principle, and, in such case, the Interactive Data File would be required only as to such revised financial statements regardless whether the Form 8-K contains other financial statements. n126

The prospectus must also state that all subsequent filings on Form 20-F, 40-F, 10-K, 10-Q or 8-K, prior to the termination of the offering, shall be deemed to be incorporated by reference into the prospectus.

The registrant may incorporate by reference any Form 6-K meeting the requirements of Form F-3. If the registrant intends to incorporate any Form 6-K subsequently submitted to the SEC, the prospectus must state that the registrant may incorporate such Form 6-K by identifying in such form that they are being incorporated by reference into the Form F-3.

The registrant must state that it will provide to each person, including any beneficial owner, to whom a prospectus is delivered, a copy of any or all of the information that has been incorporated by reference in the prospectus but not delivered with the prospectus, that the registrant will provide this information upon written or oral request, that the registrant will provide this information at no cost to the requester and the name, address and telephone number to which the request for this information must be made. n127

If the registrant sends any information that is incorporated by reference in the prospectus to security holders, it must also send any exhibits that are specifically incorporated by reference in that information. n128 The registrant must identify the reports and other information that it will file with the Commission and state that the public may read and copy any material filed with the Commission at the Commission's Public Reference Room, located at 100 F Street, N.E., Washington, D.C. 20549, and that information concerning the public reading room may be obtained by calling the Commission at 1-800-SEC-0330. Electronic filers must state that the Commission maintains an Internet site at www.sec.gov, which contains reports, proxy and other information statements, and other information regarding electronic filers. Registrants are encouraged to give their Internet address, if available.

Any information required in the prospectus in response to Item 3 through Item 5 may be included by the registrant through documents filed pursuant to the Exchange Act that are incorporated or deemed incorporated by reference into the prospectus that is part of the registration statement.

[v] Item 7. Disclosure of Commission Position on Indemnification for Securities Act Liabilities. This item requires the registrant to furnish information identical to that required by Item 13 of Form S-3. n129

[h] Information Included in the Registration Statement but Not Required in the Prospectus.

Part II of Form F-3, concerning information not required to be presented in the prospectus, contains Items 8-10.

[i] Items 8-10. These items require the registrant to furnish information identical to that required by Items 15-17 of Form S-3, n130 except that:

(1) Item 9 of Form F-3 does not require the registrant to provide a statement setting forth in reasonable detail the computation of any ratio of earnings to fixed charges, any ratio of earnings to combined fixed charges and preferred

stock dividends or any other ratios which appear in the registration statement or report; and n131

(2) Item 10 of Form F-3 requires the registration statement to contain undertakings by the registrant (i) to deliver or cause to be delivered with the prospectus, to each person to which the prospectus is sent, the registrant's latest filing on Form 20-F, Form 40-F or Form 10-K, and any filing on Form 10-Q, Form 8-K or Form 6-K incorporated by reference into the prospectus; and (ii) if the securities are being registered pursuant to Rule 415 under the Securities Act, to file a post-effective amendment to the registration statement to include any financial statements required by Item 8(A) of Form 20-F at the start of any delayed offering or throughout a continuous offering. However, financial statements and information otherwise required by Section 10(a)(3) of the Securities Act do not have to be furnished, provided that the registrant includes in the prospectus by means of a post-effective amendment, financial statements required by Item 8(A) of Form 20-F and any other information necessary to ensure that all other information in the prospectus is at least as current as the date of those financial statements. Moreover, with respect to registration statements on Form F-3, a post-effective amendment need not be filed to include financial statements and information required by Section 10(a)(3) of the Securities Act or Article 3-19 of Regulation S-X if such financial statements and information are contained in periodic reports filed with or furnished to the SEC by the registrant pursuant to Section 13 or Section 15(d) of the Exchange Act that are incorporated by reference into the Form F-3. n132

The same undertakings concerning securities being registered pursuant to Rule 415 for the registration of securities on a delayed or continuous basis ("shelf" registration, both "automatic" and "non-automatic") as called for by Item 512(a) of Regulation S-K to be furnished in Form S-3 must also be furnished in Form F-3. n133

[i] Signatures. The requirements as to signatures on Form F-3 and Instructions (1) and (2) thereto are similar to the signature requirements of Form S-3, n134 except that the registration statement must be signed by the registrant's authorized representative in the United States. n135

FOOTNOTES:

(n1)Footnote 1. Rule 405 under the Securities Act defines a "foreign private issuer" as any foreign issuer other than a foreign government except an issuer meeting the following conditions: (i) more than 50% of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; *and* (ii) any of the following (a) a majority of the executive officers or directors are United States residents or citizens, (b) more than 50% of the issuer's assets are located in the United States or (c) the business of the issuer is administered principally in the United States. For a new registrant with the Commission, the determination of whether "foreign private issuer" status applies must be made within 30 days prior to the issuer's filing of an initial registration statement. Once an issuer qualifies as a "foreign private issuer" it will maintain this status until it fails to qualify at the end of its most recently completed second fiscal quarter. A "foreign issuer" is defined as any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country. Rule 405, Regulation C. The rules under the Securities Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section C (Matthew Bender).

The ownership test for purposes of Rule 405 is based on the method of calculation used in Rule 12g3-2(a) under the Exchange Act. That rule follows the definition of "securities held of record" in Rule 12g5-1, but requires the issuer to "look through" the record ownership of brokers, dealers, banks or nominees holding securities for the accounts of their customers to determine the residency of those customers. To alleviate the burden of investigation on foreign issuers, the Commission permits them to limit their inquiry to brokers, dealers, banks or nominees located in the United States, the jurisdiction of incorporation of the issuer and the jurisdiction that is the primary trading market for the issuer's voting securities, if different from the jurisdiction of incorporation.

(n2)Footnote 2. General Instruction I(B), Form F-1. In such an instance the parent-guarantor is the issuer of a separate security consisting of the guarantee which must be concurrently registered but may be registered on the same registration statement as are the guaranteed securities. Both the parent-guarantor and the subsidiary shall each disclose

the information required by Form F-1 as if each were the only registrant, except that if the subsidiary will not be eligible to file annual reports on Form 20-F after the effective date of the registration statement, then it shall disclose the information specified in Form S-1. See Rule 3-10 of Regulation S-T, 17 C.F.R. § 210.3-10, for the required financial statements. *Id.* The forms under the Securities Act are reprinted in the Securities Primary Law Sourcebook, Volume A, Section D (Matthew Bender).

(n3)Footnote 3. General Instruction VI, Form F-1. This was previously the case for Form F-2, which was eliminated by the 2005 Rules. For specific eligibility requirements, see the text of General Instruction VI.

(n4)Footnote 4. Sec. Act Rel. No. 33-8099 (2002).

(n5)Footnote 5. The Commission expects to grant such exemptions infrequently. *Id.*

(n6)Footnote 6. General Instruction II(D). Regulation C, 17 C.F.R. § 230.400 *et seq.*, contains the general requirements regarding the preparation and filing of registration statements. General Instruction II(A), Form F-1. The registrant is also directed to Regulation S-K and Form 20-F, which govern the requirements applicable to the content of registration statements under the Securities Act. Where Form F-1 directs the registrant to furnish information required by Regulation S-K or Form 20-F and the item so provides, information need only be furnished to the extent appropriate. General Instruction II(B), Form F-1.

(n7)Footnote 7. Form 20-F is the annual report required to be filed under the Exchange Act by foreign private issuers.

(n8)Footnote 8. General Instruction III, Form F-1.

(n9)Footnote 9. General Instruction IV, Form F-1.

(n10)Footnote 10. See Rule 411(c) and Rule 439(b) under the Securities Act. General Instruction V, Form F-1.

(n11)Footnote 11. Item 501(b)(1) of Regulation S-K. See § 7.03[2][a]-[c] *supra*.

(n12)Footnote 12. For the registrant's fiscal years ending before December 15, 2011, the information required by Item 17 of Form 20-F may be furnished in lieu of the information specified by Item 18 thereof if the securities being registered are non-convertible securities that are "investment grade securities," or the only securities to be registered are to be offered: (a) upon the exercise of outstanding rights granted by the issuer of the securities to be offered, if such rights are granted on a pro rata basis to all existing security holders of the class of securities to which the rights attach and there is no standby underwriting in the United States or similar arrangement; (b) pursuant to a dividend or interest reinvestment plan; or (c) upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer of the securities to be offered, or by an affiliate of such issuer. Items 17 and 18 each deal with the furnishing of financial statements. Form 20-F, Part III.

A non-convertible security is an *investment grade security* if, at the time of sale, at least one nationally recognized statistical rating organization (as that term is used in Rule 15c3-1(c)(2)(vi)(F) under the Exchange Act) has rated the security in one of its generic rating categories (within which there may be sub-categories or gradations indicating relative standing) that signify investment grade.

In July 2008, the SEC proposed amendments that would permit foreign private issuers to comply under Item 17 of Form 20-F in a registration statement or private offering document if the issuer has issued, as of a date 60 days prior to the filing of the registration statement, for cash more than \$1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years. Security Ratings, Securities Act Release No. 8940, Securities Exchange Act Release No. 58071 (July 1, 2008).

(n13)Footnote 13. Item 1(A)-(C), Form 20-F. The registrant has to provide the information in subsection (b) if it is required to disclose the information in a jurisdiction outside the United States. These persons will not be considered "experts" or "sellers" under the Securities Act solely due to the fact that they are named in response to subsection (b). Instructions, Item 1(B), Form 20-F.

(n14)Footnote 14. Item 3(D), Form 20-F.

(n15)Footnote 15. Item 2(A)-(B), Form 20-F.

(n16)Footnote 16. Item 3(A), Form 20-F. Throughout Form 20-F, the terms "financial year" and "fiscal year" have the same meaning. The term "fiscal year" is defined in Rule 405 under the Securities Act and Rule 12b-2 under the Exchange Act. Instruction 2, Item 3, Form 20-F. Selected financial data for a predecessor may be required. See the definition of "predecessor," as defined under Rule 12b-2 under the Exchange Act and Rule 405 under the Securities Act. Instruction 1, Item 3(A), Form 20-F.

The registrant may present the selected financial data on the basis of the accounting principles used in its primary financial statements. If, however, the registrant uses a basis of accounting other than International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board (the "IASB"), the registrant must also reconcile the data to U.S. GAAP and Regulation S-X, pursuant to Items 17 or 18 of Form 20-F. In that case, the registrant need only reconcile the information to U.S. GAAP for (i) those periods for which it was required to reconcile the primary annual financial statements in a filing under the Securities Act or the Exchange Act and (ii) any interim periods. Instruction 2, Item 3(A), Form 20-F.

If the registrant is unable to provide selected financial data for the earliest two years of the five-year period, it must submit the required representation before or at the time of filing. The registrant must also disclose that such data has been omitted and provide an explanation for the omission. *Id.*

(n17)Footnote 17. Item 3(B), Form 20-F. If the registrant is including the capitalization table in a prospectus supplement for a shelf offering registered on Form F-3, the amounts shown in the table may be as of the date of the most recent balance sheet filed as part of the registration statement, if the information in the table is updated to reflect securities issued up to 60 days prior to the date of the supplement. Instruction 1, Item 3(B), Form 20-F.

If the registrant is not selling new securities in a firm commitment underwritten offering or an "all or none" best efforts offering, it must reflect the capitalization "as adjusted" for the net proceeds of the offering in the following ways:

(i) In a best efforts "minimum/maximum" offering, the registrant must reflect both the minimum and maximum proceeds; and

(ii) In a rights offering or an offering of securities upon the exercise of outstanding warrants, the registrant must reflect the proceeds only to the extent the exercise of the rights or outstanding warrants is likely in view of the current market price. Instruction 2, Item 3(B), Form 20-F.

(n18)Footnote 18. Item 3(C), Form 20-F.

(n19)Footnote 19. Instruction, Item 3(D), Form 20-F.

(n20)Footnote 20. Item 3(D), Form 20-F.

(n21)Footnote 21. Item 4(A), Form 20-F.

(n22)Footnote 22. Item 4(B), Form 20-F. The reference in this subsection to "the body of accounting principles used in preparing the financial statements" means the accounting principles used in preparing the primary financial

statements, not the accounting principles used only to prepare the U.S. GAAP reconciliation. Instruction 1, Item 4(B), Form 20-F.

(n23)Footnote 23. Instruction 2, Item 4(B), Form 20-F. See § 7.03[2][k][i][A] for the requirements of Item 101(a) of Regulation S-K.

(n24)Footnote 24. Item 4(C), Form 20-F.

(n25)Footnote 25. Item 4(D), Form 20-F. If oil and gas operations are material to the registrant of the registrant's subsidiaries' business operations or financial position, the registrant must provide the information specified in Subpart 1200 of Regulation S-K. Instruction 2, Item 4, Form 20-F. In the case of an extractive enterprise other than an oil and gas producing operation the registrant must provide material information about production, reserves, locations, developments and the nature of its interest. If individual properties are of major significance, it must provide more detailed information about those properties and use maps to disclose information about their location. Instruction 1(a), Item 4(D), Form 20-F.

If the registrant is giving reserve estimates, it must consult the staff of the Office of International Corporate Finance of the Division of Corporation Finance. That office may request that the registrant provide a copy of the full report of the engineer or other expert who estimated the reserves. See Rule 418 of Regulation C, 17 C.F.R. § 230.418, and Rule 12b-4 of Regulation 12B, 17 C.F.R. § 240.12b-4, for information about submitting supplemental information to the Commission and requesting its return. In publicly filed documents, the registrant must not disclose the estimates of reserves unless the reserves are proved or provable. The registrant is not permitted to give estimated values of those reserves, unless mandated by foreign law. If these types of estimates have already been provided to any person that is offering to acquire the registrant, however, the estimates may be included in documents relating to the acquisition. If the registrant is representing that the estimates of reserves, or any estimated valuation of those reserves, are based on estimates prepared or reviewed by independent consultants, it must name the consultants. Instruction 1(b), Item 4(D), Form 20-F.

If oil and gas operations are material to the registrant's or one of its subsidiaries' business operations or financial position, it must provide the information specified in Subpart 1200 of Regulation S-K and Appendix A to Item 4(D), attached to the end of Form 20-F. Instruction 1(c), Item 4(D), Form 20-F.

The Company is also required to furnish the information specified in any industry guide listed in subpart 229.800 of Regulation S-K that applies to it. Instruction, Item 4, Form 20-F. The industry guides applicable to registration statements include: (a) Guide 2: "Disclosure of Oil and Gas Operations"; and (b) Guide 7: "Description of Property by Issuers Engaged or to be Engaged in Significant Mining Operations." 17 C.F.R. § 229.802; Exchange Act Industry Guides 1-7.

However, if the registrant furnishes the information in Appendix A to Item 4(D), then it does not have to provide the information in Guide 2. Instruction, Item 4, Form 20-F. Appendix A to Item 4(D) requires the registrant to furnish the following information under appropriate captions (in tabular form if practicable, and with cross references, where applicable, to related information disclosed in the financial statements):

(a) As of the end of each of the last three fiscal years (but not for fiscal years ending prior to December 31, 1979), estimated net quantities of: (i) proved oil and gas reserves; (ii) proved developed oil and gas reserves; and (iii) oil and gas reserves applicable to long-term supply or similar agreements with foreign governments or authorities in which the registrant acts as producer; and

(b) Net quantities of oil (including condensate and natural gas liquids) and of gas produced for each of the last three fiscal years (but not for fiscal years ending prior to December 31, 1979) and the net quantities of each received during

each of these years applicable to long-term supply or similar agreements with foreign governments or authorities in which the registrant acts as producer by areas no larger than the geographic areas used for estimated reserves in paragraph (a) above.

(n26)Footnote 26. Item 5, Form 20-F. The registrant should refer to the Commission's interpretive release, Sec. Act Rel. No. 33-6835 (May 18, 1989), for guidance in preparing this discussion and analysis of the registrant's financial condition and results of operations. Instruction 1, Item 5, Form 20-F.

The discussion should focus on the primary financial statements presented in the document. The registrant should refer to the reconciliation to U.S. GAAP, if any, and discuss any aspects of the differences between foreign and U.S. GAAP that are not otherwise discussed in the reconciliation and that are necessary for an understanding of the financial statements as a whole. Instruction 2, Item 5, Form 20-F.

The registrant is encouraged, but not required, to supply forward-looking information, which is covered expressly by the safe harbor provisions of Section 27A of the Securities Act and Section 27A of the Exchange Act, but which differs from presently known data, which will have an impact on future operating results, such as known future increases in costs of labor or materials. If material, presently known data must be disclosed. Instruction 3, Item 5, Form 20-F.

(n27)Footnote 27. The registrant must provide the information required with respect to hyperinflation if hyperinflation has occurred in any of the periods for which it is required to provide audited financial statements or unaudited interim financial statements. See Rule 3-20(c) of Regulation S-X for a discussion of cumulative inflation rates that trigger this requirement.

(n28)Footnote 28. Item 5(A), Form 20-F.

(n29)Footnote 29. Item 5(B), Form 20-F.

(n30)Footnote 30. Item 5(C), Form 20-F.

(n31)Footnote 31. Item 6(A), Form 20-F.

(n32)Footnote 32. The term "plan" is used very broadly and includes any type of arrangement for compensation, even if the terms of the plan are not contained in a formal document. Instruction, Item 6(C), Form 20-F.

(n33)Footnote 33. Item 6(B), Form 20-F.

(n34)Footnote 34. Item 6(C), Form 20-F.

(n35)Footnote 35. If any of the listed persons beneficially owns less than one percent of the class of shares and that person's individual share ownership previously has not been disclosed to shareholders or otherwise made public, the registrant may indicate by an asterisk and explanatory footnote or similar means, that the person beneficially owns less than one percent of the class. The registrant may provide such explanation instead of providing that person's individual share ownership. Instruction, Item 6(E), Form 20-F.

(n36)Footnote 36. Item 6(E), Form 20-F.

(n37)Footnote 37. The major shareholders of a company are those shareholders that are the beneficial owners of 5% or more of each class of the voting securities (unless the registrant is required to disclose a lesser percentage in its home country, in which case that lesser percentage applies).

(n38)Footnote 38. Item 7(A), Form 20-F.

(n39)Footnote 39. An associate is an unconsolidated enterprise in which the registrant has a significant influence or

which has significant influence over the registrant.

(n40)Footnote 40. Significant influence over an enterprise is the power to participate in the financial and operating policy decisions of the enterprise but is less than control over those policies. Shareholders beneficially owning a 10% interest in the voting power of the registrant are presumed to have a significant influence on the registrant.

(n41)Footnote 41. Close members of an individual's family are those who may be expected to influence, or be influenced by, that person in their dealings with the registrant.

(n42)Footnote 42. Item 7(B), Form 20-F. If the lender is a bank, savings and loan association or broker dealer extending credit under Federal Reserve Regulation T, and the loans are not disclosed as nonaccrual, past due, restructured or potential problems under Exchange Act Industry Guide 3, the registrant's response may consist of a statement, if true, that the loans in question (A) were made in the ordinary course of business, (B) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons, and (C) did not involve more than the normal risk of collectibility or present other unfavorable features. Instruction 2, Item 7(B), Form 20-F.

(n43)Footnote 43. Accountants who provide a report on financial statements that are presented or incorporated by reference in a registration statement should note Article 2 of Regulation S-X. That Article contains the Commission's requirements for qualifications and reports of accountants. Instruction, Item 7(C), Form 20-F.

(n44)Footnote 44. This item refers to the registrant, but note that under Rules 3-05, 3-09, 3-10, 3-14 and 3-16 of Regulation S-X the registrant also may have to provide financial statements or financial information for entities other than the issuer. In some cases, the registrant may have to provide financial statements for a predecessor. See the definition of "predecessor" in Exchange Act Rule 12b-2 and Securities Act Rule 405. Instruction 1, Item 8, Form 20-F.

(n45)Footnote 45. The consolidated financial statements must report the net income attributable to the parent (or controlling interest) and the net income attributable to the noncontrolling interest. Item 5(b)(1)(iii), Regulation S-K.

(n46)Footnote 46. Item 8(A)(1), Form 20-F.

(n47)Footnote 47. Item 8(A)(2), Form 20-F. The registrant does not have to provide a balance sheet for the earliest of the specified three-year period if that balance sheet is not required by a jurisdiction outside the United States. The financial statements must be audited in accordance with U.S. GAAP, and the auditor must comply with the United States and Commission standards for auditor independence. See Article 2 of Regulation S-X with respect to the requirements for qualifications and reports of accountants.

In initial registration statements, if the presented financial statements are prepared in accordance with U.S. GAAP, the earliest of the three years may be omitted if that information has not previously been included in a filing made under the Securities Act or the Exchange Act. Selected financial data presented pursuant to Item 3(A) of Form 20-F for the full five fiscal years is still required. Instructions 1-3, Item 8(A)(2), Form 20-F.

(n48)Footnote 48. Item 8(A)(3), Form 20-F. The circumstances in which the Commission would accept an audit report containing a disclaimer or qualification are extremely limited. If this type of report is intended to be submitted, the Commission recommends that the registrant contact the staff of the Office of Chief Accountant in the Division of Corporation Finance in advance of filing the document. Instruction, Item 8(A)(3), Form 20-F.

(n49)Footnote 49. Item 8(A)(4), Form 20-F. For offerings of securities (a) upon the exercise of outstanding rights granted by the issuer of the securities to be offered, if the rights are granted pro rata to all existing security holders of the class of securities to which the rights attach; (b) pursuant to a dividend or interest reinvestment plan; or (c) upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer of the securities to be offered, or by an affiliate of that issuer, the 15-month period referred to above is extended

to 18 months. The provisions of this paragraph are not applicable if securities are to be offered or sold in a standby underwriting in the United States or similar arrangement. Instruction 2, Item 8, Form 20-F.

In calculating the 15-month requirement for the age of financial statements, the registrant must determine the age based on the period of time that has elapsed between the date of the balance sheet and "the time of the offering or listing," which means the time the registration statement is declared effective. Instruction 1, Item 8(A)(4), Form 20-F.

The additional requirement that financial statements be no older than 12 months at the date of filing applies only in those limited cases where a nonpublic company is registering its initial public offering of securities. The Commission will waive this requirement in cases where the registrant is able to represent that it is not required to comply with this requirement and that compliance is impracticable or involves undue hardship. This representation must be filed as an exhibit to the registration statement. If the 12-month requirement is waived, the registrant must comply with the specified 15-month requirement in this item. Instruction 2, Item 8(A)(4), Form 20-F.

(n50)Footnote 50. This sentence explains that the required interim financial statements may be in condensed form using major line items from the latest audited financial statements. To determine which major line items must be included in condensed interim information, see Rules 10-01(a)(1) through (7). Instruction 2, Item 8(A)(5), Form 20-F. Additionally, a registrant that files interim period financial statements under this item is not required to comply with Article 10 of Regulation S-X so long as the registrant: (a) prepares its annual financial statements in accordance with IFRS as issued by the IASB, (b) prepares its interim period financial statements in compliance with IAS 34 "Interim Financial Reporting," and (c) explicitly states its compliance with IAS 34 in the notes to the interim financial statements. Instruction 4, Item 8(A)(5), Form 20-F.

(n51)Footnote 51. This sentence requires the registrant to include interim financial information that has been published, if that information covers a more current period than the statements otherwise required by this Item 8 (Financial Information). The requirement covers any publication of financial information that includes, at a minimum, revenue and income information, even if that information is not published as part of a complete set of financial statements. Whenever more current interim financial information is provided in response to this requirement, the registrant must:

(a) Describe any ways in which the accounting principles, practices and methods used in preparing that interim financial information vary materially from the principles, practices and methods accepted in the United States, and

(b) Quantify any material variations, unless they already are quantified because they occur in other financial statements included in the document. Instruction 3, Item 8(A)(5), Form 20-F. A registrant is not required to provide the information described in (a) and (b) in this footnote if it files financial information and prepares its annual financial statements in accordance with IFRS as issued by the IASB.

(n52)Footnote 52. Item 8(A)(5), Form 20-F. For offerings of securities (a) upon the exercise of outstanding rights granted by the issuer of the securities to be offered, if the rights are granted pro rata to all existing security holders of the class of securities to which the rights attach; (b) pursuant to a dividend or interest reinvestment plan; or (c) upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer of the securities to be offered, or by an affiliate of that issuer, the interim financial statements must be as of a date within 12 months of the date of the document. The provisions of this paragraph are not applicable if securities are to be offered or sold in a standby underwriting in the United States or similar arrangement. Instruction 2, Item 8, Form 20-F.

(n53)Footnote 53. Item 8(A)(6), Form 20-F.

(n54)Footnote 54. Item 8(A)(7), Form 20-F. This item also requires disclosure of any material proceeding in which any director, any member of senior management or any affiliate is either a party adverse to the registrant or its subsidiaries or has a material interest adverse to the registrant or its subsidiaries. Instruction 1, Item 8(A)(7), Form 20-F.

(n55)Footnote 55. Item 8(A)(8), Form 20-F.

(n56)Footnote 56. Item 9(A), Form 20-F. When required to state the title of the securities, the title must indicate the type and general character of the securities, such as whether they are callable, convertible or redeemable and whether there is any preference or fixed rate of dividends. Instruction, Item 9(A), Form 20-F.

(n57)Footnote 57. This may be satisfied by providing the address of the lead underwriters for the offering. Instruction, Item 9(B), Form 20-F.

(n58)Footnote 58. Item 9(B), Form 20-F. If the registrant previously has not been required to file reports under Section 13(a) or 15(d) of the Exchange Act and any of the managing underwriters (or a majority of the principal underwriters) has been organized, reactivated or first registered as a broker-dealer within the past three years, it must disclose that fact. If true, it must also disclose that the principal business function of this underwriter will be to sell the securities being registered or that the promoters or founders have a material relationship with this underwriter. The registrant must give enough details to provide a clear picture of the underwriters' experience and its relationship with the registrant, the promoters or founders and their controlling persons. Instructions 2-3, Item 9(B), Form 20-F.

(n59)Footnote 59. Item 9(C), Form 20-F.

(n60)Footnote 60. Item 9(D), Form 20-F.

(n61)Footnote 61. Item 9(E), Form 20-F.

(n62)Footnote 62. Item 9(F), Form 20-F. Major categories of expenses include at least the following: registration fees, federal taxes, state taxes and fees, trustees' and transfer agents' fees, printing and engraving costs, legal fees, accounting fees, engineering fees, and any premiums paid to insure directors or officers for liabilities in connection with the registration, offer or sale of the securities being registered. Instruction, Item 9(F), Form 20-F.

(n63)Footnote 63. Instruction 2, Item 10, Form 20-F.

(n64)Footnote 64. Item 10(A), Form 20-F.

(n65)Footnote 65. Item 10(B), Form 20-F.

(n66)Footnote 66. Item 10(C), Form 20-F.

(n67)Footnote 67. Item 10(D), Form 20-F.

(n68)Footnote 68. Item 10(E), Form 20-F.

(n69)Footnote 69. Item 10(F), Form 20-F.

(n70)Footnote 70. Item 10(G), Form 20-F.

(n71)Footnote 71. Item 10(H), Form 20-F.

(n72)Footnote 72. *See § 7.03[2][k][x] supra.*

(n73)Footnote 73. If not otherwise required by this item, information in a registration statement or prospectus in response to Item 305(a)(2) of the Trust Indenture Act of 1939, 15 U.S.C. 77 aaa *et seq.*, as amended, is not required. Instruction 2, Item 12, Form 20-F.

(n74)Footnote 74. Item 12(A), Form 20-F.

(n75)Footnote 75. Item 12(B), Form 20-F.

(n76)Footnote 76. Item 12(C), Form 20-F.

(n77)Footnote 77. When required to state the title of the securities, the title must indicate the type and general character of the securities. Instruction 4, Item 12, Form 20-F.

(n78)Footnote 78. Item 12(D), Form 20-F.

(n79)Footnote 79. Instruction 3, Item 12, Form 20-F.

(n80)Footnote 80. Item 4A(a), Form F-1. Periodic reports include Form 6-K, Form 10-Q and Form 8-K filed under the Exchange Act.

For the registrant's fiscal years ending before December 15, 2011, financial statements or information required to be furnished by Item 4A shall be reconciled pursuant to either Item 17 or Item 18 of Form 20-F, whichever is applicable to the primary financial statements. For the registrant's fiscal years ending on or after December 15, 2011, financial statements or information required to be furnished by Item 4A shall be reconciled pursuant to Item 18 of Form 20-F. Instruction, Item 4A, Form F-1.

(n81)Footnote 81. Item 5(a), Form F-1.

The conditions for incorporating by reference any required consents are set forth in Rule 439. Note to Item 5(a), Form F-1.

(n82)Footnote 82. Item 5(b), Form F-1.

If it sends to security holders any of the information that is incorporated by reference in the prospectus, the registrant must send along with it any exhibits that are specifically incorporated by reference in that information. Note to Item 5(b)(1), Form F-1.

(n83)Footnote 83. Note to Item 5(b)(2), Form F-1.

(n84)Footnote 84. *See § 7.03[2][n] supra.*

(n85)Footnote 85. *See § 7.03[2][o] supra.*

(n86)Footnote 86. *See § 7.03[3][b]-[e] supra.*

(n87)Footnote 87. *See § 7.03[3][f] supra.*

(n88)Footnote 88. Instruction 1, Signatures, Form F-1.

(n89)Footnote 89. Form F-2 was rescinded under the 2005 Rules. The Commission proposed replacing Form F-3 with Forms A and B in its "Aircraft Carrier" release, thus eliminating the foreign/domestic distinction for registration forms. Sec. Act Re. No. 33-7606 (1998). Whether issuers filing on Form F-3 would use Form A or Form B would have depended upon the issuer meeting eligibility standards for Form B. *See § 7.01 supra* for a general discussion of the "Aircraft Carrier."

(n90)Footnote 90. General Instructions I(A), Form F-3.

(n91)Footnote 91. General Instruction I(A)(1), Form F-3.

(n92)Footnote 92. General Instruction I(A)(2), Form F-3.

(n93)Footnote 93. General Instruction I(A)(3), Form F-3. To be material the default in the aggregate must be material to the financial position of the registrant and its consolidated and unconsolidated subsidiaries, taken as a whole. See General Instruction I(A)(3), Form F-3.

(n94)Footnote 94. Discussed in § 7.03[3][d][i] *supra*.

(n95)Footnote 95. General Instructions I(B), Form F-3.

(n96)Footnote 96. The aggregate market value of the registrant's outstanding voting stock is computed by using the price at which the stock was last sold, or the average of the bid and asked prices of such stock, in the principal market for such stock as of a date within 60 days prior to the date of filing. Instruction, General Instructions I(B)(1).

(n97)Footnote 97. See Part I, Form 20-F. Item 18 deals with the requirements of disclosure of financial statements.

(n98)Footnote 98. A non-convertible security is an investment grade security if, at the time of sale, at least one nationally recognized rating organization, as defined by Exchange Act Rule 15c3-1(C)(2)(vi)(F), has rated the security in one of its generic rating categories that signify investment grade.

For the registrant's fiscal years ending before December 15, 2011, the financial statements included on Form F-3 may comply with Item 17 or Item 18 of Form 20-F. For the registrant's fiscal years ending on or after December 15, 2011, the financial statements included on Form F-3 must comply with Item 18 of Form 20-F.

In July 2008, the SEC proposed amendments that would no longer make NRSRO ratings a transaction requirement to permit registrants to register primary offerings of non-convertible debt securities for cash. Instead, primary offerings of non-convertible securities would be eligible under Form F-3 only if the register has issued, as of a date 60 days prior to the filing of the registration statement, more than \$1 billion in non-convertible securities for cash, other than common equity, through registered primary offerings over the prior three years. Security Ratings, Securities Act Release No. 8940, Securities Exchange Act Release No. 58071 (July 1, 2008).

(n99)Footnote 99. Transaction Requirement (3) of Form S-3 is discussed at § 7.04[1][a][ii][C] *supra*. In the case of such securities, the financial statements included on Form F-3 must comply with Item 17 or Item 18 of Form 20-F for a registrant's fiscal years ending before December 15, 2011; and for the registrant's fiscal years ending on or after December 15, 2011, the financial statements included on Form F-3 must comply with Item 18 of Form 20-F.

(n100)Footnote 100. Additionally, an affiliate may use Form F-3 to register securities for resale pursuant to the conditions specified in General Instruction C to Form S-8 if the registrant's financial statements in the Form F-3 comply with Item 18 of Form 20-F.

(n101)Footnote 101. Transaction Requirement (4) of Form S-3 is discussed at § 7.04[1][a][ii][D] *supra*.

(n102)Footnote 102. Transaction Requirement (6) of Form S-3 is discussed at § 7.04[1][a][ii][F] *supra*. Effective January 2008, the Commission adopted amendments to allow foreign private issuers with less than \$75 million in public float to register primary offerings of their securities on Form F-3. See Sec. Act Rel. No. 33-8878. As was noted with respect to registrant's using Form S-3, eligibility under General Instruction I(B)(5) of Form F-3 applies only to such registrant's ability to conduct a limited primary offering on Form F-3. Instruction 6 to General Instruction I(B)(5), Form F-3. That is, a registrant's eligibility to use Form F-3 under General Instruction I(B)(5) does not mean that the registrant meets the requirements of Form F-3 for purposes of any other rule or regulation of the Commission, except for Rule 415(a)(1)(x) concerning shelf registration. Sec. Act Rel. No. 33-8878.

(n103)Footnote 103. The definition of a WKSII is set forth in Rule 405. See § 7.04[1][a] *supra* for a discussion of

this definition.

(n104)Footnote 104. An automatic shelf registration statement can be used for all primary and secondary offerings securities of eligible WKSIs, other than those in connection with mortgage related securities, business combination transactions or exchange offers. *See § 7.04[1][a][iv] supra.*

(n105)Footnote 105. A previously effective Form F-3 that was not an automatic shelf registration when it became effective cannot be amended to become an automatic shelf registration statement. Instead the issuer must file a new registration statement. Question 118.05, Questions and Answers of General Applicability, Securities Act Forms.

(n106)Footnote 106. Until a prospectus, prospectus supplement, posteffective amendment to the registration statement or Exchange Act report incorporated by reference, identifying the selling security holders and the amount of securities to be sold by each of them (and, if included in a periodic or current report, a prospectus or prospectus supplement) is filed, as required by Rule 430B, pursuant to Rule 424(b)(7). General Instruction I(C)(1)(d), Form F-3.

(n107)Footnote 107. *See § 7.07[1][b], supra.*

(n108)Footnote 108. This information is discussed at § 7.04[1][b] *supra*.

(n109)Footnote 109. General Instruction IV(A), Form F-3.

(n110)Footnote 110. Pursuant to Rule 413(b). Also, the WSKI may add majority-owned subsidiaries as additional registrants, whose securities are eligible to be sold as part of the automatic shelf registration statement, by filing a post-effective amendment identifying the additional registrants. Persons required to sign the registration statement (the registrant, the additional registrants and certain other persons) must sign the post-effective amendment. General Instruction IV(B), Form F-3.

(n111)Footnote 111. General Instruction IV(B), Form F-3.

(n112)Footnote 112. *See* Rule 462(e) and Rule 462(f), Regulation C.

(n113)Footnote 113. *See § 7.04[1][c] supra.*

(n114)Footnote 114. *See § 7.07[1][g][ii][B] supra.*

(n115)Footnote 115. *See § 7.07[1][g][ii][C](2) supra.*

(n116)Footnote 116. *See § 7.07[1][g][ii][C](3) supra.*

(n117)Footnote 117. *See § 7.07[1][g][ii][G](3) supra.*

(n118)Footnote 118. *See § 7.07[1][g][ii][I] supra.*

(n119)Footnote 119. *See § 7.07[1][g][ii][J] supra.*

(n120)Footnote 120. *See § 7.07[1][g][ii][L] supra.*

(n121)Footnote 121. Item 4, Form 20-F.

(n122)Footnote 122. Material changes to be disclosed include changes in and disagreements with registrant's certifying accountant. For the registrant's fiscal years ending on or after December 15, 2009, disclosure pursuant to Item 16F of Form 20-F should be provided as of the date of the registration statement or prospectus. Instructions, Item 5, Form F-3.

(n123)Footnote 123. For a registrant's fiscal years ending before December 15, 2011, financial statements or information required to be furnished by this Item shall be reconciled pursuant to either Item 17 or Item 18 of Form 20-F, whichever is applicable to the primary financial statements. For a registrant's fiscal years ending on or after December 15, 2011, financial statement or information required to be furnished by this Item shall be reconciled pursuant to Item 18 of Form 20-F. *Id.*

(n124)Footnote 124. Instruction, Item 6, Form F-3. Reference is made to the Transaction Requirements in General Instruction I(B) that, in some cases, require the financial statements in the Form 20-F, Form 40-F or Form 10-K to comply with Item 18 of Form 20-F as a condition for eligibility to use Form F-3. *Id.*

(n125)Footnote 125. If the Registrant's latest filing on Form 20-F, Form 40-F or Form 10-K is amended to include the information specified in Item 18 of Form 20-F, the prospectus must state that the form has been so amended.

(n126)Footnote 126. Item 601(b)(101)(i), Regulation S-K.

(n127)Footnote 127. Item 6(d), Form F-3.

(n128)Footnote 128. Note to Item 6(d), Form F-3.

(n129)Footnote 129. *See § 7.04[1][e][x] supra.*

(n130)Footnote 130. *See § 7.04[1][f][i]-[iii] supra.*

(n131)Footnote 131. Item 601(b)(12), Regulation S-K.

(n132)Footnote 132. Item 512(a)(4), Regulation S-K.

(n133)Footnote 133. The information called for by Item 512(a) of Regulation S-K to be furnished in response to Item 17 of Form S-3 is discussed in § 7.04[1][f][iii] *supra*.

(n134)Footnote 134. *See § 7.04[1][f][iv] supra.*

(n135)Footnote 135. Instructions, Signatures, Form F-3.

The term "authorized U.S. representative" generally refers to an individual who is an employee of the registrant or an affiliate, or the registrant's counsel or underwriter in the United States for the offering. The Commission generally has refused to accept the appointment of a newly formed or shell corporation in the United States as the authorized representative. In the case of registrants with dual governing boards, the registration statement should be signed by whichever board has the authority to bind the registrant and performs functions most similar to those of a U.S. registrant's board of directors. In some cases, this may require the signatures of the members of both governing boards. Question 102.01, Questions and Answers of General Applicability, Securities Act Forms.



89 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 7A.syn

AUTHOR: Peter J. Romeo

§ 7A.syn Synopsis to Chapter 7A: The Registration Process

§ 7A.01 Introduction

[1] Overview

[2] Liability

[3] Important Developments

[a] SEC Reforms.

[b] Sarbanes-Oxley Act.

§ 7A.02 Key Players

[1] Parties Responsible for the Registration Statement

[a] Issuer.

[b] Directors, Officers and Controlling Persons.

[c] Sellers.

[d] Underwriters.

[e] Auditors and Other Experts.

[f] Counsel.

[2] Regulatory Authorities

[a] SEC.

[b] State Securities Authorities.

[c] Securities Exchange.

[d] FINRA.

[3] Other Essential Parties

§ 7A.03 Offering Methods

[1] Firm Commitment

[a] Selection of Underwriters.

[b] Underwriting Documents.

[c] Formation of Syndicate and Selling Group.

[2] Best Efforts

[3] Self-Underwritten

[4] Online

§ 7A.04 General Considerations

[1] IPOs

[a] Advantages.

[b] Disadvantages.

[2] Timetable

[3] Expenses

[4] Gun Jumping

[a] Free Writing Prospectuses.

[b] Traditional Offering Communications.

[c] Preventive Actions.

[5] Integration

[a] The Five-Factor Test.

[b] Methods of Avoidance.

§ 7A.05 Preparation and Filing of Registration Statement

[1] Joint Effort

[2] Preliminary Work

[3] Organizational Meeting

[4] Due Diligence

[5] Drafting Responsibilities.

[6] Plain English

[7] Materiality

[8] Forward-Looking Information

[9] Financial Statements and Data

[10] Risk Factors

[11] Management's Discussion and Analysis ("MD&A")

[12] Description of Business

[13] Pre-Filing Conferences

[14] Filing Requirements

[a] Electronic Form.

[b] Place of Filing.

[c] Date of Filing.

[d] Registration Fee.

[e] Proper Form.

[f] Delaying the Effective Date.

[g] Signature Requirements.

[h] Other Required Items.

§ 7A.06 SEC Review

[1] Statutory Framework

[2] The Review Process

[a] Organization of the Review Staff.

[b] Assignment of Filings.

[c] Time Required.

[3] The Comment Letter

[a] Responding to the Staff's Comments.

[b] Appeals of Adverse Comments.

[c] Expediting the Review Process.

[4] Special Situations

[a] IPOs.

[b] Follow-On Offerings.

[c] Shelf Offerings.

[d] Business Combinations.

[e] Asset-Backed Securities Offerings.

[f] Employee Benefit Plans.

[g] Selling Security Holders.

[h] Foreign Issuers.

[i] Risky Issuers.

[j] Small Business Issuers.

[5] Significant Processing Concerns

[a] Accounting Issues.

[b] Confidential Treatment.

[c] SEC Investigation.

[6] Marketing

[a] Circulation of Preliminary Prospectus.

[b] Road Show.

[c] Public Communications.

[d] Directed Share Program.

[7] Pricing and Effectiveness

[a] Acceleration of Effective Date.

[b] Pricing.

[c] Registration of Additional Shares.

[d] Recirculation Prior to Effectiveness.

[e] Effectiveness.

[8] Withdrawal or Abandonment

[9] Enforcement

§ 7A.07 The Post-Effective Period

[1] Prospectus Delivery

[2] Over-Allotment Option

[3] The Closing

[4] Post-Closing Events

[a] Required Filings.

[b] Deregistration.

[c] Public Company Memo.

Peter J. Romeo n*

FOOTNOTES:

(n1)Footnote *. This chapter was prepared by Peter J. Romeo, a lawyer and certified public accountant, and a partner in the law firm of Hogan & Hartson L.L.P. in Washington, D. C. Mr. Romeo formerly was with the Securities and Exchange Commission where he served in various legal capacities for 15 years, including four years as Chief Counsel of the Division of Corporation Finance. The author is grateful to Richard J. Parrino, partner of Hogan & Hartson L.L.P., for his review of this chapter prior to its publication.



90 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 § 7A.01

AUTHOR: Peter J. Romeo

§ 7A.01 Introduction

[1] Overview

The Securities Act of 1933 ("Securities Act") is based on the premise that investors are fully capable of evaluating the merits of a securities offering if they are furnished with accurate and complete information regarding the issuer of the securities and the offering itself. Disclosure is the purpose of the statute, and registration of securities with respect to an offering is the principal tool used to achieve that purpose. n1

The focal point of registration is the registration statement, n2 which is filed with the SEC and consists of two parts: a prospectus that is used to offer the securities to the investing public and a separate segment containing supplemental information that is not furnished to investors. n3 The prospectus contains both narrative and financial information about the issuer and the offering, n4 and is intended to provide prospective investors with a balanced picture of all relevant material information.

The process of registration begins with the preparation of the registration statement by a team typically consisting of members of the issuer's management, investment bankers representing the underwriters for the offering, lawyers for the issuer and the underwriters, and representatives of the auditor for the issuer. During the period the registration statement is being drafted, the responsible parties conduct a due diligence review of the issuer in an effort to ensure that the information in the registration statement satisfies the requirements of the Securities Act. A properly conducted due diligence review will provide these persons (other than the issuer) with a defense against liability that may arise from claims by investors in the offering that they suffered losses because the disclosures in the registration statement were materially deficient.

When the registration statement is deemed by the responsible parties to be accurate and complete, it is filed with the SEC. Some types of registration statements become effective automatically upon filing, but the others typically are examined by the SEC staff soon after filing to determine whether a detailed review of some or all of the registration statement should be conducted. Where a registration statement is selected for review (and virtually all registration statements for initial public offerings are so selected), the staff will examine it closely and issue a "comment letter" describing disclosure deficiencies or other issues identified by it. The issuer will address the staff's concerns in

amendments to the registration statement and informal letters or other communications. When the staff believes that its concerns have been satisfactorily addressed, it will make the registration statement effective upon request by the issuer. At that point, the issuer can complete the selling process by confirming sales to investors and taking the other steps necessary to complete the offering.

[2] Liability

The liability provisions of the Securities Act are essential to the successful application of the Act to registered offerings. n5 Without these provisions, which expose the principal parties involved in an offering to severe sanctions for violations of the Act, there would be little incentive to comply with the Act's requirements. Liability for a deficient registered offering can arise under the following provisions of the Act: n6

- Section 11 permits purchasers to sue the parties responsible for the preparation of the registration statement (i.e., the issuer, directors, officers who signed the registration statement, underwriters, and auditors and other experts) for losses sustained as a result of material misstatements or omissions in the registration statement; n7

- Section 12(a)(2) entitles purchasers to rescind the purchase (or sue for damages if they have already sold the security) if the offer or sale was made by means of a prospectus or oral communication containing material misstatements or omissions; n8

- Section 17(a)(2) prohibits the use of material misstatements or omissions to obtain money or property by any person involved in the offer or sale of a security. n9

Liability under Sections 12(a)(2) and 17(a)(2) is determined at the time of the contract of sale, rather than at a later date after the commitment to invest has been made. n10 In contrast, liability under Section 11 is determined at the time the registration statement becomes effective. n11 The statute of limitations for violations of Section 11 or 12(a)(2) of the Securities Act is one year from date of discovery or three years from the date of the violation. n12

The sanctions for violations of the Act can be substantial. They include civil and criminal money penalties, imprisonment, cease-and-desist orders, and injunctions against future violations. n13 The severity of these sanctions provides considerable motivation to the parties involved in a registered offering to take all of the steps necessary to ensure that the registration statement is accurate and complete and that the offering is conducted in a non-fraudulent manner.

[3] Important Developments

There have been two developments this past decade that have had a major impact on the registration process. The most significant development was the SEC's adoption in 2005 of the most encompassing changes to the registration requirements since the enactment of the Securities Act in 1933. Of lesser significance, but still of considerable importance, was the enactment in 2002 of the Sarbanes-Oxley Act by Congress.

[a] SEC Reforms. On December 1, 2005, the SEC implemented major changes to the requirements for registered public offerings. n14 These revisions, which are discussed as appropriate in the remainder of this chapter, generally have reduced the burdens of the registration process and increased the timeliness of information furnished to prospective investors. Among other things, the revisions:

- Liberalized offering communications; n15
- Improved shelf registration and other offering procedures; n16

- Limited the circumstances under which physical delivery of prospectuses is required; n17 and
- Clarified the timing of liability for information delivered to investors. n18

[b] Sarbanes-Oxley Act. Congress enacted the Sarbanes-Oxley Act in response to numerous corporate scandals resulting from false financial reports. Sarbanes-Oxley was not directed at the registration process, but nonetheless has a significant impact on it. Companies that are public are required by Sarbanes-Oxley, among other things, to conform to applicable corporate governance standards regarding the independence of their audit committee, n19 maintain sound internal controls, n20 and have their CEO and CFO certify to the accuracy of periodic reports containing company financial statements n21

FOOTNOTES:

(n1)Footnote 1. Relatively few offerings actually are registered, due to the availability of a variety of exemptions from registration provided by the Securities Act.

(n2)Footnote 2. See Chapter 7 for information regarding the various registration forms that are available to register securities and the conditions for using them. Form S-1 (or for foreign private issuers, Form F-1) is utilized when no other form is authorized or prescribed for a securities offering. Form S-1 commonly is used for initial public offerings and for offerings by issuers who do not qualify for Form S-3 (an abbreviated form) or any of the registration forms directed to specified types of offerings (such as Form S-8 for offerings under employee benefit plans). *See also* K&L Gates, Securities Practice Guide § 5.02, Choosing The Right Registration Form--Form S-1, S-3, (2009 Edition).

(n3)Footnote 3. Both the prospectus and the supplemental information are available to the public upon filing with the SEC. See Rule 120 under the Securities Act, which indicates that registration statements filed electronically can be accessed through the SEC's web site (<http://www.sec.gov>).

(n4)Footnote 4. The information required to be disclosed in the prospectus portion of a registration statement is specified in the applicable registration form. Each registration form contains a series of "items" and related instructions that typically refer to the disclosure requirements contained in Regulation S-K, 17 C.F.R. § 229, and to the financial statement requirements contained in Regulation S-X, 17 C.F.R. § 210. In addition, Industry Guides set forth at 17 C.F.R. § 229.800 may apply to issuers in selected industries.

(n5)Footnote 5. For a discussion of liability under the Securities Act following major reforms adopted by the SEC in 2005, see J. McLaughlin, *Liability Considerations of Securities Offering Reform*, Sec. Lit. Rep. (Legalworks) (January-February 2006).

(n6)Footnote 6. In addition to the liability provisions of the Securities Act, liability for the CEO and CFO of an issuer in a registered public offering also can arise under Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") where the CEO and CFO issue certifications of deficient periodic reports filed under the Securities Exchange Act of 1934 ("Exchange Act") that are incorporated by reference into the registration statement under the Securities Act.

(n7)Footnote 7. The Supreme Court, in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), made it more difficult for plaintiffs to plead and prove losses in registered offerings due to fraud (i.e., material misstatements or omissions) by requiring the plaintiff to allege that the loss suffered by the purchaser in the aftermarket was the direct result of the fraud becoming known in the marketplace.

(n8)Footnote 8. The defendant, however, may avoid liability under Section 12(a)(2) by proving that the misstatements or omissions did not cause the loss. See Section 12(b) of the Securities Act.

(n9)Footnote 9. The SEC has indicated that Sections 12(a)(2) and 17(a)(2) "do not require that oral statements or

the prospectus or other communications contain all information called for under our line-item disclosure rules or otherwise contain all material information." Sec. Act Rel. No. 33-8591, § IV.A.1. at n.393 (2005).

(n10)Footnote 10. See Rule 159, which was adopted by the SEC as part of major Securities Act registration reforms that became effective on December 1, 2005. As a result of Rule 159 and Rule 430B(g), any information (whether written or oral) that might mitigate liability but is conveyed to the purchaser after the time of sale, including subsequently provided information deemed part of and included in or incorporated by reference into the registration statement or prospectus, is disregarded for purposes of determining liability. See Sec. Act Rel. No. 33-8591, § IV.A.1. (2005). See also J. McLaughlin, *Securities Offerings, Late-Breaking Information and the SEC's Rule 159*, 38 Sec. Reg. & L. Rep. (BNA) 1077 (June 19, 2006); L. Silverman and J. Karpf, *When Time of Sale Disclosure Turns Out to be Wrong: Reforming the Securities Sale Contract*, 40 Rev. Sec. & Comm. Reg. 35 (February 21, 2007).

(n11)Footnote 11. See Section 11(a) of the Securities Act. The decision in *Krim v. PCOrder.com, Inc.*, 402 F.3d 489, Fed. Sec. L. Rep. (CCH) P 93,126 (5[th] Cir. 2005), has narrowed (in the Fifth Circuit, at least) the class of plaintiffs that can sue under Section 11. See generally N. Hensley, N. Even and T. Behrens, *Court of Appeals for the Fifth Circuit Sharply Curtails Potential Liability Under Section 11 of the Securities Act of 1933*, 37 Sec. Reg. & L. Rep. (BNA) (April 11, 2005) 643.

(n12)Footnote 12. See Section 13 of the Securities Act.

(n13)Footnote 13. See the following provisions of the Securities Act: Section 20(d)(2) (civil money penalties per violation of up to \$100,000 for natural persons or \$500,000 for other persons); Section 24 (criminal penalties for willful violations of up to \$10,000 and up to five years of imprisonment); Section 20(b) (injunctions); and Section 8A (cease-and-desist orders).

(n14)Footnote 14. See Sec. Act Rel. No. 33-8591 (2005). See also M. Watson, *SEC Adopts Major Changes to the Registered Offering Process Under the Securities Act of 1933*, Insights (August 2005) 27.

(n15)Footnote 15. See § 7A.04[4] *infra*.

(n16)Footnote 16. See § 7A.06[4][c] *infra*.

(n17)Footnote 17. See § 7A.07[1] *infra*.

(n18)Footnote 18. See § 7A.01[2] *supra*.

(n19)Footnote 19. See Section 301 of the Sarbanes-Oxley Act.

(n20)Footnote 20. See Section 404 of the Sarbanes-Oxley Act.

(n21)Footnote 21. See Sections 302 and 906 of the Sarbanes-Oxley Act. A joint report issued by two American Bar Association Committees in late 2009 concluded that the U. S. regulatory climate following the enactment of the Sarbanes-Oxley Act has contributed to the erosion of the dominance of the U.S. capital markets that generally existed during the six decades following the end of World War II. According to the report, the decline in the U.S. competitive position is evidenced in the U.S. share of "global IPOs (i.e., initial public offerings done outside a company's home country). The U S. share of these IPOs declined in value from 50 percent in 2000 to five percent in 2005, and in number from 37 percent in 2000 to 10 percent in 2005. Joint Report of the Committee on Business and Corporate Litigation and the Committee on Federal Regulation of Securities, *Federalization of Corporation Law in a Time of Crisis--Which Institutions Are Best Able to Improve Corporate Governance and Performance Going Forward?*, presented by the ABA Business Law Section at its 2009 Winter Meeting (November 20, 2009) 13-15.



91 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 § 7A.02

AUTHOR: Peter J. Romeo

§ 7A.02 Key Players

The parties involved in the registration process fall into three major categories. The first consists of the persons responsible for the preparation and filing of the registration statement. The second is composed of the regulatory authorities which administer the numerous legal requirements applicable to registered public offerings. And the third includes parties which provide various ancillary services necessary to complete the public offering process.

[1] Parties Responsible for the Registration Statement

Section 11(a) of the Securities Act states that in the event of a material misstatement or omission in a registration statement, an investor may sue:

- Every person (including the issuer) who signed the registration statement; n1
- Every person who was a director, or person performing similar functions, of, or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which liability is asserted;
- Every person who, with the person's consent is named in the registration statement as being or about to become a director or person performing similar functions, or partner;
- Every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with the person's consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in the registration statement, report, or valuation which purports to have been prepared or certified by the person; and
- Every underwriter with respect to the security that was offered and sold. n2

In addition, Section 15 of the Securities Act exposes to liability any person who controls a party liable under Section 11.

[a] Issuer. Only the issuer can register securities. n3 It may do so on its own behalf (a "primary offering") or on behalf of selling security holders (a "secondary offering"). n4 The term "issuer" is broadly defined in Section 2(a)(4) of the Securities Act and includes "every person who issues or proposes to issue any security." n5

The issuer is the most important party involved in the registration process. In addition to offering its securities to the public, the issuer participates (through its management) in practically all activities necessary to complete the process. These include selection of a managing underwriter (in the case of an underwritten offering), the conduct of due diligence, preparation of the registration statement, compliance with regulatory demands, marketing of the offering, and pricing and closing of the offering.

Every issuer in a registered offering n6 is required by Section 6(a) of the Securities Act to sign the registration statement and is absolutely liable under Section 11(a) of the Act for material misstatements or omissions in the registration statement, regardless of good faith. n7

[b] Directors, Officers and Controlling Persons. Under Section 6(a) of the Securities Act, a majority of the issuer's board of directors, as well as its principal executive officer or officers, principal financial officer, and its comptroller or principal accounting officer, must sign the registration statement, along with the issuer. The entire board of directors (including any person named with his or her consent in the registration statement as about to become a director), n8 as well as the above-named officers, are subject to potential civil liability under Section 11(a) of the Act for material misstatements or omissions in the registration statement. n9 Further, any person who controls the issuer or any other party subject to liability under either Section 11 or Section 12 of the Act can be held liable to the same extent as the controlled person. n10

Unlike the issuer, directors, officers, and controlling persons can avoid liability by relying on the defense of "due diligence," which is available to persons who can demonstrate that after a reasonable investigation they had a reasonable basis for their belief that the registration statement was accurate and adequate. n11

[c] Sellers. Section 12(a)(1) of the Securities Act imposes absolute liability on any person who offers or sells a security in violation of the registration requirements of Section 5. n12 In the case of a registered offering, a seller can be held liable under Section 12(a)(2) of the Act for any material misstatements or omissions in the registration statement. Thus, Section 12(a)(2) can impose liability on selling stockholders who participate in a registered secondary offering of securities. Such persons, however, may rely on the due diligence defense if it is available. n13

[d] Underwriters. The principal role of the underwriters for a registered offering is to sell the securities at a price considered reasonable by the issuer and to foster a liquid aftermarket in the securities. n14 Ordinarily, there will be a lead underwriter who will manage the offering for the underwriting syndicate (if one is formed). Often, there will be co-managers who will be involved to varying degrees. Generally, the lead underwriter (with assistance from the co-managers) will lead the due diligence effort, participate in the prospectus drafting sessions, and oversee all aspects of the marketing process.

Every underwriter involved in a registered securities offering is subject to Section 11 liability for material misstatements or omissions in the registration statement, n15 absent an ability to rely on the due diligence defense. The term "underwriter" is broadly defined in Section 2(a)(11) of the Securities Act to encompass not only professional underwriting firms being paid to bring an issue to market, but also individuals and other parties who are conduits for a distribution to the public. n16

[e] Auditors and Other Experts. Section 11(a)(4) of the Securities Act subjects "experts" to potential liability for material misstatements or omissions in any part of a registration statement purporting to be based on their authority as experts. While the term "expert" is not formally defined in the Securities Act, it is intended by virtue of Sections 7 and 11 of the Act to refer to "any accountant, engineer or appraiser, or any person whose profession gives authority to a statement made by him." n17 Generally, in most underwritten offerings (other than those of oil and gas and similar

natural resource companies) the only expert involved is the independent registered public accounting firm that has audited the financial statements. Other experts, however, may be consulted while the prospectus is being prepared to provide independent verification of important matters.

The accountants assume a critical role in the offering process. In addition to auditing the year-end financial statements and conducting a limited review of any interim financial statements included in the prospectus, the accountants will perform several other important functions. These include (i) participating in the due diligence process relating to the financial statements, pro forma financial information (if any) and "Management's Discussion and Analysis"; (ii) furnishing to the underwriters one or more "comfort letters" relating to various accounting and financial data included in the prospectus; and (iii) helping identify significant accounting issues that may warrant a pre-filing conference or other consultation with the SEC staff.

Due in large part to the substantial number of accounting scandals and financial restatements in recent years, the Sarbanes-Oxley Act instituted a number of reforms to heighten auditor independence and increase auditor oversight. The measures include (i) restrictions on non-audit services; (ii) rotation of the lead audit partner at least every five years; (iii) a prohibition against auditing a company having a high level executive who worked on the prior year's audit as an employee of the auditor; and (iv) a prohibition against improper influence by company personnel on the conduct of the audit. n18 The effort to increase auditor oversight consisted principally of the authorization of the Public Company Accounting Oversight Board to (a) register firms that audit public companies; (b) oversee the audit activities of registered firms; (c) adopt auditing, quality control, ethics and independence standards for registered firms; (d) inspect registered firms periodically; and (e) discipline registered firms for violations of applicable standards or requirements. n19

Accountants and other experts can be held liable only if they are named with their consent in the registration statement as having prepared or certified any part of the registration statement or any report or valuation mentioned in it. n20 The filing of the consent provides some assurance that the expert has reviewed the disclosures in the registration statement pertaining to its work product and is satisfied with them.

It is possible under Rule 437 to request a waiver of the consent requirement when it can be demonstrated by affidavit that obtaining a consent is "impracticable or involves undue hardship on the registrant." The Commission, however, must agree to the waiver request prior to the effective date of the registration statement in order to dispense with the consent requirement. n21

[f] Counsel. Both the issuer and the underwriters engage counsel to assist them in meeting their responsibilities under the Securities Act. n22

Issuer's Counsel. The principal function of counsel to the issuer is to assist the issuer and its management in preparing the registration statement and performing the investigation necessary to support the disclosures in it. In performing this and other functions, issuer's counsel is subject to the attorney conduct requirements established by the SEC pursuant to Section 307 of the Sarbanes-Oxley Act. n23 Among other things, these provisions require counsel to engage in "up the ladder" reporting (ultimately to the board of directors, if necessary) of evidence of a material violation of securities law or breach of fiduciary duty or similar wrongdoing by the company or its agents. n24

Counsel for the issuer ordinarily is the principal drafter of the registration statement and solicits information from a variety of sources when doing so. While it may not be entirely appropriate to characterize the lawyer's role as that of a "scribe," counsel's function is limited generally to assisting the issuer in complying with the SEC's registration requirements, and does not involve any responsibility for the accuracy or completeness of the registration statement. n25

In addition to being the principal drafter of the registration statement, counsel to the issuer will take an active role in the

due diligence process and prepare the documents necessary to put the issuer's corporate house in order for the offering (i.e., the corporate clean-up). n26 Counsel also will perform a variety of other tasks for the issuer, including (i) taking the steps necessary to have the securities being registered listed on a stock exchange (if listing is desired) and, in the case of an initial listing, assisting the issuer to identify changes to board composition and other corporate governance matters that must be addressed to meet listing standards; (ii) preparing and filing a related registration statement under the Exchange Act for any equity securities being sold (assuming registration is considered necessary); (iii) attending to the issuer's obligations under any registration rights agreements with existing security holders; (iv) obtaining consents and post-offering share "lock-up" agreements from existing security holders as agreed by the issuer and managing underwriter; (v) rendering an opinion on the validity of the securities being offered; and (vi) issuing a "legal opinion" relating to the offering and a negative assurance letter addressed to the underwriters regarding the absence of any material misstatements or omissions in the registration statement.

Underwriters' Counsel. Counsel to the underwriters will be involved in all aspects of the offering that have legal implications for the underwriters. These include (i) assisting in the underwriters' due diligence investigation; (ii) helping to prepare the registration statement; (iii) preparing and negotiating the underwriting agreement and other underwriting documents (such as agreements among underwriters and lock-up agreements); (iv) negotiating the form of comfort letter to be received from the company's accountants; and (v) obtaining clearance of the proposed underwriting compensation from FINRA.

Counsel for the underwriters also may be responsible for taking the steps necessary to assure that all state "blue sky" requirements applicable to the offering are complied with, and reviewing from a legal perspective all proposed public announcements relating to the offering. Underwriters' counsel also performs various tasks relating to the closing of the offering, including (i) the issuance of a legal opinion providing negative assurance regarding the absence of any material misstatements or omissions in the registration statement, and (ii) the preparation of a memorandum detailing the actions needed to complete the closing. As in the case of issuer's counsel, counsel to the underwriters is not considered either an expert or a controlling person where counsel does no more than perform legal services for its clients. n27

[2] Regulatory Authorities

The SEC is the dominant regulator of registered securities offerings, although other regulatory authorities also have an interest in various aspects of these offerings. These include state securities commissions, the stock exchanges and FINRA.

[a] SEC. The Commission is vested with the authority to administer the Securities Act. n28 Because the Act is purely a disclosure statute, the Commission is not permitted to pass on the merits of securities offerings. As a result, the Commission's action in making a registration statement effective does not constitute approval of the offering, and a legend to that effect is required to be included on the outside front cover page of each prospectus. n29

The Commission possesses a number of powerful tools to promote compliance with the Securities Act. For example, it can decline to make a registration statement effective until it is satisfied that the disclosures in it are adequate. n30 This has the effect of preventing the offering from taking place on the issuer's timetable and forces the issuer to reach an accommodation with the Commission. If a materially deficient registration statement becomes effective through the passage of time, n31 the Commission can institute stop order proceedings under Section 8(d) of the Act suspending the effectiveness of the registration statement or take other measures having a similar effect. n32 In only a small number of cases, however, are drastic measures necessary because an informal process exists under which the registrant and the Commission engage in a cooperative effort to produce a registration statement that meets the requirements of the Act. This process involves the issuance by the Commission staff of a "comment letter" pointing out deficiencies in the registration statement and the responses by the registrant to the comments by either making appropriate changes or, in some instances, by persuading the Commission staff that specific comments should be withdrawn. n33 The purpose of

this informal process is to correct material deficiencies before any harm to investors has occurred, since no sales of securities can take place while the process is underway.

The Commission has delegated almost all of its authority for administering the disclosure requirements of the Securities Act to its staff. n34 Specifically, the Division of Investment Management processes the registrant statements of investment companies registered under the Investment Company Act of 1940, n35 and the Division of Corporation Finance assumes responsibility for the filings of all other issuers. n36

Over the years, the Commission has demonstrated a remarkable ability to adapt the Act to the realities of the times. For example, the adoption of various short registration forms in the 1970s and the full implementation of the integrated disclosure system in the early 1980s n37 did much to counter the concern that the requirements of the Act were unduly hampering the capital formation process. More recently, in 2005, the Commission adopted substantial reforms to the registration process that have helped expedite securities offerings by modernizing registration and prospectus delivery procedures, broadening the scope of permissible communications, and clarifying liability issues. n38 The continued vitality of the Securities Act more than 75 years after its passage is due in no small measure to the Commission's imaginative approach to its administration.

[b] State Securities Authorities. Prior to the enactment of the National Securities Markets Improvement Act of 1996 ("NSMIA"), n39 public offerings of securities were subject to substantial oversight by state securities authorities, many of which were able to impose merit standards on offerings. NSMIA changed this by adding an amendment to Section 18 of the Securities Act that in all material respects preempted state regulation of most registered securities offerings. n40

Although states no longer may engage in merit regulation of offerings, the states may still institute enforcement actions for fraud and under certain circumstances require the filing of notices and the payment of fees. As a result, it remains necessary to review the securities statutes and regulations, known as the "blue sky" laws, of each state in which the securities included in an offering will be offered or sold and comply with all applicable filing and fee requirements. As previously mentioned, counsel to the underwriters typically assumes this responsibility.

[c] Securities Exchange. A domestic issuer typically will want the securities that are being offered listed on a major national securities exchange, such as the New York Stock Exchange ("NYSE") or the Nasdaq Stock Exchange ("Nasdaq"), because of the exposure and liquidity afforded by such a listing. n41 The listing requirements for the various exchanges vary, although they generally are intended to provide some degree of assurance that the issuer is a stable entity with strong corporate governance procedures that is capable of producing consistent profits and filing regular reports under the Exchange Act of its activities. Counsel to the issuer is responsible for taking the steps necessary to (i) submit a listing application; (ii) petition for an exemption from listing requirements that the issuer may not be able to satisfy; and (iii) reserve in advance the issuer's proposed trading symbol.

[d] FINRA. The Financial Industry Regulatory Authority ("FINRA") is the largest independent regulator of securities firms doing business in the U.S. It was created on July 26, 2007 by consolidating the National Association of Securities Dealers ("NASD") with the member regulation, enforcement and arbitration functions of the NYSE. Among the functions assumed by FINRA from the NASD was the review of underwriting arrangements for registered public offerings to determine whether the compensation to be paid to the underwriters (all of which ordinarily are members of FINRA) is fair and reasonable. Counsel to the underwriters is responsible for taking the steps necessary to obtain FINRA clearance. These steps include (i) obtaining information (usually by questionnaire) concerning the affiliation of offering participants with FINRA members; (ii) providing that information to FINRA in the form of representations by the underwriters; (iii) filing drafts of the registration statement and underwriting documents with FINRA; and (iv) responding to questions or comments issued by the FINRA staff.

[3] Other Essential Parties

Other parties whose involvement in the offering often is necessary include the following:

Financial Printer. A financial printer prints both the preliminary and final prospectuses distributed to investors. n42

Security Printer. Unless the securities will be issued in "book-entry" form, it will be necessary to engage a printer to print certificates for the stock or debt securities sold in the offering.

Transfer Agent and Registrar. These parties are engaged to ensure that the corporate records pertaining to stock transfers and stockholders are properly maintained.

Standard & Poors Corporation's CUSIP Service Bureau. The Bureau will issue a nine-digit "CUSIP" number that identifies each new issue of securities approved for trading in the U.S. or Canada.

Securities Clearing Agency. A securities clearing agency (such as The Depository Trust Company) is engaged where the securities involved in the offering will trade in book-entry form.

Custodian and Attorney-in-Fact. If a secondary offering by selling stockholders is involved, these parties are needed to ensure the shares sold by the sellers are properly delivered.

Experts (Other Than the Auditor). Experts (such as engineers, in the case of oil and gas offerings) are engaged if there is a portion of the registration statement that requires an opinion or other action by an expert in the field.

Indenture Trustee. The indenture trustee is used in a debt offering to administer the provisions of the indenture for the offering.

Securities Rating Agency. Where preferred stock, debt, securities or asset-backed securities are being offered, the issuer will seek a rating for the securities from a securities rating agency.

Authorized Representative. An authorized representative in the U.S. is required in the case of registered offerings by foreign private issuers. n43

FOOTNOTES:

(n1)Footnote 1. Section 6(a) of the Securities Act states that the registration statement must be signed by "each issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions (or, if there is no board of directors or persons performing similar functions, by the majority of the persons or board having the power of management of the issuer)." A person who signs a document attached to the registration statement (such as a prospectus that was not part of the offering materials), but not the registration statement itself, is not liable under Section 11. *Dorchester Investors v. Peak International Ltd.*, [2000 to 2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,356 (S.D.N.Y. 2001).

(n2)Footnote 2. Damages for a material misstatement or omission in a registration statement generally are limited under Section 11(e) of the Securities Act to the difference between the cost of the security and its value at the time the suit was brought or the price at which the security was sold. Section 11(g) of the Act indicates that the damages cannot exceed the public offering price.

(n3)Footnote 3. It is possible to have more than one issuer named in a registration statement, as in the case of a simultaneous offering of debt securities by a subsidiary and a related guarantee by the parent. In such situations, both entities are considered issuers but only as to the respective securities issued by each. Where two or more entities jointly issue the same securities, they are deemed co-issuers.

(n4)Footnote 4. Selling security holders usually are able to have their securities registered only if they have previously obtained contractual rights to register the securities or if they have a control relationship with the issuer. It is not uncommon in connection with initial public offerings to have a combined primary and secondary offering, with the selling security holders usually consisting of a few senior executives and major shareholders of the issuer.

(n5)Footnote 5. In rare cases, the identity of the issuer may be clear, but it is not practical to name the person as an issuer. For example, the writers of exchange-traded options clearly are the issuers of such securities, but it is not possible in advance of registration to know the identities of these persons. In lieu of naming the writers, the Commission requires the Options Clearing Corporation, which services the respective exchanges, to be listed as the issuer and assume the obligations of an issuer.

(n6)Footnote 6. A synonym for an issuer involved in a registered offering is the word "registrant," which appears frequently in the rules, regulations and forms adopted by the Commission under the Securities Act. The two terms are used interchangeably throughout this chapter.

(n7)Footnote 7. An issuer is not subject to liability where it can establish that the plaintiff had knowledge, at the time of acquiring the securities at issue, of the alleged misstatement or omission. See Section 11(a) of the Securities Act. This defense is difficult to sustain with respect to a broadly distributed public offering.

(n8)Footnote 8. See Rule 438, which generally requires the filing of a written consent by any person named in the registration statement as about to become a director who has not signed the registration statement.

(n9)Footnote 9. Officers who do not sign a registration statement cannot be held liable under Section 11. See, e.g., *O' Sullivan v. Trident Microsystems, Inc.*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,116, at 98,911 (N.D. Cal. 1994).

(n10)Footnote 10. See Section 15. A controlling person may avoid liability by establishing that the person had no knowledge of, or reasonable grounds to believe, false or misleading statements were made. Id.

(n11)Footnote 11. See Section 11(b)(3) and the discussion of due diligence in § 7A.05[4] *infra*.

(n12)Footnote 12. For purposes of Section 12(a)(1), a "seller" is any person who successfully solicits a purchase of securities on the basis of a desire to serve the person's own financial interests or those of the owner of the security. *Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063 (1988). The effect of the *Pinter* decision is to expose underwriters, broker-dealers, selling agents, and others directly involved in the selling process to liability as sellers.

(n13)Footnote 13. See Section 12(a)(2).

(n14)Footnote 14. Selecting an underwriter when going public is an important decision because of the positive message the use of an established underwriter sends to the marketplace. See, e.g., J. Brau and S. Fawcett, *Evidence on What CFOs Think About the IPO Process: Practice, Theory and Managerial Implications*, 18 J. Applied Corp. Fin. (Summer 2006) 107.

(n15)Footnote 15. If liability is deemed to exist, there may be a question regarding the allocation of the liability among the various underwriters and other parties involved in the registration process. This is a matter that typically is addressed through indemnification and contribution provisions included in the underwriting agreement relating to the offering. See generally S. Older and J. Bloomstein, *Indemnification and Contribution in Underwritten Offerings*, Insights (January 2003) 15.

(n16)Footnote 16. For a considerable period of time, the SEC staff adhered to the "presumptive underwriter doctrine" under which all purchasers of ten percent or more of the securities in a registered offering were presumed to be statutory underwriters acting as conduits for a distribution of securities to the public. The staff abandoned this

approach in the early 1980's "for a more flexible test which analyzes the facts and circumstances of each offering." See *American Council of Life Insurance*, SEC No-Action Letter (May 10, 1983), [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,526 (1983).

(n17)Footnote 17. See generally Sections 7(a) and 11(a)(4). Not all persons who might at first glance be thought of as experts are so deemed under the Securities Act. For example, counsel whose function is limited to assisting the issuer in preparing the registration statement is not generally considered an expert. See *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 683 (S.D.N.Y. 1968). Also, by virtue of Rule 436(g)(1), a nationally recognized statistical rating organization whose security rating is disclosed in the prospectus is not considered an expert and need not file a consent to the use of its rating in the registration statement.

(n18)Footnote 18. See Sections 201-207 and 303 of the Sarbanes-Oxley Act.

(n19)Footnote 19. See Sections 101-105 of the Sarbanes-Oxley Act.

(n20)Footnote 20. See Sections 7 and 11(a)(4) of the Securities Act, and Rule 436. The exposure of accountants to Securities Act liability is significant. See, e.g., J. Candida, *Section 11 of the Securities Act of 1933: The Disproportionate Liability Imputed to Accountants*, 27 Del. J. of Corp. Law 565-85 (2002).

(n21)Footnote 21. Generally, the Commission and its staff are reluctant to grant waivers or otherwise undermine the consent requirement.

(n22)Footnote 22. In selecting counsel (and the auditor), it is important to do so on the basis of their expertise and ability, rather than previous relationships with the issuer or its insiders. Because the process of registering a public offering is complex and carries with it significant liabilities, it should be undertaken only with the assistance of advisors who can help make the process as efficient and pain-free as possible. See generally, *IPOs From the Inside Out: The CFOs Speak*, IPO Journal, 1-4, 12-13 (1999).

(n23)Footnote 23. The SEC has taken action in recent years against attorneys whom the SEC believed issued fraudulent legal opinions for public offerings. See S. H. Callcott and A. Slonecker, *A Review of Recent SEC Actions Against Lawyers*, 42 Rev. Sec. & Comm. Reg. 71 (2009).

(n24)Footnote 24. See Section 307 of the Sarbanes-Oxley Act, and Sec. Act Rel. Nos. 33-8185 (2003) and 33-8186 (2003). For a discussion of potential liability under Section 307 of the Sarbanes-Oxley Act and the rules of the SEC for attorneys involved in securities offerings, see L. Lowenfels, A. Bromberg, M. Sullivan, and D. Alberts, *SEC Actions Against Lawyers Post Sarbanes-Oxley: A Reasoned Approach or an Assault Upon the Practicing Securities Bar?*, 41 Sec. Reg. & L. Rep. (BNA) 1739 (September 21, 2009).

(n25)Footnote 25. See, e.g., Association of the Bar of the City of New York, *Report by Special Committee on Lawyer's Role in Securities Transactions*, Guidelines 4-6, 32 Bus. Law 1870, 1894-97 (1977).

(n26)Footnote 26. For a description of many of the tasks involved in the corporate clean-up, see § 7A.05[2] *infra* and R. Stevenson, Jr., *Preparing a Company for an Initial Public Offering*, 27 Rev. Sec. & Comm. Reg. 203 (1994).

(n27)Footnote 27. See, e.g., *In re Flight Transportation Corp. Securities Litigation*; 874 F. 2d 576 (8th Cir. 1989); *Antinore v. Reavis & McGrath*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,622 (D. Minn. 1984).

(n28)Footnote 28. See Section 21 of the Exchange Act. The Commission has broad authority under Section 28 of the Securities Act to exempt "any person, security, or transaction, or any class or classes of persons, securities or transactions" from any provision of the Act or the rules or regulations hereunder if the exemption is "necessary or appropriate in the public interest, and is consistent with the protection of investors."

(n29)Footnote 29. See Item 501(b)(7) of Regulation S-K and Rule 481(b)(1).

(n30)Footnote 30. Under Section 8(a) of the Securities Act, registration statements can, in theory, become automatically effective 20 days after being filed with the Commission. But both the Commission and registrants understand that automatic effectiveness within 20 days is not practical in most cases. As a result, a method for automatically delaying the effective date through the inclusion of a legend to that effect on the front cover page of the registration statement is utilized under Rule 473 to give the Commission final authority as to when the registration statement will be declared effective.

(n31)Footnote 31. This might occur, for example, where the issuer has not included an automatic delaying amendment on the front cover page of the registration statement of the type described in Rule 473 and the document becomes effective 20 days after filing, as provided by Section 8(a) of the Act.

(n32)Footnote 32. The other measures are described in § 7A.06[9] *infra* .

(n33)Footnote 33. Because of staff shortages, the Commission is unable to review every registration statement. Therefore, the Commission staff's comment process does not extend to every registration statement.

(n34)Footnote 34. The Commission has not delegated to its staff the authority to deny acceleration requests under the Securities Act or the authority to institute stop or refusal order proceedings under Section 8 of the Act.

(n35)Footnote 35. See 17 C.F.R. 200.30-5(b), (b) and (c).

(n36)Footnote 36. See 17 C.F.R. 200.30-1(a). The organization and operation of the Division of Corporation Finance are discussed in § 7A.06[2] *infra*.

(n37)Footnote 37. Sec. Act Rel. No. 33-6383 (1982).

(n38)Footnote 38. See Sec. Act Rel. No. 33-8591 (2005), and M. Watson, *SEC Adopts Major Changes to the Registered Offering Process Under the Securities Act of 1933*, Insights (August 2005) 27.

(n39)Footnote 39. Pub. L. No. 104-290 (October 11, 1996). For additional information regarding NSMIA, see Miller and O'Brien, *The National Securities Markets Improvement Act of 1996*, 30 Rev. Sec. & Comm. Reg. 21 (1997).

(n40)Footnote 40. Under Section 18, a state generally may not require the registration or qualification of a security or transaction, or prohibit or limit the use of any offering document prepared by or on behalf of an issuer in connection with an offering, if the security offered is a "covered" security (as defined in Section 18(b) of the Act) or will become one upon completion of the offering. The definition of "covered security" is broad enough to encompass most securities registered with the SEC.

(n41)Footnote 41. Following the passage of the Sarbanes-Oxley Act, which imposes substantial disclosure and corporate governance requirements on public companies listed on U.S. exchanges, many foreign issuers have chosen to list their securities solely on foreign exchanges.

(n42)Footnote 42. As indicated in § 7A.07[1] *infra* , the adoption of Rule 172 in 2005 eliminated the need to print and deliver final prospectuses in paper form, with the result that they are not always printed.

(n43)Footnote 43. The term "foreign private issuer" is defined in Rule 405. A foreign private issuer is generally a non-U.S. company that either has 50% or less of its outstanding voting securities held of record by U.S. residents or has more than 50% of its outstanding voting securities held by U.S. residents and has no other nexus with the United States of the type described in Rule 405. As indicated in § 7A.07[1] *infra* , the adoption of Rule 172 in 2005 eliminated the need to print and deliver final prospectuses in paper form, with the result that they are not always printed.



92 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 § 7A.03

AUTHOR: Peter J. Romeo

§ 7A.03 Offering Methods

Most issuers use professional underwriters (i.e., investment bankers or broker-dealers) to market their offerings because of the ability of these firms to price and sell securities successfully and to maintain a trading market in the securities after the offering is completed. But, as explained below, a small number of issuers choose to market their offerings themselves, while some others may use relatively uncommon offering methods.

[1] Firm Commitment

The most common method of offering is through a professional underwriter that firmly commits to buy from the issuer all of the securities included in the registration statement for immediate resale to the public. A firm commitment arrangement places the underwriters at risk if they are unsuccessful in finding public purchasers, although the risk is not as great as it may seem on the surface. n1 From the issuer's standpoint, a firm commitment arrangement almost always assures the offering will be completed following the signing of the underwriting agreement, although on rare occasions the offering may be withdrawn before the closing. n2

[a] Selection of Underwriters. An issuer that is an attractive candidate for a public offering may have several reputable underwriters from which to choose. It should make the selection carefully because the underwriter's performance is critical not only to the success of the offering, but also to a well-functioning aftermarket following an IPO. The issuer should consider a variety of factors when determining which underwriter to select. These include the stature of the underwriter in the investment community, its experience in the issuer's industry, the nature of its clientele (i.e., primarily institutional or retail), the aftermarket performance of the underwriter's prior offerings, the proposed underwriting discount, and the level of compatibility with the underwriter's representatives who will be working on the offering. In some instances, particularly where competing underwriters have complementary capabilities (e.g., one has recognized expertise in the issuer's industry, another has a strong institutional capability, and a third has a large retail sales force), the issuer may select two or more firms to co-manage the offering. One of the firms selected ordinarily will serve as the lead managing underwriter. The lead manager typically will assume the role of primary decision-maker for the syndicate of underwriters that may be formed to market the offering, and also will maintain the records for the syndicate. Following the completion of the offering, the managing underwriter typically will furnish other investment banking services to the issuer, including assisting in subsequent financing efforts as necessary, and providing expertise on valuation and other matters.

[b] Underwriting Documents. There are a variety of documents prepared for underwritten offerings by counsel for the underwriter. These documents are fairly standardized, and have undergone some changes in recent years to reflect the SEC's reforms to the securities offering process in 2005. n3 The principal underwriting documents are described below.

Letter of Intent. After the issuer and the prospective underwriter have completed preliminary discussions and arrived at a general understanding, they may sign a letter of intent. Major underwriters, however, often do not use these letters. The letter of intent typically will outline the proposed terms of the offering and the underwriting compensation, but is not binding on the parties, except as to specified matters. n4

Underwriting Agreement. The underwriting agreement specifies the terms under which the offering will be underwritten. The underwriting agreement not only indicates the obligations of the underwriters, but also the conditions to which those obligations are subject. n5 The underwriters' obligations typically are conditioned on the accuracy of the issuer's representations and warranties, the issuer's compliance with specified undertakings, the non-occurrence of certain specified adverse developments prior to the closing date, and the receipt of various documents. These documents typically include opinions of counsel as to various legal matters, representations from the issuer's auditor (set forth in a "comfort letter" that provides negative assurances regarding the accuracy of certain financial data included in the registration statement), and certificates by officials of the issuer as to factual and financial matters. The closing, at which time the securities included in the offering are formally purchased by the underwriters, in most instances takes place three business days after pricing the offering. The delay between pricing and closing allows the underwriters sufficient time to collect funds from their customers for the sale of the securities.

Agreement Among Underwriters. This document provides the managing underwriter with permission from members of the underwriting syndicate to act on their behalf in negotiating and executing the underwriting agreement.

Selected Dealers Agreement. In many instances, the managing underwriter will enter into agreements with selected securities dealers that are not part of the underwriting syndicate for the purchase by the dealers of securities in the offering. The selected dealers agreement will notify each dealer of the terms of the offering, the selling concession, the allotment anticipated to be purchased by the dealer (unless declined by a specified time), and the portion of the underwriting discount allocated to the dealer.

Blue Sky Memorandum. This document indicates the states in which filings must be made and fees paid in order to sell securities in those states. Where the securities being offered will be listed on a major national securities exchange, the underwriters may not require a blue sky memorandum because NSMIA essentially preempts state blue sky laws with respect to securities listed on those exchanges.

[c] Formation of Syndicate and Selling Group. Before the marketing effort for the offering is launched, the managing underwriter will circulate a copy of the Registration Statement to other selected underwriters as part of an invitation to join the underwriting syndicate for the offering. The managing underwriter typically will want to underwrite the largest individual portion of the offering and spread the balance among other underwriters to limit the managing underwriter's risk and assure its continuous compliance with the SEC's net capital requirements. The amount allocated to the invited underwriters generally will be based upon their historical position in the investment banking community and the managing underwriter's obligation to repay them for having invited the managing underwriter to participate in their offerings. The selling group will consist of the syndicate members and selected dealers, with the latter's selection often based in large measure on the extent to which their customers tend to hold securities acquired in an underwritten offering rather than sell them to make a quick profit. Too many "buy and flip" customers can drive down the price of the securities and adversely affect the managing underwriter's ability to maintain a strong aftermarket.

[2] Best Efforts

In a "best efforts" underwriting arrangement, the underwriter agrees only to use its best efforts to sell the securities offered by the issuer. The compensation paid to the underwriter is characterized as a commission rather than an underwriting discount because the underwriter is acting as an agent for the issuer rather than as a principal buying from the issuer at a discount. The amount of underwriting compensation is less than that for a comparably-sized firm commitment offering because the underwriter's risk is considerably reduced.

Generally, only small underwriters will undertake to sell an offering on a best efforts basis. Because their capital is limited, a temporary charge against net capital of the type required by a firm commitment offering may be a hardship, and it also may be difficult for them to assemble a selling group of the type customarily seen in a firm commitment offering. The issuer likewise usually is small and frequently is in the developmental stage, lacking an operating history or financial performance of the type needed to attract an underwriter on a firm commitment basis.

A best efforts offering is subject to the condition that a specified minimum number of shares must be sold within a specified time period if any shares are to be sold at all. There usually is a ceiling on the maximum number of shares that may be sold. Because of the conditional nature of the offering, the funds received from investors are held in escrow until the minimum offering level is achieved.ⁿ⁶ If the minimum amount is not sold within the prescribed period, the funds are returned to the investors. The SEC examines best efforts offerings closely, and is particularly attentive to whether the minimum is sold and all customer funds are collected before the offering period expires.

[3] Self-Underwritten

On rare occasions, a company will make an initial public offering ("IPO") of its securities (typically common stock) without the use of a professional underwriter. Although this will eliminate investment banking fees and reduce the expenses of the offering, the difficulties attendant to self-underwritten IPOs are so significant that few companies attempt them.ⁿ⁷

Companies offering their own securities usually are small and not well known in the investment community, making it difficult to attract investors. Even if enough investors are attracted to allow the issuer to sell the minimum number of securities to be sold, the company's lack of visibility may result in a thin aftermarket that is weak and difficult to sustain. These problems are in addition to the difficulties that may be experienced when dealing with the SEC and other interested regulatory authorities, which generally presume that self-underwritten offerings are highly risky and examine them closely. The absence of a professional underwriter is particularly damaging in the regulatory context because the lack of underwriter due diligence increases the likelihood that the prospectus for the offering will be materially deficient. As a consequence, issuers undertaking a self-underwritten offering should be prepared for a searching review by the SEC of their registration statement that is likely to take a great deal longer than an underwritten public offering.

[4] Online

The use of the Internet as a vehicle for securities offerings has been infrequent but attained considerable credibility as a result of the success of the Internet IPO by Google Inc. in 2004. The Google IPO involved a Dutch auction approach to setting the IPO price, under which all interested investors submitted bids on the Internet indicating how many shares they wished to buy and at what price. The price selected was the price at which all of the offered shares could be sold. In addition to using the Internet to set the price, Google also completed many of the other tasks attendant to a public offering through the Internet, including the qualification of investors, management of the bid process, and delivery of the preliminary and final prospectuses. The end result was an IPO that attracted much attention and was fully subscribed.

Investment bankers appear to have mixed views regarding online offerings. Although they acknowledge the broad investor access provided by the Internet, they are wary of the diminished control over pricing occasioned by the Dutch auction approach. Nevertheless, the genie may have escaped from the bottle insofar as the use of the Internet for public

offerings is concerned, making it possible for the Internet eventually to become a major vehicle for such offerings.

FOOTNOTES:

(n1)Footnote 1. The underwriters limit the risk by not committing themselves to purchase any securities until they sign the underwriting agreement, which often occurs at the time the offering price is fixed. At that point, they will have completed marketing activities and obtained indications of interest from their customers that enable them to negotiate with the issuer any changes in the size and price of the offering deemed necessary to complete the offering successfully. The late signing of the agreement also allows the underwriters to minimize the period during which they must charge their capital accounts under the Commission's minimum net capital rules with the amount of their respective contractual commitments.

(n2)Footnote 2. A "market-out" clause in the underwriting agreement allows the underwriter to terminate the offering before the closing upon the occurrence of significant unanticipated economic developments or other circumstances that adversely affect the market for the underwritten securities. See e.g., *Diametrics Medical Aborts IPO as Uite Claims PPG Trade Secrets Were Stolen*, Wall St. J. (August 12, 1993) at A1.

(n3)Footnote 3. See, e.g., S. Tsacoumis, *Impact of Securities Offering Reform on Underwriting Arrangements*, Insights (October 2005) 22.

(n4)Footnote 4. Among the matters that may be binding are commitments by the issuer to reimburse the underwriter for its expenses if the offering does not proceed, and to comply with specified conditions and undertakings prior to the filing of the registration statement.

(n5)Footnote 5. A common feature of the underwriting agreement is an over-allotment option which allows the underwriters, for a period that may range from seven to 30 days following commencement of the offering, the option to purchase up to a maximum of 15 percent of the total number of shares offered to cover over-allotments to customers on the same terms and conditions as the offered shares. See generally § 7A.07[2] *infra*.

(n6)Footnote 6. Rule 10b-9 under the Exchange Act states that it is unlawful under the antifraud provisions of Section 10(b) of that Act for any person involved in a best efforts offering to represent that the conditions of sale have been satisfied unless all of the securities required to be sold within the specified time period were sold in bona fide transactions and fully paid for by the date specified in the offering.

(n7)Footnote 7. An existing public company also may make a self-underwritten offering, but this has been an uncommon occurrence to date.



93 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 § 7A.04

AUTHOR: Peter J. Romeo

§ 7A.04 General Considerations

[1] IPOs

Most companies enter the public company arena through an initial public offering. Whether a company is a viable candidate for an IPO depends on a variety of factors, including the growth potential of the enterprise, the quality of its management, its size and financial performance, and the perception by potential professional underwriters of the company's appeal to the investing public. The fact that a company may possess the attributes for a successful IPO is no guarantee that one will occur. Volatile market conditions and other considerations may stall an IPO in its tracks. Further, an IPO may not necessarily be the best approach for a particular company making it important for the company's decision makers to consider both the advantages and disadvantages of going the IPO route that are described below before committing to that approach. n1

[a] Advantages. Among the benefits that can flow to a company from an IPO are the following:

Funds for Operations. The infusion of capital from an IPO will immediately increase the company's net worth and enable it to move forward on its plans for growth and expansion.

Liquidity for Owners. The public market created by the IPO for the company's common stock will provide a measure of liquidity for existing investors and a ready basis for valuing their ownership interests for estate planning and other purposes.

Expanded Possibilities for Subsequent Financings. A public company ordinarily can move beyond the bank borrowings and costly private equity capital typically used to finance private enterprises to public methods of financing.

Engine for Growth. Because of the readily ascertainable market value of a company's common stock after an IPO, the stock can be used as consideration for future acquisitions, thereby fostering the issuer's growth and conserving the company's cash.

Improved Ability to Attract and Retain Personnel. The company should be in a better position to attract and retain executives and other personnel because of its ability to offer stock options and other stock-based compensation with

significant potential for appreciation in value.

Recognition and Prestige. The perception of the company in the marketplace usually is enhanced by an IPO and often leads to better relations with employees, suppliers and customers.

[b] Disadvantages. An IPO carries with it some unwelcome baggage that should be taken into account before plunging into it, including the following:

High Costs. The costs of registration (including legal, accounting, printing and filing fees) before the underwriters' discount are likely to be at least \$500,000 (and often much more), and will be followed by the ongoing costs of complying with the continuous disclosure and other requirements of the securities laws, including the Sarbanes-Oxley Act.

Diversion of Management Time. The company's senior managers must devote a significant amount of their time to the registration process and to the ongoing tasks of meeting SEC requirements and performing other public company responsibilities.

Loss of Privacy. The company's financial results and operations will be subject to scrutiny by the investment community, competitors and regulators, and the company will have to make public disclosure of dealings with management, including disclosure of compensation and personal transactions.

Decreased Flexibility. Following an IPO, the company's officers are likely to have less flexibility in managing the business, since they will have to take into account the impact of their decisions on the stock price and various constituencies, including public shareholders.

Increased Legal Exposure. The disclosure documents of the company and public comments by its insiders could lead to lawsuits seeking recovery of funds allegedly lost from investments in the company's securities as a result of material misstatements or omissions in the documents or comments.

Potential Loss of Control. The ownership interests of existing stockholders will be diluted by an IPO, making possible in many instances an unwanted takeover attempt that could result in a shift of control.

[2] Timetable

The amount of time required to complete the registration process depends on a number of factors, including the complexity of the issuer's operations, the amount of corporate "clean-up" and other preliminary work that needs to be done, the workload of the Commission staff, and the familiarity of the issuer's lawyers and auditor with Commission regulations and practices. For an IPO, the amount of time required typically can range from a minimum of four months, to six months or more in some cases. For other offerings, the amount of time depends to a significant extent on whether the issuer can use a short registration form (such as, Form S-3, or, for foreign private issuers, Form F-3). If either of these forms is available, the time required for preparing and processing the registration statement is significantly reduced.

Issuers that have not previously registered securities with the Commission should expect that two or three months will be necessary to complete the steps necessary for filing the registration statement. In addition to the time required to draft the document, the working group will have to devote many hours to assembling all of the relevant information and confirming the accuracy and completeness of the draft disclosures. The working group will be required to hold numerous meetings, and frequently rewrite the prospectus to meet legal requirements, address marketing considerations, and reflect new information and recent developments.

After the registration statement has been filed with the Commission, it can be made effective in as short a period as a few business days after filing for some offerings not involving a first-time registrant (and, as discussed later, can even become effective automatically upon filing if the registrant is a well-known seasoned issuer).ⁿ³ At the other extreme, the registration statement may never be made effective if it is deemed by the staff to contain material deficiencies that have not been cured. Issuers that have not previously filed with the Commission can anticipate that the review process generally will take from at least six weeks, to ten or more weeks, assuming there is a good faith effort by the issuer to satisfy the staff's concerns.ⁿ⁴

[3] Expenses

The costs to the issuer of registering securities are significant and typically include underwriters compensation, legal and accounting fees, printing costs, and registration and other expenses, as indicated below. Because the total cost of registration depends on a variety of factors, including the size and complexity of the offering, it generally is not possible to make a valid comparison of expenses in specific instances.

Underwriters Compensation. The underwriters' discount or commission usually is the largest single expense of a registered offering. The amount will vary, depending upon the size of the offering, whether it involves debt or equity securities (with debt offerings usually involving a lower rate), the selling efforts required (with a highly speculative offering generally necessitating more effort than other offerings), competition from other underwriters, and market conditions. For an initial public offering, the underwriters' discount usually ranges between seven to ten percent of the gross offering proceeds. For a billion dollar debt offering rated at the highest investment grade levels, the underwriters' commission may be one percent or less. The underwriters also may receive other compensation in the form of expense reimbursements, options or warrants to purchase stock in the future, or "cheap stock" (i.e., stock issued in advance of the offering at a price well below the public offering price).

Legal Fees. Legal expenses of the issuer include fees paid to its counsel for preparing the registration statement, negotiating the letter of intent (if any) and underwriting agreement, conducting due diligence activities, assisting with the exchange listing process and performing the corporate "clean-up" tasks necessary to get the company in shape for the public offering. In addition, a legal fee customarily is paid by the issuer (usually to counsel for the underwriter) for preparing a survey of applicable state blue sky requirements and filing any required state notices.

Accounting Fees. As with legal fees, accounting costs are unavoidable. The amount varies, depending primarily on the strength of the company's internal controls and procedures, the need for including interim financial statements in the registration statement, and the extent of the procedures necessary to produce a comfort letter. Requirements of the Sarbanes-Oxley Act may cause some IPO companies to engage in extensive review and upgrading of their internal controls over financial reporting as part of their planning process.

Printing Costs. Although registration statements are not required to be printed, underwriters insist on printed documents for most types of offerings.ⁿ⁵ To minimize printing costs, many issuers use internally-produced drafts until the point is reached where the issuer and underwriters wish to distribute a preliminary prospectus.ⁿ⁶

Filing Fees. The filing fees charged by the SEC, FINRA and a stock exchange can be significant, although they ordinarily constitute a relatively small portion of the total expenses. The Commission's fee for its 2009 fiscal year was \$55.80 per million dollars of securities being registered.ⁿ⁷ Stock exchange fees are based on the number of shares being listed, with a surcharge for initial listing applications. In certain limited circumstances involving securities not listed on a stock exchange, state regulatory authorities also may charge a fee, with the amount varying by jurisdiction.

Other Costs. There are various other costs that are incurred as part of the registration process, including registrar and transfer agent fees and premiums for director and officer indemnity insurance.

[4] Gun Jumping

Gun jumping occurs when issuers or their representatives engage in publicity-generating activities that "jump the gun" on the use of the statutory prospectus by conditioning the market favorably for a registered public offering. Activities by the issuer or its representatives that can create gun jumping concerns include advertisements and other promotional materials, public announcements and press releases, research reports and other publications, presentations at investor or industry conferences, and speeches and public commentaries. n8 The most common response by the Commission to gun jumping activities is to delay the effectiveness of the offering until the harm generated by the publicity excesses has subsided, although it may take more stringent action in extreme cases. n9

In 2005 the Commission modified substantially its traditional approach to gun jumping. n10 Believing that technological advances in the dissemination of information and other factors had reduced the need for many of the long-standing gun jumping restrictions, the Commission eased the limitations on communications relating to registered offerings in the following manner, as explained more fully in the remaining paragraphs of this section:

- It permitted issuers and their representatives to issue documents relating to a registered offering called "free writing prospectuses" that may contain information not included in the statutory prospectus if certain conditions are satisfied;
- It enabled "well-known seasoned issuers" (a category of issuers created under the revised communications rules known generally as "WKSIs") to make offers during the period prior to filing a registration statement with the Commission; n11
- It indicated the extent to which issuers may release factual business information and forward-looking information while in registration;
- It provided clear guidelines on the use of electronic media in connection with registered public offerings; and
- It broadened the scope of summary notices of an offering permitted to be issued after a registration statement for the offering has been filed.

[a] Free Writing Prospectuses. Prior to the 2005 reforms, the statutory prospectus was the sole document through which a registered securities offering could be made. The reforms changed this approach by allowing issuers possessing certain qualifications, n12 as well as participants in their offerings (such as underwriters, brokers and dealers), to publish or disseminate other written communications as part of the selling effort. The term "free writing prospectus" is used to characterize these other communications, n13 and it is defined broadly (with certain exceptions) to include "any written communication that constitutes an offer to sell or a solicitation of an offer to buy the securities relating to a registered offering." n14 The effect of the definition, when read with two other definitions relevant to its meaning, n15 is to allow free writing prospectuses to be issued in paper or electronic form or to be broadcast or telecast. n16

Free writing prospectuses may include information that goes beyond the information in the statutory prospectus, n17 and are widely used. n18 The use of a free writing prospectus, however, is subject to certain conditions. n19 Each such prospectus:

- Must not contain information that conflicts with the information in the statutory prospectus; n20
- Must include a cautionary legend regarding the advisability of reading the statutory prospectus; n21
- Must be filed with the Commission in most instances; n22 and

- If not required to be filed, must be retained for at least three years. n23

In addition, certain types of issuers generally must accompany or precede the free writing prospectus with a copy of the statutory prospectus, which limits the usefulness of the free writing prospectus in the marketing effort. n24 An unintentional or immaterial failure to comply with the legend, filing and retention requirements on a timely basis is curable where a good faith and reasonable effort to comply was made and corrective action to remedy the deficiency was taken as soon as practicable. n25

A company that qualifies as a WKSIs may use a free writing prospectus at any time, including the period prior to filing a registration statement. n26 Other issuers or offering participants eligible to use a free writing prospectus may do so only after a registration statement has been filed. n27 "Seasoned issuers," which are issuers eligible to use Form S-3 or Form F-3 for a primary offering of securities on those forms, may issue free writing prospectuses at any time after filing the registration statement for the offering. n28 Issuers that do not qualify as WKSIs or seasoned issuers but are required to file reports under Section 13 or 15(d) of the Exchange Act, and are referred to as "unseasoned issuers," n29 may issue free writing prospectuses only if they have filed a registration statement for the offering and the free writing prospectus is preceded or accompanied by the statutory prospectus. n30 The same conditions apply to a "non-reporting issuer," which is an issuer that is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act, such as an IPO company or an issuer that voluntarily files reports under the Exchange Act. n31

Issuers are liable under the antifraud provisions not only for free writing prospectuses that they prepare, use or refer to, but also for any issuer information contained in any other offering participant's free writing prospectus. n32 Offering participants are not subject to liability for a defective free writing prospectus if they do not use, refer to, or participate in the planning and use of the free writing prospectus by another offering participant who uses it.

[b] Traditional Offering Communications. The revised communications rules introduced a number of important distinctions among the types of communications that historically have raised gun jumping concerns.

Communications During Pre-Filing Period. As previously mentioned, WKSIs may make unrestricted oral and written offers of securities during the period before they file the registration statement for the offering. n33 Other issuers may not make any offers during the pre-filing period. With the exception of certain ineligible issuers, n34 any issuer that publishes or disseminates a communication more than 30 days before filing a registration statement will be deemed not to have engaged in a prohibited offer so long as (i) the communication does not refer to a securities offering that is or will be the subject of a registration statement, and (ii) the issuer takes reasonable steps to prevent further distribution or publication of the communication during the 30-day period before the filing date. n35

Regular Business Communications. Two safe harbor rules treat most ongoing business communications as not involving an offer of securities. One of these rules codifies a longstanding Commission interpretation that issuers required to file reports under Section 13(a) or 15(d) of the Exchange Act may continue to publish or disseminate regularly released factual or forward-looking business information at any time, including during the period in which the reporting issuer conducts a registered offering. n36 The second safe harbor rule provides that non-reporting issuers may publish or disseminate at any time factual business information (but not forward-looking information) of a type that is regularly released and intended for use by persons other than in their capacity as investors or potential investors. n37 Advertisements of, or other information about, the issuer's products or services are considered to be within this safe harbor. n38

Rule 134 Notices. Rule 134 provides a safe harbor for "tombstone ads" and other public notices containing limited information about an offering that are disseminated after a registration statement for the offering has been filed. The communications reforms in 2005 broadened the scope of these notices by allowing them to include additional information regarding the issuer, its business, the terms of the securities being offered, the mechanics of the offering

process, and other matters. n39 The expanded Rule 134 notice, however, may not include a detailed term sheet for the securities being offered. n40

Media Publications or Broadcasts. Offering participants generally may use the media to make offers if the requirements for free writing prospectuses are satisfied. n41 Additional requirements, however, apply to any issuer or other offering participant who either prepares or pays for a media publication or broadcast (as in the case of an "infomercial" or written advertisement). n42 Non-reporting issuers and unseasoned issuers in these situations must furnish a statutory prospectus no later than the time of the publication or broadcast, which has the effect of limiting the information that can be conveyed to that prescribed by Rule 134. n43 Seasoned issuers that prepare or pay for a media publication or broadcast must have their most recent statutory prospectus on file with the SEC. n44 Prior or simultaneous delivery of the statutory prospectus is not required where the interview or other media event constituting a free writing prospectus is prepared by an unaffiliated media person and is not paid for by the issuer or other offering participant. n45 The free writing prospectus, however, must be filed with the SEC by the issuer or offering participant. n46

Electronic Road Shows. The 2005 reforms eliminated many of the conditions imposed by SEC no-action letters on "road show" presentations to prospective investors transmitted over the Internet or other electronic media. n47 An electronic road show is considered a written communication subject to the restrictions that apply to free writing prospectuses, except where it is transmitted live and in real-time to a live audience. n48 An electronic road show or its script typically does not have to be filed with the SEC. Filing, however, is necessary for an electronic road show relating to an IPO offering of common equity or convertible equity securities where the road show is not bona fide or not readily available to an unrestricted audience. n49

Issuer Web Sites. An offer of an issuer's securities, either on the issuer's web site or on a third-party web site hyperlinked to the issuer's web site, is a written communication that, unless exempt, will be a free writing prospectus of the issuer. n50 Historical issuer information that can be accessed by visitors to the web site under a separate section containing such information ordinarily will not be considered a free writing prospectus unless it is incorporated by reference into, or included in, the statutory prospectus, or is used or referred to in connection with the offering. n51 Other information located on or hyperlinked to the issuer's web site also would not be viewed as a free writing prospectus where the information was published previously. n52

Research Reports. Research reports issued by broker-dealers and others relating to an issuer that is in registration are subject to the limitations imposed by Rules 137, 138 and 139 under the Securities Act. The reforms expanded the situations in which offering and non-offering participants may disseminate research reports during a registered offering. n53

[c] Preventive Actions. Although the communications rules adopted in 2005 have reduced the likelihood of gun jumping violations, issuers must remain sensitive to the dangers of uncontrolled communications relating to the offering. To avoid inadvertent violations, the issuer and underwriters should set up internal control procedures designed to ensure that the possibilities for gun jumping are minimized. Among other things, these procedures should require that, once the decision to proceed with an offering is made, (1) the issuer's web site be examined on a regular basis for forward-looking information and other potentially offending statements; (2) all press releases, speeches, and other proposed public statements be reviewed in advance by counsel; and (3) responses to media inquiries be limited to factual information. n54

[5] Integration

Almost from the inception of the Securities Act the Commission has been concerned that issuers might seek to circumvent the registration requirements of the Act by separating a single nonexempt offering into several purportedly exempt offerings. n55 Where it appears to the Commission staff that separate offerings are connected in a meaningful

manner, it will "integrate" them by treating them as if they were a single issue for purposes of determining whether an exemption from the registration requirements of the Securities Act is available. For example, it is not uncommon for the staff to question whether a private offering made shortly before the filing of a registration statement for a public offering should be integrated with the public offering.

Although issuers are able to resolve most integration concerns through a dialogue with the staff, in some instances the staff will not agree with the issuer's view. In such circumstances, the issuer may be forced either to (i) withdraw the registration statement and abandon the public offering for a prescribed period; (ii) make a registered rescission offer to investors in the offering that the staff believes should be integrated; or (iii) include a risk factor in the registration statement regarding the contingent liability that may exist (assuming the staff is agreeable to that approach).

[a] The Five-Factor Test. The SEC provided substantial guidance regarding the application of the integration doctrine in 1961, n56 when it announced the five-factor test described below for considering whether separate offerings should be integrated as a single offering. n57 It is not necessary that all five factors be present in order to integrate multiple offerings. n58 Because the application of the five-factor test depends on the particular facts, there often is no clear-cut answer when applying the test to an individual situation. n59 Further, the staff appears to have taken a stricter approach than it formerly did to the application of the five-factor test, making it difficult for issuers to predict what approaches will be satisfactory to the staff. n60 As a result, efforts to resolve integration issues raised by the SEC staff occasionally can be contentious.

Are the offerings part of a single plan of financing. Important considerations in applying this factor include the timing of capital raising plans and whether the offerings are financially interdependent. For example, a court declined to integrate two offerings where the second offering was necessitated by "totally unforeseen operating difficulties." n61 And the SEC staff decided not to integrate a registered secondary offering with a private sale by the issuer to a large investor, noting that one offering was by the issuer and the other by its stockholders. n62

Are the offerings made for the same general purpose. This factor often is not significantly different from the "single plan of financing" factor and the two factors have been viewed by the staff as the most important of the five factors. n63 Examples of situations in which the Commission staff has found separate offerings to have different purposes include (i) an offering of stock options to motivate employees and a later offering to raise capital, n64 and (ii) an offering of commercial paper and an offering of unsecured promissory notes where the proceeds of the commercial paper were used for short-term "current transactions" and the proceeds of the notes were segregated and used for noncurrent transactions. n65

Do the offerings involve the same class of securities. Although offerings of different classes of securities (such as common stock and notes) ordinarily are not integrated, there may be a danger of integration where the two classes of securities are functional equivalents. The danger is most acute where one security can readily be substituted for another, pursuant to a conversion privilege or otherwise. For example, the SEC staff integrated an offering of common stock with an offering of bonds that were immediately convertible into the common stock. n66 But the staff did not integrate an offering of warrants to purchase common stock with an offering of common stock where the warrants could not be exercised for five years and were not transferable. n67

Are the offerings made at or about the same time. Offerings made within less than six months of each other may be considered to be at or about the same time, based on statements by the Commission staff n68 and the adoption by the Commission of a "safe harbor" from integration for offerings separated by more than six months. n69

Is the same type of consideration received. The majority of offerings involve the same form of

consideration (i.e., cash). Where two offerings involve different forms of consideration, a sufficient basis may exist for not applying the integration doctrine. n70

[b] Methods of Avoidance. The best method of avoiding an integration problem in the context of a proposed registered offering is to discuss with the Commission staff in a pre-filing conference possible integration concerns that the staff might raise after filing. These concerns might be identified by reviewing relevant SEC releases and commentaries, including statements made by the staff in comment letters on filings made by other issuers in similar circumstances, which since August 1, 2004 have been posted on the SEC's web site with the issuers' Securities Act and Exchange Act filings. The issuer may have flexibility before filing to address staff concerns that might not exist after filing occurs. For example, a proposed private placement that contains pricing or other terms which the staff believes would cause investors not to be at market risk upon the filing of the registration statement may result in a comment by the staff that leaving the terms unchanged would require integration of the private placement with the registered offering. Concerns of this nature can be addressed before filing by changing the terms of the private placement before it is finalized. But changing the terms after filing will not resolve an integration concern raised by the staff because, as explained below, the staff requires that the investors must be irrevocably committed to the private offering before the registration statement is filed. n71

In addition to using a pre-filing conference to address potential staff concerns, an issuer may consider reliance on the following SEC rules and staff positions to avoid application of the integration doctrine:

Six-Month Gap. Rules 147(b)(2), 251(c)(2)(v) and 502(a), respectively, provide that intrastate, Regulation A and Regulation D limited offering and private placement transactions that are separated from other transactions by more than six months will not be integrated with the other transactions. n72

Discrete Exempt Offering. Rule 701 and Rule 144A both indicate that the offerings exempted by those rules are discrete from other offerings and therefore may not be integrated with the other offerings. n73 In addition, a note to Rule 502(a) indicates that foreign offerings made in compliance with Regulation S generally will not be integrated with simultaneous domestic offerings.

Prior Private Placement. Rule 152 provides a safe harbor for an issuer that engages in a valid private placement and then files a registration statement for a public offering. The rule precludes integration of the registered offering with any prior private offering under Section 4(2) of the Securities Act or Rule 506 under Regulation D, so long as the private offering is completed or abandoned before the public offering. n74 For purposes of the rule, (i) a prior private placement is deemed to have been completed when the investors irrevocably commit to purchase or accept the securities, subject only to conditions beyond their control, n75 and (ii) a registered public offering is deemed to commence upon the filing of the registration statement for the offering. n76 An important staff position that should not be overlooked is the so-called "Macy's Position," in which the staff indicated that where the closing of a public offering is a condition to the completion of a prior private placement and the decision whether to complete the public offering rests with some of the private investors who are board members, senior executives or other members of the issuer's management, integration will not be necessary because these investors are deemed not to need the protections of the Securities Act. n77

Acquisition Rights Not Currently Exercisable. The SEC staff takes the position that warrants or rights (such as conversion or subscription rights) to acquire other securities represent an ongoing offering of the underlying securities so long as the warrants or rights are currently exercisable. n78 Accordingly, a continuous private offering of securities convertible into common stock may lose its private placement exemption upon the commencement of a public offering of the common stock during the period in which the privately placed convertible securities are convertible or exercisable for common stock. To avoid integration, the issuer must complete all facets of its private placement of the convertible securities under Rule 152 before it files a registration statement for an offering of the common stock. Notwithstanding the

deemed continuous offering of the underlying common stock, the staff will evaluate whether the private offering of convertible securities would be integrated with the public offering by reference to the time of the initial private placement of the convertible securities. If the initial private placement of the convertible securities would not be integrated with the public offering, there should be no further integration concern, even though the private offering represented by the convertible securities will continue during the period in which the public offering for the common stock has commenced. The staff, however, has raised issues regarding so-called "additional investment rights," in which the investor may exercise the right to receive not only more shares, but also more warrants. For example, transactions involving "springing warrants," which are warrants that result in additional warrants springing to life upon the exercise of the original warrants, have elicited a staff comment that the private placement in which the original warrants were issued was not completed, but was still ongoing. Under current staff positions, to avoid integration in circumstances involving a post-filing offering of warrants or other rights, it generally is necessary to prohibit exercisability of the warrants or rights until at least one year after the date of issuance. n79

FOOTNOTES:

(n1)Footnote 1. See, e.g., J. Fuller, *So, Why Be Public?*, 28 *Directors & Boards*, No. 2 (2004) 27-32; J. Brau and S. Fawcett, *Evidence on What CFOs Think About the IPO Process: Practice, Theory and Managerial Implications*, 18 *J. Applied Corp. Fin.* 107 (Summer 2006).

(n2)Footnote 2. See § 7A.05[2] *infra*.

(n3)Footnote 3. Rule 405 defines the term "well-known seasoned issuer," as discussed in § 7A.06[4][c] *infra*.

(n4)Footnote 4. The SEC review process is discussed at length in § 7A.06 *infra*.

(n5)Footnote 5. The increasing use of the Internet to circulate prospectuses may result in a significant reduction in printing costs in the future.

(n6)Footnote 6. Due to advancements in desk-top publishing, it is possible to produce internally a prospectus that has the quality of one produced by a financial printer. As a result, other than in major underwritten offerings or where high-quality artwork is featured in the prospectus, some issuers seek to reduce printing costs by making all changes on the internal document, and then submitting the final version to the printer for production by offset printing of the number of copies necessary for distribution.

(n7)Footnote 7. Pursuant to Section 6(b) of the Securities Act, the registration fee is set annually by the SEC, based on the costs to the government of the registration process and related activities. The maximum aggregate offering price is determined under Rule 457. The fee ordinarily is paid at the time of filing the registration statement. Well-known seasoned issuers filing an automatic shelf registration statement, however, are permitted by Rule 457(r) to elect under Rule 456(b) to pay the registration fee on a pay-as-you-go basis, with the fee deferred to the time of a takedown of securities from the registration statement.

(n8)Footnote 8. Important cases relating to gun jumping include *Chris-Craft Indus. v. Bangor Punta Corp.*, 426 F.2d 569, (2d Cir. 1970); *SEC v. Arvada Corp.*, 169 F. Supp. 211 (S.D.N.Y. 1958); *In re Carl M. Loeb, Rhoades Co.*, 38 SEC 843 (1959). Important Commission releases on gun jumping include Sec. Act Rel. No. 33-3844 (1957); Sec. Act Rel. No. 33-4697 (1964); Sec. Act Rel. No. 33-5009 (1969); Sec. Act Rel. No. 33-5180 (1971).

(n9)Footnote 9. In extreme cases of gun jumping, the Commission can (1) require the inclusion of a risk factor in the prospectus regarding potential contingent liability under the Securities Act for the gun jumping activities and the possible existence of a rescission right by investors in the offering as a result of those activities; or (2) institute an enforcement action against the parties responsible for the gun jumping activities. For an example of the first approach,

which focuses on disclosure as the primary remedy, see the prospectus dated August 18, 2004 for the IPO registration statement of Google, Inc., available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504143377/d424b4.htm> (text of offensive gun jumping statements included in appendix to prospectus; risk factor and potential rescission right disclosed in body of prospectus). Examples of enforcement actions include the path breaking cases of *In re Carl M. Loeb Rhoades & Co.*, 38 S.E.C. 843 (1959) ; and *In re First Marine Corp.*, 38 S.E.C. 882 (1959) ; and actions in later years involving *In the Matter of Competitive Capital Corp.*, Release No. 34-9184 (1971); *In the Matter of Gold Properties Restoration Co., Inc.*, Release No. 33-6953 (1992); and *In the Matter of Goldman Sachs & Co., Inc.*, Release No. 33-8434 (2004). Finally, disclosure of a contingent liability associated with gun jumping may cause the issuer's accountants to require that the company include a contingent liability in its financial statements or discuss the possibility of a rescission right in the footnotes to the financials. See, e.g., the final prospectus of Kraft Foods, Inc., dated June 12, 2001, available at <http://www.sec.gov/Archives/edgar/data/1103982/000095013001502333/d424b1.txt>.

(n10)Footnote 10. See Sec. Act Rel. No. 33-8591, § III. (2005). For a discussion of pertinent SEC reforms, see J. Richardson and M. McCoy, *The SEC Moves Toward Freer Communication During Securities Offerings*, 9 Wall St. Lawyer (No. 4) 14-19 (2005); H.S. Bloomenthal, *Securities Offering Reform (SOR) In Action*, Securities and Federal Corporate L. Rep. (Thomson/West) (March 2006).

(n11)Footnote 11. Rule 405 indicates that an issuer will qualify as a WKSII if it is eligible to use Form S-3 or F-3 and either (i) has a worldwide public common equity float of \$700 million or more, or (ii) has issued during the immediately preceding three years in registered offerings for cash at least \$1 billion of non-convertible securities, other than common equity.

(n12)Footnote 12. As indicated in Rule 164(e)-(g), some issuers are either ineligible for, or excluded from, the benefits provided by the communications reforms, and some offerings also are excluded. Rule 164(e) states that it is not available to issuers within the definition of "ineligible issuer" in Rule 405. Generally, an ineligible issuer either (i) possesses certain disqualifying characteristics specified in Rule 405 (such as blank check companies, penny stock issuers, and shell companies); (ii) is not current in filing required Exchange Act reports; or (iii) has been the subject of certain legal or enforcement proceedings specified in the rule. Rule 164(f) states that registered investment companies and business development companies, which are subject to independent regulatory requirements, are excluded from the use of free writing prospectuses. Rule 164(g) indicates that business combination transactions as defined in Rule 165(f)(1) and offerings on Form S-8 other than those by a WKSII also are excluded.

(n13)Footnote 13. See Sec. Act Rel. No. 33-8591, § III.C.3.b.i. (2005).

(n14)Footnote 14. See Rule 405. The definition makes no reference to oral offers because these have been permitted by the statute from inception.

(n15)Footnote 15. The term "written communication" used in the definition of free writing prospectus is defined in Rule 405 to mean any communication that is written or printed, a radio or television broadcast, or a graphic communication. A "graphic communication" is defined in Rule 405 to include all forms of electronic media, such as videotapes, CD-ROMs, web sites, voice mail systems and computers, although an exception exists for any communication which, at the time of origination, is live and disseminated in real-time to a live audience.

(n16)Footnote 16. See Sec. Act Rel. No. 33-8591, § III.C.3.b.i. (2005).

(n17)Footnote 17. See Rule 433(c)(1).

(n18)Footnote 18. The most common type of free writing prospectus from the outset has been a term sheet containing the pricing terms for an offering determined after completion of the marketing period. See, e.g., S. Thel, *Free Writing*, 33 J. Corp. Law 941 (Summer 2008), and comments in late 2006 by Martin Dunn, then-Deputy Director of the SEC's Division of Corporation Finance. Mr. Dunn indicated that in the first 10 months after the revised

communications rules became effective (i.e., the ten-month period ending September 30, 2006), operating companies used free writing prospectuses in five ways: (i) 60% as a term sheet (usually in debt offerings); (ii) 29% as an offering marketing tool; (iii) 6% to furnish information previously provided to the media (such as filing a full transcript of a media interview); (iv) 4% as a prospectus update (e.g., to correct errors or update information); and (v) 1% to provide aspirational information about the issuer (i.e., "how great the company is"). 38 Sec. Reg. & L. Rep. (BNA) 1946 (November 20, 2006).

(n19)Footnote 19. Communications issued in connection with registered offerings involving a business combination transaction and communications relating to offerings of asset-backed securities registered on Form S-3 are subject to special requirements described in Rules 166 and 167, respectively, that do not apply to free writing prospectuses generally.

(n20)Footnote 20. See Rule 433(c)(1)(i). The information in the statutory prospectus is deemed to include information incorporated by reference from the issuer's reports filed under Section 13 or 15(d) of the Exchange Act. Id.

(n21)Footnote 21. See Rule 433(c)(2).

(n22)Footnote 22. See Rule 433(d) for a description of the circumstances under which a free writing prospectus must be filed with the SEC. Generally, issuers are required to file with the SEC free writing prospectuses they prepare or use, as well as free writing prospectuses prepared or used by other offering participants (such as underwriters) that contain material information about the issuer or its securities not previously filed. Issuers also must file any free writing prospectus that describes the final terms of the offering. Underwriters and other offering participants generally do not have to file free writing prospectuses used or referred to by them, except where the prospectus is distributed by or on behalf of the participant in a manner reasonably designed to lead to its broad unrestricted dissemination.

(n23)Footnote 23. See Rule 433(g).

(n24)Footnote 24. See Rule 433(b)(2).

(n25)Footnote 25. See Rule 164(b)-(d).

(n26)Footnote 26. See Rule 163 and Sec. Act Rel. No. 33-8591, § III.C. (2005). If a WKSI issues a written communication constituting an offer of securities prior to the filing of a registration statement for the offering, Rule 163 requires the WKSI to (i) include a legend in the communication indicating that the WKSI may file a registration statement with the SEC for the offering that the offeree should review before investing, and (ii) file the communication with the SEC if it later files a registration statement.

(n27)Footnote 27. See Rule 433(a).

(n28)Footnote 28. See Rule 433(b)(1)(iv).

(n29)Footnote 29. See Rule 433(b)(2).

(n30)Footnote 30. See Rule 433(b)(2)(i). Note 1 to Rule 433(b)(2)(i) indicates that an electronic communication containing an active hyperlink to the most recent statutory prospectus will satisfy the "preceded or accompanied by" requirement.

(n31)Footnote 31. See Rule 433(b)(2). One commentator has suggested that a six-question checklist be used to determine whether, and in what form, a communication can be a free writing prospectus ("FWP"): (1) Is the issuer eligible to use an FWP? (2) What is the category of the issuer for purposes of issuing an FWP? (3) Is the communication at issue within the definition of an FWP? (4) Is the communication an offer of a security? (5) Is the communication written? and (6) When is the communication made? See A. Pena, *The Free-Writing Prospectus: A Six*

Question Approach for Issuers, 35 Sec. Reg. L.J. 36 (Spring 2007).

(n32)Footnote 32. See generally Sec. Act Rel. No. 33-5981 n. 169 (2005). See, however, S. Thel, *Free Writing*, 33 *J. Corp. Law* 941(Summer 2008), in which the author argues that Section 12(a)(2) of the Securities Act should not apply to a free writing prospectus unless that prospectus is broadly distributed and a statutory prospectus meeting the requirements of Section 10(a) of the Act is not available.

(n33)Footnote 33. See Rule 163.

(n34)Footnote 34. See Rule 163A(b) for a description of the ineligible issuers.

(n35)Footnote 35. See Rule 163A.

(n36)Footnote 36. See Rule 168, which codified an interpretation issued in Sec. Act Rel. No. 33-5180 (1971).

(n37)Footnote 37. See Rule 169 and Sec. Act Rel. No. 33-8591, § III.C. (2005).

(n38)Footnote 38. See Rule 169(b)(1)(ii).

(n39)Footnote 39. See Sec. Act Rel. No. 33-8591, § III.D.3.a. (2005).

(n40)Footnote 40. The information regarding terms of the offering is limited by Rule 134(a)(2) to the title, amount and "basic terms" of the securities offered. For a discussion of the use of term sheets under the revised rules, see B. Bennett and S. McAuliffe, *Term Sheets and Other Communications After Securities Offering Reform*, Insights (March 2006) 12-19.

(n41)Footnote 41. See Rules 164 and 433(f), and Sec. Act. Rel. No. 33-8591, § III.D.3.b.iii.(F) (2005).

(n42)Footnote 42. Sec. Act. Rel. No. 33-8591, § III.D.3.b.iii.(F)(2)(a)(i) (2005).

(n43)Footnote 43. Id.

(n44)Footnote 44. Sec. Act. Rel. No. 33-8591, § III.D.3.b.iii.(F)(2)(a)(ii) (2005).

(n45)Footnote 45. Rule 433(f)(1).

(n46)Footnote 46. Rule 433(f)(1)(ii).

(n47)Footnote 47. See § 7A.06[6][b] *infra* for more information about road shows.

(n48)Footnote 48. See Rule 433(d)(8), and Sec. Act. Rel. No. 33-8591, § III.D.3.b.iii.(D) (2005). A communication issued as part of a live road show in real-time to a live audience that is made available only as part of the road show rather than as a separate document is deemed part of the road show and therefore is not a written communication that can be deemed a free writing prospectus. See Note to Rule 433(d)(8).

(n49)Footnote 49. See Rule 433(d)(8)(ii).

(n50)Footnote 50. See Rule 433(e), and Sec. Act. Rel. No. 33-8591, § III.D.3.b.iii.(E) (2005).

(n51)Footnote 51. Rule 433(e)(2). See also Release No. 34-58288, § II.B.1 (2008), which indicates that adhering to the conditions of Rule 433(e)(2) will allow an issuer to avoid concerns under the antifraud provisions that investors may not understand that materials previously posted on the issuer's web site speak as of a date or period earlier than the date on which investors access those materials.

(n52)Footnote 52. Sec. Act. Rel. No. 33-8591, § III.D.3.b.iii.(E)(2) (2005).

(n53)Footnote 53. See Sec. Act. Rel. No. 33-8591, § III.D.4. (2005).

(n54)Footnote 54. A former Chairman of the Commission long ago endorsed preventive measures for gun jumping by stating the "The lawyer should insist on both the issuer and the underwriter setting up controls on press releases and publicity. He should persuade his client that there is real danger in acting first and telling the lawyer about it afterwards." R. Demmler, *Problems Inherent in Pre-filing Publicity*, 15 *Bus. Law.* 132, 136 (1959).

(n55)Footnote 55. See Sec. Act Rel. No. 33-97 (1933).

(n56)Footnote 56. See Sec. Act Rel. No. 33-4434 (1961). See also Sec. Act Rel. No. 33-4552 (1962).

(n57)Footnote 57. See Preliminary Note 3 of Rule 147 and Rule 502(a) for examples of situations in which the Commission has cited the five-factor test in its rules.

(n58)Footnote 58. *Id.*

(n59)Footnote 59. For a thorough discussion of the historical application of the integration doctrine by the Commission staff, see S. Keller, *Integration of Private and Public Offerings Update*, American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities (August 3, 2009).

(n60)Footnote 60. See, e.g., S. Keller, *Basic Securities Act Concepts Revisited*, Insights (May 1995) 9, in which the author expressed concerns about the SEC staff's shift in the mid-1990's from a pragmatic approach to a less flexible, literalist approach when applying the integration doctrine and other basic Securities Act concepts.

(n61)Footnote 61. *Barrett v. Triangle Mining Corp.*, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,438 (S.D.N.Y. 1976).

(n62)Footnote 62. *Pacific Resources, Inc.*, SEC No-Action Letter (August 13, 1976).

(n63)Footnote 63. *Sonnenblick, Parker & Selvers*, SEC No-Action Letter (January 1, 1986).

(n64)Footnote 64. *Pacific Physician Services*, SEC No-Action Letter (August 20, 1985).

(n65)Footnote 65. *NCNB Corp.*, SEC No-Action Letter (April 28, 1978).

(n66)Footnote 66. See generally *Squadron, Ellenoff, Pleasant & Lehrer*, SEC No-Action Letter (February 28, 1992).

(n67)Footnote 67. *Monitrend Investment Management, Inc.*, SEC No-Action Letter (May 3, 1988).

(n68)Footnote 68. See, e.g., *Sonnenblick, Parker & Selvers*, SEC No-Action Letter (January 1, 1986).

(n69)Footnote 69. See Rules 147(b)(2), 251(c) and 502(a).

(n70)Footnote 70. See, e.g., *Wellington Fund, Inc.*, SEC No-Action Letter (September 22, 1976) (no integration of exchange of shares for assets of another company with continuous public offering of shares for cash); *UST Corp.*, SEC No-Action Letter (April 8, 1977) (no integration of exchange of subordinated notes for subordinated floating rate debentures with offering of similar debentures for cash to raise capital).

(n71)Footnote 71. See, e.g., *Black Box Inc.*, SEC No-Action Letter (June 26, 1990).

(n72)Footnote 72. The SEC proposed in Release No. 33-8828, § II.C.1. (2007), to reduce the six-month safe harbor

period to 90 days but has yet to take action on the proposal.

(n73)Footnote 73. See Rule 701(b)(6) relating to offerings by private non-reporting issuers of securities under a compensatory benefit plan for employees or consultants, and Rule 144A(e) relating to resales to Qualified Institutional Buyers.

(n74)Footnote 74. See, e.g., the following SEC no-action letters: *Verticom, Inc.* (February 12, 1986) and *Quad City Holdings, Inc.* (April 9, 1993), and relevant statements by the SEC in Release No. 33-8828, § II.C. (2007). Rule 152 is not available for offerings made in reliance upon Rules 504 and 505 of Regulation D or the exemptions adopted under Section 3(b) of the Securities Act, since these offerings are not required to be private in nature.

(n75)Footnote 75. See, e.g., *Black Box Inc.*, SEC No-Action Letter (June 26, 1990), which involved a private recapitalization by the issuer prior to the issuer's initial public offering, with the price of the securities determined by a formula tied to the IPO price. Where a private placement of securities is to be followed by an immediate public resale of the securities by the investors pursuant to a registration statement, *Black Box* and its progeny permit the private placement to be conditioned on the SEC making the registration statement for the resale effective, since this is an event outside the control of the parties. For a discussion of the implications of the *Black Box* letter, see Backman and Gervis, *Integration Revisited: The Black Box Restructuring*, Insights (February 1991) 3.

(n76)Footnote 76. SEC staff letter to *Michael Bradfield*, Federal Reserve Board (March 16, 1984).

(n77)Footnote 77. The Macy's Position is an unpublished staff view expressed in 1994 and subsequently affirmed in the filing comment process.

(n78)Footnote 78. Pursuant to the last sentence of Section 2(a)(3) of the Securities Act, an instrument providing a right to acquire another security is deemed not to involve an offer or sale of the other security until the right is exercisable.

(n79)Footnote 79. The one-year period is based upon a long-standing staff position that if a registrant is registering a convertible security that is convertible or exercisable within one year of the date of effectiveness of the registration statement, the underlying security must be included in the registration statement with the convertible security. Accordingly, for so long as this staff position remains in effect, securities that are not convertible or exercisable for at least one year after issuance should not be deemed to constitute an offering of the underlying security until the convertible securities become convertible or exercisable.



94 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 § 7A.05

AUTHOR: Peter J. Romeo

§ 7A.05 Preparation and Filing of Registration Statement

[1] Joint Effort

Preparing a registration statement requires a joint effort by the issuer, underwriters and auditor because all are potentially liable under Section 11 of the Securities Act for material misstatements or omissions in the registration statement. All of the parties should closely coordinate their activities during the period in which the registration statement is being drafted to minimize duplication of effort and maximize each party's understanding of the issuer and the offering. Further, all of the parties should examine each draft of the registration statement critically and express their views freely, since experience indicates that only through open and frank discussion are potential disclosure problems and inconsistencies likely to be discovered and addressed.

[2] Preliminary Work

Issuers commencing the IPO process rarely have their affairs in a condition suitable for a public offering. Accordingly, a considerable amount of preliminary work known as the "corporate clean-up" usually is necessary before the registration statement can be prepared.

The initial task in the clean-up process usually is to transform the organizational and capital structure of the company into a form suitable for a public offering. Generally, this means that the business of the issuer must be conducted through a single corporation or a parent corporation with subsidiaries. If the business has been conducted through several corporations under common ownership, through partnerships or limited liability companies, or through combinations of business entities, the underwriters often will insist that the company adopt one of the simplified organizational structures mentioned above that is more functional from a public company standpoint. This can be accomplished by reorganizing through the use of mergers, liquidations, reclassifications, forward or reverse stock splits, or capital contributions.

The corporate clean-up may involve many other changes as well. Among the tasks performed by counsel to the issuer that may result in changes are the following: (i) review of the articles of incorporation, bylaws, corporate resolutions and stock records for the purpose of uncovering and correcting defects and implementing a corporate governance structure consistent with exchange listing standards; (ii) review of material contracts (including loan agreements,

registration rights agreements, and rights of first refusal) to determine whether amendments or waivers of provisions may be necessary; (iii) examination of loan or similar arrangements with insiders to determine whether the arrangements would violate the restrictions on loans or other prohibited extensions of credit to directors and executive officers contained in Section 402 of the Sarbanes-Oxley Act; (iv) preparation, revision or termination of employment contracts with insiders as necessary; (v) adoption or amendment of stock incentive and other benefit plans for employees and directors as appropriate; and (vi) termination or revision of affiliated party arrangements as required.

If the issuer has not already done so, it should engage as its auditor an established accounting firm that is registered with the Public Company Accounting Oversight Board ("PCAOB") pursuant to Section 102 of the Sarbanes-Oxley Act. A registered firm that is in good standing with the PCAOB should have no difficulty in satisfying the Commission's requirement that it be independent of the issuer. Further, its expertise can be extremely valuable if the issuer has not previously been audited, since a first audit ordinarily will bring to the surface a large number of problems that a less experienced firm might have difficulty coping with.

Finally, those issuers with a preexisting obligation to file periodic reports with the Commission under Section 13(a) or 15(d) of the Exchange Act should make certain they are in full compliance with the periodic reporting requirements of the Exchange Act at the time of filing the registration statement. Form S-3, which is the short registration form that permits incorporation by reference of Exchange Act periodic reports, automatically attaches Securities Act liability to materially deficient disclosures in the reports. More important, the Commission staff will not process a registration statement unless the issuer currently is in compliance with its Exchange Act reporting obligations.

[3] Organizational Meeting

The organizational meeting is the first opportunity for the entire group involved in the proposed offering to begin working as a team. The meeting typically is held shortly after the managing underwriter is selected and is attended by representatives of the issuer, the managing underwriter and the auditor, as well as counsel for the issuer and the underwriter. Among the matters ordinarily discussed at the meeting are the size and structural aspects of the offering, sensitive disclosure concerns, significant accounting issues, stock exchange listing matters and prospective compliance with the exchange's corporate governance standards, and the time and responsibility schedule prepared by the managing underwriter. The selection of the registration form also may be discussed, although Form S-1 or (for foreign private issuers) Form F-1 is required for an IPO involving an issuer for which no specialized form is available.

[4] Due Diligence

Due diligence is the process by which parties who may be liable for material misstatements or omissions in a registration statement seek to verify the disclosures in the registration statement. Due diligence not only provides support for the disclosures, but it also shields all parties other than the issuer from liability if they can establish that a reasonable basis existed for their belief that the registration statement was accurate and complete. n1 The standard of reasonableness is "that required of a prudent man in the management of his own property." n2 Important cases involving the due diligence defense include *Escott v. Bar Chris Construction Corp.*, n3 *Feit v. Leasco Data Processing Equipment Corp.*, n4 and *In re WorldCom, Inc. Securities Litigation*. n5

There is some uncertainty as to what is necessary to establish a due diligence defense, since the courts have held that due diligence for Section 11 persons "will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data." n6 The Commission has issued its own statement on the subject of due diligence in Rule 176, which describes circumstances bearing on the reasonableness of a person's due diligence investigation. According to the Commission, the rule allows each person who may have liability under Section 11 to "evaluate the surrounding facts, including the extent of his prior relationship with the registrant, and utilize techniques of investigation appropriate to the circumstances of the offering." n7 The rule also confirms the concept stated in the case law that the degree of investigation is not the same for all Section 11 persons, but varies, depending on the

circumstances. n8

Rule 176 states that the following circumstances are relevant in determining whether the due diligence defense can be relied upon by a person:

- The type of issuer;
- The type of security;
- The type of person;
- The office held when the person is an officer;
- The presence or absence of another relationship to the issuer when the person is a director or proposed director;
- Reasonable reliance on officers, employees, and other whose duties should have given them knowledge of the particular facts (in light of the functions and responsibilities of the particular person with respect to the issuer and the filing);
- When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registration; and
- Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

At the least, it seems clear that each director and officer must become thoroughly familiar with the registration statement to have any hope of relying successfully on the defense. n9 These persons should review the document critically and raise questions about doubtful disclosures. n10 Moreover, directors and officers should not labor under the erroneous belief that they can avoid their responsibility by relying on counsel or some other person, since *Bar Chris* indicates that they must fulfill their investigative obligation personally. n11

The investment banks that act as professional underwriting firms traditionally have hired experienced counsel to assist them in meeting their due diligence responsibilities under Section 11. Where a shelf registration occurs, however, there frequently is little time before an offering is taken down from the shelf, even with the assistance of counsel, to conduct the type of due diligence investigation necessary for a high level of comfort. n12 The Commission's adoption of Rules 176 and 412 has allayed to some extent concerns by some professional underwriters about their ability to meet their due diligence responsibilities with respect to periodic reports under the Exchange Act incorporated by reference into shelf registration statements. Nonetheless, shelf registration, particularly automatic shelf registration permitted for well-known seasoned issuers under the SEC's 2005 reforms, has heightened the need for offering participants to conduct their due diligence as rapidly as possible. n13 Further, the numerous corporate scandals in the early 2000s involving financial and accounting misdeeds have emphasized the necessity for directors and underwriters to utilize in-depth due diligence procedures to justify reliance on the issuer's audited financial statements. n14

[5] Drafting Responsibilities. The objective when drafting the registration statement is to produce a document that both interests investors in purchasing the issuer's securities and shields the participants in the registration process from Securities Act liability. In effect, the registration statement is both a marketing and defensive document. It will be successful in meeting its dual purposes only if it has a compelling story to tell investors that is described in a complete and truthful manner.

The drafting process involves an allocation of duties among the parties. The issuer, through its counsel, generally prepares the nonfinancial portions of the registration statement, the auditor examines the financial portions, and the underwriters and their counsel assume responsibility for the underwriting documents. Counsel for the issuer usually takes the lead role in coordinating the activities of all of these parties and in drafting the registration statement.

The process of preparing the registration statement should be an organized one, with time schedules set up and adhered to, working groups formed, and meetings held to discuss the document. n15 The process usually begins with the issuer's counsel identifying the information to be assembled, seeking to verify the information, and then preparing a draft in conjunction with the issuer. Drafting the registration statement is not a simple "fill in the blanks" exercise in which the requirements of the applicable registration form are complied with by rote. Instead, the draft is prepared in narrative form, with basic information about the issuer and the offering set forth in a "Summary" in the forepart of the document and other detailed information included in later sections. n16 The initial draft is circulated to all concerned parties and thereafter typically undergoes substantial revision at numerous drafting sessions in which all parties participate before it is considered ready for filing with the Commission.

[6] Plain English

The SEC's rules require the prospectus for registration statements to be written in "plain English." n17 According to the Commission, writing in plain English requires at a minimum:

- Short sentences;
- Definite, concrete, everyday language;
- Active voice;
- Tabular presentation or a "bullet list" for complex material whenever possible;
- No legal jargon or highly technical business terms; and
- No multiple negatives. n18

The issuer must prepare the entire prospectus in accordance with the following four general writing techniques designed to make life easier for readers of the prospectus: n19

- Present information in clear, concise sections, paragraphs, and sentences, using short explanatory sentences and bullet lists whenever possible;
- Use descriptive headings and subheadings;
- Avoid frequent reliance on glossaries or defined terms as the primary means of explaining information in the prospectus; and
- Avoid legal and highly technical business terminology.

The Commission also has stated that persons preparing a prospectus should avoid the following writing conventions because they make the prospectus harder to read: n20

- Legalistic or overly complex presentations that make the substance of the disclosure difficult to understand;

- Vague boilerplate explanations that are readily subject to differing interpretations;
- Copying of complex information directly from legal documents without any clear and concise explanation of the provisions; and
- Repetitive disclosures that increase the size of the document but do not enhance the quality of the information.

In its comment letters on registration statements, the staff has identified a number of other principles that it believes all issuers should adhere to when preparing documents in plain English. Among other things, the letters indicate that issuers should:

- Eliminate legalese (evident from words such as "certain," "such," and "hereof"), jargon (such as "synergy" or "leverage"), vague terminology (such as "strategic alternatives"), and technical terms;
- Restrict defined terms to industry and proprietary terms only, and avoid acronyms;
- Limit the use of cross-references;
- Avoid parenthetical phrases, embedded lists of information, and excessive capitalization
- Avoid excessive use of footnotes in summary or selected financial information;
- Use Arabic numerals or alphabet letters, instead of roman numerals;
- Make right margins free-flowing, rather than justified; and
- Describe each risk factor by using a fully descriptive caption in sentence form and a concise paragraph that emphasizes the risk early in the discussion.

[7] Materiality

Contrary to popular wisdom, the Securities Act does not require all material information to be included in a registration statement. n21 What is essential for inclusion is any specifically required information, as well as any information that would prevent included statements from being misleading. n22 The term "material" is defined in Rule 405. The definition indicates that the term, when used in connection with a requirement to disclose information about a specified subject, applies only to information for which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered. n23

It is relevant to note the Supreme Court's view in *Basic, Inc. v. Levinson* that the materiality of a speculative event should be determined by balancing the magnitude of the event and the probability that it will happen, with the probability threshold being reduced as the magnitude increases. n24 Also relevant is the SEC's comment in Staff Accounting Bulletin 99 that materiality in the financial statement context should not be measured solely by quantitative standards, such as the percentage effect of an event on revenue or net income. n25 When addressing materiality concerns, an issuer also should consider qualitative factors that take into account the nature of the event and the surrounding circumstances. Thus, a company is required by the SEC to take into account all of the relevant circumstances, rather than simply using a formulaic approach involving the application of numerical standards to determine materiality.

[8] Forward-Looking Information

For much of its existence, the Commission prohibited public companies from including projections and forecasts in their registration statements and other disclosure documents. In the late 1960s, however, this attitude began to change, in recognition of the increasing dependence by the marketplace on estimates of future earnings. n26 By 1978, the Commission completed its turnaround on this issue by formally encouraging the inclusion of forward-looking statements in filed documents and annual reports. n27 The Commission adopted at that time essentially identical safe harbor rules under both the Securities Act and the Exchange Act (Rules 175 and 3b-6, respectively) for the issuance of projections, forecasts and other forward-looking information under prescribed circumstances. n28 Essentially, the rules require that the forward-looking statements have a reasonable basis (although it is not necessary to state the assumptions upon which they are based) and be made in good faith. n29 As a result, public companies can issue forward-looking statements within prescribed limits. n30

Despite the Commission's reversal of policy, the vast majority of public companies were nervous about issuing projections during the registration period because of the potential liability that could result if a court found that the requirements of Rule 175 were not met. n31 Most issuers did not want to risk being sued, or be faced with an obligation to correct a forecast that later proved to be materially inaccurate. Much of this concern eventually was dissipated by two developments. The first was the adoption by the judiciary in the early 1990s of the "bespeaks caution" doctrine. Under this doctrine, an issuer may escape liability for forward-looking statements made in good faith if the issuer shrouds the statements in meaningful, prominently disclosed, cautionary language warning investors about the dangers of relying on the statements. n32 The second was the enactment by Congress in 1995 of the Private Securities Litigation Reform Act ("PSLRA"), n33 which contains a safe harbor from Securities Act liability for forward-looking statements by certain qualifying issuers n34 that is broader than the Commission's safe harbor. n35

The PSLRA safe harbor covers both written and oral forward-looking statements that satisfy certain requirements. The safe harbor can be relied upon by qualifying issuers if the forward-looking statement either (i) is identified as a forward-looking statement and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement, or (ii) a plaintiff fails to prove that the statement was made with actual knowledge that it was false or misleading. The legislative history of the PSLRA makes it clear that "boilerplate warnings will not suffice as meaningful cautionary statements" for issuers relying on approach (i) above, and that courts should "examine only the cautionary statement" and "should not examine the state of mind of the person making the statement." n36

The safe harbor also is available for oral forward-looking statements by employees, directors and other persons acting on behalf of qualifying issuers. To qualify for the safe harbor, the speaker must (i) provide a warning that the statement is a forward-looking one and actual results could differ materially from those contained in the forward-looking statement, and (ii) identify a readily available written document (such as a registration statement or Exchange Act report) containing additional relevant information. Neither oral nor written forward-looking statements are required to be updated under the safe harbor. n37

[9] Financial Statements and Data

All registration statements for public offerings must contain audited financial statements, and most usually include other financial data as well. n38 Pursuant to Section 401 of the Sarbanes-Oxley Act, the financial statements must reflect all material correcting adjustments identified by the issuer's auditor as being in accordance with GAAP and SEC requirements. Consistent with a separate provision of Section 401, the SEC has adopted Regulation G and amended Item 10 of Regulation S-K for the purpose of restricting the presentation of pro forma and other non-GAAP financial data. n39 Item 10, which is applicable to all non-GAAP financial measures included in Commission filings (including registration statements), imposes numerous disclosure obligations and other conditions on the use of such measures. Among other things, the presentation of the financial measure must include (i) the most directly comparable GAAP

financial measure (or measures); (ii) a reconciliation of the non-GAAP measure to the GAAP measure; (iii) the reasons why the issuer believes the non-GAAP financial measure provides useful information to investors regarding the issuer's financial condition and results of operations; and (iv) any additional purposes, if material, for which management uses the non-GAAP financial measure.

In 2009, the SEC adopted rules requiring domestic and foreign public companies that prepare their financial statements in accordance with U.S. generally accepted accounting principles ("US GAAP") to file financial statements contained in their registration statements, periodic reports, and transition reports in an interactive data format using eXtensible Business Reporting Language ("XBRL"). n40 The interactive data required to be filed must be included as an exhibit to the registration statements and periodic reports filed by these companies. The XBRL requirement, which is being phased in over a three-year period, n41 currently applies only to financial statements included in registration statements and periodic reports but is expected to encompass other data in the future. n42

[10] Risk Factors

A discussion of the principal factors that make an offering speculative or risky must be included in the forepart of the prospectus, immediately after the "Summary" section under the caption "Risk Factors." n43 Perhaps more than any other section of the prospectus, the "Risk Factors" section provides the issuer with the best means for avoiding liability for the offering. The warnings to investors in this section generally should put the issuer in good position to rely on the "bespeaks caution" defense if a purchaser later alleges that the offering involved fraud. n44

The Risk Factors section should concisely summarize in plain English n45 the major risks attendant to an investment in the issuer. Disclosure of the individual risk factors should adhere generally to the following guidelines evident from informal statements by the SEC staff in staff legal bulletins and comment letters issued to individual issuers:

- The risk factors should be limited to those that are specific to the company, and not include risks that could apply to any issuer or any offering; n46
- The risk factors generally should be grouped into three categories: (i) company risks, (ii) industry risks, and (iii) investment risks; n47
- The risk factors should be presented in the order of their importance within a particular category;
- Individual risk factors should be presented by using a boldface caption describing the nature of the risk in a single sentence followed by a brief explanation of the information relevant to the risk;
- Where possible, examples of the risk should be included in the explanation; n48 and
- Countervailing considerations that may mitigate the described risk should not be included because they would diminish the effect of the warning regarding the risk and reduce the protection from liability otherwise available. n49

The number of risk factors will vary depending on the issuer and its particular circumstances. Although no material risk factors should be omitted, the issuer should not include generic risk factors unless they apply specifically to the issuer.

[11] Management's Discussion and Analysis ("MD&A")

The SEC views the MD&A as one of the most important sections of the prospectus, and its legal and accounting staff focus closely on it. The purpose of the MD&A is to provide the investing public with management's view of the issuer's business from both a short-term and long-term perspective, as well as its analysis of year-to-year changes in the issuer's

financial statements for the last three fiscal years. n50 The analysis must encompass not only the issuer's results of operations, but also its liquidity and capital resources.

A key element of the MD&A is the requirement that the issuer disclose any known trends, demands, commitments, events or uncertainties that could materially affect its financial condition or results of operations. n51 The SEC staff has been known to review MD&A disclosures at a later date and, with the benefit of hindsight, inquire why the issuer did not alert the public to trends or uncertainties that led to subsequent material developments. Accordingly, it is imperative at the time of preparing the MD&A that the issuer focus not only on what has occurred in the past but also on what the future may hold. n52

The SEC staff also has emphasized the need for issuers to harmonize the presentation of its financial results in the MD&A with the presentations of those results outside its Exchange Act reports and other filings with the SEC, including registration statements. n53 Where the staff believes there may be a discrepancy in the presentations, it may require an issuer to reconcile inconsistent disclosure or to explain why the MD&A omits material information disclosed outside the filing. n54

[12] Description of Business

Item 101 of Regulation S-K requires the issuer to describe (i) the general development of its business, (ii) the business it has conducted and intends to conduct through itself and its subsidiaries, (iii) data for each of its segments (assuming there are at least two significant segments), n55 and (iv) data regarding its foreign operations. Ordinarily, the Commission staff does not comment heavily on the description of business where it perceives the description to be fair and balanced. In such situations, it generally seeks only to assure that the issuer has included, in a clear and concise manner, all of the information specifically required by Item 101 and can support the information. n56

[13] Pre-Filing Conferences

Important questions of a unique or unusual nature sometimes arise during the preparation of the registration statement that can materially affect the disclosures to be made or, indeed, the decision whether to make the offering at all. For example, there may be major difficulties in complying with the applicable financial statement requirements because of the unavailability of audited financial statements for the requisite period. n57 Or, there may be questions as to whether a prior failed enterprise is a predecessor of the issuer and therefore must be fully described in the registration statement. A pre-filing conference with the SEC staff is one way of obtaining guidance on these issues or possibly a waiver of the troublesome requirements where good cause is shown.

Although the SEC staff is not enthusiastic about pre-filing conferences and would prefer that most offerings simply be filed, it does hold itself out as being available for them when circumstances warrant. n58 Generally, however, the staff will insist that the requesting party submit a letter in advance describing the nature of the problems causing concern. The letter enables the staff to determine whether the problems can be resolved by telephone or letter without a conference. Where the staff agrees to hold a conference (and it almost always will if the registrant is insistent), the letter is used to determine whether members of the Division's accounting or legal staff also should attend. The staff, however, has made it clear that it will rarely review a draft copy of the registration statement at a conference or any other time prior to the filing date.

In the case of pre-filing conferences involving complex accounting issues, the SEC's accounting staff has prescribed a protocol to be followed by prospective registrants. n59 Generally, the protocol requires a submission in writing (by mail, fax or e-mail) of the relevant information to the Office of Chief Accountant, with a copy to the Chief Accountant of the Division of Corporation Finance. The submission should encompass a dozen specific items, including background information and facts, the question being raised, possible alternative answers and recommendations, and bases for the recommendations. If a formal meeting is requested, sufficient advance notice (usually at least five business

days) is required to be given in writing. Following resolution of the issue, the registrant is required to submit a letter to the staff describing its understanding of the staff's position. If the staff objects to the description, it will inform the registrant. If the registrant fails to revise the letter to the staff's satisfaction, the staff will issue its own letter describing its understanding of the facts and the position taken.

Although pre-filing conferences do not always result in a resolution of the matters at issue, they often are useful even if the registrant fails to receive the response desired. As one commentator put it, "[i]n those instances in which the staff either is without authority to bend the rules or is simply unwilling to do so for fear of compromising investor protection, it is better to learn of the problem before wasting time and effort in the preparation of the registration statement." n60

[14] Filing Requirements

Filing the registration statement with the Commission involves a number of considerations, including compliance with the Commission's electronic filing requirements and payment of the registration fee.

[a] Electronic Form. The Commission requires all registration statements under the Securities Act to be filed in electronic form. n61 The submissions are made on EDGAR, the Commission's electronic filing system. n62 The requirements applicable to EDGAR submissions are set forth in Regulation S-T, n63 the Commission's electronic filing regulation.

As a result of the mandate to file electronically on EDGAR, a number of Commission rules prescribing specific requirements for filing registration statements in paper form with the Commission no longer apply to domestic issuers. n64 The rules effectively have been superseded by Rules 308 and 309 of Regulation S-T, which state that provisions in the Commission's rules relating to type size, font and other legibility requirements, as well as requirements for paper size, binding, sequential page numbering and number of copies, do not apply to documents satisfying the electronic format requirements of EDGAR. The legibility requirements of Rules 403 and 420 under the Securities Act (including requirements as to paper size, printing, language and pagination) continue to apply to prospectuses of issuers distributed in paper form to the investing public.

[b] Place of Filing. Registration statements filed electronically are deemed to be filed at the Commission's main office in Washington, D.C. if certain conditions are met, including payment of the required fee and compliance with the applicable electronic filing standards. n65 A copy of the registration statement, as well as various other documents relating to the fairness and reasonableness of the underwriting compensation, must be filed with FINRA for its review. n66 In addition, the issuer should supply copies of the registration statement to the securities administrator of any state that has a notice requirement for a public offering made in the state. Typically, counsel for the underwriters will take responsibility for making the requisite filings with FINRA and the states.

[c] Date of Filing. The date of filing a registration statement and any amendment thereto is deemed to be the date of receipt by the Commission. n67 A registration statement will be accepted for filing, however, only if all applicable filing requirements have been met and the requisite fee has been paid. n68 A registration statement generally will be accepted for filing only if it is filed electronically on EDGAR. n69

[d] Registration Fee. A registration fee must be paid electronically in connection with the filing of a registration statement. n70 Section 6(b)(5) of the Securities Act provides the Commission with the authority to set the fee rate for registration statements annually in accordance with the guidelines set forth in that section. n71 The fee is payable at the time of filing of the registration statement, n72 except in the case of certain shelf registration statements. n73

In computing the registration fee, reference should be made to Rule 457, which sets forth the Commission's view on the computation of the fee in certain selected circumstances. n74 If doubt persists about how to compute the fee after reviewing Rule 457, the registrant should contact the Division of Corporation Finance's Office of Chief Counsel for assistance.

[e] Proper Form. Except where the prospectus is being delivered electronically, it must be on "good quality, unglazed, white paper no larger than 8 x 11 inches in size, insofar as practicable." n75 Although the prospectus typically is printed, it may be typewritten, lithographed, mimeographed or prepared by any similar process that will produce clear, easily readable copies suitable for both a permanent record and repeated photocopying n76 Finally, the entire registration statement must be in the English language, although exhibits may be in a foreign language if accompanied by a complete or summary translation in English. n77

The form and content of the registration statement must conform to the applicable rules and forms in effect on the initial filing date. n78 If the rules or forms are changed after the filing date, the issuer must comply with the new provisions upon the filing of an amendment if the provisions so require. n79 If not required, the issuer may voluntarily comply if it wishes. n80

Generally, the issuer is automatically deemed to have filed on the proper registration form unless the Commission objects prior to the effective date. n81 Further, an issuer is permitted to file an amendment to a registration statement on any other registration form (including a shorter form) for which it is eligible on the filing date of the amendment. n82

[f] Delaying the Effective Date. Under Section 8(a), registration statements automatically become effective 20 days after filing, unless an amendment is filed to restart the 20-day period. Twenty days generally are not sufficient in most cases to allow the review process to run its course. To provide adequate time for the Commission to work with the registrant in curing deficiencies in the registration statement, and at the same time avoid the necessity for an amendment every 20 days to start the statutory time clock running again, the Commission created a device known as the "automatic delaying amendment."

Rule 473 indicates that the inclusion of a prescribed legend on the bottom of the front cover page (also known as the "facing page") of the registration statement and any amendment thereto will remove the necessity for filing amendments solely for the purpose of restarting the 20-day period. Failure to include the legend on the facing page or to use other measures to delay the effective date n83 means that the registration statement will become effective in the manner prescribed by Section 8(a).

Because of the Commission's manpower limitations, the Commission decided that certain registration statements relating to investments that generally have a low degree of risk should become automatically effective pursuant to Section 8(a). n84 Accordingly, Rule 473(d) states that these filings may not contain automatic delaying amendments. n85

[g] Signature Requirements. Section 6(a) requires that at least one copy of the registration statement be manually signed by the issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of the board of directors or persons performing similar functions. Rule 471 imposes a similar obligation with respect to amendments to the registration statement. The signature requirement serves the purpose of impressing upon the signing parties, all of whom are subject to potential civil liabilities under Section 11(a) for material misstatements or omissions, their responsibility for the accuracy and completeness of the registration statement.

Because registration statements and amendments are filed electronically on EDGAR, a manually signed copy does not have to be filed with the Commission. Instead, the manual signature requirement is met by including a conformed signature in the electronic filing, and retaining in the issuer's files for five years a manually signed signature page or other document authenticating, acknowledging or otherwise adopting the signature included in the filing. n86

An issuer often will experience difficulty in finding a majority of directors available to sign amendments to the registration statement, since it usually is not practical to assemble the Board each time an amendment is to be filed. There are at least three ways of dealing with this problem:

- Incorporate into the initial filing of the registration statement powers of attorney from the directors to officials of the issuer enabling the officials to sign amendments when the directors are unavailable (the most widely used approach);
- Obtain and file counterpart signature pages, (i.e., a separate signature page for each director); or
- Obtain in advance (perhaps on the date the initial filing is signed) signed signature pages for later amendments, which should be used only if the directors have approved the amendment by telephone or otherwise for filing.

[h] Other Required Items. Also required to be included in a registration statement are any required consents of experts,ⁿ⁸⁷ and any power of attorney pursuant to which a person signs the registration statement on behalf of another.ⁿ⁸⁸ In addition, it also generally is necessary under Rule 424 to file copies of any prospectus containing substantive changes from or additions to a previously filed prospectus, as well as certain other prospectuses or documents.

FOOTNOTES:

(n1)Footnote 1. See generally Section 11(b)(3).

(n2)Footnote 2. Section 11(c).

(n3)Footnote 3. 283 F. Supp. 643 (S.D.N.Y. 1968) .

(n4)Footnote 4. 332 F. Supp. 544 (S.D.N.Y. 1971) .

(n5)Footnote 5. 346 F. Supp. 2d 628 (S.D.N.Y. 2004) .

(n6)Footnote 6. 332 F. Supp. at 577 (S.D.N.Y. 1971) .

(n7)Footnote 7. Sec. Act Rel. No. 33-6383 (1982).

(n8)Footnote 8. Insider directors with intimate knowledge of corporate affairs and particular transactions are expected to make a more complete investigation and have more extensive knowledge than outside directors of facts supporting or contradicting information included in the registration statement. Similarly, accountants and underwriters are expected to investigate to various degrees. See generally, *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. at 578 (S.D.N.Y. 1971) .

(n9)Footnote 9. See, e.g., *Weinberger v. Jackson*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,693 (N.D. Cal. 1990), in which an outside director was held to have exercised reasonable due diligence where he reviewed six drafts of the registration statement, discussed certain aspects of it with management, and saw nothing suspicious or inconsistent with the knowledge he had acquired as a director. Other examples of situations in which the due diligence defense was successfully relied upon by directors include *Laven v. Flanagan*, 695 F Supp. 800 (D.N.J. 1988) , and *In re Avant Garde Computing Inc. Securities Litigation* 1989 U.S. Dist. LEXIS 10483 (D.N.J. 1989) . For a discussion of director due diligence responsibilities in the light of the WorldCom and other corporate scandals in the early 2000s, see L.N. Silverman & J. L. Fisher, *Director Due Diligence After WorldCom*, 39 Rev. Sec. & Comm. Reg. 1 (January 18, 2006).

(n10)Footnote 10. An example of an inadequate investigation by outside directors was cited in *BarChris*, and included review of a draft of the registration statement for approximately ten minutes, a failure to review the registration statement in its final form or to question management regarding specific statements contained in the registration statement, and sole reliance on representations of management regarding the accuracy of the registration statement. 283 F. Supp. at 687-89 .

(n11)Footnote 11. 283 F. Supp. at 697 .

(n12)Footnote 12. See generally, C. Young, *Looking Back on WorldCom: Addressing Underwriters' Due Diligence in Shelf Registration Offerings and the Need for Reform*, 40 Suffolk U. L. Rev. 521 (2006-07).

(n13)Footnote 13. See generally S.M. Krus, H.S. Pangas, & C. Zochowski, *To Market, To Market*, Legal Times (November 21, 2005) 36.

(n14)Footnote 14. See, e.g., J. W. Dickens, P. Dutka & J.S. Amsel, *Underwriter Due Diligence: WorldCom and Beyond*, Insights (April 2005) 2-12.; R.C. Sauer, *The Changing Dimensions of Director Liability Under the Federal Securities Laws*, Sec. Reg. & L. Rep. (BNA) (March 7, 2005) 413.

(n15)Footnote 15. Advance planning and preparation on the issuer's part should expedite the registration process and improve the prospects for a successful offering. See, e.g., Hass and Sils, *Inside the Allstate IPO*, Financial Executive (March-April 1994) 36-41.

(n16)Footnote 16. Although the registration statement serves the dual (and conflicting) purpose of being both a selling document and an "insurance policy" against potential liability, the concern for liability usually predominates. As a result, the information typically will be presented in a rather sober style, devoid of puffery or unverifiable claims.

(n17)Footnote 17. The plain English requirements are set forth primarily in Rule 421. Other provisions implementing these requirements include Rules 461 and 481, and Items 101, 501, 502, 503 and 508 of Regulation S-K. The plain English requirements were announced in Sec. Act Rel. No. 33-7497 (1998), and became effective on October 1, 1998. The SEC has provided guidance regarding the application of the plain English requirements in Staff Legal Bulletin No. 7 (1998), and in two booklets: *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*, and *Before & After Plain English Examples and Sample Analyses*.

(n18)Footnote 18. See Rule 421(d).

(n19)Footnote 19. See Rule 421(b).

(n20)Footnote 20. See Note to Rule 421(b).

(n21)Footnote 21. See generally Sec. Act Rel. No. 33-8591, § IV.A.1 at n. 393 (2005). See also remarks of M. McAlevey, Deputy Director of SEC's Division of Corporation Finance (November 11, 2000), reported in *The Securities Reporter* (ABA) (Spring 2001) 28.

(n22)Footnote 22. Id. This view is evident from the fact that none of the Securities Act registration forms contains a "sweep" provision stating that in addition to the information specifically required by the form, any other information considered material also must be included.

(n23)Footnote 23. The Commission's definition is consistent with the Supreme Court's view of materiality expressed in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) .

(n24)Footnote 24. 485 U.S. 224 (1988) .

(n25)Footnote 25. SAB No. 99, 7 Fed. Sec. L. Rep. (CCH) P 75,563 (1999).

(n26)Footnote 26. See, e.g., Securities and Exchange Commission, *Disclosure to Investors: A Reappraisal of Administrative Policies Under the 1933 and 1934 Acts* (1969) at 94 (known generally as the "Wheat Report").

(n27)Footnote 27. Sec. Act Rel. No. 33-5992 (1978).

(n28)Footnote 28. Rule 175 and Rule 3b-6 indicate that the safe harbor provided by them is available only if (i) the forward-looking statement is included in specified disclosure documents filed with the SEC (including registration statements under the Securities Act and periodic reports under the Exchange Act), and (ii) it cannot be demonstrated that the statement "was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."

(n29)Footnote 29. See, e.g., *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989) (estimates alleged to be misleading had a reasonable basis and were covered by the safe harbor of Rule 175).

(n30)Footnote 30. The Commission's policy on projections, including its guidance on the format for presenting them, is set forth in Item 10(b) of Regulation S-K. Further, Item 303 of Regulation S-K, discussed in § 7A.05 [11] *infra*, encourages the inclusion of forward-looking information in management's discussion and analysis of financial condition and results of operations. Finally, Rule 11-03 of Regulation S-X permits financial forecasts in lieu of pro forma condensed statements of income.

(n31)Footnote 31. The reluctance to make projections can be traced to the limited coverage of the SEC's safe harbor rules. See, e.g., *In re Donald Trump Casino Sec. Lit.*, 7 Fed. 3d 357 (3d Cir. 1993) ; *In re Worlds of Wonder SEC. Lit.*, 814 F. Supp. 850, 858 (N.D. Cal. 1993) , *aff'd*, 35 F.3d 1407 (4th Cir. 1994) .

(n32)Footnote 32. For more information on the "bespeaks caution" doctrine, see D. Langevoort, *Disclosures that "Bespeak Caution,"* 49 Bus. Law. 481 (1994).

(n33)Footnote 33. Pub. L. No. 104-67 (1995).

(n34)Footnote 34. Section 27A(b) of the Securities Act states that the PSLRA safe harbor is not available to issuers who (i) were not subject to the periodic reporting requirements of the Exchange Act at the time of the statement; (ii) were convicted or disciplined in connection with certain activities proscribed by the securities laws during the three years preceding the statement; or (iii) made the statement in connection with certain types of transactions, including initial public offerings, "blank check" offerings, rollup transactions, penny stock offerings, going private transactions, and offerings by investment companies.

(n35)Footnote 35. See Section 27A(c) of the Securities Act, which incorporates the PSLRA safe harbor into the Act.

(n36)Footnote 36. Joint Explanatory Statement of the Committee of Conference, H.R. Report No. 104-369, 104th Cong., 1st Sess. at 43-44 (1995).

(n37)Footnote 37. See Section 27A(d) of the Securities Act.

(n38)Footnote 38. In 2008, the staff of the Commission's Division of Corporation Finance published for the first time its internal Financial Reporting Manual. The Manual contains the staff's positions on issues that have arisen in its reviews of issuer filings, as well as responses by the Division's Office of Chief Accountant to public inquiries. The Manual is a useful tool for addressing in advance of filing a registration statement issues relating to the financial statements to be included in the filing. See <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf> for the text of the Manual.

(n39)Footnote 39. Regulation G is set forth in 17 C.F.R. § 244. See also Sec. Act Rel. No. 33-8176 (2003).

(n40)Footnote 40. Sec. Act Rel. No. 33-9002 (2009).

(n41)Footnote 41. The Commission decided to phase in the XBRL requirement for companies which use US GAAP by requiring them to begin filing the required XBRL exhibit in a periodic report for a fiscal period ending on or after the following dates: (i) June 15, 2009, for large accelerated filers (both domestic and foreign) having a worldwide

public common equity float of more than \$5 billion; (ii) June 15, 2010, for all other domestic and foreign large accelerated filers; (iii) June 15, 2011, for all other filers currently using US GAAP; and (iv) the due date of their first periodic report, for other filers that first become subject to the XBRL requirement after the third year.

(n42)Footnote 42. The SEC said in its release announcing the adoption of the XBRL requirement that the requirement is part of its plan to replace the EDGAR system with the Interactive Data Electronic Applications ("IDEA") system. IDEA is based on an architecture that is completely new, and the SEC said it intends to phase IDEA in initially as a supplement to EDGAR and eventually as its replacement. See Release No. 33-9002, at n.35 (2009).

(n43)Footnote 43. See Item 503(c) of Regulation S-K. A boldface reference to the "Risk Factors" section is required to be included on the front cover page of the prospectus, pursuant to instruction (5) to Item 501(b)(3) of Regulation S-K. In addition, registrants that are required to file annual and quarterly reports with the SEC pursuant to Section 13 or 15(d) of the Exchange Act must include a description of their risk factors in their annual reports on Form 10-K and indicate any material changes to those risk factors in their quarterly reports on Form 10-Q. See Item 1A of Part I of Form 10-K, and Item 1A of Part II of Form 10-Q. See also, R. B. Robbins and P. L. Rothenberg, *Writing Risk Factor Disclosure in Exchange Act Reports*, 39 Rev. Sec. & Comm. Reg. 87 (May 3, 2006).

(n44)Footnote 44. See § 7A.05[8] *supra* for a discussion of the "bespeaks caution" defense.

(n45)Footnote 45. Rule 421(d) requires that the risk factors be stated in plain English. In *Updated Staff Legal Bulletin No. 7* (June 7, 1999), the SEC's Division of Corporation Finance provided specific guidance on the use of plain English principles in preparing risk factor disclosures.

(n46)Footnote 46. See Item 503(c) of Regulation S-K.

(n47)Footnote 47. See SEC Division of Corporation Finance, *Updated Staff Legal Bulletin No. 7* (June 7, 1999).

(n48)Footnote 48. See, e.g., R. B. Robbins and P. L. Rothenberg, *Writing Effective Risk Factor Disclosure in Offering Documents and Exchange Act Reports*, Insights (May 2005).

(n49)Footnote 49. *Id.*

(n50)Footnote 50. See Item 303 of Regulation S-K.

(n51)Footnote 51. See generally Item 303(a) of Regulation S-K.

(n52)Footnote 52. The staff of the Division of Corporation Finance makes available on the SEC's web site sample comment letters on MD&A disclosure regarding selected topics of current interest, such as allowances for loan losses and fair value measurements. These letters are available at <http://www.sec.gov/divisions/corpfin/cfdisclosure.shtml>. Significant SEC statements regarding the disclosures required in the MD&A include Sec. Act Rel. Nos. 33-6835 (1989), 33-7101 (1994), 33-8056 (2002) and 33-8350 (2003). Enforcement actions by the SEC relating to the MD&A include *SEC v. Bank of New England Corp.*, Lit. Rel. No. 34-12743 (1990), and administrative proceedings against the parties described in Exchange Act Rel. Nos. 34-30532 (1992); 34-31934 (1993); 34-33632 (1994) (1994); 34-34047 (1994); 34-34865 (1994); 34-35814 (1995); and 34-36357 (1995).

(n53)Footnote 53. See Release No. 34-48960 (2003).

(n54)Footnote 54. Remarks of SEC staff members at 2009 Winter Meeting of ABA Committee on Federal Regulation of Securities (November 20, 2009).

(n55)Footnote 55. The Commission has not defined the term "segment" for purposes of the description of a registrant's business under Item 101 of Regulation S-K, stating instead in the Item that the term is "defined by generally accepted accounting principles." The Accounting Standards Codification ("ASC") of the Financial Accounting

Standards Board ("FASB") provides in ASC Topic 280, Subtopic 10-50, that "an operating segment is a component of a public entity that has all of the following characteristics:

- a. It engages in business activities from which it may earn revenues and incur expenses ... ;
- b. Its operating results are regularly reviewed by the public entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- c. Its discrete financial information is available.

(n56)Footnote 56. See Barker, *SEC Registration of Public Offerings Under the Securities Act of 1933*, 52 *Bus. Law.* 63, 101 (1996).

(n57)Footnote 57. See Article 3 of Regulation S-X, for a summary of the requirements for audited financial statements in registration statements filed under the Securities Act.

(n58)Footnote 58. Rule 2 of the Commission's Informal and Other Procedures, 17 *C.F.R.* § 202.2, provides that:

The staff of the Commission renders interpretative and advisory assistance to members of the general public, prospective registrants, applicants and declarants. For example, ... persons contemplating filings with the Commission may receive advice of a general nature as to the preparation thereof, including information as to the forms to be used and the scope of the items contained in the forms. Inquiries may be directed to an appropriate officer of the Commission's staff. In addition, informal discussions with members of the staff may be arranged whenever feasible ...

(n59)Footnote 59. See *The SEC Today*, (December 3, 1999) at 102.

(n60)Footnote 60. D. Goldwasser, *Processing Registration Statements and Post Registration Obligations*, Capital Formation: Private and Public Financing, at 367-368 PLI Course Handbook No. 287 (1982).

(n61)Footnote 61. See Rule 101 of Regulation S-T. Rules 201 and 202 of Regulation S-T provide for hardship exemptions from the electronic requirements, but the Commission historically has not granted hardship exemptions for registration statements filed under the Securities Act.

(n62)Footnote 62. The Commission adopted final rules implementing the EDGAR system in Sec. Act Rel. No. 33-7427 (1997). Registrants seeking to file a registration statement on EDGAR should refer to the instructions contained on the SEC's web site at <http://www.sec.gov/info/edgar/.shtml>. The EDGAR Filing Manual, available at <http://www.sec.gov/info/edgar/edmanuals.shtml>, is the principal source of guidance for filing. Investors and other persons seeking to use EDGAR for search purposes should follow the instructions set forth on the SEC's web site at <http://www.sec.gov/edgar/quickedgar.htm>.

(n63)Footnote 63. See 17 *C.F.R.* § 232 et seq.

(n64)Footnote 64. See generally Rules 402, 403, 420, 424, 470 and 472.

(n65)Footnote 65. See Rule 13(a)(2) of Regulation S-T.

(n66)Footnote 66. See Rule 5110(b)(5)(B) of the FINRA Manual, available at <http://finra.complinet.com>, which indicates that documents filed electronically with the SEC are deemed to be filed with FINRA. FINRA may object to the proposed underwriting terms and arrangements if it believes they are unfair and unreasonable, in which case

modifications to them can be filed with FINRA for further review.

(n67)Footnote 67. See Section 6(c) of the Securities Act and Rule 456.

(n68)Footnote 68. See Rule 456. Pursuant to that rule, the failure to pay an insignificant amount of the required fee at the time of filing, due to a bona fide error, will not affect the date of filing.

(n69)Footnote 69. See Rule 14 of Regulation S-T. The SEC staff will make an accommodation for a foreign private issuer's first proposed filing (whether on Form F-1 or Form 20-F), by allowing the issuer to submit the filing in paper form on a confidential pre-filing basis. After the staff's comments have been incorporated by the issuer into its draft registration statement, the registration statement is then officially filed electronically.

(n70)Footnote 70. The registration fee for the SEC's 2009 fiscal year was \$55.80 per million dollars of securities being registered. Fee payments must be submitted to U.S. Bank, N.A. in St. Louis, Missouri, in accordance with Rule 202.3a of the SEC's Rules of Practice and Investigations.

(n71)Footnote 71. See SEC Press Release No. 2006-64 (May 3, 2006). The maximum aggregate offering price is determined in accordance with Rule 457.

(n72)Footnote 72. See Section 6(b)(2) of the Securities Act.

(n73)Footnote 73. See Rule 457(r).

(n74)Footnote 74. Some fee calculation issues not covered by Rule 457 have been addressed by the Commission staff in no action letters. See, e.g., *H. & Val J. Rothschild, Inc.*, SEC No-Action Letter (May 4, 1981), in which the staff indicated that no additional fee would be charged on the principal amount of debt securities rolled over at maturity, provided certain conditions were met.

(n75)Footnote 75. Rule 403(a).

(n76)Footnote 76. Rule 403(b).

(n77)Footnote 77. Rule 403(c).

(n78)Footnote 78. Rule 401(a)

(n79)Footnote 79. Rule 401(f).

(N80)Footnote 80. *Id.*

(n81)Footnote 81. Rule 401(g). This principle does not apply to some registration statements (such as those on Form S-8) and post-effective amendments that become effective immediately upon filing pursuant to Rule 462 or Rule 464.

(n82)Footnote 82. Rule 401(c)

(n83)Footnote 83. Pursuant to Rule 473(c), the registrant also can delay the effective date by sending a letter or telegram to the Commission prior to the deadline for automatic effectiveness stating that the registrant will amend the facing page of the registration statement to alter the proposed date of public sale of the securities being registered. Any such amendment made by telegram must be confirmed in writing within a reasonable time by filing the amendment.

(n84)Footnote 84. The registration statements that are made effective automatically are described in Rules 462, 464 and 467. They include filings (i) on Form F-7, F-8, or F-80 by certain Canadian issuers; (ii) on Form F-9 or F-10

relating to an offering being made contemporaneously in the United States and Canada by certain Canadian issuers; (iii) on Form S-8 relating to compensation plans; (iv) on Form S-3 or F-3 relating to a dividend or interest reinvestment plan; and (v) on Form S-4 complying with General Instruction G of that form.

(n85)Footnote 85. Most of these registration statements and amendments thereto become effective automatically upon filing with the Commission. See Rule 467 (Forms F-7, F-8 and Form F-80) and Rule 462 (Form S-8 and Forms S-3 and F-3 relating to dividend or interest reinvestment plans).

(n86)Footnote 86. See Rule 471(b) under the Securities Act and Rule 302 of Regulation S-T.

(n87)Footnote 87. As indicated in § 7A.02[1][e] *supra*, Section 7 of the Securities Act states that the written consent of any expert "shall be filed with the registration statement unless the Commission dispenses with such filing as impracticable or as involving undue hardship on the person filing the registration statement." See also Rule 436, which provides additional information regarding the consent requirement, and Rule 437, which deals with applications to dispense with the requirement.

(n88)Footnote 88. See Item 601(b)(24) of Regulation S-K.



95 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 § 7A.06

AUTHOR: Peter J. Romeo

§ 7A.06 SEC Review

Registration statements are subject to review, in whole or in part, by the Commission staff before they can be used for the sale of securities. In addition, it typically is necessary to obtain clearance of the underwriting compensation from FINRA and to file notices with some state authorities before sales can be made. The process of navigating these regulatory waters is discussed below.

[1] Statutory Framework

The disclosure purpose of the Securities Act precludes the SEC from approving or disapproving of securities offerings on the basis of their perceived merit. Consequently, the SEC focuses its efforts on methods to achieve the statutory purpose of full and fair disclosure of securities offerings. As explained below, the principal method utilized by the SEC staff is the issuance of comment letters on the disclosures contained in registration statements selected for review. n1

[2] The Review Process

Pursuant to authority delegated by the Commission, the staff of the Division of Investment Management processes registration statements filed by registered investment companies and the staff of the Division of Corporation Finance processes all other registration statements. Because of the latter's preeminent role in the review of registration statements, its organization and method of operation are described below.

[a] Organization of the Review Staff. The task of processing registration statements is the responsibility of the Division's 14 Disclosure Operations Offices, all of which are located at the Commission's headquarters in Washington, D.C. n2 Eleven of these offices specialize in specific sectors of the economy and review registration statements and other disclosure filings by companies in the sectors for which the respective offices are responsible. n3 Each of these offices is headed by an Assistant Director, n4 The remaining three Disclosure Operations Offices, each of which is headed by a Chief, deal with matters related to the disclosure review function. n5 The Disclosure Operations Offices are supported by seven other offices that deal with legal and regulatory policy matters relating to the Division's disclosure program. n6 Overseeing all of this activity is the senior management of the Division, consisting of the Director, two Deputy Directors (one of whom oversees the entire filing review process, in consultation with the Director), and seven Associate Directors (three of whom have oversight responsibility for specific Assistant Director Offices assigned to

them). n7

The most important person involved in the review process is the Assistant Director, who heads the office to which the company's registration statement or other disclosure filing is assigned. The Assistant Director supervises the activities of 25-35 professionals (primarily attorneys and accountants), and is the principal person responsible for resolving significant disclosure and other issues that arise in the review of disclosure filings assigned to the office. Perhaps the most important responsibility of the Assistant Director with respect to registered offerings of securities is making the determination whether or when the registration statement for the offering will become effective.

[b] Assignment of Filings. Registration statements are assigned to an Assistant Director's office on the basis of the issuer's standard industrial code ("SIC"). n8 Each office specializes in particular industries, and is responsible for the filings made by the companies in those industries. Within each office, registration statements that are designated for review (after screening by a senior staff member) are assigned to a team consisting of an accountant who reviews the accounting aspects of the filing, and an examiner (i.e., an attorney or financial analyst) who reviews the non-accounting aspects. The work of these persons is reviewed by senior staff members, and leads eventually to the issuance of a formal letter of comment to the issuer regarding the perceived deficiencies in the registration statement.

A registration statement or other disclosure document that is selected for review will undergo one of three types of review. n9 The most complete type is a full cover-to-cover review, in which the staff will examine the entire filing for compliance with applicable disclosure and accounting requirements. Another type of review is a financial statement review, in which the staff will examine the financial statements and related disclosures, such as the MD&A, for compliance with applicable accounting standards and related disclosure requirements. The final type of review is a targeted review, in which the staff will examine one or more disclosure items of the filing for compliance with applicable disclosure and accounting requirements. The level of review is determined on the basis of various factors, including the type of filing and industry issues. n10

[c] Time Required. The amount of time required by the staff to process a registration statement will vary, depending on several factors. The most important of these is the type of review accorded to the registration statement. The review alternatives range from full review (as in the case of almost all IPOs) to no review at all (as in the case of registration statements that automatically become effective and other filings deemed to present lesser risk of problems than others). n11 If there will not be any review (a determination usually made within two to five business days after filing), the staff can make the registration statement effective within 48 hours after notifying the registrant of its no-review determination. On the other hand, if the filing is selected for full review, the staff will seek to issue its initial comment letter within 30 days of the filing date. On occasion, the staff is unable to meet the 30-day goal, and may take as long as 40-50 days to issue the comment letter. Factors that can delay the issuance of the letter include a large backlog of filings, the quality of the registration statement, the nature of the issuer or the transaction, n12 the time of year, n13 and the need to consult with other parties. n14

After the initial comment letter is issued, the time required to complete the review process will depend largely on how rapidly the registrant can amend the registration statement in a manner that will satisfy the staff's concerns. Often, more than one amendment will be needed to deal with those concerns, in part because the staff may raise additional issues in one or more follow-up comment letters after seeing the initial amendment. Depending on the volume of revised disclosures or supplemental information it receives in response to comments, the staff may take anywhere from a few days to a week or more to convey whatever comments it may have on an amendment. Under ideal circumstances, the time required to complete a full review from the date of filing may be as short as six or seven weeks, but can be much more protracted in some cases.

[3] The Comment Letter

The staff's comment letter describes deficiencies believed by the staff to exist in the registration statement and also often

requests supplemental information about matters that the staff wishes to explore further outside the filing. The letter typically is faxed to counsel for the issuer, although where time is of the essence the SEC examiner may telephone its contents and follow up later with the written version. When preparing the comment letter, the staff seeks to focus on all material disclosure deficiencies and makes an effort to avoid issuing comments of a trivial nature. Consistent with the plain English directive applicable to registrants, the staff structures its comments in simple, concise language.

Generally, the staff's comments are of three types: (i) substantive comments requesting revision or clarification of specified disclosures (so-called "advise or revise" comments); (ii) comments requesting supplemental information; and (iii) "housekeeping" comments regarding various technical or procedural matters. Although the staff's goal is to raise all of its concerns in the initial comment letter, it is not foreclosed from raising additional concerns in subsequent comment letters. n15 Often, the staff will do so on the basis of its review of the supplemental information that it previously requested.

[a] Responding to the Staff's Comments. Upon receipt of the staff's comment letter, all parties involved in the registration effort (i.e., the issuer, its counsel and accountants, and the managing underwriter and its counsel) should discuss the comments in a meeting or conference call and generally agree on how to respond to them. Some comments may be unclear, in which case a representative of the issuer should contact the SEC examiner and seek clarification. The issuer's financial and accounting personnel should work with the issuer's auditor in responding to the accounting comments, while other management personnel should work with the issuer's counsel in preparing responses to the remaining comments.

After determining appropriate responses to the staff's comments, the issuer should prepare an amendment to the registration statement that addresses the comments. When the amendment is filed, it should be accompanied by a transmittal letter submitted electronically on EDGAR explaining how the registrant dealt with each of the comments. The issuer should include, where possible, references to the location in the amended prospectus (by caption, paragraph, and page number) where changes have been made in response to the comment under discussion. If the issuer has not complied with a comment by the staff, it should state its reasons in the transmittal letter. At the other extreme, if the amendment contains changes not called for by the staff, such as those reflecting a recent development, the nature of the changes should be fully explained in the letter.

Some staff comments request that additional information be included in the registration statement, even though the information does not appear to be required by the applicable form, rules or regulations or by general materiality standards. n16 The inclusion of this information is necessary only if its omission would result in a materially misleading document. Where this is not so, many practitioners nonetheless include the information where the registrant has no important interest at stake, but resist doing so where the disclosure would be harmful to the registrant or would be costly or time-consuming to obtain.

[b] Appeals of Adverse Comments. In some cases, the staff may issue comments that present significant concerns for the issuer, either because an adequate foundation does not appear to exist for the comments or some other reason. The staff has an open mind with respect to these concerns, as evidenced by its statement that "a company should not hesitate to request that the staff reconsider a comment it has issued ... at any point in the filing review process." n17

Accounting comments that appear to be unwarranted should be discussed by the issuer's accounting staff and accounting representative (typically its auditor) with the Accounting Branch Chief in the Assistant Director's office who examined the accounting aspects of the filing. If a satisfactory response is not received at that level, the issuer's representative should seek to discuss the matter with the Senior Assistant Chief Accountant in that office. Where an acceptable result remains elusive after this discussion, the controversy can be addressed with an Associate Chief Accountant in the Division's Office of Chief Accountant or with the Chief Accountant directly. Counsel for the issuer should be kept fully informed regarding these discussions.

Troublesome non-accounting comments involving legal or textual disclosure matters should be discussed initially with the examiner who reviewed the non-accounting aspects of the filing. If the matter cannot be resolved at that level, the appropriate course is to request a conference with the Legal Branch Chief in the Assistant Director's office, and then directly with the Assistant Director if the matter continues unresolved. If the Assistant Director is unwilling to withdraw or modify the comment to the issuer's satisfaction, counsel may properly request that the matter be considered by the Associate Director responsible for overseeing the Assistant Director's office, or ultimately, in the case of matters of fundamental importance, to the Deputy Director responsible for disclosure operations or to the Director of the Division. In no case, however, should counsel appeal to a more senior official unless the matter is highly important and the issuer has exhausted all opportunities at the lower level for reaching an accommodation.

The Commission staff generally is reasonable in dealing with soundly-based objections to its comments. As to matters of fundamental disagreement, however, the reality is that the staff almost always will prevail. The registrant's only alternatives in such situations are to comply with the staff's views or to challenge them by filing an amendment to the registration statement that will become effective automatically in 20 days. n18 Where a challenge is made, the Commission will then have to determine whether to institute a stop order proceeding or take other enforcement action. Obviously, the risk that it will do so is very high, and no registrant, after dispassionate consideration, should be willing to take that risk. Accordingly, even though the staff's comments are not legally binding, as a practical matter the issuer must reach an accommodation with the staff before the offering can proceed.

[c] Expediting the Review Process. Avoiding delays in the registration process is extremely important. The market, for example, may not remain receptive indefinitely and a "window" for making the offering successfully may be lost if the registration process is protracted. Further, excessive time in registration may necessitate updating the financial statements, n19 a costly and time-consuming process that should be avoided where possible. By following the procedures and techniques described below, an issuer should be able to minimize the time required to complete the registration process.

File the Best Document Possible. The registration statement should not be filed until all parties responsible for its preparation are satisfied that it complies with all applicable requirements. Filing an incomplete or substandard document simply to start the review process as early as possible is an unwise approach for several reasons. First, if the registration statement is in poor shape, the Commission may decline to review it by sending a "bedbug" letter, or, even worse, may institute formal stop order or other enforcement proceedings if the deficiencies appear to stem from careless disregard of the statutes and rules. n20 Second, there is no guarantee that the Commission staff will discover the deficiencies, with the result that the issuer and its counsel may be exposing themselves to potential liability for material misstatements and omissions by not taking their responsibilities more seriously. Finally, the filing of a highly deficient registration statement may result in a loss of credibility with the staff, making it more difficult to reach a meeting of the minds on future filings.

Avoid Surprises. After filing the registration statement, the issuer should studiously avoid activities that could require material changes in the disclosures previously made. For example, it would be advisable to suspend activities that might cause a potential major business combination under preliminary consideration to be viewed as probable and therefore disclosable. On the other hand, if an event occurs that could affect the processing of the registration statement, such as the loss of an underwriter or unexpected difficulty in meeting the updating requirements for financial statements, the issuer should promptly advise the staff of the problem so that the staff may consider its impact as quickly as possible.

Inquire About Delays. If the staff of the Commission has not provided comments or otherwise communicated with the registrant during the period contact was anticipated (e.g., within 30 days after a first-time registrant has filed or within five days after a repeat registrant has done so), counsel should call the office responsible for the filing to determine the status of the registration statement. Taking a passive approach in this type of situation may result in unnecessary delays, as might occur when the staff is grappling with disclosure issues that perhaps could be resolved quickly through the submission of supplemental data or a meeting with the staff, or both.

Respond Promptly and Fully to Staff Requests. Frequently, the staff will request support for particular statements or ask for further information regarding a matter discussed in the registration statement. Presumably, the items in question can be fully documented and ample supporting materials can be supplied. The best course is to gather all relevant materials and supply them as promptly as possible to the staff, along with a cover letter providing explanations where appropriate.

Anticipate the Need for Updating. As the countdown to the 135th day for updating financial statements (or the 130th day for accelerated and large accelerated filers) approaches its last few weeks, the registrant should anticipate a request by the staff to update financial statements and data and make appropriate preparations for doing so. n21

[4] Special Situations

The Commission's experience in the disclosure process has enabled it to craft approaches to unique situations that generally have the effect of maximizing the use of its limited resources without seriously undermining the quality of disclosures or placing undue burdens on registrants. The nature of the offering and the status of the issuer usually will determine which of the approaches the SEC will apply, as indicated below.

[a] IPOs. The Commission's policy is to review fully all registration statements by issuers that have not previously made any filings under the securities laws. n22 Registration statements for IPOs by domestic issuers typically are filed on Form S-1, the Commission's general registration form. The staff reviews IPOs with particular care, and it is not uncommon for it to issue a multitude of comments (70, 80 or more) on such filings. n23 Where an IPO is being made by an entity deemed to be an "ineligible issuer" within the definition of that term in Rule 405, staff sensitivities are at their highest level, and the issuer should anticipate not only a lengthy comment letter but also extensive delays in the processing of its registration statement.

[b] Follow-On Offerings. As a result of the adoption of the integrated disclosure system, n24 many issuers that have made timely filings under the securities laws for at least 12 calendar months can make public offerings on Form S-3, an abbreviated registration form which ordinarily requires much less time and effort to prepare than a registration statement for an IPO. Form S-3 allows the issuer to satisfy the disclosure requirements largely through incorporation by reference from public documents filed by the issuer under the Exchange Act. n25 Recognizing that repeat issuers generally are seasoned veterans of the disclosure system whose reports have been periodically examined by the staff over the years, n26 the Division reviews a relatively small percentage of registration statements filed by these entities.

[c] Shelf Offerings. Since 1982, the Commission has permitted issuers meeting certain conditions prescribed in Rule 415 and Form S-3 to register securities in advance for sale at later dates when market conditions and the issuer's need for capital are best suited for an offering. n27 The process whereby an issuer can place registered securities "on the shelf" for later sale affords the issuer great flexibility to tap the equity or debt markets at the right time, n28 at relatively low cost, without undue delay. n29

In 2005, the SEC made significant changes to the shelf registration rules designed to expedite shelf offerings. n30 Chief among these changes is a procedure for automatic shelf registration by well-known seasoned issuers ("WKSIs") that eliminates delays in shelf takedowns by these issuers. n31 Shelf registration statements filed by WKSIs become effective automatically upon filing. n32 In addition, a WKSI may (i) add immediately at any time after effectiveness (a) additional classes of securities not previously registered, and (b) majority-owned subsidiaries as registrants, n33 and (ii) pay registration fees either in advance or on a "pay-as-you-go" basis as securities are taken down from the shelf. n34

Other changes to the shelf registration process implemented in 2005 to reduce the restrictions on shelf offerings included: (i) adding Rule 430B to codify in a single rule the information that shelf issuers may omit from the base prospectus for the shelf offering and include instead in either a prospectus supplement, an Exchange Act report incorporated into the shelf registration statement, or a post-effective amendment; n35 (ii) deleting the requirement in

former Rule 415(a)(2) that limited an issuer to registering only the amount of securities that it reasonably expected to offer and sell within two years; (iii) eliminating the restrictions on "at-the-market" shelf offerings by "seasoned issuers" with a \$75 million public float; and (iv) permitting immediate takedowns from a shelf registration statement on Form S-3 or F-3 n36

[d] Business Combinations. The disclosures appropriate for mergers and other business combinations are distinctly different from most other types of securities offerings. As a result, the Commission adopted a special registration Form, S-4, for these offerings that heavily utilizes the principles of the integrated disclosure system. The SEC also adopted Regulation M-A to modernize the requirements applicable to business combinations. n37 In addition, the Commission clarified the financial statement requirements applicable to acquisitions in registered public offerings. n38

Where an S-4 filing is selected for full review by the staff, as most are, the processing time can be considerably longer than the time required for other types of offerings, due to the complexity of most business combinations. In addition, delays can result where the issuer inadequately conforms the registration statement to the Commission's plain English requirements. n39

[e] Asset-Backed Securities Offerings. Asset-backed investment grade securities provide qualified issuers with a ready means for securitizing assets through an offering on Form S-3. The frequency of these offerings caused the Commission to adopt Regulation AB, which prescribes the disclosure regime for asset-backed securities offerings. n40 Regulation AB requires significant additional disclosures beyond those formerly required for parties to asset-backed securities transactions, including sponsors, originators, servicers, administrators, and trustees. In addition, extensive static pool data are required, including information about performance trends with respect to groups of assets of the same type originated at the same time, as well as information about delinquencies and losses for static pools of the same asset type with the same sponsor. n41

[f] Employee Benefit Plans. In 1990, the Commission adopted a simplified method of registering securities issued in connection with employee benefit plans on Form S-8. n42 As amended, Form S-8 is little more than a notice to the Commission that an offering under a plan is being made by the issuer. Unlike other registration forms, no prospectus is required to be filed with the registration statement n43 and the registration statement becomes effective automatically upon filing with the Commission. n44 Operating on the theory that most information required by Form S-8 about the plan and the issuer is contained in documents required to be prepared for other purposes (such as to satisfy ERISA or the reporting requirements of the Exchange Act), the Commission has indicated that the statutory prospectus will consist of (i) documents delivered by the issuer to plan participants containing the information about the plan required by the form; (ii) a written statement of the availability, upon request, of certain other documents (e.g., the registrant's latest annual report) that are incorporated by reference; and (iii) the documents incorporated by reference. n45 Because registration statements on Form S-8 become effective automatically upon filing, there is no review or processing of these filings by the Commission staff.

[g] Selling Security Holders. Issuers from time to time may register securities for resale by their security holders pursuant to registration rights agreements or otherwise. n46 Resale registration statements are filed most commonly on Form S-3, which incorporates by reference information about the issuer from its Exchange Act reports, and typically contain little additional information beyond the names of the selling security holders, a broad description of the plan of distribution and, in some cases, a discussion of risk factors. Until the securities offering reforms of late 2005, it was necessary to include the names of all selling security holders known at the time of effectiveness and to add new or previously unidentified selling security holders thereafter by filing a post-effective amendment to the registration statement. As part of the 2005 rule changes, however, the SEC excepted from these requirements seasoned issuers eligible to use Form S-3 or Form F-3 for primary offerings. Further, issuers that qualify as WKSIs need not include the identities of selling security holders in an automatic shelf registration statement until after effectiveness n47 if they satisfy the conditions specified in Rule 430B(b). n48

[h] Foreign Issuers. Believing that the globalization of the international securities markets is a desirable objective, the Commission has taken a number of steps during the past two decades designed to lower the barriers to foreign issuers who wish to tap the United States markets. These initiatives include (i) the adoption of a separate integrated disclosure system for foreign private issuers containing a number of accommodations to foreign practices and policies, n49 (ii) the development of a multi-jurisdictional disclosure system with Canada designed to allow transactions to proceed in both the United States and Canada on the basis of home country disclosures and rules, n50 (iii) the adoption of Regulation S, which provides a safe harbor from registration for offshore distributions, n51 (iv) the adoption of Rule 144A, which provides an exemption for certain private resales in an effort to improve the efficiency of private placement markets in the United States for foreign securities, n52 (v) the adoption of changes to the non-financial statement disclosure requirements for foreign private issuers to conform the requirements more closely to the international disclosure standards endorsed by the International Organization of Securities Commissions, n53 and (vi) the adoption of exemptions designed to facilitate the inclusion of U.S. investors in cross-border tender offers, exchange offers, business combinations and rights offerings for the securities of foreign companies. n54

In addition, the Commission has expanded the universe of foreign issuers eligible to use short form registration and shelf registration, n55 streamlined financial statement reconciliation and financial schedule requirements, n56 expanded the safe harbor protection provided for certain announcements by issuers of exempt offerings or unregistered offerings, n57 provided a safe harbor in Rule 135e to facilitate U.S. press access to offshore activities relating to present or proposed offerings of securities, n58 enhanced the timeliness and quality of information regarding foreign private issuers required to be available to U.S. investors, n59 and made other changes designed to make the U.S. public markets more accessible to these issuers. n60

[i] Risky Issuers. In some instances, certain issuers will attract the attention of the SEC staff because of circumstances suggesting that offerings by these entities present a greater risk of Securities Act problems than other offerings. Issuers which are in precarious financial condition, members of industries experiencing severe financial difficulties, and companies with a limited history (such as shell companies), often will find that their Securities Act filings receive increased scrutiny from the SEC staff. Similarly, issuers that have been the subject of recent enforcement proceedings by the SEC, or are engaging in offerings (such as a rescission offer) indicating that there may have been a violation of the Securities Act in the recent past, may find their filings being reviewed more frequently and with greater depth than those of issuers not laboring under these disabilities.

[j] Small Business Issuers. The Commission has made numerous efforts over the years to ease the registration and other burdens imposed by the Securities Act on small businesses. n61 A major initiative was the adoption of Regulation S-B in 1992, which prescribed a separate disclosure scheme and special registration forms for small business issuers. n62 In 2007, the SEC decided to replace Regulation S-B and the registration forms related to it with a simplified system that contained new eligibility requirements designed to encompass a greater number of small issuers, referred to as "smaller reporting companies," than Regulation S-B. n63 To facilitate the use of the new system by eligible issuers, the SEC has issued an extensive guide to financial reporting by such issuers, n64 as well as other useful information available on its web site. n65

[5] Significant Processing Concerns

During the review process, the issuer is likely to be faced with a number of concerns that can seriously impede the offering if not resolved satisfactorily. Some of the more common ones are described below.

[a] Accounting Issues. Following the corporate scandals that led to the passage of the Sarbanes-Oxley Act in 2002, the SEC received funding for a substantial increase in the size of its accounting staff. As a consequence, accounting comments on registration statements increased, and in some instances are more numerous than the non-accounting comments. Among the issues that are frequently the subject of accounting comments are the following.

Cheap Stock. Many companies that anticipate going public in the future issue stock, stock options, or warrants to

corporate insiders during the period prior to the IPO at prices well below the eventual IPO stock price. Because applicable accounting standards require a company to recognize compensation expense for issuances of equity securities for less than fair value, n66 the Commission staff generally will review stock options and other compensatory stock awards granted by an IPO registrant during the 12 months before the date of the issuer's most recent balance sheet included in the IPO prospectus.

In 2005, the staff began to apply the recommendations contained in an AICPA Practice Aid when reviewing cheap stock issues. n67 In accordance with these recommendations, the staff requires extensive MD&A and financial statement footnote disclosure of the process by which issuers comply with the Practice Aid. Among other things, issuers must reconcile and explain the differences between the fair values of the underlying common stock at each valuation date, and show the difference between the most recent fair value and the midpoint of the IPO offering range.

Deemed Dividends. The approach to cheap stock generally is applied by the SEC staff to sales made by the issuer to outside investors. Specifically, some sales made to investors in the six months preceding the IPO at prices significantly less than the IPO price have been viewed by the staff as involving a "deemed dividend" that requires a one-time accounting charge equal to the difference between the selling price and the deemed market value at the time. The sales that most often present this problem are those made to existing investors because the SEC staff frequently is skeptical that the sale price was arrived at on an arm's length basis.

Discounted Equity Sales. Sales of equity securities made during the pre-IPO period to strategic partners having a commercial relationship with the issuer, such as customers and suppliers, also attract the attention of the SEC accounting staff. The concern is that the sale price may not represent the actual market value because the investor may transfer value to the issuer in the course of the commercial relationship in exchange for a reduced purchase price. Where the staff believes that such a discounted sale may have occurred, it may insist on an accounting adjustment to be amortized over the life of the contract or other arrangement with the investor.

[b] Confidential Treatment. For competitive or other reasons, an issuer may feel that the disclosure of certain information in a registration statement will be harmful to it. In situations of this sort, it is permissible to request confidential treatment of the information pursuant to Rule 406, although the granting of the request is entirely within the Commission's discretion. n68

General Considerations. Although it is theoretically possible under Rule 406 to receive confidential treatment of any information, the SEC staff has made it clear that it will not, "except in unusual circumstances," grant confidential treatment to information specifically required to be disclosed by Regulation S-K or any other applicable disclosure requirement, or to information that is material. n69 From a practical standpoint, this means that only information included in an exhibit is likely to be a serious candidate for confidential treatment. Moreover, issuers should recognize that submitting a confidential treatment request could delay the effectiveness of the registration statement because effectiveness cannot occur until the request is resolved.

Substantive Requirements. The staff will deny a confidential treatment request if the information at issue already has been disclosed publicly. Thus, *any* public disclosure of the information, including unintentional disclosure or unauthorized disclosure by a third party, will defeat the application. n70 The application for confidential treatment should be as narrowly drawn as possible, focusing only on the information necessary to prevent competitive harm to the issuer, because the staff generally is not amenable to excluding entire sections from a document. The application also must set forth a legal analysis, with appropriate case law references, in support of the issuer's claim that an exemption from the Freedom of Information Act is available for the request. n71 Finally, the application should identify clearly the information that is the subject of the application, specify a particular date for the termination of confidential treatment of the information, and contain a consent to the release of the information for official purposes to other government agencies or bodies and to the Congress. n72

Procedural Requirements. Rule 406 and Staff Legal Bulletin No. 1 set forth the procedural requirements for confidential treatment requests. n73 Among other things, the request must be submitted in paper form (rather than electronically) with the Secretary of the Commission, and should be submitted at the same time the issuer files the registration statement containing the exhibit from which it omitted the confidential information. The issuer should note in the filed exhibit the places at which the information has been omitted and should submit to the Secretary of the Commission a complete copy of the document containing the confidential information, marked to show clearly the portions covered by the request. The issuer should also indicate to whom correspondence, orders, and notices should be sent.

[c] SEC Investigation. On rare occasions, an issuer in registration simultaneously is being investigated by the Commission's Enforcement Division for possible violations of the federal securities laws. While there is no rule or regulation mandating disclosure of the investigation, many issuers elect to make disclosure if the matters under investigation could have a material adverse impact. n74

A separate concern is whether the Commission will accelerate the effectiveness of the registration statement while the investigation is open. The answer is that it will grant an acceleration request by the issuer (assuming all other conditions for acceleration are met) if the issuer furnishes to the Commission prior to effectiveness a letter containing representations that:

- The disclosures in the registration statement are the responsibility of the issuer;
- The issuer is aware that the staff did not provide comments on the registration statement or specific parts thereof because of a pending investigation by the Division of Enforcement; and
- The issuer will not assert any action or inaction by the staff as a defense in any proceeding initiated by the Commission or any person under the federal securities laws. n75

Although the foregoing representations now are required in connection with the granting of all acceleration requests, even if the issuer is not being investigated, the Commission staff also may ask for a letter containing these representations in a situation where it will not accelerate the effective date but will allow the registration statement to become effective by operation of law. The purpose in doing so is to preclude the issuer from later asserting as a defense the Commission's passive action in allowing the registration statement to become effective without having instituted stop order or other enforcement proceedings.

[6] Marketing

[a] Circulation of Preliminary Prospectus. It is common in IPOs to make a "quiet filing" of the preliminary prospectus at the time the registration statement for the offering is submitted to the SEC. The filing is considered quiet because the preliminary prospectus is not circulated to investors (even though it becomes a public document upon filing). Instead, the issuer and the underwriters delay the commencement of the marketing effort until they have been able to incorporate changes made in response to the SEC's comments into a subsequently filed prospectus and can distribute the amended prospectus to investors. Waiting in this manner has two salutary effects. It reduces the time lag between the commencement of marketing and effectiveness of the registration statement, thereby limiting the possibility of investor concerns that might be occasioned by a lengthy delay after the initial filing. And it generally avoids the prospect of recirculation of the prospectus to address staff concerns, an event which is to be avoided at all costs because of the dampening effect it may have on the sales effort. n76

[b] Road Show. During the period following the filing of the registration statement, the managing underwriter will initiate various activities as part of the marketing effort. These include meetings with potential members of the syndicate and with personnel of the underwriter to organize the marketing effort. The principal focus of the marketing effort, however, will be on the "road show," which will commence after an amended prospectus reflecting the SEC's

comments is available for distribution. The road show involves a series of meetings, usually over a period ranging from several days to one or two weeks, with securities dealers and institutional investors in various major cities designed to generate enthusiasm for the offering. Present at the road show meetings will be senior members of company management and representatives of the managing underwriter, who will combine to make an orchestrated presentation of the strengths of the issuer and its responses to any investor concerns that might exist.

Road shows can involve meetings with large audiences or smaller meetings with selected investors. As a result of reduced restrictions on electronic communications, road shows increasingly have included electronic presentations over the Internet or other electronic media. Where road shows are originated live and in real-time to a live audience, rather than in recorded form, they are deemed not to be a written communication or a free writing prospectus. n77

[c] Public Communications. During the offering period the issuer will publish a variety of communications as part of its ongoing business operations, and also will issue some communications specifically related to the offering. Two safe harbor rules generally insulate issuers from potential liability for regular business communications, as mentioned previously. n78 Other communications that may be related to the offering, including notices of the offering (such as "tombstone ads"), media interviews, and electronic road shows, may qualify for various exemptions. n79 Where they do not qualify for an exemption, they may be issued as a free writing prospectus so long as they do not conflict with the statutory prospectus, as discussed previously. n80

[d] Directed Share Program. A directed share program is one in which underwriters typically allocate a portion of an IPO (usually up to a maximum of 5%, but occasionally a bigger portion) to employees, vendors, customers and others having a friendly relationship with the issuer. These "friends and family" programs can cause problems for the issuer unless they are carefully conducted to avoid registration concerns. Specifically, a directed share program can be deemed to involve written offers to sell in violation of Section 5 of the Securities Act where prospective participants in the program are offered in writing the opportunity to participate before the registration statement relating to the offered securities is filed with the SEC. Or they can be deemed to violate Section 5 where they result in a binding commitment to participate before the registration statement has been declared effective. In these situations, the SEC may insist on the inclusion of a risk factor in the registration statement describing the apparent violation and indicating the potential right of purchasers to seek refunds or damages.

To avoid problems with directed share programs, some commentators have suggested that issuers and underwriters observe the following guidelines: (i) avoid contacting potential participants in writing or electronically by e-mail; (ii) hold group meetings for prospective employee participants at which an executive can explain the program orally; (iii) avoid the use of the issuer's web site to invite participation in the program; (iv) make clear to prospective participants that (a) they have no obligation to purchase shares until the registration statement becomes effective, (b) they may not receive the shares they request, and (c) they can change their minds about purchasing when the offering actually takes place; (v) delay implementation of the program until preliminary prospectuses are available for each potential participant; (vi) send only the information that is necessary (including the preliminary prospectus, the FINRA-required questionnaire, and a brief letter explaining the program); (vii) make certain, if the materials are distributed electronically, that the participants see the preliminary prospectus before indicating an interest in the program; (viii) include in each communication relating to the program the appropriate Rule 134(d) legend; and (ix) decline to accept any funds in advance of the effective date. n81

[7] Pricing and Effectiveness

After the SEC staff has reached the point where it believes the disclosures in the registration statement are satisfactory, the issuer may then take the steps necessary to seek acceleration of the effective date and to price the offering.

[a] Acceleration of Effective Date. Section 8(a) of the Securities Act provides that a registration statement shall become effective automatically 20 days after filing, unless the Commission determines that an earlier effective date is appropriate. n82 The ability to advance or "accelerate" the effective date provides the Commission with a powerful tool

to promote compliance with the Act. Because issuers and underwriters ordinarily cannot afford any significant delays when the offering is ripe for pricing, acceleration almost always is essential. Accordingly, these parties have little choice but to conform to applicable Commission requirements for acceleration.

The Acceleration Process. Requests for acceleration are required by Rule 461 to be submitted to the staff at least 48 hours before the desired effective date. The acceleration request may be made orally, although any oral request must be confirmed in a follow-up letter submitted electronically on EDGAR. n83 The 48-hour period is needed to allow the Assistant Director who will be signing the order of effectiveness sufficient time to make a final review of the filing and determine whether there are any remaining disclosure issues. On occasion, the Assistant Director may raise concerns not previously mentioned by the staff. If the issuer cannot persuade the Assistant Director that the concerns do not warrant revisions to the prospectus, timing constraints and other considerations usually preclude the issuer from doing anything other than amending the prospectus to deal with the concerns. n84

Standards for Acceleration. In most instances, the acceleration process proceeds with little difficulty because the registrant will defer making an acceleration request until the prerequisites for acceleration mentioned in Rules 460 and 461 have been satisfied. These include: (i) the resolution of all outstanding staff comments on the registration statement; n85 (ii) clearance from FINRA regarding the reasonableness of the underwriting compensation; n86 and (iii) evidence that the preliminary prospectus has been adequately distributed to prospective investors. n87 Among the matters that can have a negative impact on an acceleration request (and possibly result in a refusal to grant it) are: (a) the existence of a Commission investigation of the issuer, an affiliate of the issuer, or one of the underwriters for possible securities law violations; n88 (b) the inclusion in a firm commitment offering of an underwriter which does not meet the financial responsibility requirements of Rule 15c3-1 under the Exchange Act; n89 (c) transactions by the issuer or other persons connected with the offering having an artificial effect on the market price of the offered securities; n90 (d) a failure to follow up the distribution of a materially inaccurate preliminary prospectus with appropriate correcting material; n91 or (e) in the case of a significant follow-on offering at the market, a failure by the registrant, selling security holders and underwriters to take sufficient measures to ensure compliance with Regulation M under the Exchange Act, which prohibits specified activities by offering participants that might be deemed to have a manipulative effect on the price of the securities being distributed. n92

[b] Pricing. When the SEC staff is satisfied with the registration statement and ready to make it effective, the managing underwriter can fix the public offering price. Unless an auction process is used to determine the offering price, n93 the price will be decided in an unscientific manner that takes into account various considerations. These include the degree of interest of potential major investors at various price levels, the desire to satisfy the issuer's pricing expectations, and the hope of having room for upward price movement in the aftermarket following effectiveness.

The offering price may be set either before or after effectiveness of the registration statement. Until 1987, the SEC required that the price be set prior to effectiveness, but in that year it also allowed pricing after effectiveness pursuant to Rule 430A, n94 as explained below.

Rule 430A. This rule allows the SEC to make the registration statement effective without the pricing or underwriting information where the securities are offered for cash and the omitted information is included in a prospectus filed with the SEC under Rule 424(b) within 15 business days after the effective date. In effect, the issuer has a three-week period under Rule 430A to price the offering, form the underwriting syndicate, and commence the offering. n95 Because of the flexibility afforded by the rule, this procedure has become dominant.

Pricing Amendment. Under this approach, several steps are required within a period of less than 24 hours beginning with the close of the trading market for the issuer's securities (if there is one) on the day before the anticipated date of effectiveness. These include (1) determining the offering price and underwriting discount; (2) executing the agreement among underwriters and the underwriting agreement; (3) preparing an amendment to the registration statement reflecting the pricing information and final underwriting arrangements; (4) filing the amendment with the SEC; and (5)

the SEC declaring the registration statement effective. Because of the strict timetable for filing pre-effective pricing amendments and the need to wait for the SEC to declare such amendments effective before proceeding with the offering, this method is rarely used.

[c] Registration of Additional Shares. In some instances, market considerations make it necessary after effectiveness to add shares to the registration statement. For example, additional shares may be needed to accommodate unexpectedly heavy demand for the offering, or may be required to achieve a desired level of offering proceeds (e.g., by lowering the per share price and increasing the total number of shares). Where the number of shares to be added will not cause the maximum aggregate offering price to change by more than 20% from the previous estimate in the registration statement, the shares can be added by simply filing a new registration statement prior to the time confirmations are sent or given. n96 Because the registration statement becomes effective upon filing, n97 it does not cause any delays in the offering, n98 and therefore provides considerable flexibility to the issuer and underwriters.

[d] Recirculation Prior to Effectiveness. On occasion, the preliminary prospectus that the issuer hopes will be made effective by the SEC does not reflect a significant last-minute development. Situations of this sort present the thorny question whether the prospectus must be amended to reflect the development and then recirculated to prospective investors before they make their final investment decisions. n99 Recirculation is highly undesirable because it can imperil an offering by creating doubts in the marketplace about the impact of the last minute changes and by providing time for investors to reconsider and perhaps decide to place their money elsewhere.

Changes in the Maximum Aggregate Offering Price. The most common last-minute development not reflected in the preliminary prospectus is a significant change in the number or price (or both) of the shares being offered. An instruction to Rule 430A affords issuers considerable latitude in dealing with these types of situations. As previously indicated, the rule states that increases or decreases in volume or price representing no more than a 20% change in the maximum aggregate offering price set forth in the registration fee table will not require an amendment to the registration statement (and by implication will not require recirculation). n100 In effect, the instruction provides a safe harbor from recirculation for these types of changes. Moreover, even if the 20% limit is exceeded, the SEC has indicated that it is not necessary to file an amendment where the change will not have a material effect. n101

Current Staff Approach to Recirculation Concerns. Prior to the 2005 Securities Act reforms, the SEC staff had the final say regarding recirculation issues. Frequently, rather than requiring a formal amendment and recirculation of the amended prospectus, it would request that the managing underwriter undertake reasonable efforts to convey information about the recent development orally to prospective buyers. With the adoption of Rule 159 in 2005, however, the staff instituted a new approach to recirculation issues.

Rule 159 indicates that in determining liability under the antifraud provisions of the Securities Act for material misstatements or omissions, information conveyed to the purchaser after the time of sale will not be taken into account. This change has made it necessary for an issuer to ensure that all required information has been conveyed to purchasers before they finalize their investment decisions. n102 This change is counterbalanced to some extent by another change in 2005 that allows issuers to use free writing prospectuses to communicate information about last-minute developments in a written communication that can be transmitted electronically if hyperlinked to the statutory prospectus. The consequence of these changes is that the SEC staff no longer specifies how issuers should communicate the new information to investors. n103 Instead, the staff requests only that the new information be conveyed to investors but does not ask about, or express views on, the facts and circumstances of the conveyance. n104 In some instances, however, the staff may request a specific undertaking stating that the issuer understands its conveyance obligations. n105

[e] Effectiveness. As previously mentioned, some registration statements and post-effective amendments become effective automatically upon filing pursuant to various Commission rules. n106 Other registration statements can become effective automatically by waiting 20 days after filing pursuant to Section 8(a) of the Securities Act. But as

explained earlier, n107 no issuer should unilaterally take the 20-day route because it almost surely will lead to an SEC enforcement action unless the issuer amends the registration statement before the 20[th] day by adding to the cover page a legend of the type prescribed by Rule 473 that delays the effective date. Consequently, the normal route to effectiveness is to wait until the registration statement is declared effective by the Assistant Director to whose office the filing was assigned. n108

[8] Withdrawal or Abandonment

Rule 477 provides that any registration statement and any amendment or exhibit thereto may be withdrawn by the registrant if the Commission finds that the withdrawal is "consistent with the public interest and the protection of investors." n109 The application by the registrant for withdrawal must be signed and should fully state the grounds upon which it is made and indicate that no securities were sold. n110 Typically, the Commission will not permit withdrawal if the registration statement is the subject of an investigation or inquiry by the Division of Enforcement. n111

Somewhat related to the withdrawal issue is the matter of "abandoned" registration statements. The Commission has stated in Rule 479 that when a registration statement or a post-effective amendment thereto has been on file for a period of nine months without becoming effective, the Commission may seek to have it declared abandoned. It is rarely necessary, however, for the Commission actually to declare a registration statement abandoned, since a simple inquiry by the SEC staff to the registrant will often spark either a withdrawal request or activity designed to revive the filing.

An issue that sometimes arises in connection with a withdrawn public offering is the effect that the failed offering may have on the ability of the issuer to raise capital privately. There historically was a concern that a private offering soon after withdrawal or abandonment of the registration statement could cause the offering to be "integrated" with the failed public offering and thereby deprive the nominally private offering of its securities registration exemption. This concern was addressed by the Commission in Rule 155, which was adopted in 2001 and mandates a 30-day waiting period before a private offering can commence after an aborted public offering.

[9] Enforcement

Any investor who purchased securities in an offering that violated the Securities Act may sue in a U.S. District Court to recover damages sustained as a result of the purchase. n112 The Commission also may institute proceedings to enforce the Act. Generally, the Commission prefers to enforce the registration provisions of the Act through the comment letter process. It will, however, institute formal action to enforce the registration provisions where there has been an apparent willful disregard of the applicable disclosure requirements or a willful attempt to conceal or mislead. In such situations, the Commission has a wide array of remedies available:

Cease-and-Desist Order. Section 8A of the Securities Act authorizes the Commission to enter a temporary or permanent order requiring a violator to cease and desist from committing or causing a violation in the future. n113

Injunction. Section 20 permits the Commission to seek from a U.S. District Court a temporary or permanent injunction against any person engaging, or about to engage, in any violation of the Act or the rules or regulations thereunder. n114

Stop Order. Section 8(d) permits the Commission to issue a stop order suspending the effectiveness of a registration statement or preventing a registration statement that has not yet become effective from being used. n115

Refusal Order. Section 8(b) permits the Commission to issue an order refusing to permit a registration statement to become effective until it has been amended in accordance with the order. n116

Denial of Effectiveness. Section 8(c) permits the Commission to decline to make effective an amendment filed after the effective date of the registration statement to which it relates. n117

Civil Monetary Penalty. Section 20(d) authorizes the Commission to seek from a U.S. District Court civil monetary penalties of up to \$100,000 per violation of the Act by a natural person and up to \$500,000 per violation by other persons, depending on the nature of the violation. n118

Criminal Penalty. Section 24 authorizes criminal penalties of up to \$10,000 and prison terms of up to five years for each willful violation of the Act or the rules and regulations thereunder.

The Commission has established through various enforcement proceedings its resolve to make full use of the many weapons available to remedy Securities Act violations. Moreover, investors are not shy about instituting private lawsuits to recover any losses sustained by them as a result of such violations. The possibility that these parties may bring an enforcement action where an offering performs poorly provides a strong incentive for all parties responsible for a registration statement to exercise care when preparing it and to make a studious effort to comply with all applicable provisions of the Act.

FOOTNOTES:

(n1)Footnote 1. Comment letters on registration statements under the Securities Act selected for review by the staff are made available to the public on the SEC's web site 45 days or more after the staff's review is completed. See generally SEC Press Release No. 2004-89 (June 24, 2004). See also J. O. Newell, *Dealing With Public Availability of SEC Comment Letters*, Insights (February 2006) 2.

(n2)Footnote 2. The Commission's headquarters are located at 100 F Street, N.E., Washington D.C. 20549.

(n3)Footnote 3. The sectors assigned to these offices are (1) health care and insurance; (2) consumer products; (3) computers and online services; (4) natural resources and food; (5) structured finance, transportation and leisure; (6) manufacturing and construction; (7) financial services; (8) real estate and business services; (9) beverages, apparel and health care services; (10) electronics and machinery; and (11) telecommunications.

(n4)Footnote 4. The Assistant Director is assisted by a Legal Branch Chief and by a Senior Assistant Chief Accountant who has three Accounting Branch Chiefs under his or her direct supervision.

(n5)Footnote 5. The matters for which these three offices are responsible are (1) disclosure support, (2) information technology, and (3) global support.

(n6)Footnote 6. These other offices consist of: (i) the Office of Chief Counsel; (ii) the Office of Mergers and Acquisitions; (iii) the Office of Chief Accountant; (iv) the Office of International Corporate Finance; (v) the Office of Small Business Policy; (vi) the Office of Rulemaking; and (vii) the Office of Enforcement Liaison.

(n7)Footnote 7. A description of the Division's filing review process is available at <http://sec.gov/divisions/corpfin/cffilingreview.htm>. The identity of the members of senior management and the persons who head the various offices of the Division is available at <http://sec.gov/divisions/corpfin/cfconcise.shtml>.

(n8)Footnote 8. The SIC code is assigned to an issuer on the basis of the activity which generates the most significant portion of the issuer's revenues.

(n9)Footnote 9. SEC Division of Corporation Finance, *Filing Review Process* (January 2009), available at <http://sec.gov/divisions/corpfin/cffilingreview.htm>. The Division adopted the tiered levels of reviews following the enactment of Section 408 of the Sarbanes-Oxley Act in 2002. Section 408 requires that the reports of every issuer required to report under Section 13(a) or 15(d) of the Exchange Act be reviewed on a regular and systematic basis, no less frequently than once every three years. See generally, remarks of Alan Beller, then-Director of the Division, at a meeting on November 20, 2004 of the American Bar Association's Committee on Federal Regulation of Securities.

(n10)Footnote 10. The Division does not publicly disclose its criteria for determining the level of review accorded to registration statements and other disclosure documents. The SEC's Office of the Inspector General issued a report in 2006 evaluating the Division of Corporation Finance's preliminary review process. The report recommended that the Division (i) enhance its consideration of risk factors when selecting companies for preliminary review; (ii) maintain surveillance of the largest companies; and (iii) continue to manage its workload more efficiently. See *Inspector General Recommends Improvements to Corporation Finance Review Process*, Corporate Secretary's Guide (CCH), (July 11, 2006) 293.

(n11)Footnote 11. See, e.g., Rules 462, 464 and 467, which provide for immediate effectiveness of certain registration statements and post-effective amendments.

(n12)Footnote 12. Some issuers, such as those in troubled industries, receive greater scrutiny from the staff, thereby increasing the processing time. Further, some transactions, such as business combinations, may be so complex that they require more processing time than ordinarily is necessary.

(n13)Footnote 13. During the first three months of the calendar year, the staff usually is reviewing a heavy volume of other filings, particularly proxy statements for annual meetings of stockholders.

(n14)Footnote 14. The Division, for example, may consult with other government agencies that have regulatory authority over the issuer's activities, or with the Division of Enforcement when the issuer is currently the subject of a formal order of investigation.

(N15)Footnote 15. See generally Sec. Act Rel. No. 33-5622 (1975). For a description of topics of particular interest or importance to investors in 2009 that could be the subject of staff comments on annual disclosure documents of issuers, see M. Mullany and E. Jerrehian, *2009 Annual Disclosure Documents*, 42 Rev. Sec. & Comm. Reg. 61 (March 4, 2009). Because annual disclosure documents are required under the integrated disclosure system to contain various items of information that also must be included in registration statements for public offerings, many of the topics discussed by the authors are pertinent to registered offerings and could be the subject of comments on the registration statements for such offerings.

(n16)Footnote 16. In some circumstances, it is permissible not to include required information. See Rule 409, which states that required information that is unknown and not reasonably available to the registrant may be omitted if obtaining the information would involve unreasonable effort or expense, or the information rests peculiarly within the knowledge of another person not affiliated with the registrant. A registrant attempting to rely on Rule 409 to omit required information should include a full explanation of the reasons for its position in the transmittal letter to the staff, and include in the registration statement any information on the subject that it possesses or can acquire without unreasonable effort or expense.

(n17)Footnote 17. SEC Division of Corporation Finance, Filing Review Process (January 2009), available at [http://sec.gov/divisions/cffiling review.htm](http://sec.gov/divisions/cffiling%20review.htm).

(n18)Footnote 18. To become effective automatically within 20 days after filing, the delaying amendment language specified in Rule 473(a) must be omitted from the filing.

(n19)Footnote 19. Under Rule 3-12 of Regulation S-X, the most recent financial statements included in the registration statement generally cannot be more than 135 days old at the time of effectiveness.

(n20)Footnote 20. See Rule 3(a) of the Commission's Informal and Other Procedures, 17 C.F.R. 202.3(a).

(n21)Footnote 21. Where circumstances warrant, the staff may informally grant a waiver of the applicable deadline although such grants are relatively rare and generally are issued only if the financial statements will be filed within a few days after the deadline.

(n22)Footnote 22. After a lull of more than year in IPO filings due to the depressed stock market that began in mid-2008, the IPO market began a resurgence in the fall of 2009. See, e.g., L. Cowan, *IPO Market Regains Momentum*, Wall St. J. C3. (September 21, 2009); *Big Names Come Back to Resurgent IPO Market*, SEC Today, cover page (September 10, 2009).

(n23)Footnote 23. For an insight into concerns of the SEC staff that frequently arise in connection with its review of IPOs by smaller companies, see SEC Division of Corporation Finance, *Staff Observations in the Review of Smaller Reporting Company IPOs* (March 4, 2009), available at <http://sec.gov/divisions/corpfina/guidance/cfsmallcompanyregistration.htm>.

(n24)Footnote 24. Adopted in Sec. Act Rel. No. 33-6383 (1982), the integrated disclosure system not only brought uniformity to the disclosure requirements of the Securities and Exchange Acts, but also permitted periodic reports under the Exchange Act to be used to satisfy many disclosure requirements under the Securities Act through the process of incorporation by reference.

(n25)Footnote 25. Documents subsequently filed by the issuer under the Exchange Act prior to the termination of the offering also are automatically incorporated into the Form S-3 registration statement, pursuant to Item 12(b) of the form.

(n26)Footnote 26. As previously indicated, the Commission is required by Section 408 of the Sarbanes-Oxley Act to review the Exchange Act filings of reporting issuers at least once every three years.

(n27)Footnote 27. Prior to 1982, the Commission generally permitted registration only of securities proposed to be offered presently, based on a literal interpretation of Section 6(a) of the Securities Act.

(n28)Footnote 28. The Commission expanded this flexibility in 1992 when it first permitted so-called "universal shelf" offerings. Under this approach, qualified issuers may register securities on short Form S-3 by gross dollar amount, without specifying the amount or type of takedowns (equity or debt) that might be made in the future. See Sec. Act Rel. No. 33-6964 (1992). For a description of the advantages and disadvantages of universal shelf registration, see V. Demont, *Show Me the Money and How to Get It: The Speed and Flexibility of Universal Shelf Registrations*, (Pepper Hamilton LLP) (May 28, 2009), available at <http://www.pepperlaw.com>.

(n29)Footnote 29. Takedowns from the shelf can be made without review by the SEC staff.

(n30)Footnote 30. See Sec. Act Rel. No. 33-8591, § V.B. (2005). See also J. T. Bostelman and E. J. Kadel, Jr., *The SEC's New Securities Offering Rules: Implications for Shelf Issuers*, Insights (October 2005) 2.

(n31)Footnote 31. See Rule 415(a)(5). A "WKSI" is defined in Rule 405 as an issuer eligible to use Form S-3 or Form F-3 that has either a worldwide public common equity float (i.e., equity held by non-affiliates) of at least \$700 million, or issued in the preceding three years at least \$1 billion of non-convertible securities, other than common equity, in registered primary offerings for cash. A "seasoned issuer" is an issuer eligible to use Form S-3 or Form F-3 to register a primary offering of securities because it has a public common equity float of at least \$75 million and meets the other requirements of the applicable form. An "unseasoned issuer" is an issuer that is required to file reports pursuant to Section 13 or 15(d) of the Exchange Act, but is not eligible to register a primary offering on Form S-3 or Form F-3.

(n32)Footnote 32. See Rule 462(e).

(n33)Footnote 33. See Rule 413(b).

(n34)Footnote 34. See Rule 457(r).

(n35)Footnote 35. See Rule 430B(a) and (b).

(n36)Footnote 36. See Rule 430A(f), and Rule 462(e) and (f).

(n37)Footnote 37. Sec. Act Rel. No. 33-7760 (1999). For a discussion of Regulation M-A, see M. Brown et al, *The SEC's New M&A Rules in Operation: What's Different?*, Insights (April 2000) 11.

(n38)Footnote 38. Sec. Act Rel. No. 33-7355 (1996). See also Staff Accounting Bulletin No. 80 (Topic 1J) (1988). For a discussion of financial statement requirements in the acquisition context, see V. Jacob et al., *Financial Statement Requirements for Acquisitions in Registered Public Offerings*, 33 Rev. Sec. & Comm. Reg. 9 (January 12, 2000).

(n39)Footnote 39. See generally S. Glover & M. Fajfar, *Plain English Comes to M&A Disclosure*, The M&A Lawyer (April 1999) 1.

(n40)Footnote 40. See § 229.1100 *et seq* and Sec. Act Rel. No. 33-8518 (2004).

(n41)Footnote 41. For additional information about Regulation AB, see E. Gainor, *New Regulatory Scheme for Issuers of Asset-Backed Securities*, 21 Rev. of Banking & Fin. Services 31 (2005).

(n42)Footnote 42. See Sec. Act Rel. No. 33-6867 (1990).

(n43)Footnote 43. See Rules 424(b) and 428(a), and the headnote to Part I of Form S-8.

(n44)Footnote 44. See Rule 462.

(n45)Footnote 45. See Rule 428(a)(1) and the headnote to Part I of Form S-8.

(n46)Footnote 46. A relatively common situation that gives rise to registration statements for selling security holders is a PIPE ("Private Investment in Public Equity"). A PIPE typically involves a private offering of securities (frequently large in size) that is subject to the condition that the stock purchased by investors in the PIPE will be able to be sold by the investors pursuant to an effective registration statement filed with the SEC promptly after the investors commit to the purchases. For information about PIPEs and a rebound in their popularity, see G. Gooding and J. Rossman, *Everything Old Is New Again: Private Equity PIPEs Go Up-Market*, 13 M&A Lawyer (July-August 2009) 16, *see also* K&L Gates, Securities Practice Guide § 7.03 (2009 Edition).

(n47)Footnote 47. Pursuant to Rule 430B(d), the omitted information subsequently may be included in the registration statement for the resale offering by (i) a post-effective amendment; (ii) a prospectus supplement; or (iii) an Exchange Act report that is incorporated by reference into the registration statement.

(n48)Footnote 48. For seasoned issuers that are not WKSIs using an automatic shelf registration statement, these conditions include (i) completion prior to registration of the offering in which the securities being resold were acquired; (ii) issuance of the resale securities prior to the filing of the resale registration statement; and (iii) the inclusion of a generic reference in the registration statement to any unnamed selling security holders. The benefits of the rule are not available to a blank check company, shell company or penny stock issuer.

(n49)Footnote 49. See, e.g., Form F-3.

(n50)Footnote 50. See generally Quigley, *The Multi-jurisdictional Disclosure System*, 28 Rev. Sec. & Comm. Reg. 117 (1995).

(n51)Footnote 51. See Rules 901-04 and Sec. Act Rel. No. 33-6863 (1990).

(n52)Footnote 52. See Sec. Act Rel. No. 33-6862 (1990).

(n53)Footnote 53. Sec. Act Rel. No. 33-7745 (1999). For more information regarding these changes, see M. Bergman, *SEC Overhauls Disclosure Rules for Foreign Issuers*, Insights (November 1999) 29; and S. Kinsey, *New Rules for Foreign Private Issuers*, Insights (September 2000) 9.

(n54)Footnote 54. Sec. Act Rel. No. 33-7759 (1999). See J. Basnage, W. Curtin and J. Rubin, *Cross-Border Tender Offers and Other Business Combination Transactions and the U.S. Federal Securities Laws: An Overview*, 61 *Bus. Law* 1071 (2006).

(n55)Footnote 55. Sec. Act Rel. No. 33-7053 (1994).

(n56)Footnote 56. *Id.* See also Sec. Act Rel. No. 33-8879 (2007), which announced the adoption of rules permitting foreign private issuers to include in their filings with the SEC financial statements prepared in accordance with International Financial Reporting Standards without reconciliation to generally accepted accounting principles as used in the U.S.

(n57)Footnote 57. *Id.*

(n58)Footnote 58. Sec. Act Rel. No. 33-7470 (1997).

(n59)Footnote 59. Sec. Act Rel. No. 33-8959 (2008).

(n60)Footnote 60. *Id.*

(n61)Footnote 61. These efforts have included the establishment of an Office of Small Business Policy to address the special concerns of small businesses under the Act.

(n62)Footnote 62. See Sec. Act Rel. No. 33-6949 (1992).

(n63)Footnote 63. See Sec. Act Rel. No. 33-8876 (2007).

(n64)Footnote 64. See *SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers* (November 2008), available at <http://www.sec.gov/news/speech/2008/spch111708wc-slides.pdf>. Although the title suggests that the guide is confined to financial reporting issues, it contains a substantial amount of helpful non-financial information regarding the processes of the Commission relating to the system for small issuers.

(n65)Footnote 65. See <http://www.sec.gov/info/smallbus.shtml>.

(n66)Footnote 66. See generally Staff Accounting Bulletin No. 83 (1989).

(n67)Footnote 67. See AICPA, *Valuation of Privately-Held Company Equity Securities Issued as Compensation*. Previously, the SEC staff typically had permitted an issuer to justify its fair-value determinations based on "rule of thumb" discounts from the IPO price range.

(n68)Footnote 68. A failure to comply fully with the SEC's confidential treatment requirements can expose documents to disclosure under the Freedom Information Act ("FOIA") even though the documents might otherwise qualify for protection under the FOIA. See M. Rivera and K. Cain, *The FOIA Blitzkrieg/ Company Documents Provided to the SEC Are Under Attack*, *Business Law Today* (March/April 2007) 44.

(n69)Footnote 69. See Staff Legal Bulletin No. 1 (February 28, 1997), with addendum dated July 11, 2001.

(n70)Footnote 70. *Id.*, at § II.B.1.

(n71)Footnote 71. *Id.*, at § II.B.2.

(n72)Footnote 72. Id., at § II.B.3., 4. and 5.

(n73)Footnote 73. Rule 406, however, does not apply to requests for confidential treatment of supplemental information or other information not required to be filed under the Securities Act. These requests are governed by Rule 190 of the Commission's rules concerning information and requests, 17 C.F.R. 201.190.

(n74)Footnote 74. See D. Stuart and D. Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 *Bus. Law.* 973 (2009), for a discussion of the considerations involved in the determination whether and when to disclose an investigation by a government agency.

(n75)Footnote 75. Letters containing these representations originally were referred to as "Tandy" letters, after the name of the first company that was required to submit such a letter.

(n76)Footnote 76. See § 7A.06[7][d] *infra* for more information about recirculation.

(n77)Footnote 77. Electronically transmitted road show presentations not made in this manner must meet the requirements for a free writing prospectus. See generally the discussion in § 7A.04[4][b] *supra*.

(n78)Footnote 78. See § 7A.04[4][b] *supra*.

(n79)Footnote 79. Id.

(n80)Footnote 80. See § 7A.04[4][a] *supra*

(n81)Footnote 81. See A. Austin, D. Porter, and A. Bennington, *The SEC Cracks Down on Directed Share Programs*, *Insights* (October 1999) 2.

(n82)Footnote 82. The issuer typically extends indefinitely the 20-day statutory deferral of the effective date by placing on the facing page of the registration statement the "delaying amendment" language of Rule 473(a). See generally § 7A.05[14][f] *supra*.

(n83)Footnote 83. The issuer also must submit by letter a statement (which may be the acceleration request) that the issuer and the managing or principal underwriters are aware of their obligations under the Securities Act. See Rule 461(a).

(n84)Footnote 84. Although neither the Assistant Director nor any other member of the staff may deny an acceleration request, the effect of a denial can be achieved by the staff simply indicating that it is not in a position to grant the acceleration request. At that juncture, the registrant has the right to appeal the staff's determination to the full Commission, but should resist the urge to do so. Any such appeal is likely to consume considerable time and be fruitless in the end, since the Commission is loath to undermine its staff in such situations.

(n85)Footnote 85. By complying with all outstanding comments, the registrant will effectively satisfy the requirement of Rule 461(b)(1) that it have made a bona fide effort to make the prospectus reasonably concise and readable.

(n86)Footnote 86. Rule 461(b)(6).

(n87)Footnote 87. Rule 460.

(n88)Footnote 88. Rule 461(b)(3). But see § 7A.05[6][c] *supra* regarding representations by the issuer to the SEC that can allow acceleration to occur despite an ongoing investigation.

(n89)Footnote 89. Rule 461(b)(4).

(n90)Footnote 90. Rule 461(b)(5).

(n91)Footnote 91. Rule 461(b)(2).

(n92)Footnote 92. Rule 461(b)(7).

(n93)Footnote 93. Two studies separately concluded that auctions more often than not result in an offering price that is superior to that produced by the fixed price process, based on fewer instances of underpricing (as reflected in smaller spikes in the aftermarket price), and reduced underwriting fees. See S. Hauser, U. Yaari, Y. Tanchuma and H. Baker, *Initial Public Offering Discount and Competition*, 49 *Journal of Law & Economics* 331 (2006); K. Pukthuanthong, N. Varaiya, and T. Walker, *Bookbuilding Versus Auction Selling Methods: A Study of US IPOs*, 9 *Venture Capital: International Journal of Entrepreneurial Finance* 311 (2007). A third study concluded that IPO underpricing decreases with detailed disclosure of the intended uses of the offering proceeds. See S. Rock and M. Willenborg, *Disclosure of Intended Use of Proceeds and Underpricing in Initial Public Offerings*, 45 *Journal of Accounting Research* 111 (2007).

(n94)Footnote 94. See Sec. Act Rel. No. 33-6714 (1987).

(n95)Footnote 95. Where the 15-business day filing requirement of the rule is not met, the omitted information relating to pricing and underwriting is required by Rule 430A(a)(3) to be included in a prospectus filed by post-effective amendment. As a result, the prospectus in such situations cannot be used until the SEC declares the amendment effective.

(n96)Footnote 96. Rule 462(b). The new registration statement essentially is identical to the one on file except for the number of shares shown as being registered.

(n97)Footnote 97. *Id.*

(n98)Footnote 98. Where, however, the registration of additional shares would cause the offering size to increase by more than 20%, the registration statement would not become effective automatically. Instead, it would have to be declared effective formally by the Commission.

(n99)Footnote 99. At least one court has suggested that civil liability may result where an issuer failed to recirculate a prospectus that has been amended substantially. See generally, *In re Regeneron Pharmaceuticals, Inc. Securities Litigation* [1995 Transfer Binder] Fed. Sec. L. Rep. P 98,637 (S.D.N.Y. 1995).

(n100)Footnote 100. According to the instruction to Rule 430A, the changes can be reflected in the final prospectus required to be filed after effectiveness under Rule 424(b). Where additional shares that are within the 20% limit need to be registered after the registration statement has been made effective, Rule 462(b)(3) permits the new registration statement for the additional shares to become effective automatically upon filing with the Commission.

(n101)Footnote 101. See instruction to Rule 430A(a).

(n102)Footnote 102. This is in contrast to the situation prior to the adoption of Rule 159 under which the information could be conveyed in a final prospectus filed under Rule 424(b).

(n103)Footnote 103. See remarks by John White, then-Director of the SEC's Division of Corporation Finance, on April 7, 2006 to the American Bar Association's Committee on Federal Regulation of Securities, described in the Committee's newsletter to its members, at 3.

(n104)Footnote 104. *Id.*

(n105)Footnote 105. *Id.*

(n106)Footnote 106. See Rules 462, 464 and 467.

(n107)Footnote 107. See § 7A.05[14][f] *supra* for information about the method of delaying the effective date prescribed by Rule 473.

(n108)Footnote 108. The Assistant Director's action in declaring the registration statement effective is made pursuant to authority delegated by the Commission and has the effect of accelerating the effective date prescribed by Section 8(a) by eliminating the 20-day waiting period. On May 22, 2006, the Commission eliminated its historic practice of providing a paper notice of effectiveness and instead began the practice of posting on its web site EDGAR orders of effectiveness on the morning after a filing is determined to be effective. See SEC Press Release No. 2006-61 (April 25, 2006).

(n109)Footnote 109. In an application for withdrawal of a registration statement filed on Form S-4 for a transaction meeting the requirements of General Instruction G of that form, the Commission will grant the request automatically if the application is submitted prior to the effective date. See Rule 477(b).

(n110)Footnote 110. Rule 477(c). The registrant's letter containing the withdrawal application must be submitted electronically on EDGAR, where it will be posted on the SEC's web site. If the issuer of an aborted IPO that results in a withdrawal of the IPO registration statement makes a second attempt at an IPO, a study indicates that the aborted IPO is likely to have an adverse effect on the valuation of the subsequent IPO attempt. See P. Lian and Q. Wang, *Does the Market Incorporate Previous IPO Withdrawals When Pricing Second-Time IPOs?*, 38 Financial Management 357 (2009).

(n111)Footnote 111. See, e.g., Sec. Act Rel. No. 33-8502 (2004) (withdrawal request denied where registrant issued misleading press release in connection with withdrawal request).

(n112)Footnote 112. See Section 12(a) of the Securities Act. Generally, Section 13 of the Act requires that such a lawsuit be instituted within one year of the date of discovering the violation, but no later than three years after the date the violation occurred.

(n113)Footnote 113. The Commission obtained cease-and-desist authority in 1990, and now uses that authority as the principal means of remedying violations of the Securities Act.

(n114)Footnote 114. The issuance of an injunction relating to violations of the Securities Act is not utilized often. The reason is that essentially the same relief as an injunction can be obtained with much less difficulty through the issuance of a cease-and-desist order by the Commission.

(n115)Footnote 115. Although the language of the statute clearly permits the Commission to institute stop order proceedings against registration statements that have become effective, it is ambiguous regarding the use of such proceedings with respect to pre-effective filings. The Commission, however, believes the statute provides adequate authority to issue stop orders against pre-effective registration statements. See *In re Red Bank Oil Co.*, 20 SEC 863 (1945), and W. McLucas, *Stop Order Proceedings Under the Securities Act of 1933: A Current Assessment*, 40 Bus. Law. 515, 531 (1985).

(n116)Footnote 116. Refusal orders have been used only twice, in each case early in the statute's history. The refusal order remedy apparently was used because of the severe time constraints in the statute that require a notice of hearing relating to such an order to be issued "not later than ten days after the filing of the registration statement." See *In re Gold Producers, Inc.*, 1 SEC 1 (1933), and *In re International Investors Fund System, Inc.*, 1 SEC 461 (1936).

(n117)Footnote 117. For an example of a rare instance in which this remedy was employed, see Sec. Act Rel. No. 33-6955 (1992).

(n118)Footnote 118. The Commission appears to follow the policy of seeking civil monetary penalties primarily for egregious violations of the Act, such as those involving fraudulent conduct.



96 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7A The Registration Process

2-7A Federal Securities Act of 1933 § 7A.07

AUTHOR: Peter J. Romeo

§ 7A.07 The Post-Effective Period

The period after the registration statement has been made effective involves a variety of activities relating to the completion of the offering.

[1] Prospectus Delivery

The Securities Act requires delivery to each investor in a registered offering of a final prospectus meeting the requirements of Section 10(a) of the Act. n1 The SEC made a major change affecting this requirement by adopting Rule 159 in 2005. The rule provides that information conveyed to a purchaser after the time of sale will not be taken into account in determining liability under the antifraud provisions of the Act. n2 This can limit the utility of a final prospectus to memorializing the information in it for purchasers in the aftermarket. n3 In recognition of both this fact and technological advances that provide investors with greater access to information about securities offerings, the SEC adopted in 2005 the rule revisions described below that allow electronic availability of the final prospectus to satisfy the delivery obligation. n4

Deemed Delivery. The Commission adopted Rule 172 in 2005 for the purpose of applying an "access equals delivery" model to the delivery of final prospectuses. n5 This model presumes that investors have access to the Internet (including the SEC's web site containing a copy of the final prospectus) and therefore the delivery obligation is satisfied by simply having the final prospectus on file with the SEC. n6 As a consequence, offering participants do not have to print final prospectuses or physically deliver them if the final prospectus is filed with the SEC under Rule 424 n7 and certain other conditions are met. n8 Rule 174, however, requires delivery by a dealer of a prospectus for aftermarket transactions for 25 days following effectiveness where an issuer was not previously subject to the reporting requirements of the Exchange Act (or for 90 days if an IPO issuer's securities are not listed on a national securities exchange).

Confirmation of Sale. Each underwriter, broker or dealer participating in a registered offering (or the issuer, if the offering is made directly by it) is required to provide each purchaser in the offering with a confirmation of sale that is accompanied or preceded by a copy of the final prospectus. The confirmation requirement can be satisfied under Rule 173 by sending an e-mail notice or other form of written communication to each customer and member of the selling group within two business days after completion of the sale indicating the allocation of securities to the person and

stating that the sale was made pursuant to a registration statement.

[2] Over-Allotment Option

It is common to include in a firm commitment underwriting agreement an "over-allotment option" enabling the underwriters to purchase additional shares for a specified period after effectiveness of the registration statement. The additional shares (which are limited by FINRA rule to 15% of the original allotment) may be needed to cover a short position created by overselling the original commitment. Overselling is relatively common, since it usually will assure that the full allotment is sold, even if some investors renege on their purchase commitments. An over-allotment option (also known as a "green shoe" option for the company that first utilized it) typically is exercisable for up to 30 days one or more times following effectiveness. Accordingly, the decision whether to exercise it will be made during the post-effective period. Nothing unusual needs to be done with respect to the exercise because the shares subject to the over-allotment option are among the number of shares included in the registration statement at the time it is declared effective.

[3] The Closing

After the securities that constitute the original allotment have been sold and the offering has been completed, the closing takes place. n9 The closing is a formal meeting that marks the conclusion of the offering, and it typically occurs within three or four business days after pricing the offering. n10 The parties represented at the meeting include the issuer and underwriters, counsel for the issuer and underwriters, the auditor, the registrar and the transfer agent (and, in the case of an offering of debt securities, the indenture trustee).

At the closing, the underwriters pay for the securities sold in the offering and the certificates for the securities (if any) are released for issuance. n11 In addition, various other events customarily occur. These include (i) delivery by the issuer's counsel of a legal opinion and a "negative assurance" letter relating to disclosures in the registration statement, the texts of which were previously negotiated with counsel for the underwriters; n12 (ii) the issuance of certifications to the underwriters by specified company officers attesting to certain facts; (iii) the delivery of a comfort letter by the auditors on the unaudited financial data included in the registration statement; and (iv) the furnishing of other documents requested by the underwriters, such as certified copies of the articles of incorporation, good standing certificates, and the like. The closing usually is brief, lasting no more than a few hours, since it typically is preceded the day before by a "pre-closing" in which the interested parties assemble the various documents to be exchanged and agree on their final content.

[4] Post-Closing Events

After the closing, a few additional tasks remain to complete the registration process.

[a] Required Filings. If any substantive changes are made to the prospectus as it existed on the date the registration statement became effective, the issuer must file under Rule 424(b) the revised form of prospectus with the SEC within the applicable time period prescribed in the rule. With respect to a prospectus that discloses pricing and other information that was allowed to be omitted under Rule 430A at the time of effectiveness, the issuer must file the amended prospectus under Rule 424(b)(1) no later than the second business day following the earlier of the date of pricing or the date the prospectus is first used after effectiveness.

Where a registration statement relates to an IPO, the issuer should report the use of proceeds in its first periodic report filed after effectiveness under Section 13 or 15(d) of the Exchange Act. n13 Further, the issuer should report any later application of offering proceeds in each subsequent periodic report filed through the date of termination of the offering. n14

[b] Deregistration. In some registered offerings, the issuer is unable to sell all of the securities before the offering

is terminated. This can happen, for example, when the underwriter decides not to exercise an over-allotment option or the minimum amount required to complete a "best efforts" offering is not subscribed. When it is apparent that the securities will not be sold because the offering has been completed or terminated, or the registration statement has been withdrawn, the issuer is supposed to deregister them. n15 In practice, however, deregistration frequently does not occur and there are no adverse consequences for failing to do so. n16

Deregistration is accomplished by filing a post-effective amendment consisting of a facing sheet, a page stating the number of securities being deregistered and the reason for deregistration, and a signature page. If the issuer later decides to resell the deregistered securities in a registered offering, it will have to file an entirely new registration statement for that purpose. Any unused registration fee that results from not having sold securities that were registered may be applied to any future registration statement filed within five years of the initial filing date of the earlier registration statement. n17

[c] Public Company Memo. An issuer which becomes a public company as a result of a registered offering incurs a number of new responsibilities under the federal securities laws. To alert a newly public company to these responsibilities, it is customary for issuer's counsel to send the client a "public company memo." Typically, the memorandum will include a discussion of the requirement to file periodic reports under Section 13(a) or 15(d) of the Exchange Act, and the application of various requirements of the Exchange Act and, if applicable, stock exchange rules that flow from registration of a class of equity securities under Section 12 of that Act. n18

FOOTNOTES:

(n1)Footnote 1. See Section 5(b)(2) of the Securities Act.

(n2)Footnote 2. See generally Sec. Act Rel. No. 33-8591, § IV.A. (2005).

(n3)Footnote 3. See generally Sec. Act Rel. No. 33-8591, § VI.A. (2005).

(n4)Footnote 4. Previously, the Commission had eased prospectus delivery obligations in various circumstances. See Rule 153 (delivery of prospectuses between brokers taking place over a national securities exchange deemed to have occurred by delivery to exchange of number of copies specified by it) and Rule 434 (delivery of final prospectus within T+3 settlement cycle in firm commitment offerings for cash satisfied by making delivery of offering documents at different intervals in offering process). Other rules that relate to the delivery of prospectuses under the Securities Act include Rule 153A (delivery of prospectus in merger or other transaction specified in Rule 145) and Rule 153B (delivery of prospectus for standardized options).

(n5)Footnote 5. To implement the access equals delivery model in 2005, the Commission amended Rule 153 (transactions between brokers on exchanges), Rule 173 (notice of registration), and Rule 174 (delivery of prospectuses in aftermarket). See Sec. Act Rel. No. 33-8591, § VI.B. (2005).

(n6)Footnote 6. See Sec. Act Rel. No. 33-8591, § VI.B. (2005).

(n7)Footnote 7. The Rule 424 filing condition is deemed satisfied if the issuer makes a good faith and reasonable effort to file the final prospectus within the Rule 424 period. Rule 172(c)(3) indicates that if the issuer unintentionally has failed to file the final prospectus by the Rule 424 deadline, it can cure the deficiency by filing the prospectus under Rule 424 as soon as practicable after the failure to file.

(n8)Footnote 8. The other conditions are specified in Rule 172(c) and include requirements that (i) the registration statement be effective and not be the subject of an enforcement proceeding under Section 8(d) or 8(e) of the Securities Act; and (ii) neither the issuer nor an underwriter or participating dealer be the subject of a pending proceeding under Section 8A of the Act in connection with the offering.

(n9)Footnote 9. If the over-allotment option is exercised, there will be a separate closing relating to the sale of

shares pursuant to that option.

(n10)Footnote 10. See Rule 15c6-1 under the Exchange Act. If pricing occurs after 4:30 p.m. Eastern time and the offering is a firm commitment underwritten offering for cash, the rule permits the closing to take place on the fourth business day after pricing. The parties also are permitted to agree to a closing date different from that prescribed by the rule, although this occurs infrequently.

(n11)Footnote 11. If the issuer uses a book entry system of transfer, it will not issue certificates.

(n12)Footnote 12. For a report on negative assurance and an illustrative form of negative assurance letter, see Report of the Subcommittee on Securities Law Opinions, Committee on Federal Regulation of Securities, ABA Section of Business Law, *Negative Assurance in Securities Offerings (2008 Revision)*, 64 *Bus. Law.* 395 (2009).

(n13)Footnote 13. See Rule 463(a), which indicates the disclosure should be in accordance with Item 701 of Regulation S-K or Regulation S-B, or Item 14(e) of Form 20-F, as applicable.

(n14)Footnote 14. *Id.*

(n15)Footnote 15. See, e.g., Item 512(a)(3) of Regulation S-K, which sets forth the text of an undertaking required in shelf registration statements under Rule 415 to deregister any of the securities remaining unsold upon termination of the shelf offering.

(n16)Footnote 16. The Commission does not appear ever to have instituted an enforcement action based on an issuer's failure to deregister unsold securities. Indeed, in at least one instance, the Commission staff has indicated that although deregistration is desirable, it is not absolutely necessary. See Sec. Act Rel. No. 33-6281, § I.D. (1981), which discusses the deregistration of shares included in a Form S-8 registration statement for an employee benefit plan.

(n17)Footnote 17. See Rule 457(p).

(n18)Footnote 18. Typically, registration under Section 12 for a company that completes an IPO occurs at the same time that the registration statement under the Securities Act for the IPO is made effective by the SEC.



97 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 7B.syn

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.syn Synopsis to Chapter 7B: Registration Of Investment Company Securities

§ 7B.01 Introduction to the Registration of Investment Company Securities

[1] Investment Company Defined

[a] Basic Definition.

[b] Companies Issuing Face-Amount Certificates of the Installment Type.

[c] Inadvertent Investment Companies.

[2] Classification and Sub-classification of Investment Companies

[a] Management Companies.

[i] Open-end or Closed-end.

[ii] Diversified or Non-Diversified.

[b] Unit Investment Trusts.

[c] Face-Amount Certificate Companies.

[3] Exceptions from the Definition of Investment Company

[a] Companies Primarily Engaged in Other Businesses.

[b] "Private" Investment Companies.

[c] Companies in Certain Financial Businesses.

[d] Miscellaneous Exceptions.

[4] Exempt Investment Companies

[5] Securities Act Exemptions Available to Investment Companies

[6] Basic Registration Requirements

[a] General.

[i] "Notification of Registration."

[ii] Capitalization.

[b] Mutual Funds (Form N-1A).

[c] Closed-End Funds (Form N-2).

[d] Unit Investment Trusts (Forms S-6 and N-8B-2).

[e] Variable Insurance Products (Forms N-3, N-4, and N-6).

[f] Small Business Investment Companies (Form N-5).

[g] Face-Amount Certificate Companies (Forms S-1 and N-8B-4).

[h] Business Development Companies (Form N-2).

[i] Certain Business Combinations (Form N-14).

[j] Exchange Act Requirements.

[k] EDGAR: Mandatory Electronic Filing.

§ 7B.02 Statutory Provisions, Regulations, and Procedures Governing Registration of Investment Company Securities

[1] Activities Before and During Registration

[a] Pre-Filing.

[b] Investment Company Registration.

[i] Notification of Registration.

[c] Offering Securities and Advertising.

[2] Filing the Registration Statement

[a] Basic Statutory Requirements.

[b] Coordination of Securities Act and Investment Company Act Requirements.

[c] Other Investment Company Act Registration Provisions.

[d] Procedural and Formal Requirements.

[i] Introduction.

[ii] General Requirements.

[iii] Form and Content of the Prospectus.

[iv] Written Consents.

[v] Filing, Fees, Effective Date.

[A] Registration of an Indefinite Number of Shares.

[vi] Amendments and Withdrawals.

[vii] Special Rules for Investment Companies and Business Development Companies.

[3] Information Required in the Registration Statement

[a] General.

[b] Additional Requirements Applicable to Investment Companies.

[i] Recital of Policy with Respect to Certain Activities.

[4] Taking Effect of Registration Statements and Amendments Thereto

[a] Original Registration Statement.

[i] Permanent Delaying Amendment.

[ii] Assignment to Branch.

[iii] Review and Comment.

[iv] Amendment and Acceleration.

[b] Post-Effective Procedures.

[i] General.

[ii] Continuous Offerings.

[iii] Offerings by Series of Unit Investment Trusts.

[5] Information Required in Prospectus

[a] General.

[b] Omitting Prospectus.

[c] Summary Prospectus.

[6] SEC Plain English Requirements

[a] Rule 421(b): Minimum Plain English Requirements.

[b] Rule 421(d): Minimum Plain English Principles.

[c] Rule 461: Refusal to Accelerate.

[d] Rule 481: Information Required in Investment Company Registration Statements.

[i] Legends.

[ii] Table of Contents.

§ 7B.03 Form N-1A--Registration of Securities of Open-End Management Investment Companies

[1] Introduction

[2] Facing Sheet

[3] Cross-Reference Sheet

[4] General Instructions

[a] Definitions.

[b] Filing and Use of Form N-1A.

[c] Preparation of the Registration Statement.

[d] Form N-1A: Three Parts.

[e] Incorporation by Reference.

[5] Part A: Information Required in a Prospectus

[a] Item 1. Front and Back Cover Pages.

[b] Item 2. Risk/Return Summary: Investment Objectives/Goals.

[c] Item 3. Risk/Return Summary: Fee Table.

[d] Item 4. Investments, Risks and Performance.

[i] Item 4(b)(2). Risk/Return Bar Chart and Table.

[e] Item 5. Management.

[f] Item 6. Purchase and Sale of Fund Shares

[g] Item 7. Tax Information

[h] Item 8. Financial Intermediary Compensation

[i] Item 9. Investment Objectives, Principal Investment Strategies and Related Risks, and Disclosure of Portfolio Holdings.

[j] Item 10. Management, Organization and Capital Structure

[k] Item 11. Shareholder Information.

[l] Item 12. Distribution Arrangements.

[m] Item 13. Financial Highlights Information.

[6] Part B: Information Required in a Statement of Additional Information

[a] Item 14. Cover Page and Table of Contents.

[i] Front Cover Page.

[ii] Table of Contents.

[b] Item 15. Fund History.

[c] Item 16. Description of the Funds and Its Investments and Risks.

[i] Classification.

[ii] Investment Strategies and Risks.

[iii] Fund Policies.

[iv] Temporary Defensive Position.

[v] Portfolio Turnover.

[d] Item 17. Management of the Fund.

[i] Board of Directors.

[ii] Management Information.

[iii] Sales Loads.

[iv] Additional Director Information.

[v] Proxy Voting Policies.

[e] Item 18. Control Persons and Principal Holders of Securities.

[i] Control Persons.

[ii] Principal Holders.

[iii] Management Ownership.

[f] Item 19. Investment Advisory and Other Services.

[i] Investment Advisers.

[ii] Principal Underwriter.

[iii] Certain Services and Payment Therefor.

[iv] Service Agreements.

[v] Other Investment Advice.

[vi] Dealer Reallowances.

[vii] Rule 12b-1 Plans.

[viii] Other Service Providers.

[g] Item 20. Portfolio Managers.

[h] Item 21. Brokerage Allocation and Other Practices.

[i] Brokerage Transactions.

[ii] Commissions.

[iii] Brokerage Selection.

[iv] Directed Brokerage.

[v] Regular Broker-Dealers.

[i] Item 22. Capital Stock and Other Securities.

[i] Capital Stock.

[ii] Other Securities.

[j] Item 23. Purchase, Redemption, and Pricing of Shares.

[i] Purchase of Shares.

[ii] Fund Reorganization.

[iii] Offering Price.

[iv] Redemption in Kind.

[k] Item 24. Taxation of the Fund.

[l] Item 25. Underwriters.

[i] Distribution of Securities.

[ii] Compensation.

[iii] Other Payments.

[m] Item 26. Calculation of Performance Data.

[i] Money Market Funds.

[ii] Other Funds.

[n] Item 27. Financial Statements.

[i] Registration Statement.

[ii] Annual Report.

[7] Part C: Other Information

[a] Item 28. Exhibits.

[b] Item 29. Persons Controlled By or Under Common Control With the Fund.

[c] Item 30. Indemnification.

[d] Item 31. Business and Other Connections of the Investment Adviser.

[e] Item 32. Principal Underwriters.

[f] Item 33. Location of Accounts and Records.

[g] Item 34. Management Services.

[h] Item 35. Undertakings.

§ 7B.04 Form N-2: Registration of Securities of Closed-End Management Investment Companies

[1] Introduction

[2] General Instructions

[3] Part A: Information Required in a Prospectus

[a] Item 1. Outside Front Cover.

[b] Item 2. Cover Pages: Other Offering Information.

[c] Item 3. Fee Table and Synopsis.

[d] Item 4. Financial Highlights.

[e] Item 5. Plan of Distribution.

[f] Item 6. Selling Shareholders.

[g] Item 7. Use of Proceeds.

[h] Item 8. General Description of the Registrant.

[i] Item 9. Management.

[j] Item 10. Capital Stock, Long-Term Debt, and Other Securities.

[k] Item 11. Defaults and Arrears on Senior Securities.

[l] Item 12. Legal Proceedings.

[m] Item 13. Table of Contents of the Statement of Additional Information.

[4] Part B: Information Required in a Statement of Additional Information

[a] Item 14. Cover Page.

[b] Item 15. Table of Contents.

[c] Item 16. General Information and History.

[d] Item 17. Investment Objective and Policies.

[e] Item 18. Management.

[f] Item 19. Control Persons and Principal Holders of Securities.

[g] Item 20. Investment Advisory and Other Services.

[h] Item 21. Portfolio Managers.

[i] Item 22. Brokerage Allocation and Other Practices.

[j] Item 23. Tax Status.

[k] Item 24. Financial Statements.

[5] Part C: Other Information

[a] Item 25. Financial Statements and Exhibits.

[b] Item 26. Marketing Arrangements.

[c] Item 27. Other Expenses of Issuance and Distribution.

[d] Item 28. Persons Controlled by or Under Common Control.

[e] Item 29. Number of Holders of Securities.

[f] Item 30. Indemnification.

[g] Item 31. Business and Other Connections of Investment Adviser.

[h] Item 32. Location of Accounts and Records.

[i] Item 33. Management Services.

[j] Item 34. Undertakings.

[k] Item 35. Signatures.

§ 7B.05 Forms N-8B-2 and S-6--Unit Investment Trusts

[1] Introduction

[2] Coordination of the Requirements of Forms N-8B-2 and S-6

[3] General Instructions

[a] Form N-8B-2.

[b] Form S-6.

[4] Categories of Information Required

[a] Organization and General Information.

[b] General Description of Trust and Securities of Trust.

[i] General Information Concerning the Securities of the Trust and the Rights of Holders.

[ii] Information Concerning Portfolio Securities.

[iii] Information Concerning Loads, Fees, Charges, and Expenses.

[iv] Information Concerning the Operations of the Trust.

[c] Organization, Personnel and Affiliated Persons of Depositor.

[i] Organization and Operations of Depositor.

[ii] Officials and Affiliated Persons of Depositor.

[iii] Companies Owning Securities of Depositor.

[iv] Controlling Persons.

[v] Compensation of Officers and Directors of Depositor.

[d] Distribution and Redemption of Securities.

[i] Distribution of Securities.

[ii] Information Concerning Principal Underwriter.

[iii] Offering Price.

[iv] Suspension of Redemption Rights.

[v] Redemption Valuation.

[e] Information Concerning Trustee or Custodian.

[f] Information Concerning Insurance of Holders of Securities.

[g] Policy of Registrant.

[h] Tax Status.

[i] Financial and Statistical Information.

[j] Exhibits.

[5] Proposed Form N-7 for UITs

§ 7B.06 Form N-14: Certain Business Combinations

§ 7B.07 Other Investment Companies

[1] Variable Insurance Separate Accounts

[a] General.

[b] Form N-3 (Management Companies).

[i] General Requirements.

[ii] Particular Disclosures About Insurance Features.

[c] Form N-4 (Unit Investment Trusts).

[i] General Requirements.

[ii] Particular Disclosures About Insurance Features.

[d] Form N-6 (Variable Life Insurance).

[2] Small Business Investment Companies--Form N-5

[a] General Requirements.

[b] Information Required for Registration Under the Investment Company Act.

[c] Information Required for Registration Under the Securities Act.

[3] Business Development Companies--Form N-2

[a] General Requirements.

[b] Special Disclosures.

§ 7B.08 Other Prospectus Disclosure Issues

[1] High Yield Bond Fund Disclosure

[2] Disclosure Cases

[a] Adequacy of Comparisons.

[b] Adequacy of Disclosure.

[i] Fund Risk Category.

[ii] Fund Investments.

[A] Unauthorized Investments.

[B] Mortgage-Backed Securities.

[iii] Conversion of a Closed-End Fund to an Open-End Fund.

Thomas P. Lemke

Gerald T. Lins n1

FOOTNOTES:

(n1)Footnote 1. This chapter was updated by Thomas P. Lemke and Gerald T. Lins. Mr. Lemke is General Counsel of Legg Mason, Inc. Mr. Lins is General Counsel of ING Investment Management Americas. The original and prior versions of this chapter were prepared by Richard W. Grant, a partner in Morgan, Lewis & Bockius LLP, Philadelphia, Pennsylvania.



98 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.01

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.01 Introduction to the Registration of Investment Company Securities

Investment companies, unless exempt, must register with the Securities and Exchange Commission (the "SEC" or the "Commission") under the Investment Company Act of 1940 (the "Investment Company Act" or "Act"). The Investment Company Act imposes a comprehensive regulatory system on registrants, and a number of provisions and related rules and regulations apply to the offering of securities by investment companies. The Securities Act of 1933 ("Securities Act") also applies to public offerings of securities of investment companies. As a result, both an investment company and the securities it offers must be registered. The Commission has developed special forms and rules under both Acts governing registration of different types of investment companies and their securities, and investment companies may generally satisfy the registration requirements of both Acts by filing a single form. These forms now permit most types of investment companies to bifurcate disclosure between a somewhat shortened statutory prospectus, which must be provided to investors, and a "Statement of Additional Information" or "SAI," which must be provided to investors only upon request.

Procedurally, the initial registration of investment company securities is roughly comparable to that of other securities, although the particular ways in which securities of certain types of investment companies are brought to market have led to the development of procedures unique to those types of securities. In particular, open-end investment companies, commonly referred to as "mutual funds," generally offer their shares continuously. Accordingly, SEC rules permit funds to register an indefinite number of shares and to update their prospectuses through annual or, if necessary, more frequent post-effective amendments that become effective automatically, either immediately on filing or through lapse of time. Administratively, the Commission's Division of Investment Management (rather than the Division of Corporation Finance) is responsible for review of the registration of investment companies and their securities.

The substantive regulation of investment companies under the Investment Company Act is beyond the scope of this chapter, but a general knowledge of the applicability of that statute to certain types of issuers is a prerequisite to understanding the registration process for investment company securities. n1 Therefore, the chapter includes a summary discussion of the basic definition of an investment company and the exceptions therefrom, and of the different types of investment companies. In addition, the chapter includes a discussion of the applicability to investment companies of the Securities Act exemptions from registration of certain securities and transactions.

A number of different types of investment companies are regulated under the Investment Company Act, and both the substantive regulation and the format for disclosure will vary depending upon the category into which a particular investment company falls. In addition, there are a number of important exceptions from the Investment Company Act's broad definitions of investment company, as well as certain exemptions from regulation for entities that are considered investment companies.

[1] Investment Company Defined

[a] Basic Definition. Section 3(a)(1)(A) of the Investment Company Act defines "investment company" to include any issuer which is, holds itself out to be, or proposes to be engaged primarily in the business of investing, reinvesting or trading in securities. n2

[b] Companies Issuing Face-Amount Certificates of the Installment Type. Section 3(a)(1)(B) of the Investment Company Act defines investment company to include any issuer which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type or has been engaged in such business and has any such certificate outstanding (registration of face-amount certificate companies and their securities is extremely rare and will, therefore, not be covered in depth in this chapter). n3

[c] Inadvertent Investment Companies. Finally, Section 3(a)(1)(C) of the Investment Company Act also includes within the definition of investment company any issuer engaged or proposing to engage in the business of investing, reinvesting, owning, holding, or trading securities and which owns or proposes to acquire "investment securities" having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.

Section 3(a)(2) defines the term investment securities to include all securities other than government securities, securities of employees' securities companies and securities of majority owned subsidiaries that are not investment companies. This provision applies regardless of whether a company intends to be an investment company, so holding companies and other companies that regularly acquire interests in other companies in the form of securities may "inadvertently" come within the definition of an investment company and, therefore, be required to register and be regulated under the Investment Company Act unless an exemption or exception from this definition is available. n4

[2] Classification and Sub-classification of Investment Companies

Companies that come within the definition of an investment company are further "classified" and "sub-classified" pursuant to Sections 4 and 5.

[a] Management Companies. As a technical definitional matter, "management company" under Section 4(3) of the Investment Company Act is a catch-all category that includes all investment companies that do not fall into another category, i.e., all investment companies that are not unit investment trusts n5 or face-amount certificate companies. Management companies generally have actively managed portfolios of securities and offer primarily, if not exclusively, equity securities which evidence an undivided interest in that securities portfolio. Mutual funds and closed-end funds fall into this category. The Investment Company Act imposes a number of regulatory requirements on the governance and operations of management companies, including requirements as to the structure of the board of directors; n6 the approval of contracts with investment advisers and distributors; n7 transactions with affiliates; n8 capital structure; n9 and transactions in securities of the investment company. n10

[i] Open-end or Closed-end. Section 5(a)(1) of the Investment Company Act defines an "open-end" management company as one that offers for sale or has outstanding any security which it has issued and which may be redeemed by the holder. Investment companies that fall into this category are commonly known as "mutual funds." Typically they offer on a continuous basis to sell securities to or redeem securities from investors at a price based on "net asset value," as adjusted to reflect any sales charge (or "load"). Net asset value is generally determined by deducting liabilities from

the value of the fund's portfolio plus any cash or other assets. n11 Mutual funds issue only common stock or the equivalent. n12

"Closed-end" companies (Section 5(a)(2)) usually do not offer shares on a continuous basis and there is no right of redemption, although closed-end funds may make tenders for outstanding shares. n13 Following their initial offering, closed-end fund shares are generally traded in the secondary markets, including securities exchanges. Closed-end funds may issue one class each of debt and preferred stock subject to asset coverage requirements set forth in Section 18 of the Investment Company Act.

[ii] Diversified or Non-Diversified. Subject to the requirements of the Internal Revenue Code, n14 management companies may choose whether their portfolios of securities will be treated as "diversified" (Section 5(b)(1)) or "non-diversified" (Section 5(b)(2)). If, however, a management company declares in its registration statement that it will be diversified, then pursuant to Section 13(a)(1) it must continue to be diversified unless shareholders approve a change. To be diversified a company must invest 75 percent or more of its total assets in:

- cash and cash items (including receivables), Government securities, securities of other investment companies; and
- other securities, provided that no more than 5 percent of its total assets may be invested in any one issuer (and it may own no more than 10 percent of the outstanding voting securities of any issuer).

It may invest the remaining 25 percent of its assets without restriction (except that it may not include in this 25 percent "basket" any securities if securities of the same issuer are included in the 75 percent basket). n15

[b] Unit Investment Trusts. Section 4(2) of the Investment Company Act states that a "unit investment trust" is a type of investment company which is organized under a trust indenture or a similar instrument, which does not have a board of directors, and which issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. A voting trust is not included in this definition. The assets of a unit investment trust typically consist of a portfolio of securities that normally remains fixed, securities of a specified mutual fund, or some combination of the two.

[c] Face-Amount Certificate Companies. Section 4(1) states that a "face-amount certificate company" is an investment company which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or which has been engaged in such business and has any such certificate outstanding.

[3] Exceptions from the Definition of Investment Company

As discussed below, the investment company regulatory scheme includes a number of exceptions from the broad definition of investment company both in the Investment Company Act and in the rules adopted by the Commission.

[a] Companies Primarily Engaged in Other Businesses. Section 3(b) excepts certain investment companies that fall within Section 3(a)(3). n16 Section 3(b)(1) excepts any issuer primarily engaged directly or through wholly-owned subsidiaries in a business or businesses other than investing, reinvesting, owning, holding or trading in securities. n17

In addition, Section 3(b)(2) authorizes the Commission to issue orders declaring an issuer not to be an investment company if the SEC finds that such issuer is primarily engaged in a business or businesses other than the investment company business, either directly or through majority-owned subsidiaries or through controlled companies which, as among themselves, are conducting similar types of business. n18

Finally, Section 3(b)(3) excepts a company all of whose outstanding securities (other than short-term paper and directors' qualifying shares) are owned by a company that comes within Section 3(b)(1) or Section 3(b)(2).

In addition, based on its administrative experience, the SEC has adopted several rules that exempt other types of investment companies from regulation under the Investment Company Act. Rule 3a-1 excepts companies that meet certain numerical asset and income tests generally designed to assure that such companies more closely resemble companies engaged in one or more operating businesses than they do companies that the SEC believes should be subject to investment company regulation. n19 Rule 3a-2 excepts so-called "transient" companies; that is, companies that intend to take steps to take themselves out of the definition of investment company within a year. n20 Rule 3a-3 excepts certain investment subsidiaries of companies that are not themselves investment companies.

In addition, the SEC has adopted exemptive rules for certain finance subsidiaries of non-investment companies. n21 Rule 3a-6 exempts certain foreign banks and insurance companies. Rule 3a-7 exempts certain entities formed in connection with securitization transactions.

[b] "Private" Investment Companies. Sections 3(c)(1) and 3(c)(7) except from the definition of investment company (and, therefore, from registration or any of the other requirements of the Investment Company Act) two types of investment companies that are not publicly offered and that meet other tests. Section 3(c)(1) applies to a company if its outstanding securities are beneficially owned by not more than 100 persons. For purposes of determining the number of beneficial owners of an issuer's securities, ownership of securities of the issuer by a company is generally deemed to be beneficial ownership by one person. However, under certain circumstances Section 3(c)(1) would require "looking through" that company and counting its shareholders. Specifically, if that company owns more than 10 percent of the outstanding voting securities of the issuer whose status as an investment company is being determined, ownership of the securities will be attributed not to the company but to the holders of the company's securities if the company n22 would itself be an investment company but for Section 3(c)(1) or Section 3(c)(7).

Section 3(c)(7) generally excepts companies that have as investors only "qualified purchasers." n23 For purposes of the Section 3(c)(7) exception, a "qualified purchaser" is defined as: (i) a natural person (including a spouse owning a joint or similar interest) owning not less than \$5 million in investments; (ii) a company owning not less than \$5 million in investments that is owned directly or indirectly by or for two or more related natural persons (i.e., persons related as siblings, spouses, direct lineal descendants as well as estates, foundations, trusts or charitable organizations established by or for these persons); n24 (iii) a trust that was not formed for the purpose of investing in a Section 3(c)(7) fund, n25 and that is managed solely by "qualified purchasers" and whose settlor or other contributors were all "qualified purchasers;" n26 and (iv) any person acting for its own account or the accounts of other "qualified purchasers" who in the aggregate owns and invests on a discretionary basis at least \$25 million in investments. n27

[c] Companies in Certain Financial Businesses. Section 3(c) of the Investment Company Act also excepts various types of financial services companies that might come within the broad definition of an investment company but which Congress did not intend to regulate under the Investment Company Act, including:

- underwriters and brokers; n28
- banking institutions, including common trust funds of banks; n29
- insurance companies (but not their separate accounts); n30
- certain companies engaged in factoring or similar financing businesses or in investing in interests in real estate (as long as they do not issue installment face-amount certificates, periodic payment plan certificates, or redeemable securities); n31 and
- trusts relating to qualified employee benefit plans, as well as collective trust funds maintained by banks holding the assets of such trusts and insurance company separate accounts for such trusts. n32

[d] Miscellaneous Exceptions. Other exceptions in Section 3(c) include those for certain companies regulated under the Interstate Commerce and Public Utility Holding Company Acts (Section 3(c)(7) and (8) respectively); for eligible companies that hold oil, gas or mineral rights (Section 3(c)(9)); and for certain charitable entities (Section 3(c)(10)) and church plans (Section 3(c)(14)). In addition, Section 2(b) excludes certain governmental entities.

[4] Exempt Investment Companies

Under Section 6 of the Investment Company Act, certain types of investment companies are exempt from regulation or may be exempted conditionally or unconditionally n33 by the Commission. Section 6(a) exempts companies with businesses limited to certain territories, companies in bankruptcy, and certain other companies in special circumstances. n34 Section 6(b) contemplates exemptive applications by employees' securities companies. n35

Section 6(d) gives the Commission the authority to exempt small, closed-end investment companies that operate intrastate. n36 Section 6(f) provides a limited exemption for business development companies.

Finally, Section 6(c) authorizes the SEC to exempt any company to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act. n37 The Commission has used this broad exemptive authority many times in cases where the protections of the Investment Company Act were unnecessary or where alternative regulatory mechanisms could be found.

[5] Securities Act Exemptions Available to Investment Companies

Section 24 of the Investment Company Act makes certain Securities Act exemptions unavailable to investment companies. The exemption from registration for certain insurance contracts in Section 3(a)(8) of the Securities Act does not apply to any security issued by an investment company. The intrastate offering exemption in Section 3(a)(11) of the Securities Act does not apply to a security of which a registered investment company is the issuer. Unless the SEC provides an exemption, the limited dealer transaction exemption provided by Section 4(3) of the Securities Act does not apply to transactions in securities issued by open-end management companies, unit investment trusts, or face-amount certificate companies, if any other security of the same class is at the same time being offered or sold by the issuer or by or through an underwriter in a non-exempt transaction. The Commission has not promulgated such an exemption.

[6] Basic Registration Requirements

[a] General. Section 7 of the Investment Company Act provides that an investment company not entitled to rely on one of the exemptions or exceptions discussed above generally must register as an investment company before it can engage in activities in interstate commerce, including the public offering of their securities. n38 Generally speaking, public offerings of investment company securities are fully subject to the Securities Act, including the registration provisions thereof. Moreover, many of the SEC's general rules and regulations under the Securities Act apply to the registration of investment company securities. n39 However, the SEC has adopted special forms for the registration of investment company securities and, to a greater degree than is generally true for other types of issuers, the forms themselves set forth the requirements for registration, especially those regarding the content of registration statements. In many cases investment companies that offer their securities publicly may fulfill their registration obligations under both the Investment Company Act and the Securities Act by filing a single form. Investment companies, other than exchange-traded closed-end funds, are generally exempt from the registration requirements of the Securities Exchange Act of 1934 ("Exchange Act") and all types of investment companies may generally satisfy Exchange Act reporting requirements by filing reports required under the Investment Company Act.

[i] "Notification of Registration." Management investment companies must file a very brief "Notification of Registration" on Form N-8A to become registered under the Investment Company Act. They must then file within three months the prescribed longer form that both completes Investment Company Act registration and registers shares under

the Securities Act.

[ii] Capitalization. Pursuant to Section 14(a) of the Investment Company Act, no registered investment company may make a public offering unless:

- it has a net worth of at least \$100,000;
- it has previously made a public offering and at that time had a net worth of at least \$100,000; or
- satisfactory subscription agreements for at least \$100,000 from no more than 25 persons have been obtained.

A single registered investment company may issue shares evidencing interests in multiple portfolios of securities. The SEC staff does not require each portfolio to satisfy the Section 14(a) requirement as long as the registrant as a whole does.

[b] Mutual Funds (Form N-1A). Mutual funds are open-end management investment companies and are more often than not diversified. Generally, they offer their shares to investors on a continuous basis and must, therefore, keep a registration statement effective under the Securities Act at all times. Mutual funds may complete their registration under both the Investment Company Act and the Securities Act by filing Form N-1A. n40

Briefly, mutual funds make disclosure to investors primarily in a two-part format. The prospectus, which must be provided to investors, satisfies the delivery requirements of the Securities Act. However, in addition, mutual funds are required to make available to investors, free of charge, a "Statement of Additional Information" or "SAI." Mutual funds may, and most do, incorporate the statement of additional information by reference into the prospectus. Mutual funds file post-effective amendments to their registration statements, both as may be required by economic or other changes and developments that are material to investors, and on an annual basis in order to keep their financial statements and other information current. n41

Many mutual funds are authorized to issue multiple series of shares with each series evidencing interests in a separate portfolio of securities. For all practical purposes, a series is a separate investment company. Such funds may combine all their series in a single registration statement but may choose whether to have a single prospectus for all such series or to have separate prospectuses for some or all such series. Mutual funds may also issue separate "classes" of shares in each separate series. n42 Typically, such share classes have different levels of expenses and/or offer different levels of service to investors.

[c] Closed-End Funds (Form N-2). A closed-end fund is a management investment company that offers shares that do not carry a right of redemption. Most closed-end funds do not offer shares continuously. n43 Accordingly, the registration process for securities of closed-end funds is more comparable to that of many other types of non-investment company issuers. Closed-end funds may register under both the Investment Company Act and the Securities Act by filing Form N-2, which the SEC has amended to permit two-part disclosure in a manner similar to mutual funds. After the initial registration closed-end funds must amend their investment company act registrations on an annual basis unless, pursuant to Rule 8b-16, they can include necessary updating information in their annual reports. n44

[d] Unit Investment Trusts (Forms S-6 and N-8B-2). Unit investment trusts are required to file separate registration statements under the Investment Company Act and the Securities Act. However, the requirements of the two forms overlap significantly and the requirements of Form N-8B-2 (the Investment Company Act registration form) are satisfied to a great extent through incorporation by reference of information from Form S-6. n45

In many cases, an umbrella registration statement under the Investment Company Act is filed. Under that umbrella various series of unit investment trusts are formed and interests in those series are offered to the public. A series is, in

essence, a separate fixed and passive portfolio. For each series a separate registration statement on Form S-6 is filed. Within certain limits units of one series may be deposited in a later series. There are expedited registration procedures for series that have policies similar to those of previously registered series. n46 The SEC has proposed, but not adopted, Form N-7 for unit investment trusts (see *Section 7B.07[5]* below).

[e] Variable Insurance Products (Forms N-3, N-4, and N-6). Separate accounts of insurance companies offering variable annuities or variable life insurance (other than those offered exclusively to *Internal Revenue Code Section 401* qualified plans and governmental plans) must register as investment companies. A variable annuity separate account organized as a management investment company may register on Form N-3 (see *Section 7B.07[b]* below), and a variable annuity separate account organized as a unit investment trust may register on Form N-4 (see *Section 7B.07[c]* below). Because these insurance products constitute a highly specialized segment of the investment company industry, this chapter discusses Forms N-3 and N-4 only briefly. n47

Variable life insurance separate accounts have available exemptions pursuant to Rule 6e-2 or Rule 6e-3(T) under the Investment Company Act and those organized as unit investment trusts use Form N-6 for Securities Act registration (see *Section 7B.07[d]* below).

[f] Small Business Investment Companies (Form N-5). Under the Investment Company Act, small business investment companies ("SBICs") are subject to certain special regulatory requirements, reflecting differences in their operations from those of typical investment companies and also reflecting their regulation by the Small Business Administration. SBICs register under the Investment Company Act and register their securities under the Securities Act by filing Form N-5. n48

[g] Face-Amount Certificate Companies (Forms S-1 and N-8B-4). As stated above, registration of face-amount certificate companies is rare. Such companies are required to register under the Investment Company Act by filing Form N-8B-4. Since there is no special Securities Act registration form for face-amount certificate companies, such a company would register securities on Securities Act Form S-1.

[h] Business Development Companies (Form N-2). Business development companies are subject to a special system of regulation under the Investment Company Act. However, technically they do not register under the Investment Company Act. Instead, they would have to satisfy the registration requirements of the Exchange Act. In registering their securities they may use Form N-2, while making additional disclosures as required by the SEC staff. n49

In addition, there are forms for business development companies to use in electing to be regulated as such. n50

[i] Certain Business Combinations (Form N-14). The SEC has adopted Form N-14--a combined proxy statement/prospectus--for management investment companies to register shares under the Securities Act issued in connection with business combinations and to act as the proxy statement for soliciting approval from the target fund's shareholders (see *Section 7B.06* below).

[j] Exchange Act Requirements. Section 12(g)(2)(B) of the Exchange Act specifically exempts any registered investment company from registration pursuant to the requirements of that Section. However, certain exchange traded investment companies are subject to registration pursuant to Section 12(a) of the Exchange Act. In practice, only the shares of closed-end funds and "exchange-traded funds" ("ETFs") are traded on securities exchanges. All other investment companies are subject to Section 15(d) of the Exchange Act if their Securities Act registration statements become effective. However, with the exception of face amount securities companies, registered investment companies, even those traded on exchanges, are generally effectively exempted from reporting requirements under the Exchange Act.

The Exchange Act annual reporting requirements, as set forth in Rules 13a-1 and 15d-1, require annual reports on

whatever form is prescribed for the particular type of registrant. All registered investment companies (except face amount certificate companies) are required to file Form N-SAR as both their annual and semi-annual reports. Similarly, investment companies that are filing Form N-SAR are not required to file quarterly and current reports under the Exchange Act (although funds are required to file Form N-Q under the Investment Company Act). n51 Rule 30e-1 requires management investment companies to send semi-annual reports containing prescribed information to shareholders. Rule 30e- 2 contains a similar requirement for unit investment trusts investing in management companies.

[k] EDGAR: Mandatory Electronic Filing. In 1994, the SEC created the Electronic Data Gathering, Analysis, and Retrieval System ("EDGAR"), and mandated that certain funds make electronic filings of certain registration statements, such as Forms N-1A, N-2, N-3, N-4 and N-5 and other filings, including Form N-SAR and certain proxy materials (as specified in Item 22(a)(4) of Schedule 14A under the Exchange Act). n52 The SEC also promulgated a comprehensive set of electronic filing rules, found in Regulation S-T. n53 The SEC has its own separate Internet Web site--www.sec.gov--which makes EDGAR filings as well as certain SEC releases and announcements available. n54

FOOTNOTES:

(n1)Footnote 1. For comprehensive coverage of the substantive regulation of investment companies under the Investment Company Act, *see* Lemke, Lins & Smith, Regulation of Investment Companies (Matthew Bender 2009) [hereinafter cited as "Lemke, Lins & Smith"].

(n2)Footnote 2. A number of the key terms in Section 3(a)(1) are themselves defined elsewhere in the Investment Company Act (the "Act"), including: "issuer" (Section 2(a)(22)), "person" (Section 2(a)(28)), "company" (Section 2(a)(8)), and "security" (Section 2(a)(36)).

See also SEC v. Fifth Avenue Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968) , *aff'd*, 435 F.2d. 510 (2d Cir. 1970)

(n3)Footnote 3. Section 2(a)(15) defines a face-amount certificate to include an:

obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than 24 months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security will be known as a face-amount certificate of the "installment type"); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face-amount certificate). *See SEC v. Mt. Vernon Memorial Park*, 664 F.2d 1358 (9th Cir.) , *cert. denied*, 456 U.S. 961 (1982) .

(n4)Footnote 4. A company that is "excepted" from the definition of investment company is in consequence not subject to regulation under the Investment Company Act.

For discussion of exceptions from the definition of investment companies, *see* § 7B.01[3] above. *See also* Lemke, Lins & Smith § 3.07.

(n5)Footnote 5. *See* § 7B.01[2][b] above.

(n6)Footnote 6. *See* Section 10 of the Securities Act of 1933, reprinted in the Primary Law Sourcebook, Volume A, Section B.

(n7)Footnote 7. *See* Section 15 of the Investment Company Act.

(n8)Footnote 8. *See* Section 17 of the Investment Company Act.

(n9)Footnote 9. See Section 18 of the Investment Company Act.

(n10)Footnote 10. See Sections 22 and 23 of the Investment Company Act.

(n11)Footnote 11. Section 2(a)(32) of the Investment Company Act defines redeemable security to mean any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof. "Value" is defined in Section 2(a)(41) of the Investment Company Act. Money market funds may value their assets on the basis of "amortized cost" rather than market value if they comply with Rule 2a-7 under the Investment Company Act.

(n12)Footnote 12. Funds organized as business trusts issue units of beneficial interest with characteristics similar to common stock. Certain provisions of the Investment Company Act, especially Section 18, regulate the attributes of mutual fund securities. Rule 18f-3 under the Investment Company Act allows mutual funds to issue multiple classes of common stock that are identical except for the allocation of certain expenses.

(n13)Footnote 13. Such tenders might be made if the fund's shares were trading in the secondary market at a price below their net asset value ("trading at a discount"). In addition, so-called "prime rate funds" that invest principally in loan participations typically make quarterly tenders to provide liquidity to shareholders. Rule 23c-3 under the Investment Company Act permits certain closed-end funds (so-called 'interval funds') to make regular tenders subject to a number of conditions. However, funds that make tenders have, to date, generally not relied on this rule.

(n14)Footnote 14. Subchapter M of the Internal Revenue Code permits investment companies to avoid taxation of income and gains distributed to shareholders if certain requirements are satisfied. One such requirement is a diversification test that is similar to, but less restrictive than, the Investment Company Act test. See *I.R.C. Section 851(b)(4)*.

(n15)Footnote 15. Money market funds are subject to stricter diversification requirements.

(n16)Footnote 16. See the discussion of inadvertent Investment Companies in § 7B.01[1][c] below. See also Lemke, Lins & Smith § 3.03.

(n17)Footnote 17. Section 2(a)(43) of the Investment Company Act provides that a company is a "wholly-owned subsidiary" if 95 percent of its voting securities are owned by another company.

(n18)Footnote 18. Unlike Section 3(b)(1), Section 3(b)(2) requires a company to seek a determination of its status by the SEC. However, a company that requests such a determination in good faith receives a statutory 60 day exemption and the SEC customarily grants extensions as necessary prior to a final determination. Section 2(a)(24) of the Investment Company Act provides that a company is a "majority-owned subsidiary" when 50 percent or more of its outstanding voting securities are owned by another person. Under Section 2(a)(9) "control" means the power to exercise a controlling influence over the management or policies of a company, unless this power is solely the result of an official position with the company. However, any owner of more than 25 percent of the voting securities of the company is presumed to control that company, and there is a presumption that no natural person can be controlled. Both of these presumptions may be rebutted by evidence. The SEC generally considers five areas of inquiry relevant to a status determination: the nature of the company's assets; sources of income; primary activities of officers and employees; representations about the nature of the company's business; and the company's history. See, e.g., *Tonopah Mining Co. of Nevada*, 26 S.E.C. 426 (1947). But see *SEC v. National Presto Industries, Inc.*, No. 05-4612 (May 15, 2007, 7th Cir.). However, in certain situations, the SEC may consider an additional factor--the turnover rate of portfolio securities--in determining an issuer's primary engagement. See *SEC v. Dart Group Corp.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) [Middle dot] 94,953 (D.D.C. Feb. 28, 1990).

(n19)Footnote 19. Under Rule 3a-1 under the Investment Company Act, reprinted in the Primary Law Sourcebook,

Volume A, Section C: (a) a company must not be an investment company within the meaning of Section 3(a)(1) or 3(a)(2) (see §§ 7B.01[1][a] and [b] below) or a so-called "special situation investment company;" and (b) not more than 45 percent of its assets and 45 percent of its income may consist of or be derived from securities (other than government securities, employees' securities companies, and securities of primarily controlled companies which are not themselves investment companies).

(n20)Footnote 20. The primary test that must be met under rule 3a-2 is that the company relying on the Rule must intend to take steps to remove itself from the definition of an investment company within a year. Intent is evidenced by the adoption of appropriate board of director resolutions and by the company's business activities. The rule also defines when the one year time period commences.

(n21)Footnote 21. See Rules 3a-5 and 6c-9.

(n22)Footnote 22. A group of entities may be regarded as a single "company" for purposes of the 10 percent test if they are acting in concert. See *Bancroft Convertible Fund, Inc. v. ZICO Investment Holdings, Inc.*, 825 F.2d 731 (3d Cir. 1987) and *Clemente Global Growth Fund, Inc. v. T. Boone Pickens*, 705 F. Supp. 958 (S.D.N.Y. 1989).

(n23)Footnote 23. Section 2(a)(51) defines "qualified purchaser" to include certain high net worth individuals and institutions. See also Rules 2a51-1, 2 and 3.

(n24)Footnote 24. The SEC staff believes that a trust generally may rely on Section 2(a)(51)(A)(ii) if all present or future vested or contingent economic interests in the trust's assets are held exclusively by eligible family members. In addition, according to the SEC staff, the family relationship requirements of Section 2(a)(51)(A)(ii) of the Investment Company Act are satisfied if a trust's beneficiaries are direct lineal descendants of a settlor and related as aunts, uncles, nieces and nephews. See *Meadowbrook Real Estate Fund*, 1998 SEC No-Act. LEXIS 805 (Aug. 26, 1998). The SEC staff has also granted relief to a charitable corporation that otherwise would meet the requirements of Section 2(a)(51)(A)(ii). See *Goldman Sachs Asset Management, L.P.*, SEC No-Action Letter (pub. avail. Mar. 13, 2007).

(n25)Footnote 25. The SEC staff has determined that a special liquidating trust established to receive distributions of Section 3(c)(7) interests would not be deemed to have been formed for the specific purpose of acquiring securities of a Section 3(c)(7) fund. See *SCP Private Equity Partners II, L.P.*, 2006 SEC No-Act. LEXIS 478 (June 6, 2006).

(n26)Footnote 26. The SEC staff believes the appropriate time to determine the qualified purchaser status of the trustee is when the trustee makes the decision to acquire securities of the Section 3(c)(7) fund. See *Meadowbrook Real Estate Fund*, 1998 SEC No-Act. LEXIS 805 (Aug. 26, 1998); *American Bar Ass'n Section of Business Law*, 1999 SEC No-Act. LEXIS 456 (Apr. 22, 1999). If a trust has more than one trustee, only the trustee responsible for making investment decisions for the trust needs to be a "qualified purchaser." See *American Bar Ass'n Section of Business Law*, 1999 SEC No-Act. LEXIS 456 (Apr. 22, 1999). Furthermore, in certain situations where the contributions to the trust were made before the enactment of Section 3(c)(7), the staff believes the settlor to be a qualified purchaser if the amount of the contribution at the time it was made exceeds the \$5 million threshold in terms of 1996 dollars. See *Trusts Under the Will of Marion Searle*, 2005 SEC No-Act. LEXIS 494 (Mar. 29, 2005). The SEC staff has also granted relief to a charitable corporation that otherwise would meet the requirements of Section 2(a)(51)(A)(iii). See *Goldman Sachs Asset Management, L.P.*, SEC No-Action Letter (pub. avail. Mar. 13, 2007).

(n27)Footnote 27. Section 2(a)(51)(A) of the Investment Company Act. The SEC staff takes the position that a person may satisfy the \$25 million threshold by aggregating investments the person owns with investments of accounts (including accounts of non-qualified purchasers) that the person invests on a discretionary basis. See *Service Corporation Int'l*, 1998 SEC No-Act. LEXIS 894 (Oct. 6, 1998). The SEC staff has also taken the position that a person who meets the requirements of this provision may invest jointly with a spouse who is not a qualified purchaser. See *McDermott Will & Emery*, 2007 SEC No-Act. LEXIS 542 (July 26, 2007). Section 2(a)(51) also provides that an entity that invests in the private investment company and, but for the exceptions in Section 3(c)(1) and 3(c)(7), would itself be

an investment company will not be considered a "qualified purchaser" unless all direct and indirect beneficial owners of its securities who acquired their interests prior to April 30, 1996 consent to the entity's treatment as a "qualified purchaser." This provision ensures that investors who purchased with no intent of becoming an indirect investor in a Section 3(c)(7) company are not forced to do so.

(n28)Footnote 28. Section 3(c)(2) excepts from the definition of investment company any person primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more such activities, whose gross income normally is derived principally from such business and related activities.

(n29)Footnote 29. Section 3(c)(3) excepts banks, savings and loan associations, building and loan associations, cooperative banks, homestead associations, or similar institutions, (as well as any receiver, conservator, liquidator, liquidating agent or similar official). Section 2(a)(5) defines bank to mean: (a) a national bank; (b) a member bank of the Federal Reserve System; (c) any other bank as long as a substantial portion of its business consists of receiving deposits or exercising fiduciary powers and as long as it is subject to state or federal regulation and is not operated for the purpose of evading the Investment Company Act; and (d) a receiver, conservator, or liquidating agent. Section 3(c)(3) also excepts bank common trust funds if they are maintained exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian. Under historical interpretations of the Glass-Steagall Act, interests in such common trust funds could not be marketed to investors unless the fund is registered under the Investment Company Act. Common trust funds may be used solely as an aid in the administration of fiduciary accounts, such funds may not be advertised or publicly sold except in the course of the ordinary advertising of fiduciary services, and fees and expenses charged must not contravene fiduciary principles.

(n30)Footnote 30. Section 3(c)(3) excepts insurance companies, as well as banking institutions. Insurance company separate accounts, unless otherwise excepted, must register as investment companies. *See § 7B.01[6][e] above.*

(n31)Footnote 31. Section 3(c)(5) excepts eligible companies primarily engaged in: (a) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other merchandise, insurance and services; (b) making loans to manufacturers, wholesalers and retailers of, and prospective purchasers of, specified merchandise, insurance and services; and (c) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Section 3(c)(6) excepts certain companies that are engaged in a combination of businesses excepted in Sections 3(c)(3), (4) and (5).

(n32)Footnote 32. Section 3(c)(11) excepts any employees' stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under *Section 401 of the Internal Revenue Code*; or any collective trust fund maintained by a bank consisting solely of assets of such trusts; or any separate account, the assets of which are derived solely from (a) contributions under pension or profit-sharing plans which meet the requirements of such section or the requirements for deduction of the employer's contribution under Section 404(a)(2) of such Code, and (b) advances made by an insurance company in connection with the operation of such separate account. The Commission takes the position that such a fund is not eligible for the Section 3(c)(11) exception since IRAs are qualified under *Section 408 of the I.R.C.* rather than Section 401.

(n33)Footnote 33. *See* Section 6(e) of the Investment Company Act.

(n34)Footnote 34. Section 6(a)(1) exempts companies organized and operating in Puerto Rico, the Canal Zone, the Virgin Islands, or other possessions of the United States. However, this exemption is available only as long as the investment company does not offer its securities in any state. Section 6(a)(2) limits the exemption for companies in bankruptcy to the time during which the company is under court supervision and also conditions the exemption on the company not selling securities, other than short-term paper and receiver's or trustee's certificates sold exclusively for

cash. Section 6(a)(3) exempts certain companies that have been through court supervised reorganization and are not making a public offering of securities. Sections 6(a)(4) and (5) contain additional specialized and limited exemptions.

(n35)Footnote 35. Section 2(a)(13) defines an "employees' securities company" as an investment company the securities of which (other than short-term paper) are owned by a company's employees, former employees, and members of the immediate family of employees or former employees. The SEC may exempt employees' securities companies in whole or in part from the Investment Company Act but normally grants only limited and conditional exemptions.

(n36)Footnote 36. To be eligible for the exemption provided by Section 6(e), the company must not sell or offer securities having a value in excess of \$100,000; the securities must be sold intrastate; and exemption must not be contrary to the public interest or inconsistent with the protection of investors. For discussion of registration of business development companies, *see* § 7B.01[6][h] *above*.

(n37)Footnote 37. *See* Section 1(b) of the Investment Company Act for a description of the policy and purposes of the Investment Company Act, which are, in essence, to eliminate the conditions which led to its enactment.

(n38)Footnote 38. Investment companies organized outside the U.S. may not make public offerings in the U.S. However, the SEC staff has permitted them to make private placements in the U.S. in compliance with limits that would be applicable if they were U.S. companies relying on Section 3(c)(1) or 3(c)(7). *See* § 7B.01[3][b] *below*.

(n39)Footnote 39. *See* § 7B.02 *above*.

(n40)Footnote 40. Filing requirements for mutual funds are discussed in § 7B.03 and § 7B.04 *above*.

(n41)Footnote 41. *See* § 7B.02[3][b] *above*.

(n42)Footnote 42. Rule 18f-3 regulates issuance of multiple classes of shares. Prior to the adoption of this rule, funds could issue multiple classes of shares only pursuant to SEC exemptive orders specifically applicable to them.

(n43)Footnote 43. Like a traditional non-investment company issuer, a closed-end fund generally raises capital in an initial public offering of common stock. As a practical matter, most closed-end funds find it difficult to issue stock thereafter except through dividend reinvestment and occasional rights offerings. Some closed-end funds issue debt or preferred stock publicly or privately.

(n44)Footnote 44. Registration requirements for closed-end funds are discussed in § 7B.04 *above*.

(n45)Footnote 45. *See* § 7B.05[2] *above* for discussion of coordination of requirements for Forms S-6 and N-8B-2.

(n46)Footnote 46. Some unit investment trusts issue units continuously, rather than in series, and use the proceeds of sales to accumulate shares of one or more registered management companies.

(n47)Footnote 47. *See* § 7B.07 *above* for discussion of Forms N-3 and N-4.

(n48)Footnote 48. SBIC registrations are rare because the preponderance of SBICs are closely held but the requirements are summarized briefly in § 7B.07[2] *above*.

(n49)Footnote 49. *See* Inv. Co. Act Rel. No. 11703, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,858 (1981). The areas of disclosure covered in this release include special risks of business development companies; some of the financial information required of operating companies; disclosure about small business investment company subsidiaries; more detailed disclosure about portfolio companies; information about special compensation; and additional disclosure about the regulatory provisions of the Investment Company Act.

(n50)Footnote 50. Form N-6F, the notice of intent to file a notification of election, essentially allows a company that would come within the exclusion from the definition of an investment company in Section 3(c)(1) of the Investment Company Act except for the fact that it had a present intention of making a public offering to continue to operate without being regulated under the Investment Company Act for a limited period of time. Form N-54A is the form used to notify the SEC of an election to be regulated as a business development company, and Form N-54C is the form for notification of withdrawal of such an election.

(n51)Footnote 51. See Rules 13a-11, 13a-13, 15d-11 and 15d-13 under the Exchange Act and Rules 30a-1 and 30b1-1 under the Investment Company Act.

(n52)Footnote 52. See *Inv. Co. Act Rel. No. 20783, 1994 SEC LEXIS 4107*, Fed. Sec. L. Rep. (CCH) P 85,475 (Dec. 19, 1994).

(n53)Footnote 53. 17 C.F.R. § 232. All correspondence (including cover letters and requests for acceleration) related to electronic filings also must be submitted electronically. See Rule 101(a) of Regulation S-T.

(n54)Footnote 54. See *Inv. Co. Act Rel. No. 21399, 1995 SEC LEXIS 2662*, Fed Sec. L. Rep. (CCH) P 85,702 at n. 6 (Oct. 6, 1995). The SEC Internet Web site address is <http://www.sec.gov>. The SEC has also established an electronic mailbox for comments and questions concerning electronic prospectuses and other investment-related issues at "e-prospectus@sec.gov." Messages sent to the mailbox should include a posted return address and a daytime telephone number. For a discussion of EDGAR, see Gavis, *The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Initiatives*, 52 *Bus. Law.* 317 (1996).



99 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.02

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.02 Statutory Provisions, Regulations, and Procedures Governing Registration of Investment Company Securities

The Securities Act and most of the SEC's procedural and formal requirements thereunder are applicable to the offering of securities by investment companies. This Chapter addresses the registration process but it is important to remember that the liability provisions of the Securities Act (and, for that matter the Exchange Act) apply to the offering and sale of investment company securities. n1 In addition, the Investment Company Act requires investment companies to register and to include certain disclosures in their registration statements. In many cases, investment companies may accomplish registration pursuant to the Securities Act and the Investment Company Act by filing a single form. Registration of investment companies and their securities is overseen by the staff of the SEC's Division of Investment Management.

[1] Activities Before and During Registration

[a] Pre-Filing. Section 5 of the Securities Act, which applies to the offering of securities by an investment company, accordingly limits pre-filing activities by investment companies. n2

With respect to unregistered unit investment trusts, no depositor or trustee of, or underwriter for, such a company may offer, sell, deliver, purchase, redeem, or otherwise acquire a security of a trust by use of the jurisdictional means or sell or purchase for the account of such company, by use of the jurisdictional means, any security or interest in a security, by whomever issued. In addition, unless a registration statement has been filed under the Investment Company Act, no promoter or underwriter for an investment company may offer, sell, or deliver, in connection with a public offering, any pre-organization certificate or subscription.

[b] Investment Company Registration.

[i] Notification of Registration. Under Section 8(a) an investment company may become registered by filing a "Notification of Registration" and will be deemed to be registered upon receipt by the SEC thereof. The form prescribed by the SEC for this purpose, Form N-8A, is very brief and requires only basic identifying information. n3 The form requires information such as the registrant's name, address and telephone number, agent for service of process, state of domicile, form of organization, classification under the Act, and total assets. Also required is the identity of the company's investment adviser and its board of directors, as applicable. Names must be given in full; initials or

abbreviations will not suffice.

The instructions to the form caution that all items must be answered fully and accurately. If an item is not applicable to the registrant, it must indicate that fact by answering "NOT APPLICABLE." Items required by the form are to be answered as of the date the form is prepared, unless the context clearly indicates otherwise.

An original and three copies of the form must be filed with the SEC in Washington, D.C. The three copies may have facsimile or typed signatures. If the investment company has a board of directors, a director, officer, or trustee must sign the original on behalf of the registrant. In other cases (*i.e.*, a UIT), the original must be signed on behalf of the registrant by an officer or director of its sponsor. If no sponsor exists or is functioning as of the date of filing, the signature may be made by an officer or director of the trustee or custodian.

In addition to the instructions in the form itself, Rules 8b-1 to 8b-32 under the Investment Company Act specify various procedural requirements applicable to Form N-8A as well as other forms. n4

The filing of this notification permits an investment company to engage in certain activities in interstate commerce and to be eligible for treatment as a regulated investment company under the Internal Revenue Code n5

However, filing Form N-8A does not constitute the filing of a registration statement under the Securities Act.

Pursuant to Section 8(b) and Rule 8b-5 under the Investment Company Act an investment company must file its full registration statement within three months after the filing of its notification of registration, except that, if the company's fiscal year ended within this three month period, it would be required to file its full registration statement within three months after its fiscal year end.

[c] Offering Securities and Advertising. Once a Securities Act registration statement has been filed in the manner described below, investment companies may offer their securities in interstate commerce by means of a variety of communications. As is the case with other issuers, investment companies may, pursuant to Section 5(c) of the Securities Act, make offers during the pre-effective period by means of a "red herring" prospectus meeting the requirements of Section 10(a) of the Securities Act.

The period after the registration statement is filed, but prior to its effectiveness, is known as the "waiting period." In many offerings of new securities--both of investment companies and other issuers--this period is used to disseminate information to potential investors. This practice not only assists issuers and underwriters in more accurately gauging the interest of potential investors but also provides potential investors with more time to evaluate and consider the securities to be offered.

To facilitate the dissemination of relevant information during the "waiting period," while also minimizing the possibility of sales activities prior to a registration statement's effective date, the SEC adopted Rule 430 n6 under the Securities Act. Rule 430 permits an investment company to provide potential investors with a preliminary prospectus during the "waiting period" so long as the preliminary prospectus contains substantially the information required in a final prospectus (except for information dependent on the offering price) and potential investors can obtain a Statement of Additional Information without charge upon written or oral request. Although the literal wording of Rule 430 could suggest that it is available only to registrants with *no* effective registration statement, the SEC staff has confirmed that a series company with an effective registration statement can rely on Rule 430 for a *new* series added by post-effective amendment. n7

Rule 481(b)(2) under the Securities Act requires that a preliminary prospectus disseminated during the waiting period must prominently include the following statement on the outside front cover page of the prospectus: n8

The information in this prospectus (or Statement of Additional Information) is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus (or Statement of Additional Information) is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer is not permitted.

Because this legend historically has appeared in red ink, this type of prospectus is frequently referred to as a "red herring." Rule 497(a) requires that five copies of the preliminary prospectus must be filed with the SEC at or prior to the time of first use if it varies from the form of prospectus included in the registration statement. n9 Rule 481(b)(2) also requires a similar legend to be included in any Statement of Additional Information used before the effective date. n10

The general requirements of Securities Act Rule 460 apply to investment companies. However, the granting of acceleration will not be conditioned upon distribution of preliminary prospectuses to underwriters and dealers in the case of certificates issued by face-amount certificate companies, or redeemable securities issued by open-end management companies or unit investment trusts if any other security of the same class is currently being offered or sold pursuant to an effective registration statement. n11

After the filing of a registration statement, investment companies may also advertise. n12 Except as noted below, the rules relating to advertising apply equally after the effectiveness of the registration statement. The Financial Industry Regulatory Association ("FINRA") n13 generally regulates the use of investment company advertising by its members. n14

Investment companies also may use supplemental sales literature as permitted by Section 2(10)(a) of the Securities Act after effectiveness of the registration statement. Investment companies may include sales literature in their prospectuses. Pursuant to Section 24(b) of the Investment Company Act, registered open-end companies, unit investment trusts and face-amount certificate companies must file three copies of sales literature within ten days after use. n15

Until 1978 the Commission had in effect a Statement of Policy concerning the contents of investment company sales literature. The Commission has withdrawn the Statement of Policy, although the Commission has suggested that some of the principles in the Statement of the Policy may remain valid. n16 The Commission has also adopted Rule 156 under the Securities Act, an interpretive rule applicable to sales literature. n17

Rule 135a permits investment companies to use so-called "generic" advertisements, which provide limited information about investment companies but not naming them.

Investment companies may also use advertising in the form of "omitting prospectuses" as permitted by Section 10(b) of the Securities Act. Rule 482 governs this type of advertising and generally permits inclusion of any information that is in the prospectus or that fairly summarizes information that is in the prospectus. n18 The Rule, in combination with Form N-1A, effectively permits the advertising of performance information that is more current than the information in the prospectus. A Rule 482 omitting prospectus may be used in conjunction with a "summary prospectus" permitted by 498.

Performance information used in Rule 482 advertisements must be computed in accordance with the requirements of the applicable registration form. In the case of money market funds, "yield" and "effective yield" quotations must be based on the annualized performance over a specified seven day period of a hypothetical one share account. n19 Other types of funds must base yield on performance over a 30-day period. Such funds may (and, if they quote yield, must) provide total return data over one, five and ten years (or the life of the fund, if less) in accordance with a prescribed formula. Such funds may also, within limits, advertise non-standard total return. Finally, any advertisement containing performance data must include disclosure about risk and fees. n20

[2] Filing the Registration Statement

[a] Basic Statutory Requirements. Section 6(a) of the Securities Act, which governs the method of registration of securities under the Securities Act, applies to investment company securities. As noted above, Section 8(b) of the Investment Company Act, together with Rule 8b-5 thereunder, generally requires a registered investment company (i.e., an investment company that has filed a notification of registration) to file a full registration statement under the Investment Company Act within three months. Section 8(b) further provides that the registration statement shall contain an original and such copies, and shall be in such form, as the Commission provides.

The procedural and formal requirements applicable to investment company registration statements generally correspond to those applicable to Securities Act registration statements. Finally, Section 8(b) enumerates certain specific categories of information that must be included to the extent prescribed by Commission rules and regulations as necessary or appropriate in the public interest or for the protection of investors. n21

[b] Coordination of Securities Act and Investment Company Act Requirements. Section 8(c) authorizes the Commission to permit the filing of certain other documents, including documents filed under the Securities Act and under the Exchange Act, in lieu of the information and documents required by Section 8(b).

Specifically, the Commission may so designate:

- copies of the most recent Securities Act registration statement, or, in the absence thereof, a registration statement filed under the Exchange Act;
- copies of any reports filed pursuant to Section 13 or 15(d) of the Exchange Act; and
- a reasonably current report regarding the matters included in the foregoing and such other information as the Commission is authorized to require under Section 8(b).

As noted earlier, management companies may register under both the Investment Company Act and the Securities Act by filing a single form. n22

For unit investment trusts that invest exclusively in other registered investment companies, the Commission is authorized to permit a registration statement which eliminates inappropriate duplication. Unit investment trusts must file separate forms for registration under the Investment Company Act and the Securities Act but are able to avoid much of the duplication that doing so might otherwise cause through incorporation by reference.

[c] Other Investment Company Act Registration Provisions. Under Section 8(e) of the Investment Company Act the Commission may, in certain circumstances, suspend or revoke the registration statement of an investment company that has failed to file required registration statements or reports or has filed false or misleading registration statements or reports. In addition, under Section 8(f) the Commission may, upon its own motion or upon application, deregister an investment company, conditionally or unconditionally, if it concludes that the company has "ceased to be an investment company." n23 The Commission has simplified the deregistration process for most companies by adopting Rule 8f-1 and Form N-8F-1. Liquidation of a series of a registrant does not necessitate deregistration.

[d] Procedural and Formal Requirements.

[i] Introduction. For the most part, Regulation C (Rules 400-498 under the Securities Act), which governs the registration of securities generally, applies to the registration of investment company securities. Some of the rules in Regulation C have special provisions applicable to investment companies and a number of the rules (generally those numbered 480 and higher) apply exclusively to investment companies.

In addition, Rules 8b-1 through 8b-32 under Section 8(b) of the Investment Company Act govern investment company registration statements. Many of these rules closely parallel related rules in Regulation C.

[ii] General Requirements. A number of Regulation C's General Requirements (Rules 401-419) have direct counterparts under the Investment Company Act. n24

Other rules under Section 8(b) are similar but not identical to corresponding rules under Regulation C. Rules 404 and 8b-13, concerning preparation of the registration statement, are similar except that the latter requires the inclusion of items, numbers and captions. For the most part, however, the applicable forms modify or supersede this requirement. The definitional provisions (Rules 405 and 8b-2) have some overlap. It is noteworthy that the two definitions of "material" differ in certain respects. n25

The rules on incorporation by reference (Rule 411 of Regulation C and Rules 8b-23 and 8b-32 (as well as Rule 0-4) under the Investment Company Act) are generally comparable, although the various investment company registration forms modify these provisions in certain ways. Rule 414 governing registration of certain successor issuers has no counterpart under the Investment Company Act but the SEC staff has given "no-action" relief. n26 Finally, Rule 415 governing shelf registration is available only to closed-end management companies.

Regulation C has no counterpart to Rules 8b-4 and 8b-14. The former provides general guidance on interpreting requirements of forms, and the latter prohibits the use of riders in registration statements.

[iii] Form and Content of the Prospectus. The provisions of Regulation C dealing with the form and content of prospectuses (Rules 420 to 433) apply to investment companies unless otherwise specified. However, in many cases the registration forms for particular types of investment companies contain special requirements as to form and content that may modify or supersede Regulation C. Rule 497 contains particular requirements for investment companies filing on Form N-1A, N-2, N-3 and N-4. n27

[iv] Written Consents. Rules 436 through 439 under the Securities Act, which deal with consents by experts or counsel, are applicable to investment companies. In addition, Rule 483(c) contains additional technical requirements for the filing of consents by investment companies. n28

[v] Filing, Fees, Effective Date. Generally, the provisions of Securities Act Rules 455 through 461 apply to investment companies. n29

Although the provisions of Section 6(b) of the Securities Act and of Rule 457 thereunder governing computation of registration fees generally apply to investment companies, the Investment Company Act and the rules thereunder make special provision for fees with respect to securities of face-amount certificate companies and redeemable securities of open-end management companies and unit investment trusts. The current registration fee is \$55.80 per million dollars of the aggregate offering price of the securities being registered. n30

Both Rule 0-8 under the Investment Company Act and Rule 111 under the Securities Act require that payment of fees be made by wire transfer, or by certified check, United States postal money order, bank cashier's check or bank money order payable to the Securities and Exchange Commission, omitting the name or title of any official of the Commission.

Rule 487 makes special provision for the effectiveness of registration statements under the Securities Act by unit investment trusts offered in series form. n31

[A] Registration of an Indefinite Number of Shares. Mutual funds may register an indefinite number of shares and pay fees annually based on net shares sold (i.e., purchases less redemptions). Section 24(f) of the Investment Company Act provides that funds are deemed to have registered an indefinite number of shares. Funds must pay the fee (and file Form 24f-2) within 90 days after the end of each fiscal year. Interest is charged on late payments.

[vi] Amendments and Withdrawals. Rules 470 through 479 under the Securities Act concerning amendments and withdrawals of registration statements are generally applicable to investment companies unless plainly inapplicable by their terms. n32 However, in the case of amendments, the appropriate form for the particular type of investment company will prescribe the information and documents to be included.

Rules 8b-15 and 0-3 under the Investment Company Act impose additional formal requirements in connection with amendments of investment company registration statements. n33

In addition, Rule 8b-16 requires management companies to file annual post-effective amendments to the registration statement under the Investment Company Act. n34

[vii] Special Rules for Investment Companies and Business Development Companies. Rules 480 through 489 constitute a section of Regulation C applicable only to investment companies and business development companies. n35 In addition, Rules 495 through 497 apply to mutual funds. n36 Many of these special rules are counterparts of requirements applicable to other types of issuers set forth elsewhere in Regulation C or in Regulation S-K.

Rule 480 requires investment companies or business development companies to include certain information in registration statements "wherever the title of securities is required to be stated." In the case of shares, the information must include par value, if any; the rate of dividends, if fixed, and whether dividends are cumulative or non-cumulative; a brief indication of any preference; and, if the securities are convertible, a statement to that effect. In the case of "funded debt," the registration statement must include the rate of interest; the date of maturity (or indication of serial maturities); any contingencies with respect to payment of principal or interest; any indication of the priority of the issue; and, if the securities are convertible, a statement to that effect. Comparable information is required for any other type of security. n37

Rule 481 is headed "Information Required in the Prospectus" but the applicability of the Rule is not limited to the prospectus. In particular, Rule 481(a) requires that the facing page of the registration statement set forth the approximate date of the proposed sale to the public and that there be a cross reference sheet showing the location of information in the prospectus required to be included in the prospectus in response to the items of the applicable registration form.

Rule 481(b) requires that the prospectus outside front cover contain a disclaimer of SEC approval n38 and that any preliminary prospectus be captioned as such and contain a description legend. n39

Rule 481(c) requires a table of contents on the inside or outside front cover, or the outside back cover of the prospectus. Rule 481(d) requires, in the case of stabilization, compliance with essentially the same type of regulations that apply to other types of issuers, including disclosure regarding over-allotments.

The requirements of Rule 482, the general advertising rule for mutual funds, generally permits an advertisement to contain information included or not included in the prospectus so long as it is not misleading. n40

Rule 483 pertains to exhibits in registration statements filed by investment companies and business development companies. Specifically, these companies must file an exhibit index and copies of any powers of attorney and consents. Registrants may include additional exhibits. However, they need not file certain documents that are substantially identical to others filed, and need not refile certain exhibits if immaterial changes are made after the original filing.

The other Rules in this special section of Regulation C are discussed elsewhere in this chapter. n41

Rule 495 applies to preparation of registration statements by mutual funds on Form N-1A and is substantially identical to Rule 404, except insofar as it extends certain flexibility accorded in the preparation of the Statement of Additional Information. n42 Specifically, the Statement of Additional Information does not have to be prepared in item and answer

format; no reference need be made to inapplicable items; and negative answers may be omitted.

Rule 496 concerns the contents of prospectuses used after nine months and is identical to Rule 427 except that it extends the requirements thereof that are applicable to financial statements to the Statement of Additional Information.

Similarly, Rule 497 imposes requirements as to the filing of prospectuses that are comparable to those contained in Rule 424, but extends those requirements to the Statement of Additional Information.

[3] Information Required in the Registration Statement

[a] General. The requirements of Section 7 of the Securities Act governing information that must be in the registration statement apply to investment companies. In addition, Section 8(b) of the Investment Company Act applies to the contents of registration statements of investment companies.

[b] Additional Requirements Applicable to Investment Companies.

[i] Recital of Policy with Respect to Certain Activities. Section 8(b)(1) enumerates certain types of activities and requires that the registration statement under the Investment Company Act include such information about the registrant's policies with respect to those activities as the Commission by rules and regulations prescribes as necessary or appropriate in the public interest or for the protection of investors. Those activities include:

- the classification and sub-classifications of the investment company; n43
- borrowing money;
- the issuance of senior securities; n44
- engaging in the business of underwriting securities issued by other persons; n45
- concentrating investments in a particular industry or group of industries; n46
- the purchase and sale of real estate n47 and commodities n48 or either of them;
- making loans to other persons; and n49
- portfolio turnover.

Section 8(b)(2) requires a recital of all investment policies of the investment company, not including those enumerated above, which are changeable only by shareholder vote. Section 8(b)(3) requires a recital of all additional policies which the registrant deems "matters of fundamental policy." Section 13(a) of the Investment Company Act generally requires adherence to the policies set forth pursuant to Section 8(b).

Section 8(b)(4) requires the registration statement to include the name and address of each affiliated person of the registrant; n50 the name and principal address of every company, other than the registrant, of which each such person is an officer, director or partner; and a brief statement of the business experience for the preceding five years of each officer and director of the registrant. Section 8(b)(5) requires the information and documents which would be required to be filed in order to register under the Securities Act and the Exchange Act.

[4] Taking Effect of Registration Statements and Amendments Thereto

[a] Original Registration Statement.

[i] Permanent Delaying Amendment. Typically, the original registration statement of an investment company includes an amendment as provided for in Rule 473(a) which prevents the registration statement from becoming effective automatically 20 days after it is filed pursuant to Section 8(a) of the Securities Act. This "permanent delaying amendment" is a convention which allows time for the SEC staff to review and comment on the registration statement.

[ii] Assignment to Branch. As stated above, the Division of Investment Management of the SEC reviews registration statements of investment companies and business development companies. All registration statements of insurance company separate accounts are assigned to a branch specializing in insurance products. Other registration statements of investment companies are assigned to any one of several other branches, depending on the circumstances. If, for example, the registrant is a new fund in a "family" or "complex" of funds--a group of mutual funds that have the same investment adviser, distribution or other sponsoring organization--the registration statement will normally be assigned to the branch that reviews filings of all the other investment companies in that family or complex. Some investment company registration statements may be assigned to branches that have developed expertise in that particular type of investment company. Other registration statements are assigned on a rotating basis.

[iii] Review and Comment. Generally initial registration statements of investment companies and business development companies are reviewed in detail, and the staff attempts to give written comments within approximately 30 days.

From time to time the SEC publishes the views of its staff on procedures to be followed in filing a registration statement (as well as other types of filings). In Securities Act Release No. 5738 n51 the staff reminded registrants about certain requirements that the staff believed were frequently overlooked and also described various levels of staff review procedures. Some of these overlooked requirements have been superseded but others are still relevant. The staff reminded registrants to be sure to file the correct number of copies as required by Rule 402 under the Securities Act. The staff also pointed out that the letter of transmittal accompanying a registration statement should describe possible problem areas and set forth the registrant's desired time schedule. The staff also reminded registrants of the existence of published guidelines for the preparation of investment company registration statements. n52

Release No. 5738 also describes various review procedures. In some cases where a registration statement appears to have been properly prepared and raises no novel or complex issues, the staff may give the registration statement only cursory review. In such cases the staff would give no written or oral comments but could advise the registrant in writing that it had given the registration statement only a cursory review and that, in any event, staff review may not be relied upon to indicate that the registration statement is true, complete or accurate.

Even where the staff has given a registration statement only cursory review, it will, absent some unusual circumstances, nevertheless grant a request for acceleration of the effectiveness of the registration statement. In a subsequent release n53 the staff announced that registration statements of new investment companies in a "complex" of funds might receive cursory review under certain circumstances. Cursory review would be used where such a new investment company had investment objectives, policies and techniques similar to those of a recent prior offering by another fund in the complex and where the registration statement contained disclosure that was not substantially different than the disclosure contained in one or more prior filings by funds in the complex. This type of review is also referred to as selective review.

Securities Act Release No. 5738 also discusses "customary review" and "deferred review." Deferred review is used in cases of very poorly prepared registration statements. The staff does not review the registration statement in detail but advises the registrant of the general nature of the problems the registration statement presents. Other registration statements are given customary review. A repeated theme in releases of this type is that, regardless of staff review, registrants are responsible for the adequacy of the disclosure they make.

Beginning in 1990, the staff issued annual letters commonly known as "generic comment letters," highlighting

disclosure issues of particular prominence in the most recent year. The staff has announced that it will no longer issue such letters generally but will continue to send letters on accounting issues to chief financial officers. The staff has sought input from the investment company industry on improving the disclosure process and outlined certain steps it was taking in response. n54

[iv] Amendment and Acceleration. After the initial review and comment, the registrant generally files a pre-effective amendment, either formally or informally, making the requested changes or explaining in a transmittal letter why it proposes not to comply with the staff's comment. The staff has no formal guidelines for responding to pre-effective amendments so the registrant or its counsel needs to be diligent in following up with the staff on these filings. There may follow, depending on the circumstances, discussions between the registrant, or its counsel, and the SEC staff, followed by further pre-effective amendments.

As the culminating step in this process, the registrant may request acceleration of the effectiveness of the registration statement pursuant to Rule 461. The SEC staff has delegated authority from the Commission to grant such acceleration if it believes the statutory standard of Section 8(a) of the Securities Act is satisfied. n55

Rules 461(c) and 484 contain special provisions on indemnification. Rule 461(c) states that, in the case of investment companies or business development companies, the Commission may refuse to accelerate the effective date of a registration statement if the registrant is organized or administered pursuant to an instrument that protects or purports to protect any director or officer of the company against any liability to the company or its security holders to which he or she would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office. n56

Rule 484 conditions acceleration requests by registered investment companies or business development companies on an undertaking to submit certain types of indemnification provisions to a court of appropriate jurisdiction. n57

If the staff, and the Commission, will not grant acceleration, the registrant may go effective by removing its permanent delaying amendment. However, such removal is rare and risky, and the SEC staff, as a matter of policy, will not review or comment on any registration statement which does not have an effective permanent delaying amendment. The SEC has the authority under Section 8(d) of the Securities Act to issue a "stop order" preventing effectiveness of the registration statement.

[b] Post-Effective Procedures.

[i] General. Under the Securities Act, an investment company that is making a continuous offering of its securities must maintain a "current" prospectus for use in connection with those sales. Specifically, Section 10(a)(3) of the Securities Act requires that any prospectus used more than 9 months after the registration statement's effective date must contain financial and other information as of a date not more than 16 months prior to such use. An investment company making a continuous offering of its securities can update its prospectus by filing a post-effective amendment to its registration statement that contains updated financial statements and other information. n58

For most investment companies, Rule 485 under the Securities Act specifies the procedures by which a post-effective amendment becomes effective. n59 Rule 485(b) permits routine post-effective amendments to become effective automatically on filing or on a date specified by the registrant not later than 30 days after filing. A post-effective amendment is considered *routine* if it is filed for one of the following purposes:

- bringing the financial statements and other information up-to-date pursuant to Section 10(a)(3) of the Securities Act or the Commission's accounting regulations; or
- complying with the undertaking required in connection with acceleration of registration statements to

file a post-effective amendment with updated financials within four to six months;

- designating a later effective date for a post-effective amendment under paragraph (a);
- updating information regarding portfolio managers or management's discussion of fund performance (if included in the prospectus);
- making any non-material changes which the registrant deems appropriate; n60
- changes by a unit investment trust to correspond to changes in an underlying investment company; and
- other changes approved by the Commission.

In addition, to be permitted to use Rule 485(b), the registrant must represent, in effect, that no material events have occurred. Finally, the facing sheet of the post-effective amendment must state that the registrant proposes that the amendment become effective pursuant to Rule 485(b).

Rule 485(a) permits *non-routine* post-effective amendments to become effective automatically but only on a date (selected by the registrant) between 60-80 days after filing, except in the case of a post-effective amendment to add a new series, which becomes effective on the 75th day after filing or on a later date (but not past the 95th day after filing) selected by the registrant. n61 In calculating this time period, the SEC staff treats the first day *following* the filing--rather than the day of filing--as the first day "after" the filing. n62 In addition, non-routine filings may become effective on an earlier date if accelerated by the SEC. n63

Registrants making a non-routine filing should file in advance of the 60-day time period (or, in the case of a new series, the 75-day time period) to ensure adequate time for staff review. SEC staff policy is to try to give comments on post-effective amendments within 30-45 days of the date of the filing, although the staff's workload at any given time could result in comments being given later.

In addition, the SEC staff has not objected where registrants treat other types of non-substantive changes as routine. For example, a sponsoring insurance company for a variable insurance contract may file an amendment to a registration statement under Rule 485(b) to add the representation required by Section 26(e)(2) of the Investment Company Act (*i.e.*, that aggregate charges under the variable insurance contracts are "reasonable" in relation to services rendered, etc.). n64 Moreover, in certain cases where the SEC or the staff revises disclosure requirements, the staff has explicitly permitted prospectus revisions including such disclosure to be considered routine and filed under Rule 485(b). Examples include the requirement to include disclosure on telephonic redemptions n65 and the fee table. n66

A registrant making a routine filing must certify on the signature page of the amendment that no material event requiring disclosure in the prospectus, other than those specified in the rule, has occurred since the effective date of its most recent filing or the filing date of a not-yet-effective non-routine Rule 485(a) filing. *If counsel prepares or reviews a routine Rule 485(b) filing, the filing must include a written representation from counsel that it contains no information that would make it a non-routine filing.* n67 *This representation may be included in a cover letter to the filing.* To deter potential abuse in relying on Rule 485(b), the SEC retains the authority, delegated to the Division of Investment Management, to suspend a fund's ability to use Rule 485(b) if the fund designates an amendment under Rule 485(b) when it is not eligible to rely on that paragraph. n68

When submitting a non-routine Rule 485(a) filing, in addition to providing a red-lined copy to highlight disclosure changes made from the most recently filed post-effective amendment, a registrant should set forth in an accompanying transmittal letter the material changes which make the filing non-routine.

A non-routine Rule 485(a) filing will not become effective if a second non-routine Rule 485(a) filing is filed before the first filing has become effective. However, a routine Rule 485(b) filing can be made during the pendency of a non-routine Rule 485(a) if the routine Rule 485(b) filing is designated to become effective on the same date as the non-routine Rule 485(a) filing. This mechanism permits an investment company to make a non-routine Rule 485(a) filing without financial statements and subsequently file a routine Rule 485(b) filing for the sole purpose of adding updated financial statements to the registration statement.

Rule 486 permits closed-end funds and BDCs that periodically repurchase shares under Rule 23c-3 to file post-effective amendments and registration statements that become effective automatically. n69 Rule 487 provides a comparable process for new registration statements filed by UITs organized as series companies. n70

A registrant may request acceleration of the effectiveness of a post-effective amendment. The SEC staff may deny acceleration when, among other things:

- There has not been a *bona fide* effort to make the prospectus concise and readable;
- An inaccurate or incomplete preliminary prospectus has been distributed;
- The SEC is currently investigating the issuer, a controlling person, or one of the underwriters; or
- The investment company is organized or administered pursuant to any instrument that protects or purports to indemnify any director or officer against any liability to the company or its shareholders by reason of willful misfeasance, bad faith, gross negligence, or reckless disregard of duties.

What distinguishes a "routine" filing under Rule 485(b) from one that is "non-routine" under Rule 485(a) is the nature of the changes included therein. According to Rule 485, a filing is *non-routine* if it contains material changes (other than certain changes discussed below) such as:

- Changes in the registrant's investment objectives or fundamental policies;
- Suspension of sales or redemptions of shares;
- Termination of an investment advisory contract;
- Adding a new series to a series fund; amendments to permit the fund to advertise performance; n71 and
- In some cases, the resignation of the registrant's independent public accountant or one of its directors.

[ii] Continuous Offerings. Under Rule 485(c), the automatic effectiveness of a post-effective amendment under the rule may be suspended if it appears to the SEC that the amendment "may be incomplete or inaccurate in any material respect." The Commission has delegated this authority to the Director of Division of Investment Management, though this power has been used only rarely.

Subparagraph (d) of Rule 485 is a technical provision dealing with the effect of subsequently filed post-effective amendments on pending post-effective amendments.

Rule 486 applies to closed-end "interval funds"(i.e., those that make periodic tenders pursuant to Rule 23c-3 and may

offer shares continuously), permitting automatic effectiveness of certain post-effective amendments. n72 Rule 488(a) permits 30-50 day automatic effectiveness of post-effective amendments filed on Form N-14 to register shares of a mutual fund in connection with certain business combinations.

[iii] Offerings by Series of Unit Investment Trusts. As discussed above, some unit investment trusts offer units continuously and use the proceeds of sales of units to accumulate shares of one or more other issuers (usually management investment companies). However, other unit investment trusts offer units representing interests in a portfolio of specifically identified securities that normally remains fixed. Typically, the securities in such a portfolio would be municipal or corporate obligations of comparable quality and maturities. Once the units evidencing an interest in that portfolio were sold, no additional portfolio securities would be acquired and no new units would be sold. A trust portfolio of this type is called a series.

A single unit investment trust registered under the Investment Company Act may offer numerous series, each with a different portfolio and each registered pursuant to a new registration statement under the Securities Act on Form S-6. Since units are redeemable, and redemptions could force the sale of portfolio securities, sponsors of unit investment trusts organized in the series format typically make a secondary market in trust units at a price equal to or higher than the redemption price.

The various series of such a unit investment trust may closely resemble each other in investment objectives and policies and manner of operation. If so, the textual portion of the registration statement for a given series may be identical, or nearly so, with that of one or more previous series, with only the detailed information about the particular portfolio securities being different. Accordingly, the SEC adopted Rule 487 to permit the registrant to set the date and time of effectiveness of the registration statement for a series that closely resembles one or more earlier series. Obviously, Rule 487 may not be used for the first series of a trust, but it may be used for any subsequent series if the following criteria are satisfied:

- the registrant is not engaged in the business of investing in securities issued by one or more open-end management investment companies;
- the registrant designates the date and time of effectiveness on the facing sheet of the registration statement;
- the registrant identifies one or more previous series of the trust for which the effective date of the registration statement was determined by the Commission or its staff, and makes the following representations:
 - (a) the portfolio securities for the new series do not differ materially in type or quality from those deposited in the previous series identified by the registrant;
 - (b) the registration statement does not contain disclosures that differ in any material respect from those in such previous registration statement (except to the extent necessary to identify specific portfolio securities and provide related financial information);
- the registrant represents that it has complied with Rule 460 under the Securities Act; n73
- the foregoing identifications and representations must be on the signature page of the registration statement; n74 and
- there must be a representation of any counsel as to availability of the Rule.

Subparagraph (c) of Rule 487 contains provisions relating to suspension of the ability to use the Rule and to petition for review of such a suspension.

[5] Information Required in Prospectus

[a] General. The provisions of Section 10(a) of the Securities Act apply to registration statements of investment companies. However, each applicable registration form sets the particular requirements for prospectus disclosure.

[b] Omitting Prospectus. Section 10(b) of the Securities Act also generally governs omitting prospectuses, but, as discussed above, Rule 482 prescribes the detailed requirements applicable to omitting prospectuses of investment companies and business development companies.

[c] Summary Prospectus.

In 2009, the SEC amended Rule 498 under the Securities Act to allow funds to sell shares by means of an abbreviated document called a "summary prospectus."ⁿ⁷⁵ ; alternatively, they may request the statutory prospectus and/or obtain it from the fund complex's Web site. Rule 498(c) requires the following information to appear either on the cover page or beginning of the "summary prospectus:"

- The fund's name (and, if applicable, the class to which the summary prospectus relates);
- The fund's or class's exchange ticker symbol;
- A statement identifying the document as a "summary prospectus;"
- The approximate date of the summary prospectus's first use;
- The following legend: "Before you invest, you may want to review the Fund's prospectus, which contains more information about the Fund and its risks. You can find the Fund's prospectus and other information about the Fund online at [_____]. You can also get this information at no cost by calling [_____] or by sending an e-mail request to [_____]."

In addition, the following specific disclosures must be covered *in this order*:

- Investment Objectives
- Risk/Return Summary and Fee Table
- Principal Investment Strategies, Risks and Performance
- Investment Advisers and Portfolio Managers
- Purchase and Sale Information
- Tax Information
- Financial Intermediary Compensation

With limited exceptions (e.g., for variable annuity products), the summary prospectus cannot be bound together other materials.

To rely on Rule 498, a fund must make various documents--including the summary prospectus, statutory prospectus, SAI and most recent annual and semi-annual reports--available on the Internet free of charge. These documents must permit the viewer to move back and forth online between the tables of contents of the summary prospectus and statutory prospectus and various referenced sections of the documents; in essence, to use a summary prospectus, the fund complex will need to have current versions of the summary prospectus and the statutory prospectus available on its Web site at all time. In addition, under certain circumstances, the fund may incorporate specified other documents (e.g., statutory prospectus, SAI, shareholder reports, etc.) by reference into the summary prospectus. The 2009 amendments to Rule 498 eliminated the previously permitted "profile" prospectus.

[6] SEC Plain English Requirements

The SEC has adopted rules that require use of "Plain English" writing principles when drafting the front part of prospectuses--i.e., the cover page, summary, and risk factor sections. The rules require public companies and mutual funds to write this information in everyday language that investors can understand. n76 Specifically, the SEC adopted amendments to Rule 421 (presentation of information in prospectuses), 461 (acceleration of effective date), and 481 (inclusion of certain information (such as legends) required in investment company registration statements) under the Securities Act (these rule changes are discussed immediately below), Regulation S-K and to various forms under the Securities Act and the Act. n77 To help explain the plain English principles in the rule, the SEC issued a handbook, entitled *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*. This handbook recommends a number of Plain English techniques for drafting clearer documents.

With respect to the SEC staff's review of the Plain English requirements during the registration process, the SEC has stated that the staff will not correct grammatical mistakes, but rather will focus on whether the registrant discloses material information and whether that disclosure is clear and readable. n78

[a] Rule 421(b): Minimum Plain English Requirements. Rule 421(b) provides guidance on the minimum requirements for drafting prospectus disclosure that is clear, concise and understandable. n79 The rule requires registrants to prepare prospectuses using the following standards:

- Information must be presented in clear, concise paragraphs and sentences. If possible, the information must be presented in short explanatory sentences and "bullet" lists;
- Captions and subheading letters must specifically describe the disclosure included in the section;
- Terms that are not clear from the context generally should be defined in a glossary or other section of the document. Glossaries are recommended where they facilitate understanding of the disclosure. Frequent reliance on defined terms as the primary means of explaining information in the body of the prospectus must be avoided; and
- Legal and highly technical business language should be avoided.

The rule also notes some drafting conventions to avoid, including:

- Legalistic or overly complex presentations that make the substance of the disclosure difficult to understand;
- Vague boilerplate explanations that are readily subject to differing interpretations;
- Complex information copied directly from legal documents without any clear and concise explanation of the provision(s); and

- Repetitive disclosure that increases the size of the document, but does not enhance the quality of the information.

[b] Rule 421(d): Minimum Plain English Principles. Rule 421(d) codifies six minimum Plain English writing principles that public companies and mutual funds should use in drafting the front and back cover pages of, and any summary section included in, the prospectus. These principles are:

- Active voice;
- Short sentences;
- Definite, concrete, everyday words;
- Tabular presentations or "bullet" lists for complex material, whenever possible;
- No legal jargon, or highly technical business terms; and
- No multiple negatives.

[c] Rule 461: Refusal to Accelerate. Rule 461 generally provides that the SEC staff may consider the clarity of the disclosure in a registration statement when determining whether to accelerate its effectiveness. Paragraph (b)(1) of Rule 461 permits the staff to refuse to accelerate a registration statement not drafted in Plain English as required by Rule 421(d).

[d] Rule 481: Information Required in Investment Company Registration Statements. Rule 481 requires that certain information be disclosed in registration statements prepared on a form available solely to investment companies registered under the Investment Company Act. Among other things, amended Rule 481 requires that all legends must be written in Plain English and prescribes the location of the table of contents.

[i] Legends. All required legends must be written in Plain English, including the SEC legend and the "Subject to Completion" legend. The SEC has stated that using all capitalized letters for the legends does not give them proper prominence but rather makes them hard to read. The rule contains examples of Plain English legends. n80

[ii] Table of Contents. The table of contents must appear on the outside front, inside front, or outside back cover page of the prospectus. It must immediately follow the cover page in any prospectus delivered electronically.

FOOTNOTES:

(n1)Footnote 1. For a general discussion of Securities Act liability, see § 7A.03 *below*. Litigation involving investment company securities is discussed in *Section 7B.08[2]* below.

(n2)Footnote 2. "Gun-jumping" and other problems associated with the pre-filing period are discussed in § 7A.03[4] *below*.

For most of its history, the mutual fund industry generally believed that "gun jumping"--the unlawful advertising or promotion of an offering prior to filing or during the waiting period--was not a significant problem for open-end mutual funds because they continuously offer their shares at the current net asset value and thus generally did not seem subject to gun jumping concerns. Historically, these concerns have focused on the fact that investors may pay artificially inflated prices for newly issued shares because an issuer or underwriter created an instant demand for the offering through impermissible, pre-effectiveness advertising. In 1993, the SEC staff announced a rather expansive view of what may constitute "gun jumping" by mutual funds when dealing with the press. See SEC Industry Comment Letter at 8

(Feb. 22, 1993). The staff believes that discussions about a new fund in speeches, interviews, or press conferences that are then reprinted, excerpted, or used in articles or broadcasts before the effective date of a fund's registration statement may be "gun jumping." In the staff's view, anytime a fund, its adviser, underwriter, or their respective officers, directors, employees, agents, and affiliates talk to the press about a new fund, they run the risk that the press may reduce statements to an article/broadcast prior to effectiveness that may violate the law and for which the *fund* could be held liable. In such a case, the staff may decline to accelerate the effectiveness of the fund's registration statement and may impose a "cooling off" period and require re-circulation of any preliminary prospectus.

In addition, Section 7 of the Investment Company Act severely limits the domestic activities of any investment company that has not registered under that Act. Specifically, a domestically organized management company that has not registered under the Investment Company Act may not use the jurisdictional means to offer, sell, deliver after sale, purchase, redeem, retire, or otherwise acquire any of its securities; control any investment company that does any of the foregoing; engage in any business in interstate commerce; or control any company that engages in business in interstate commerce.

These limitations do not apply to transactions which are merely incidental to the dissolution of an investment company. Investment companies organized "offshore" may not use the jurisdictional means to make a public offering of their securities without first obtaining an exemption from the SEC but may otherwise engage in U.S. activities. See Section 7(d) of the Investment Company Act. Regulation D under the Securities Act permits non-public offers to unlimited numbers of "accredited investors." However, as a policy matter, the SEC staff will not condone a non-public offering in the U.S. of shares of an offshore fund except to the extent permissible for U.S. companies excepted from the definition of an investment company by Section 3(c)(1) or (7). See Goodwin, Proctor & Hoar, SEC No-Action Letter (pub. avail. Feb. 28, 1997).

(n3)Footnote 3. Form N-8A requires name, address, telephone number, and name and address of agent for service of process; the state under the laws of which the registrant was organized and the date thereof; registrant's form of organization; the classification and sub-classification of the registrant for purposes of the Investment Company Act; the name and address of each investment adviser (which would include sub-advisers); the name and address of any officers and directors; for unit investment trusts information about the sponsor, trustee, and any custodian; information about outstanding securities and any current or proposed public offerings; the current value of the registrant's total assets; a statement of whether the registrant proposes to operate as a small business investment company; and a copy of the registrant's last regular periodic report to its securityholders, if any.

(n4)Footnote 4. Among the matters addressed by these rules are: definitions (Rule 8b-2); number of copies, signatures, binding (Rule 8b-11); requirements as to paper, printing, and language (Rule 8b-12); incorporation by reference (Rule 8b-23); extension of time for furnishing information (Rule 8b-25); and incorporation of exhibits by reference (Rule 8b-32). The rules adopted under the Act are reprinted at the end of volume 1 *below*.

(n5)Footnote 5. Subchapter M of the Internal Revenue Code (Sections 851-855 and 860) provides for special tax treatment for eligible regulated investment companies. An eligible regulated investment company that distributes at least 90 percent of its income and satisfies certain other tests is not subject to regular federal tax on amounts distributed to shareholders (although an excise tax is imposed unless more stringent tests are satisfied).

(n6)Footnote 6. 17 C.F.R. § 230.430.

(n7)Footnote 7. See Over-The-Counter Sec. Group, Inc., 1989 SEC No-Act. LEXIS 1214 (Dec. 19, 1989) .

(n8)Footnote 8. 17 C.F.R. § 230.481(b)(2). The rule provides that this language (or other clear and understandable language) may be used.

(n9)Footnote 9. 17 C.F.R. § 230.497(a).

(n10)Footnote 10. *17 C.F.R. § 230.481(g)*.

(n11)Footnote 11. *See* Rule 460(c)(2) under the Securities Act of 1933, reprinted in the Primary Law Sourcebook, Volume A, Section B.

(n12)Footnote 12. For further coverage of the regulation of investment company advertising, *see* Lemke, Lins & Smith chs. 13-23.

(n13)Footnote 13. FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange.

(n14)Footnote 14. Advertising must be filed with FINRA. For a comprehensive discussion of FINRA advertising requirements, *see* Lemke, Lins & Smith ch. 19.

(n15)Footnote 15. Rule 24b-3 under the Securities Act, reprinted in the Primary Law Sourcebook, Volume A, Section C provides that filing sales literature with FINRA will satisfy this filing requirement. Rule 24b-1 contains several definitions that elaborate on the types of documents and information that constitute sales literature. Rule 24b-2 requires that filings of sales literature be accompanied by a letter of transmittal.

(n16)Footnote 16. *See* Inv. Co. Act Rel. No. 10,621, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,993 (1979). The statement of policy was adopted in Sec. Act Rel. No. 33-3385, [1949-1950 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,077 (1950). Citations of later amendments thereto are contained in Inv. Co. Act Rel. No. 10,647, 6 Fed. Sec. L. Rep. (CCH) P 48,920B (1979).

(n17)Footnote 17. Rule 156 contains general anti-fraud provisions and specifically addresses certain potential problem areas in investment company sales literature (for example, statements implying that future gain may be inferred from past performance). Rule 156 also defines sales literature for purposes of the Rule broadly enough to include other types of advertising as well. *See also* Lemke, Lins & Smith § 19.01.

(n18)Footnote 18. A Rule 482 advertisement must contain only information the substance of which is in the full prospectus; must state conspicuously how a full prospectus may be obtained; and, if used prior to effectiveness of the registration statement, must contain the standard legend required by Rule 481(b)(2). *See* § 7B.02[2][d][vii] *above*. A Rule 482 advertisement does not have to include the standard legend required by Rule 481(b)(1) that the securities have not been "approved or disapproved" by the SEC. In addition, a Rule 482 advertisement does not have to be filed as a part of the registration statement (but does have to be filed pursuant to Rule 497). *See* § 7B.02[2][d][iii] *above*.

(n19)Footnote 19. Calculations of effective yield assume reinvestment of dividends.

(n20)Footnote 20. *See* § 7B.02[5][d] for a discussion of Rule 498 under the Securities Act, which permits mutual funds to use "summary prospectuses" to provide specified information to investors.

(n21)Footnote 21. These categories include a recital of policies on various activities, a recital of all policies changeable only by shareholder vote, and the name and address of each person affiliated with the fund.

(n22)Footnote 22. *See* § 7B.01[6] *below*.

(n23)Footnote 23. Section 13(c)(4) provides that an investment company may not, without shareholder approval, change its business so as to cease to be an investment company. Nevertheless, the SEC staff has allowed funds to liquidate without shareholder approval where consistent with applicable state laws.

(n24)Footnote 24. These rules include: requirements as to proper form (Rules 401 and 8b-10); number of copies, etc. (Rules 402 and 8b-11); requirements as to paper, etc. (Rules 403 and 8b-12); additional information (Rules 408 and 8b-20); information not known and not reasonably available (Rules 409 and 8b-21); disclaimer of control (Rules 410

and 8b-22); and title of securities (Rules 480 and 8b-3).

Rule 482 contains a cross reference to Rule 434d.

(n25)Footnote 25. Rule 405 provides that the term "material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered" whereas Rule 8b-2 provides that the term "material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling any security of the particular company."

(n26)Footnote 26. A no-action letter is a mechanism whereby the public and practitioners can obtain the informal views of the SEC staff on proposed transactions that appear to raise issues under the federal securities laws and rules thereunder. For a discussion of the mechanics of this process, see Lemke, *The SEC No-Action Letter Process*, 42 *Bus. Law.* 1019 (1987).

(n27)Footnote 27. Rule 431 conditions use of summary prospectuses on, among other things, registration under the Exchange Act. Open-end investment companies are exempt from this requirement.

(n28)Footnote 28. The SEC staff takes the position that a rating assigned to a mutual fund by a statistical rating organization is the statement of an expert under Section 7 of the Securities Act and, therefore, it cannot be included in the fund's prospectus without the organization's consent. *See* Franklin Tax-Free Trust, 1985 (Sept. 24, 1985). *See also* Rule 436(g) under the Securities Act; Inv. Co. Act Rel. No. 20508, at n. 19 (Aug 31, 1994). However, a company that provides general information to the public about issuers, including mutual funds, and whose services are not procured by a fund to assign the fund a rating, such as Morningstar, Inc., is not considered by the staff to be an expert for this purpose. *See* SEC Industry Comment Letter at 6 (Feb. 22, 1993). The staff believes that any ranking must be accompanied by a statement that past performance is no guarantee of future performance and a brief explanation of the manner in which the ranking is calculated, including whether sales loads and other fees and charges are factored in. The staff also requires that the ranking be current.

(n29)Footnote 29. Investment companies are specifically exempted from the provisions of Rule 463 governing reports of offerings of securities and the use of proceeds therefrom. In addition, Rules 462, 464, 466 and 467 are, by their terms, inapplicable to investment companies.

(n30)Footnote 30. *See* SEC Fee Rate Advisory No. 5 for Fiscal Year 2009 (Mar. 11, 2009).

(n31)Footnote 31. *See* § 7B.02[4][b][iii] above.

(n32)Footnote 32. *See, e.g.*, Rule 475a under the Securities Act.

(n33)Footnote 33. Rule 8b-15 requires that all amendments be filed under cover of the facing sheet of the appropriate form, be clearly identified as amendments, and comply with all pertinent requirements applicable to registration statements and reports. The Rule also requires that amendments be filed separately for each registration statement or report amended. Rule 0-3 contains requirements as to amendments that substantially duplicate those in the various forms and also specifies the form of facing sheet.

(n34)Footnote 34. Special requirements governing post-effective amendments to Securities Act registration statements of management investment companies and certain insurance company separate accounts are discussed in § 7B.02[4][b][ii] above.

(n35)Footnote 35. The note to this section of Regulation C specifies that certain rules are applicable only to investment companies and business development companies but that the rest of Regulation C also applies to such

companies, unless the context specifically indicates otherwise.

(n36)Footnote 36. Rules 490 through 494 are applicable only to foreign issuers.

(n37)Footnote 37. Section 18 of the Investment Company Act limits the degree to which investment companies may issue debt or other senior securities.

(n38)Footnote 38. The disclaimer must be in Plain English (*see Section 7B.02[6] below*). The rule does not require any specific language but the staff of the Division of Investment Management has generally required registrants to use either of the two examples provided in the rule.

(n39)Footnote 39. The rule requires that the legend be in the following language "or other clear and understandable language:"

The information in this prospectus (or Statement of Additional Information) is not complete and may be changed. We may not sell the securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus (or Statement of Additional Information) is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

(n40)Footnote 40. Rule 482 is discussed in detail in § 7B.02[1][c] *below*. *See also* Lemke, Lins & Smith ch.16.

(n41)Footnote 41. Rule 484 is discussed in § 7B.02[4][a][iv] *below*. Rules 485, 486 and 488 are discussed in § 7B.02[4][b][ii] *above*. Rule 487 is discussed in § 7B.02[4][b][iii] *above*.

(n42)Footnote 42. *See* § 7B.01[6][b] *below* for discussion of registration requirements for mutual funds.

(n43)Footnote 43. *See* Sections 4 and 5 of the Investment Company Act and § 7B.01[2] *below*.

(n44)Footnote 44. Section 18 limits the ability of investment companies to borrow money or issue senior securities.

(n45)Footnote 45. Section 12(c) of the Investment Company Act regulates participation by investment companies in underwriting. Underwriting by investment companies is rare at best.

(n46)Footnote 46. The SEC staff has long taken the position that investment of more than 25 percent of the value of an investment company's assets in a particular industry or group of industries represents concentration. Investment companies may preserve only limited freedom of action to concentrate pursuant to management's discretion and without shareholder approval unless the specific conditions under which any changes in concentration will be made are set forth in the fund's statement of investment policy. The U.S. Government is not considered an industry and money market funds may reserve freedom of action as to investments in domestic banks. Investment companies have some flexibility in defining industry categories.

(n47)Footnote 47. Investment companies generally do not invest in real estate but reserve the right to invest in companies that do invest in real estate, including real estate investment trusts.

(n48)Footnote 48. Many investment companies reserve the right to invest in financial futures within limits that allow them to avoid regulation by the Commodity Futures Trading Commission.

(n49)Footnote 49. Section 21 of the Investment Company Act prohibits an investment company from lending to a controlling person or a person under common control with the investment company.

(n50)Footnote 50. Section 2(a)(3) of the Investment Company Act defines "affiliated person" and Section 17, in particular, regulates certain types of dealings with affiliated persons. In general, most transactions with affiliated persons (as well as principal underwriters and affiliated persons of principal underwriters or affiliated persons) are prohibited without SEC approval, by rule or by order.

(n51)Footnote 51. [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,700 (1976).

(n52)Footnote 52. These guidelines relate to registration forms that are no longer in use. Nevertheless, to the extent that similar disclosures are required in the forms that are now being used, many of these guidelines are still applicable, or at least, of assistance. *See* Inv. Co. Act Rel. No. 7220, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. P 78,834 (1972) and Inv. Co. Act Rel. No. 7221, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,835 (1972).

(n53)Footnote 53. Sec. Act Rel. No. 33-6510, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,491 (1984).

(n54)Footnote 54. *See* Letter to Amy B.R. Lancellotta, Investment Company Institute (May 15, 1995).

(n55)Footnote 55. Section 8(a) provides that the SEC may accelerate a registration statement:

[H]aving due regard to the adequacy of the information respecting the issuer theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of holders thereof can be understood, and to the public interest and the protection of investors.

(n56)Footnote 56. Sections 17(h) and (i) of the Investment Company Act generally prohibit a fund from indemnifying a director or officer against liability to the company or its shareholders that would otherwise result by "reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office." The SEC staff believes that this prohibition extends to advances of legal fees and payments for settlements and judgments. *See, e.g.,* Inv. Co. Act Rel. No. 11330 (Sept. 4, 1980).

(n57)Footnote 57. The required undertaking must be in substantially the following form:

Insofar as indemnification for liability arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

(n58)Footnote 58. Open-end and closed-end funds also must be mindful of Rule 3-18 of Regulation S-X, 17 C.F.R. 210, which requires a fund that files a post-effective registration statement that is expected to become effective 245 or more days beyond the date of the fund's most current financial statements to update those financial statements with a new set of unaudited statements as of an interim date within the 245-day period. For example, assume that a series fund, whose financials are dated December 31, files a post-effective amendment to add a new series as of October 1. In this case, the fund would have to update the financial statement information contained in its prospectus with interim

financials, often referred to as a "stub period." Typically, a fund in this circumstance would use its semi-annual unaudited financial report information to meet this requirement.

(n59)Footnote 59. *17 C.F.R. § 230.485.*

(n60)Footnote 60. *See* Rule 405 in Regulation C under the Securities Act for the definition of "material." *See also Basic Inc. v. Levinson*, 485 U.S. 224 (1988) .

(n61)Footnote 61. To extend the time period past the 95th day, a registrant may file an amendment pursuant to Rule 485(b)(1)(iii) to extend the time period by up to 30 days. *See Inv. Co. Act Rel. No. 20486*, 1994 SEC LEXIS 2510 , Fed. Sec. L. Rep. (CCH) P 85,423, at 85,643 n. 19 (Aug. 17, 1994) ["Release 20486"].

The staff ordinarily limits its review of annual updating post-effective amendments filed under subparagraph (a) of Rule 485 to financial statements; material which has been underscored or otherwise marked to indicate textual changes; and areas in which recent developments suggest that changes in disclosure are likely to be appropriate. *See* Sec. Act Rel. No. 5988 (1978) and Sec. Act Rel. No. 6510 (1984). To expedite the processing of these filings, the staff has asked that the transmittal letter with such post-effective amendments explain the reason for the use of the delayed effectiveness procedures in subparagraph (a) of Rule 485 and whether the material portions of the amended registration statement have been reviewed in some other context, such as the post-effective amendment of another fund in the complex. *See* Sec. Act Rel. No. 6510 (1984). Finally, the staff has standby procedures pursuant to which it will not review certain post-effective amendments, particularly during especially busy times of the year. In connection with adopting these standby procedures, the staff particularly emphasized the importance of clear descriptions of material changes in transmittal letters. *See* Sec. Act Rel. No. 6353 (1981).

(n62)Footnote 62. *See* 1994 Industry Comment Letter.

(n63)Footnote 63. Rule 461 under the Securities Act, *17 C.F.R. § 230.461*, prescribes the procedures for requesting acceleration of the effective date of a filing. The registrant and principal underwriter must request acceleration in writing. A request for acceleration is deemed to be confirmation that the requestor is aware of its obligations under the Securities Act.

(n64)Footnote 64. *See* Letter to Registrants from Susan Nash, Assistant Director, SEC Division of Investment Management (Nov. 7, 1996).

(n65)Footnote 65. *See* Letter from Max Berueffy, Special Counsel, SEC Division of Investment Management, to Matthew P. Fink, President, Investment Company Institute (Apr. 19, 1993).

(n66)Footnote 66. *See* Letter from Kathryn B. McGrath, Director, SEC Division of Investment Management, to Matthew P. Fink, General Counsel, Investment Company Institute (Mar. 4, 1988); Letter from SEC Division of Investment Management to Registrants (Mar. 7, 1988).

(n67)Footnote 67. *17 C.F.R. § 230.485(b)(4).*

(n68)Footnote 68. *See* Release 20486, *above*.

(n69)Footnote 69. *17 C.F.R. § 230.486.*

(n70)Footnote 70. *17 C.F.R. § 230.487.*

(n71)Footnote 71. *See* Letter from Kathryn B. McGrath, Director, SEC Division of Investment Management, to Matthew P. Fink, General Counsel, Investment Company Institute (Mar. 4, 1988).

(n72)Footnote 72. *See* § 7B.01[2][a][i] *below*. The Commission also amended Rule 415 under the Securities Act

of 1933, reprinted in the Primary Law Sourcebook, Volume A, to permit interval funds to offer shares on a continuous or delayed basis.

(n73)Footnote 73. Under certain circumstances, unit investment trust sponsors may use, as the preliminary prospectus for a series of the trust, a supplemented (or "stickered") copy of the final prospectus for an earlier series.

(n74)Footnote 74. The Commission may suspend use of the Rule by furnishing written notice if it appears to the Commission that "any registration statement containing a designation pursuant to this Section is incomplete or inaccurate in any material respect, whether or not such registration statement has become effective, or that the registrant has not complied with the conditions of this Section." The suspension remains in effect until the Commission furnishes written notice that the suspension has been terminated. The suspension would apply to pending and future registration statements. The registrant may, in its petition for review of the suspension, request a hearing.

(n75)Footnote 75. *See* Inv. Co. Act Rel. No. 28584 (Jan. 13, 2009).

(n76)Footnote 76. *See* Inv. Co. Act Rel. No. 23011, 1998 SEC LEXIS 149 (Jan. 28, 1998) [hereinafter cited as "Release 23011"].

(n77)Footnote 77. Release 23011 , *above*, amended Form N-2 to reflect the new amendments to Rule 481.

(n78)Footnote 78. *See* Release 23011 , *above*.

(n79)Footnote 79. *See* Release 23011 , *above*.

(n80)Footnote 80. For example, Rule 481(b)(1) provides the following two examples for the required SEC legend:

Example A:

The Securities and Exchange Commission has not approved or disapproved these securities or passed upon the adequacy of the prospectus. Any representation to the contrary is a criminal offense

Example B:

The Securities and Exchange Commission has not approved or disapproved these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.



100 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.03

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.03 Form N-1A--Registration of Securities of Open-End Management Investment Companies

Open-end investment companies, commonly referred to as mutual funds, generally offer their shares to the public on a continuous basis and must offer to redeem those shares at net asset value per share. Mutual funds use Form N-1A for registration pursuant to both the Securities Act and the Investment Company Act. Form N-1A is a three-part document: a "simplified prospectus;" (b) a Statement of Additional Information, which must be delivered to investors upon request; and (c) additional information that must be filed with the SEC. As noted earlier, the SEC has adopted substantial changes to Form N-1A on several occasions.

[1] Introduction

Mutual funds were traditionally sold as a means for smaller investors to pool their assets in order to, in effect, achieve diversification of risk and to be able to contract for investment management at a reasonable cost. However, the mutual fund market has become highly complex and includes many large, sophisticated investors, including financial institutions, employee benefit plans, and corporations. Nevertheless, the typical mutual fund investor is still thought to be relatively unsophisticated. Before the adoption of Form N-1A, mutual fund prospectuses were "full disclosure" documents but there was a wide-spread belief that, in the words of the SEC, "under present requirements, mutual fund prospectuses are not effective disclosure documents for most investors because they are too long and complex." n1

Form N-1A seeks to address this problem by providing for a "simplified prospectus," which was intended to be a relatively brief document that may be used as the statutory prospectus, while requiring that a "Statement of Additional Information" or "SAI" containing more elaborate disclosures be made available to investors upon request and free of charge (the SAI may be, and generally is, incorporated by reference into the prospectus). The approach of Form N-1A embodies the widely shared conviction that the traditional mutual fund prospectus had, in the pursuit of full disclosure, become too long and complex. n2 The form implements the philosophy that a fund prospectus should contain clear and concise information about the fundamental characteristics of the fund, but additional information should be available--in the SAI--to those investors that need or desire it. The SEC also may use the information provided in Form N-1A in its regulatory, disclosure review, inspection, and policymaking roles.

In 1999, the SEC amended Form N-1A to "focus the disclosure in a fund's prospectus or essential information about the

fund." n3

Specifically, these amendments to the form were intended to: (1) provide for a standardized risk/return summary at the beginning of the prospectus that concisely summarizes investment objectives, strategies, risks and performance and fees; (2) elicit discussion of risks of a portfolio as a whole rather than focusing on risks associated with each particular type of portfolio investment; and (3) provide for a graphic presentation of returns to help investors assess risk. These disclosures must be made in "Plain English" in accordance with Rule 421 under the Securities Act. n4 The SEC staff provided interpretive guidance based on experience with revised Form N-1A in letters to the Investment Company Institute dated May 19, 1998 and October 2, 1998. In early 2009, the SEC adopted further substantive amendments to the form and amended a number of rules, in an effort to make the form more user-friendly and facilitate the use of Web sites and other electronic media. n5

[2] Facing Sheet

The facing sheet required by Regulation C must be included. If a filing is made only under the Investment Company Act or the Securities Act, it should refer only to that Act. n6

[3] Cross-Reference Sheet

The cross reference sheet formerly required by Rules 481(a) and 495 is no longer included.

[4] General Instructions

[a] Definitions. This section defines certain commonly used terms, such as "class," "master-feeder fund," and "series," as a part of the SEC's efforts to reorganize and simplify the general instructions. Terms in Form N-1A have the same meaning as in the Investment Company Act or related rules, unless otherwise indicated.

[b] Filing and Use of Form N-1A. This section prescribes eligibility to use Form N-1A and states that it is to be used for Investment Company Act and Securities Act registration purposes. The section also reviews the various parts of the registration statement and refers registrants to applicable rules, particularly Regulation C under the Securities Act and the 8b series of Rules under the Investment Company Act, as well as the EDGAR filing requirements. The form also refers registrants to Rule 24f-2 under the Investment Company Act for information about filing fees.

[c] Preparation of the Registration Statement. The form stresses the importance of document design techniques that promote effective communication and inclusion of only as much information as is necessary to enable an average investor to understand the registrant's characteristics while discouraging over emphasis on "possible investments or activities of the fund that are not a significant part of the fund's investment operations."

[d] Form N-1A: Three Parts. Form N-1A is divided into three parts: Part A is the prospectus; Part B is the Statement of Additional Information; and Part C requires information that the registrant does not have to give to investors. The general instructions admonish registrants to avoid cross-references to the SAI or to shareholder reports in the prospectus. However, such cross-references are not precluded and registrants may, as a protection against liability for false or misleading prospectuses, wish to include in the description of investment policies and risks in the prospectus a cross-reference to the additional information in the SAI. As discussed in more detail below, the general incorporation of the SAI into the prospectus is on the outside cover of the prospectus in the Form N-1A. Court decisions have respected the concept of incorporating the SAI by reference into the prospectus, n7 but may be less inclined to do so if such incorporation is not prominent.

Rule 154 under the Securities Act permits funds to transmit one copy of the prospectus to multiple shareholders (who need not be related) with the same residential or electronic address (referred to as "householding"), provided the shareholders have consented *in writing* and the prospectuses are addressed either to *each* shareholder individually or to

the shareholders as a group. Alternatively, for shareholders at the same post office box or residential street address who have the same last name (or who the fund reasonably believes are members of the same family), the fund can provide a separate written notice to them that the fund will deliver only one report to the shared address unless it receives contrary instructions. This written notice must be given at least 60 days before the fund starts to rely on it and must contain certain information, including how the shareholder can decline or revoke consent and a pre-addressed reply form or toll-free number to do so. Whether the fund obtained written consent or provided written notice, at least annually the fund must explain to consenting shareholders how they can revoke their consent. Where funds rely on Rule 154 to "household" combined proxy statement-prospectuses, they nonetheless need to provide separate proxy cards for each security holder.

[e] Incorporation by Reference. Mutual funds may incorporate the SAI by reference into the prospectus without delivering the SAI with the prospectus and most do. In addition, mutual funds may satisfy the financial statement requirements of Form N-1A by incorporating shareholder reports by reference. n8 Finally, the general rules on incorporation by reference are applicable in filings on Form N-1A. n9

[5] Part A: Information Required in a Prospectus

Part A of Form N-1A requires the following thirteen key items:

- Front and Back Cover Pages (Item 1)
- Risk/Return Summary: Investment Objectives/Goals (Item 2)
- Risk/Return Summary: Fee Table (Item 3)
- Investments, Risks, and Performance (Item 4)
- Management (Item 5)
- Purchase and Sale of Fund Shares (Item 6)
- Tax Information (Item 7)
- Financial Intermediary Compensation (Item 8)
- Investment Objectives, Principal Investment Strategies, Related Risks, and Disclosure of Portfolio Holdings (Item 9)
- Management, Organization and Capital Structure (Item 10)
- Shareholder Information (Item 11)
- Distribution Arrangements (Item 12)
- Financial Highlights Information (Item 13)

Form N-1A requires that Items 2 through 8--known as "summary disclosure"--be presented in "plain English" at the beginning of the prospectus after the cover page and table of contents. While no specified length for the "summary disclosure" is mandated, the SEC expects that it would be approximately three (3) to four (4) pages in length. Partly for

this reason, the summary disclosure may **not** include information beyond that specifically required (although such information could be included elsewhere in the prospectus). The summary disclosure portion of each fund in a multi-fund prospectus must be presented separately, although certain aspects, most notably those relating to tax and distribution and intermediary compensation, can be combined if they are identical. n10

These requirements are summarized below.

[a] Item 1. Front and Back Cover Pages. Item 1 requires the prospectus front cover to disclose the following items:

- Fund's name and class (or classes) to which the prospectus relates;
- The exchange ticker symbol of the fund's shares (or the class offered by the prospectus). If the fund is an exchange-traded fund (ETF), the principal U.S. market(s) on which it trades should also be identified.
- Date of the prospectus;
- The legend required by Rule 481(b)(1) under the Securities Act (*i.e.*, indicating that neither the SEC nor any state's securities commission has approved the securities or passed on the adequacy of the prospectus disclosure).

A fund also may include on the front cover page a statement of its investment objectives, a brief (e.g., one sentence) description of its operations, or any additional information, subject to a general rule about the presentation of information not required in the prospectus. n11

The back cover of the prospectus is required to include information about the availability of additional information about a fund. n12 This disclosure states that the SAI includes additional information about the fund, that additional information about the fund's investments is available in the fund's annual and semi-annual reports, and that in the fund's annual report, there is a discussion of the market conditions and investment strategies that significantly affected the fund's performance during its last fiscal year. The back cover page should also explain that the fund's annual and semi-annual reports are available, without charge, upon request and explain how shareholders can make inquiries. The fund must also provide a toll-free (or collect) number to call to request various fund documents. The fund may indicate if the various fund documents are available via email request or from a financial intermediary. Funds must send an SAI within three business days of request, and the SEC's Office of Compliance Inspections and Examinations will examine funds' compliance with this requirement in the course of routine inspections. n13 Finally, if the fund incorporates other information by reference, it must state where the information is incorporated from.

[b] Item 2. Risk/Return Summary: Investment Objectives/Goals.

Item 2 of Form N-1A requires that fund prospectuses contain a risk/return summary at the beginning providing key information about a fund's investment objectives or goals. The fund may identify its type or category (e.g., money market fund, balanced fund, etc.).

[c] Item 3. Risk/Return Summary: Fee Table. Item 3 of Form N-1A requires that the prospectus must contain a fee table, in plain English, after Item 2 of Form N-1A. The fee table is designed to show investors the cost of their investment by clearly setting out the fees and charges that investors incur directly or indirectly as a fund shareholder. The fee table must include the following:

Fees and Expenses of the Fund

This table describes the fees and expenses that you may pay if you buy and hold shares of the Fund.

Shareholder Fees (fees paid directly from your investment)

Maximum Sales Charge (Load) Imposed on Purchases (as a percentage of offering price)	_____ %
Maximum Deferred Sales Charge (Load) (as a percentage of _____)	_____ %
Maximum Sales Charge (Load) Imposed on Reinvested Dividends [and other Distributions] (as a percentage of _____)	_____ %
Redemption Fee (as a percentage of amount redeemed, if applicable)	_____ %
Exchange Fee	_____ %
Maximum Account Fee	_____ %

Annual Fund Operating Expenses (expenses that you pay each year as a percentage of the value of your investment)

Management Fees	_____ %
Distribution [and/or Service] (12b-1) Fees	_____ %
Other Expenses	_____ %
_____	_____ %
_____	_____ %
_____	_____ %
Total Annual Fund Operating Expenses	_____ %

Example

This example is intended to help you compare the cost of investing in the Fund with the cost of investing in other mutual funds.

The Example assumes that you invest \$10,000 in the Fund for the time periods indicated and then redeem all of your shares at the end of those periods. The Example also assumes that your investment has a 5 percent return each year and that the Fund's operating expenses remain the same. Although your actual costs may be higher or lower, based on these assumptions your costs would be:

[Click here to view image.](#)

You would pay the following expenses if you did not redeem your shares:

1 year	\$

3 years	\$

5 years	\$

10 years	\$

The Example does not reflect sales charges (loads) on reinvested dividends [and other distributions]. If these sales charges (loads) were included, your costs would be higher.

Portfolio Turnover

The Fund pays transaction costs, such as commissions, when it buys and sells securities (or "turns over" its portfolio). A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when Fund shares are held in a taxable account. These costs, which are not reflected in annual fund operating expenses or in the example, affect the Fund's performance. During the most recent fiscal year, the Fund's portfolio turnover rate was ____% of the average of its portfolio.

As noted above, the fee table is divided into several parts:

- **Shareholder Transaction Expenses** - These are the sales charges or transaction fees that investors incur when they buy or sell fund shares. These expenses usually, but not always, are charged directly to the investor. The first three items apply to load funds, while the latter three apply to all funds.
- **Annual Fund Operating Expenses** - These are the ongoing fees for running the fund, such as management fees, custody fees, Rule 12b-1 fees, and legal and accounting expenses. The total of these expenses is commonly referred to as the fund's "expense ratio," because it represents the total of the fund's annual operating expenses expressed as a percentage of average net assets. These expenses are not paid directly by shareholders but rather are deducted against the fund's assets and, as a result, they reduce fund performance. Note that the fund's expense ratio does not include brokerage expenses incurred by the fund in buying and selling securities.
- **Hypothetical Example** - This is a projection that illustrates the estimated expenses a fund shareholder might pay over the next 10-year period. The hypothetical example is designed to illustrate to investors, in actual dollar amounts, how much they should expect to pay for investing in the fund. The hypothetical fee example shows the effect of the fund's expenses on a hypothetical \$10,000 investment at the end of 1-, 3-, 5-, and 10-year periods, based on certain assumptions (because the example is seeking to predict future events), including whether the shareholder redeems their investment at the end of any of these periods. The hypothetical fee example reflects all expenses incurred by the typical shareholder, directly

or indirectly, because it includes both shareholder transaction expenses and that portion of the fund's annual operating expenses paid by the shareholder.

■ **Portfolio Turnover** - This provides information on the level of the fund's trading activity, which can impact performance and incur tax liabilities.

[d] Item 4. Investments, Risks and Performance.

Item 4 of Form N-1A requires a fund to disclose various information about its principal investment strategies, the risks they may pose, and the fund's performance. The prospectus must summarize the fund's principal investment strategy, including the specific types of securities in which the fund principally invests or will invest, and any concentration policy of the fund. In addition, the fund must describe, in narrative form, the principal risks of investing in the fund, including the risks to which the fund's portfolio as a whole is subject and circumstances reasonably likely to affect adversely the fund's net asset value, yield, and total return. n14 Unless the fund is a money market fund, this item requires a fund to disclose that loss of money is a risk of investing in it. A fund can disclose information about the types of investors for whom the fund is intended and the types of investment goals that may be consistent with an investment in the fund. n15 A fund may not, however, describe in this section the rewards of investing in a fund. n16 A money market mutual fund must include special risk disclosure in this section of the prospectus, n17 as well as any fund sold through insured depository institutions. n18 Further, a fund must state if it is non-diversified and must describe the effect of non-diversification (*i.e.*, disclose that, compared to other funds, the fund may invest a greater percentage of its assets in a particular industry or group of industries) and attendant risks. n19

Where a fund has a principal investment strategy of investing in securities of U.S. Government-sponsored entities such as the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), Federal Home Loan Banks and similar entities whose securities are not backed by the full faith and credit of the U.S. Government, special risk disclosure is required. In particular, the SEC staff would expect the fund to disclose prominently that although the issuer may be chartered or sponsored by Acts of Congress, its securities are neither issued nor guaranteed by the United States Treasury. Likewise, risks pertaining to debt and mortgage-backed securities generally and to specific types of securities, such as "interest-only" and "principal-only" securities, should be clearly described. n20

[i] Item 4(b)(2). Risk/Return Bar Chart and Table.

A fund must include a bar chart showing the fund's annual returns for each of the last 10 calendar years and a table comparing the fund's average annual returns for the last 1, 5, and 10 calendar years n21 to those of a broad-based securities market index n22 as required by Item 4(b) Form N-1A. n23 Specifically, if a fund (other than a money market fund or a fund described in General Instruction C.3.(d)(iii) of Form N-1A) has annual returns for at least one calendar year, it must provide a table showing the fund's: (1) average annual total return (before taxes); (2) average annual total return (after taxes on distributions); (3) average annual total return (after taxes on distributions and sale of fund shares); and (4) index. n24 The table should include the following captions:

AVERAGE ANNUAL TOTAL RETURNS

(For the periods ended December 31, ...)

	1 year n25	5 years [or Life of Fund]	10 years [or Life of Fund]
Return Before Taxes	_____	_____	_____
	___ %	___ %	___ %
Return After Taxes on Distributions	_____	_____	_____
	___ %	___ %	___ %

Return After Taxes on Distributions and Sale of Fund Shares	_____ %	_____ %	_____ %
Index (reflects no de- ductions for [fees, ex- penses, or taxes])	_____ %	_____ %	_____ %

Adjacent to this table, a fund must provide a brief explanation that:

- After-tax returns are calculated using the historical highest individual federal income tax rates and do not reflect the impact of state and local taxes;
- Actual after-tax returns depend on an investor's tax situation and may differ from those shown, and after-tax returns shown are not relevant to investors who hold their fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts;
- If the fund is a multiple class fund that offers more than one class in the prospectus, after-tax returns are shown for only one class and after-tax returns for other classes will vary; and
- If average annual total return (after taxes on distributions and redemption) is higher than average annual total return, the reason for this result may be explained. n26

The fund must provide a brief explanation of how the information required shows the variability of the fund's returns. n27 For example, the fund can state that the information provides some indication of the risks of investing in the fund by showing changes in the fund's performance from year-to-year and by showing average annual returns for 1, 5, and 10 years compared to a broad measure of market performance. The fund also should provide a statement that the fund's past performance, before and after taxes, is not an indication of future performance. n28

A money market fund may provide its 7-day yield ending on the date of the most recent calendar year or disclose a toll-free (or collect) telephone number for investors to obtain the current 7-day yield. n29 A fund also must disclose its best and worst returns for a quarter during the 10-year (or other) period reflected in the bar chart. n30 The date of the performance information in the table must be disclosed adjacent to it. To help investors, a fund must briefly explain how the information illustrates the variability of the fund's returns.

[e] Item 5. Management.

Item 5 of Form N-1A requires disclosure of each investment adviser of the fund, including sub-advisers. If a fund has three or more sub-advisers, only those sub-advisers responsible for a significant portion of the fund's net assets (i.e., 30 percent or more) must be identified. Except in the case of money market funds, if a sub-adviser's only responsibility is day-to-day management of cash and cash equivalents, it need not be identified. The fund must also disclose information about the person or persons primarily responsible for the day-to-day management of the fund's portfolio, including name, title and length of service. n31 Funds managed by a committee, team or other group have additional disclosure obligations. If a committee, team, or other group of persons is jointly and primarily responsible for the day-to-day management of the fund's portfolio, a fund should provide information for each member of such committee, team, or other group. n32

[f] Item 6. Purchase and Sale of Fund Shares

Item 6 calls for information relating to any minimum initial or subsequent investment requirements and, if the shares are

redeemable, the procedures for doing so (e.g., telephone, written request, etc.). If the fund is an exchange-traded fund, the fund must specify the number of shares that it will issue (or redeem) in exchange for the delivery of a basket of assets and also explain that shares can be purchased and sold only on a national securities exchange through a broker-dealer. The fund must also disclose that the fund shares are based on market price and may trade at a price greater or less than the fund's net asset value.

[g] Item 7. Tax Information

In response to Item 7, a fund must disclose if it intends to make distributions that may be taxed as ordinary income or capital gains or that the fund intends to distribute tax-exempt income. If the fund holds itself out as investing in securities that generate tax-exempt income, the fund should provide a general statement that a portion of the fund's distribution may be subject to federal income tax.

[h] Item 8. Financial Intermediary Compensation

If the fund or its related companies pays financial intermediaries for the sale of fund shares or related services, it must include a statement substantially similar to the following:

Payments to Broker-Dealers and Other Financial Intermediaries.

If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information.

[i] Item 9. Investment Objectives, Principal Investment Strategies and Related Risks, and Disclosure of Portfolio Holdings.

Rather than focusing on the characteristics and risks of each type of security in which a fund may invest, Item 9 of Form N-1A addresses a fund's principal investment strategies and the principal risks of the fund as a whole. ⁿ³³ A fund is required to focus on a fund's anticipated investment operations, rather than on investments that the fund might make, and to disclose how it intends to achieve its investment goals. Under Item 9(b), whether a particular investment strategy (including a strategy to invest in a particular type of security) is a principal investment strategy depends upon the strategy's anticipated importance in achieving the fund's investment objectives and how the strategy affects the fund's potential risks and returns. ⁿ³⁴ The SEC also requires a fund to explain generally how the fund's adviser decides what securities to buy and sell. ⁿ³⁵ In addition, Item 9(c) requires a fund to disclose the principal risks of investing in it, including the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect it adversely.

Item 9 also addresses the following four specific areas:

- *Concentration* - Instruction 4 to Item 9(b)(1) requires a fund to disclose its policies on industry concentration. ⁿ³⁶
- *Temporary Defensive Positions* - The prospectus also must disclose, if applicable, that in response to unfavorable market conditions, a fund may make temporary investments that are not consistent with its principal investment objectives and policies and the effect of such temporary investments. ⁿ³⁷
- *Portfolio Turnover* - The prospectus must disclose if the fund may engage in active and frequent

trading of portfolio securities and, if so, the tax consequences of increased portfolio turnover and how the tax consequences and trading costs may affect performance. n38

- *Risks* - A fund must disclose the risks to which the fund's portfolio as a whole is expected to be subject and discuss the circumstances reasonably likely to affect adversely the fund's net asset value, yield, or total return. n39 Item 9(d) requires that the fund prospectus state that the fund's policies and procedures with respect to the disclosure of the fund's portfolio securities are available in the SAI and on the fund's Web site, if applicable.

[j] Item 10. Management, Organization and Capital Structure

Item 10 calls for more extensive information about the following items:

- *Investment Adviser (Item 10(a)(1))* - Item 10 requires information in the prospectus about each investment adviser and sub-adviser to the fund. n40 Among other things, it requires disclosure of the name and address of each adviser to the fund, as well as a description of the adviser's experience. In addition, Item 10 requires prospectus disclosure of the aggregate advisory fees paid by a fund to the adviser during the most recent fiscal year and the basis of the compensation.

- *Portfolio Manager[s] (Item 10(a)(2))* - A prospectus must disclose the business experience for each portfolio manager identified in Item 5(b) and statement that the SAI provides information about the manager's compensation, other account managed by the manager, and the manager's ownership of fund shares. If the portfolio manager is a member of a committee or group that is jointly responsible for the day-to-day management of the portfolio, for each such member, a fund must provide a brief description of the person's role on the committee, team, or other group (e.g., lead member), including a description of any limitations on the person's role and the relationship between the person's role and the roles of other persons who have responsibility for the day-to-day management of the fund's portfolio.

- *Material Legal Proceedings (Item 10(a)(3))* - The fund must make disclosure about any material legal proceedings (other than routine litigation incidental to the business) to which the fund, the investment adviser or the principal underwriter is a party. This disclosure would include the court in which the proceedings are pending, the date instituted, the principal parties involved, a description of the factual basis alleged to underlie the proceedings, and the relief sought. In addition, the must disclose material proceedings instituted, or known to be contemplated, by a governmental authority. n41

- *Capital Stock (Item 10(b))* - With respect to a fund's capital structure, Item 10 requires prospectus disclosure of any unique or unusual restrictions or potential liabilities associated with holding a fund's shares (other than investment risks) that may expose an investor to significant risks. n42

[k] Item 11. Shareholder Information. Item 11 of Form N-1A requires disclosure about a fund's purchase and redemption procedures, dividends, and distributions, but information about a fund's principal underwriter and service providers can be given in the SAI. n43 For example, the fund's prospectus must describe the circumstances under which it will use fair value pricing and its effects. n44 This Item addresses the following:

- *Pricing of Fund Shares (Item 11(a))* - A fund must disclose the methods used to value its shares. n45 A fund also must disclose when net asset value is calculated. n46 Further, a fund must describe the circumstances under which it will use fair value pricing and its effects. n47 In responding to this Item, a fund may use a list of specific days or any other means that effectively communicates the information (e.g., explaining that shares will not be priced on the days on which the New York Stock Exchange is closed for trading). If a fund has portfolio securities that are primarily listed on foreign exchanges that

trade on weekends or other days when the fund does not price its shares, a fund must disclose that the net asset value of its shares may change on days when shareholders will not be able to purchase or redeem the fund's shares.

■ *Purchase of Fund Shares (Item 11(b))* - A fund must describe the procedures for purchasing the fund's shares

■ *Redemption of Fund Shares (Item 11(c))* - A fund must describe the procedures for redeeming the fund's shares, including: (i) any restrictions on redemptions; (ii) any redemption charges, including how these charges will be collected and under what circumstances the charges will be waived; (iii) if the fund has reserved the right to redeem in kind; (iv) any procedure that a shareholder can use to sell the fund's shares to the fund or its underwriter through a broker-dealer, noting any charges that may be imposed for such service. The specific fees paid through the broker-dealer for such service need not be disclosed; (v) the circumstances, if any, under which the fund may redeem shares automatically without action by the shareholder in accounts below a certain number or value of shares; (vi) the circumstances, if any, under which the fund may delay honoring a request for redemption for a certain time after a shareholder's investment (e.g., whether a fund does not process redemptions until clearance of the check for the initial investment); and (vii) any restrictions on, or costs associated with, transferring shares held in street name accounts.

■ *Dividends and Distributions (Item 11(d))* - A fund must describe its policy with respect to dividends and distributions, including any options that shareholders may have as to the receipt of dividends and distributions.

■ *Frequent Purchases and Redemptions of Fund Shares (Item 11(e))* - A fund must describe the risks that frequent purchases and redemptions of fund shares pose to fund shareholders and whether the fund's directors have adopted policies and procedures regarding frequent purchases and redemptions of fund shares. If the fund's directors have adopted policies and procedures, they must be described in detail, including any restrictions (e.g., restrictions on the volume or number of transactions, fees or charges, exchange limitations, minimum holding periods, etc.), whether they apply uniformly and whether they apply to omnibus accounts. n48

■ *Tax Consequences (Item 11(f))* - To simplify tax disclosure, Item 11 requires disclosure on the likely tax consequences to the fund and its shareholders if the fund operates as described in its prospectus. n49 Thus, disclosure about a fund's qualification under Subchapter M of the Internal Revenue Code can be provided in the SAI, unless the fund does not expect to qualify for Subchapter M treatment. n50 Item 11 also requires a fund to describe the tax consequences to shareholders of buying, holding, exchanging, and selling a fund's shares, and to disclose that the fund intends to make distributions to shareholders that may be taxed as ordinary income or capital gains and, if expected, that the fund's investment objectives or strategies will result in its distributions primarily consisting of ordinary income or long-term capital gains. n51

■ *Exchange-Traded Funds (Item 11(g))* - If the fund is an exchange-traded fund and issues or redeems funds shares in creation units of at least 25,000 shares each, it does not need to provide the information on procedures for purchasing and redeeming shares, or the calculation as to when net asset values are calculated. The fund must also provide a table that shows the number of days the fund's market price was greater than and was less than the fund's net asset value (i.e., premium and discount) for the most recent completed calendar year and any quarters thereafter. This table is not required if the fund provides a free Internet Web site at which investors can obtain this information regarding premiums and discounts. n52

[l] Item 12. Distribution Arrangements. Under Item 12 of Form N-1A, a fund must provide information about its distribution arrangements (such as sales charges, Rule 12b-1 fees, multiple class and master-feeder fund arrangements) in a central location in the prospectus. The form requires Rule 12b-1 plan disclosure to focus on the amount of fees paid under the plan and to move detailed technical disclosure to the SAI. In addition to the amount of the fee, disclosure must provide that:

- The plan allows the fund to pay fees for the sale and distribution of fund shares;
- Distribution fees are continuous in nature and that these fees, over time, cumulatively may exceed other types of sales loads; n53
- Because distribution rates are paid out of the fund's assets on an ongoing basis, the fees may, over time, cost investors more than other types of sales loads. n54

Disclosure about service fees paid outside a Rule 12b-1 plan, the disclosure must be modified to reflect those payments. n55 Item 12 requires also disclosure in the *prospectus* about the amount of any sales load charged on an investment in a fund, disclosure indicating when a sales load may be reduced or eliminated, (e.g., letters of intent, accumulation plans, dividend reinvestment plans, withdrawal plans, exchange plans, etc.) as well as information about each different breakpoint as a percentage of the offering price and amount invested. The prospectus must also provide a summary of shareholder eligibility requirements (e.g., a description or list of types of accounts, account holders, and fund holdings that may be aggregated to determine eligibility for a breakpoint), a description of the various types of information and documents that will be needed to verify eligibility, and a description of how accounts are valued (e.g., historical cost, net amount invested and offering price). Finally, the prospectus must also state if additional information on breakpoints is available in the SAI and whether the fund makes information on sales loads and breakpoints available free or on its Web site. The SEC does not require information about additional classes or feeder funds that are not offered in the prospectus. n56

[m] Item 13. Financial Highlights Information. Item 13 requires a fund to include a financial highlights table in the prospectus, though the fund generally has flexibility as to where to place it. The financial highlights table shows in fairly significant detail how the fund's historical activities have affected each share of the fund, which is why it is sometimes referred to as the "Per Share Table."

The financial highlights table contains the most complete discussion of the fund's financial history. It typically consists of multiple lines of financial information set out in comparative columns for up to five years. n57 The purpose of this disclosure is to show how a single share of the fund was affected by the fund's investment activities during each year. The table's five year timeframe is intended to show how a share performed over what is assumed to be one full cycle of up-down fluctuations in the general financial markets. Disclosure regarding how a fund calculates its performance appears in the SAI. n58

The table is divided into two the following two parts:

- *Per Share Data* - The first several lines of the Per Share Data show a variety of historical financial facts about the fund--on a "per share" basis--such as the fund's yearly income and capital changes, the components of how much the fund earned (*i.e.*, income and capital gain) or lost, and how much of the fund's earnings were distributed to shareholders.
- *Ratios/Supplemental Data* - The last few lines of the table show various ratios and supplemental information about the fund, including fund net assets, expense ratio, income ratio, and portfolio turnover rate.

The financial highlights table must include the following:

Financial Highlights

The financial highlights table is intended to help you understand the Fund's financial performance for the past 5 years [or, if shorter, the period of the Fund's operations]. Certain information reflects financial results for a single Fund share. The total returns in the table represent the rate that an investor would have earned [or lost] on an investment in the Fund (assuming reinvestment of all dividends and distributions). This information has been audited by _____, whose report, along with the Fund's financial statements, are included in [the SAI or annual report], which is available upon request.

Net Asset Value, Beginning of Period

Income From Investment Operations

Net Investment Income

Net Gains or Losses on Securities (both realized and unrealized) Total From Investment Operations

Less Distributions

Dividends (from net investment income)

Distributions (from capital gains)

Returns of Capital

Total Distributions

Net Asset Value, End of Period

Total Return

Ratios/Supplemental Data

Net Assets, End of Period

Ratio of Expenses to Average Net Assets

Ratio of Net Income to Average Net Assets

Portfolio Turnover Rate

[6] Part B: Information Required in a Statement of Additional Information

Part B of Form N-1A, commonly referred to as the "Statement of Additional Information" (SAI), is designed to provide shareholders with additional information about the fund that is not required to be included in the simplified prospectus but may be of material interest to some shareholders. The SAI includes the following fourteen items:

- Cover Page and Table of Contents (Item 14)

- Fund History (Item 15)
- Description of Fund and Its Investments and Risks (Item 16)
- Management of the Fund (Item 17)
- Control Persons and Principal Holders of Securities (Item 18)
- Investment Advisory and Other Services (Item 19)
- Portfolio Managers (Item 20)
- Brokerage Allocation and Other Practices (Item 21)
- Capital Stock and Other Securities (Item 22)
- Purchase, Redemption, and Pricing of Shares (Item 23)
- Taxation of the Fund (Item 24)
- Underwriters (Item 25)
- Calculation of Performance Data (Item 26)
- Financial Statements (Item 27)

In many cases the SAI requires disclosure that is more expansive and detailed about topics that are summarized in the simplified prospectus.

[a] Item 14. Cover Page and Table of Contents.

[i] Front Cover Page. The Statement of Additional Information front cover must contain

- The fund's name and class (or classes) to which the SAI relates.
- The date of the SAI and the prospectus to which it relates.
- The exchange ticker symbol of the fund's shares (or the class offered by the prospectus). If the fund is an exchange-traded fund (ETF), the principal U.S. market(s) on which it trades should also be identified.

It must also indicate that the Statement of Additional Information is not a prospectus; state how a prospectus may be obtained.

[ii] Table of Contents. The Statement of Additional Information must contain a table of contents and "when useful" cross references to the prospectus.

[b] Item 15. Fund History. The Statement of Additional Information must contain the date of the fund's organization as well as the form and state in which it is organized. If the name of the fund has been changed, the

Statement of Additional Information must so state. The Statement of Additional Information must also provide information about any change of business within the last five years.

[c] Item 16. Description of the Funds and Its Investments and Risks.

[i] Classification. The fund must state that it is an open-end management investment company and, if it is diversified, it must say so.

[ii] Investment Strategies and Risks. The Statement of Additional Information must discuss strategies and types of securities that are "not principal strategies" and the related risks.

[iii] Fund Policies. The Statement of Additional Information must describe the policy towards items specified in Section 8(b)(1) of the Investment Company Act: senior securities; borrowing; underwriting; industry concentration; real estate or commodities; loans; and any other fundamental policies or policies that may not be changed without shareholder approval. The Statement of Additional Information must also describe the vote required to obtain any such shareholder approval.

[iv] Temporary Defensive Position. The Statement of Additional Information, rather than the prospectus, should describe the types of investments the fund may make for temporary defensive purposes.

[v] Portfolio Turnover. The Statement of Additional Information must explain significant variations in turnover during the two most recent fiscal years or any anticipated variation. Money market funds are excepted from this requirement because they generally do not have to calculate portfolio turnover.

[d] Item 17. Management of the Fund.

[i] Board of Directors. There must be a brief description of the responsibility of the Board under state law, similar to what was formerly contained in prospectuses.

[ii] Management Information. With respect to directors and officers, there must be the familiar tabular showing of information relating to positions with the fund and principal occupations. For directors and advisory board members, there continues to be a requirement that compensation be described in detail.

[iii] Sales Loads. The Statement of Additional Information must describe sales load breaks for directors and other affiliates.

[iv] Additional Director Information. Expanded disclosure about directors will be required effective January 31, 2002. There must be disclosure within dollar ranges of director beneficial ownership of shares of each particular fund and of all funds within a fund complex. The definition of beneficial ownership is taken from Rule 16a-1(a)(2) under the Securities Exchange Act and the focus is on economic interest. The fund must also disclose certain positions, interest or transactions involving independent directors that might be viewed as creating conflicts of interest. Finally there must be information relating to the various board committees and as to the board's basis for approving the fund's investment advisory contract.

[v] Proxy Voting Policies. Unless a fund invests exclusively in non-voting securities, it must describe its proxy voting policies and procedures, including the procedures used to address conflicts of interest. The fund also must disclose how it voted proxies during the most recent 12-month period ending June 30[th], and make such information available by calling a specified toll-free number or on the fund's website at a specified Internet address, or both, and on the SEC's website.

[e] Item 18. Control Persons and Principal Holders of Securities.

[i] Control Persons. The Statement of Additional Information must include detailed information about the

interests of persons who control the fund, generally those that own more than 25 percent of the voting stock or who otherwise exert control, if any.

[ii] Principal Holders. This item requires detailed information about holders of five percent or more of the fund's equity securities.

[iii] Management Ownership. The ownership interests of officers, directors and advisory board members must be stated as a group, except that, if their ownership interest is less than one percent, a statement to that effect will suffice.

[f] Item 19. Investment Advisory and Other Services.

[i] Investment Advisers. The Statement of Additional Information must include details about persons who control the investment adviser and must identify organizations affiliated with both the fund and the adviser. There must also be detailed information about the advisory fee, including the basis for calculating the fee; dollar amounts paid; credits; and expense limitations.

[ii] Principal Underwriter. The Statement of Additional Information must give the name and principal business address of the principal underwriter and disclose certain affiliations.

[iii] Certain Services and Payment Therefor. This item requires disclosure about services paid for by the investment advisor or a third party.

[iv] Service Agreements. This item requires information about "management-related service contracts," such as those related to daily administration of the fund. It does not require information about investment advisers, custodians, transfer agents, dividend-paying agents, counsel or auditors. Required information includes the identity of the service provider, certain relationships to the adviser or underwriter and the compensation.

[v] Other Investment Advice. This item requires information about certain other entities that may come within the definition of investment adviser to the fund in the Investment Company Act.

[vi] Dealer Reallowances. The Statement of Additional Information must disclose any portion of a front-end sales load that is reallowed to dealers. This information was formerly in the prospectus.

[vii] Rule 12b-1 Plans. The Statement of Additional Information must describe material aspects of a Rule 12b-1 Plan and any related agreements. Required information includes distribution activities; whether the plan is designed to "reimburse" or "compensate;" any carried over unreimbursed expenses; any joint distribution activities; and the interest of certain other persons.

[viii] Other Service Providers. This item requires that service providers not previously identified be listed.

[g] Item 20. Portfolio Managers. This item requires various information about portfolio managers required to be identified in response to Item 10(a)(2) who is primarily responsible for the management of any other account, including the number of other accounts managed within certain categories and a description of any material conflicts of interest that may arise with the portfolio manager's management of these other accounts.

[h] Item 21. Brokerage Allocation and Other Practices.

[i] Brokerage Transactions. This item requires a description of how the fund allocates brokerage transactions, as well as any material year-to-year differences in commissions paid.

[ii] Commissions. This item requires information about payments of brokerage commissions to affiliates.

[iii] Brokerage Selection. This item requires a description of how brokers are selected, including soft-dollar

arrangements.

[iv] Directed Brokerage. This item requires a description of specific arrangements to direct the fund's brokerage for research.

[v] Regular Broker-Dealers. This item requires disclosure of holdings of securities issued by the fund's regular broker-dealers.

[i] Item 22. Capital Stock and Other Securities.

[i] Capital Stock. This item requires information about each class of fund stock, including: the title of the class; restrictions on transferability; obligations or liabilities; dividend rights; voting rights; liquidation rights; preemptive rights; conversion rights; redemption provisions; sinking fund provisions; and calls or assessments. There must also be disclosure if the rights of any class are limited or qualified by those of any other class.

[iii] Other Securities. The Statement of Additional Information must disclose information about other types of securities the fund issues, if any.

[j] Item 23. Purchase, Redemption, and Pricing of Shares.

[i] Purchase of Shares. This item requires description of how shares are sold, including any special purchase plans.

[ii] Fund Reorganization. This item requires disclosure of arrangements as to sales loads breakpoints in connection with reorganizations.

[iii] Offering Price. This item requires a description of how the offering price is determined, including valuation procedures and the impact of sales charges.

[iv] Redemption in Kind. This item requires disclosure of any circumstances under which redeeming shareholders might receive portfolio securities rather than cash.

[k] Item 24. Taxation of the Fund. The fund must indicate any intention to qualify under Subchapter M of Internal Revenue Code and any consequences of not doing so. There also must be disclosures in any unusual tax aspects of the fund, including those resulting from foreign investment.

[l] Item 25. Underwriters.

[i] Distribution of Securities. The Statement of Additional Information must disclose the nature of any principal underwriter's obligation; whether the offering is continuous; and information about underwriting commissions.

[ii] Compensation. The Statement of Additional Information must include a table reflecting compensation to affiliated underwriters;

[iii] Other Payments. This item requires disclosure about other payments to underwriters and dealers;

[m] Item 26. Calculation of Performance Data.

[i] Money Market Funds. Money Market Funds must provide yield in accordance with a prescribed formula if the fund advertises such quotations.

[ii] Other Funds. Other types of funds that advertise performance must provide as applicable total return, yield, effective yield and non-standardized performance information.

[n] Item 27. Financial Statements.

[i] Registration Statement. The fund must provide the financial statements required by the SEC's Regulation S-X.

[ii] Annual Report. The Statement of Additional Information prescribes information required to be in the fund's annual and semi-annual reports to shareholders.

[7] Part C: Other Information

Part C of Form N-1A addresses other information, including exhibits, required to be included in a registration statement. Part C includes information about, among other things, the person maintaining physical possession of the fund's accounts and records, indemnification of officers or directors, and persons controlled by or under common control with the fund and the fund's principal underwriters. n59

Form N-1A also requires a number of exhibits in Part C, including a fund's organizational documents and certain key contracts. Part C is not required to be delivered to investors. Companies are not required to make it available to investors free of charge, but it is available for public examination at the SEC.

[a] Item 28. Exhibits. Form N-1A continues to require the filing of numerous exhibits, but the requirements have been simplified and modernized somewhat.

[b] Item 29. Persons Controlled By or Under Common Control With the Fund. The Statement of Additional Information continues to require disclosure of these control relationships.

[c] Item 30. Indemnification. There must be disclosure as to any arrangements under which any director, officer, underwriter or affiliate may be insured or indemnified.

[d] Item 31. Business and Other Connections of the Investment Adviser. This requirement relates not only to the adviser, but to directors, officers or partners of the adviser.

[e] Item 32. Principal Underwriters. The Statement of Additional Information continues to require identification of other funds for which its principal underwriter acts in that capacity; details about each director, officer or partner of the principal underwriter; and compensation to unaffiliated principal underwriters.

[f] Item 33. Location of Accounts and Records. The Statement of Additional Information must identify where required books and records are maintained.

[g] Item 34. Management Services. The Statement of Additional Information must summarize the substantive provisions of management related service contracts not discussed in the prospectus or Statement of Additional Information.

[h] Item 35. Undertakings. The form now requires only one undertaking: to file an amendment with certified financial statements showing the seed capital.

FOOTNOTES:

(n1)Footnote 1. *See* Inv. Co. Act Rel. No. 13,436, 1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) [Middle dot] 83,413 (1983), the release adopting Form N-1A. Along with the adoption of Form N-1A, the SEC published staff guidelines intended to assist persons who were preparing Form N-1A. A major purpose of these guidelines was to collect and adapt to Form N-1A many traditional SEC staff views on disclosure related topics. Amendments to Form N-1A have superseded the guidelines. *See* Inv. Co. Act Rel. No 23064 (Mar. 13, 1998); Inv. Co. Act Rel. No. 58284 (Jan. 13, 2009).

(n2)Footnote 2. *See, e.g.,* R. Grant & P. Solmssen, Form N-1A: The Simplified Mutual Fund Prospectus 1 (1986).

(n3)Footnote 3. *See* Inv. Co. Act Rel. No 23064 (Mar. 13, 1998).

(n4)Footnote 4. The SEC's Plain English principles require that disclosure documents: present information in an easily readable format; use everyday language that investors can easily understand; and eliminate repetition of disclosure that lengthens a document and overwhelms the investor.

(n5)Footnote 5. *See* Inv. Co. Act Rel. No. 58284 (Jan. 13, 2009).

(n6)Footnote 6. *See* Rule 495(a) of Regulation C and Rule 481(a), which require investment company facing sheets to set forth the approximate date of proposed sale to the public. The typical mutual fund states that it proposes to make a public offering as soon as practicable after the effective date of the registration statement.

(n7)Footnote 7. *See White v. Melton*, 757 F.Supp. 267 (SDNY 1991) and discussion in *Section 7B.08[2] below*.

(n8)Footnote 8. Mutual funds may also satisfy requirements of periodic reports to shareholders by transmitting the prospectus and statement of additional information if they so choose.

(n9)Footnote 9. *See* § 7B.02[2][d][ii] *below*.

(n10)Footnote 10. *See* Inv. Co. Act Rel. No. 28584 (Jan. 13, 2009).

(n11)Footnote 11. *See* Instruction to Item 1(a) and General Instruction C.3(b) of Form N-1A.

(n12)Footnote 12. Item 1(b)(3) requires a fund to include on the back cover page of its prospectus a statement that information about the fund is available at the SEC's Public Reference Room and on the SEC's Internet site.

(n13)Footnote 13. *See* Instruction 3 to Item 1(b)(1); Release 23064, *above*, at n. 189 and accompanying text. The staff has stated that to demonstrate compliance with this requirement a fund must maintain policies and procedures, internally and with financial intermediaries through which fund shares are traded, that establish that the fund honors requests for the prospectus, SAI and annual/semi-annual reports within the three-business day period. The fund should also be able to demonstrate that its policies and procedures in fact result in timely distribution of these documents. *See* Letter from Barry D. Miller, Associate Director, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute (May 19, 1998) [hereinafter cited as "Form N-1A Staff Comment Letter 1"].

(n14)Footnote 14. In the SEC's view, the purpose of this summary risk disclosure is to identify briefly the principal risks of investing in the particular fund and to emphasize those risks reasonably likely to affect the fund's performance. The SEC expects this disclosure to consist of a succinct summary of the principal risks and not to repeat the fuller discussion of these risks required elsewhere in the prospectus. The SEC believes it would generally be inconsistent with this requirement for a fund to include a "laundry list" of generic risk factors that does not identify the risks of investing in the fund. *See* Release 23064, *above*, at n. 34 and accompanying text.

(n15)Footnote 15. *See* Item 4(b)(1)(i) of Form N-1A.

(n16)Footnote 16. A fund could discuss the potential rewards of investing in the fund elsewhere in its prospectus as long as the information is not incomplete, inaccurate, or misleading. *See* Release 23064, *above*, at n. 40 and accompanying text.

(n17)Footnote 17. Item 4(b)(1)(ii) of Form N-1A requires the following money market mutual fund disclosure:

An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your

investment at \$1.00 per share, it is possible to lose money by investing in the Fund.

A money market mutual fund advised by or sold through a bank also would disclose in the risk summary of its prospectus:

An investment in the Fund is not a deposit of the bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other governmental agency.

Disclosure about the types of risks associated with investing in a tax-exempt money market fund that concentrates its investments in a particular state is not required in either the profile or the prospectus. *See Release 23064, above*, at n. 46 and accompanying text.

(n18)Footnote 18. Item 4(b)(1)(iii) of Form N-1A (the fund must make the disclosure set forth toward the end of the prior footnote).

(n19)Footnote 19. Item 4(b)(1)(iv) of Form N-1A.

(n20)Footnote 20. *See Letter to Craig Tyle, General Counsel, Investment Company Institute, from Paul F. Royce, Director, SEC Division of Investment Management (Oct. 17, 2003).*

(n21)Footnote 21. Item 4(b)(2) of Form N-1A provides that the bar chart of a fund in operation for fewer than 10 years must include annual returns for the fund's life. Both the bar chart and the performance table must be based on calendar year periods. *See Release 23064, above*, at n. 59 and accompanying text. Item 4(b)(2)(iii) permits, but does not require, a fund to include performance information for the fund's life if it exceeds 10 years. *See Release 23064, above*, at n. 71 and accompanying text. Instruction 4 to Item 4(b)(2) permits a fund that has not had the same adviser for the last 10 years to begin the bar chart and performance information on the date the new adviser began to provide advisory services to the fund, provided the conditions in Instruction 11 of Item 22(b)(7) are met. Instruction 1(a) to Item 4(b)(2) provides that if a fund's shares are sold subject to a sales load or account fees, the fund must state that sales loads or account fees are not reflected in the bar chart and that, if they had been reflected, returns would be less than those shown. The staff has stated that a load fund may not include load-waived performance returns in its performance table under Instruction 2 to Item 4(b)(2). *See Letter from Barry D. Miller, Associate Director, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute (Oct. 2, 1998) [hereinafter cited as "Form N-1A Staff Comment Letter 2"]*.

(n22)Footnote 22. Instruction 2(b) of Item 4(b)(2) of Form N-1A permits a fund to use one or more indexes in addition to the required broad-based index in the table accompanying the bar chart. If an additional index is included, the fund must disclose information about the additional index in the narrative explanation accompanying the bar chart and table (e.g., by stating that the information shows how the Fund's performance compares with the returns of an index of funds with similar investment objectives). Instruction 2(c) of Item 4(b)(2) provides that if a fund selects an index that is different from the index used in a table for the immediately preceding period, the fund must explain the reason(s) for the selection of a different index and provide information for both the newly selected and the former index.

(n23)Footnote 23. The bar chart is intended to illustrate the variability of a fund's return. The average annual return information is designed to help investors evaluate a fund's performance and risks relative to "the market." *See Release 23064, above*, at n. 52 and accompanying text.

(n24)Footnote 24. General Instruction C.3.(d)(iii) of Form N-1A provides that the following entities are exempt: (1) a defined contribution plan that qualifies under *Section 401(k) of the Internal Revenue Code of 1986* ("Code"); (2) a tax-deferred arrangement under Section 403(b) or 457 of the Code; (3) a variable contract as defined in Section 817(d) of the Code; (4) a similar plan or arrangement pursuant to which the investor is not taxed on the investment in the fund

until it is sold; or (5) entities not subject to individual federal income tax (e.g., tax-exempt foundations, colleges and corporations). A fund may not rely on this exemption if the prospectus is used indirectly to offer shares to persons that are subject to individual taxation, such as an offer to a partnership whose individual partners are taxed on a pass-through basis.

Instruction 2(a) to Item 4(b)(2) provides that money market funds are to calculate 7-day yield. Instruction 2(e) to Item 4(b)(2) provides that returns required by paragraphs 2(c)(2)(iii)(A), (B) and (C) for a fund or a series must be adjacent to one another and appear in that order. When more than one fund or series is offered in the prospectus, a registrant may not intersperse returns of one fund or series with returns of another fund or series. The returns for a broad-based securities index cannot be interspersed with the returns of the fund or series, but rather must precede or follow them.

(n25)Footnote 25. The SEC Staff has stated that a fund may not use year-to-date return information until a fund has annual return information for at least one calendar year. *See* Form N-1A Staff Comment Letter 2, *above*.

(n26)Footnote 26. *See* Item 4(b)(2)(iv) to Form N-1A. With respect to a multiple class fund offering more than one share class in the prospectus, see Instruction 3 to Item 4(b)(2).

(n27)Footnote 27. *See* Item 4(b)(2)(i) of Form N-1A; *see also* Release 23064, *above*, at n. 57 and accompanying text.

(n28)Footnote 28. *See* Item 4(b)(2)(i).

(n29)Footnote 29. The staff has confirmed that while a money market fund that has annual return information for at least one calendar year must include the performance table in its prospectus, a money market fund need not compare its performance to a broad-based securities index. A money market fund, however, may include information for one or more other indices as permitted by Instruction 6 to Item 22(b) of Form N-1A.

In addition, Instruction 2(d) of Item 4(b)(2) of Form N-1A requires a non-money market fund that discloses yield to provide a toll-free (or collect) telephone number that investors can use to obtain current yield information. A non-money market fund, like a money market fund, has the option of providing yield information in its prospectus (together with the telephone number to obtain current yield information) or merely disclosing a telephone number that investors can use to obtain this information. *See* Form N-1A Staff Comment Letter 2, n. 28 *above*.

(n30)Footnote 30. *See* Item 4(b)(2)(ii) of Form N-1A; *see also* Release 23064, *above*, at n. 55 and accompanying text. The staff has stated that, consistent with the other information in the bar chart and the performance table, the highest and lowest quarterly performance information should be based on calendar quarters. *See* Form N-1A Staff Comment Letter 2, n. 28 *above*.

(n31)Footnote 31. This requirement does not apply to a money market fund.

(n32)Footnote 32. If more than five persons are jointly and primarily responsible for the day-to-day management of the fund's portfolio, the fund need only provide information for the five persons with the most significant responsibility for the day-to-day management of the fund's portfolio. *See* Instruction 2 to Item 5(b) of Form N-1A.

(n33)Footnote 33. The SEC believes that disclosing information about all the securities in which a fund might invest, particularly securities that do not contribute significantly to its investment objectives (e.g., illiquid securities, repurchase agreements, and options and futures contracts), does not help a typical investor evaluate how the fund's portfolio will be managed or the overall risks of investing in the fund. *See* Release 23064.

(n34)Footnote 34. *See* Instruction 2 to Item 9(b)(1). Instruction 1 to Item 9(b)(1) defines a strategy to include any policy, practice, or technique used to achieve a fund's investment objectives. Instruction 2 to Item 9(b)(1) provides that when determining whether a strategy is a principal investment strategy, a fund must consider, among other things, the

amount of assets that it expects to commit to the strategy, the amount of assets that it expects to place at risk by the strategy, and the likelihood that it will lose some or all of those assets in implementing it. Instruction 3 to Item 9(b)(1) provides that a negative strategy (*i.e.*, practices in which a fund may not or does not intend to engage) is not a principal investment strategy. Under this disclosure requirement, a bond fund, for example, typically would discuss generally the maturities, durations, ratings, and types of issuers of the bonds in which the fund invests principally. On the one hand, it generally will be unnecessary for a fund (other than, for example, a money market mutual fund) to disclose in its prospectus its cash management practices (*e.g.*, entering into overnight repurchase agreements), because these practices are not typically among the principal investment strategies that a fund uses to achieve its investment objectives. However, a fund that has a principal investment strategy of allocating its assets among stocks, bonds, and money market instruments would need to disclose its use of cash equivalents.

(n35)Footnote 35. See Item 9(b)(2) of Form N-1A. In meeting this requirement, an equity fund could describe, for example, whether it emphasizes value or growth, or blends the two approaches. A value-oriented fund might state that the fund's adviser selects stocks that it considers to be undervalued by recognized measures of economic value such as earnings, cash flow, and book value. Other types of disclosure may relate to whether the adviser employs a "top-down" or "bottom-up" approach. Item 9(b)(2) of Form N-1A.

(n36)Footnote 36. The SEC believes that a fund investing more than 25 percent of its assets in a particular industry or group of industries is concentrating in that industry. Section 8(b)(1) of the Act requires a fund to disclose any policy to concentrate its investments in a particular industry or group of industries. Section 13(a)(3) of the Act requires that a fund obtain shareholder approval to change a policy to concentrate its investments.

(n37)Footnote 37. See Instruction 6 to Item 9(b)(1).

(n38)Footnote 38. See Instruction 7 to Item 9(b)(1).

(n39)Footnote 39. See Item 9(c) of Form N-1A.

(n40)Footnote 40. The prospectus must also include a statement that a discussion regarding the basis for the fund directors' approval of the investment advisory contract is available in the semi-annual or annual report to shareholders (along with the period covered by the report). See Item 10(a)(1)(iii) of Form N-1A.

(n41)Footnote 41. See Item 10(a)(3) of Form N-1A.

(n42)Footnote 42. See Release 23064, *above*, at n. 137 with accompanying text; Item 10(b) of Form N-1A. Given the remoteness of the risk, it is not necessary for funds organized as Massachusetts business trusts to disclose the possibility of contingent shareholder liability.

(n43)Footnote 43. See Release 23064, *above*, at n. 146 and accompanying text.

(n44)Footnote 44. See Item 11(a)(1) of Form N-1A. Where the fund invests in another registered open-end investment company, the fund may explain that the fund's net asset value is calculated based upon the net asset values of the registered open-end funds and that the prospectuses of those funds describe when fair value pricing is used.

(n45)Footnote 45. See Release 23064, *above*, at n. 153 with accompanying text. The SEC added an instruction to Item 11(a)(1) of Form N-1A to encourage funds to discontinue the use of boilerplate disclosure of the technical aspects of valuation and require them to include a statement about the effect of the fund's use of fair value net asset calculation.

(n46)Footnote 46. See Release 23064, *above*, at n. 154 and accompanying text.

(n47)Footnote 47. See Item 11(a)(1) of Form N-1A. Where the fund invests in another registered open-end investment company, the fund may explain that the fund's net asset value is calculated based upon the net asset values

of the registered open-end funds and that the prospectuses of those funds describe when fair value pricing is used.

(n48)Footnote 48. *See* Item 11(e) of Form N-1A; *Inv. Co. Act Rel. No. 26418, 2004 SEC LEXIS 843 (Apr. 16, 2004)* . If the fund has arrangements permitting frequent purchases or redemptions of fund shares, these must be disclosed in the fund's SAI.

(n49)Footnote 49. *See* Release 23064, *above*, at n. 161 and accompanying text.

(n50)Footnote 50. *See id.* at n. 163 and accompanying text.

(n51)Footnote 51. *See id.* at n. 164 and accompanying text; Item 11(e) of Form N-1A. Funds subject to this requirement would include, for example, those often described as "tax-managed," "tax-sensitive," or "tax-advantaged," which have investment strategies to maximize long-term capital gains and minimize ordinary income. In light of tax changes, the amended form also requires a fund to disclose that capital gains may be taxable at different rates depending upon the length of time that the fund holds its assets. *See id.* at n. 165 and accompanying text.

(n52)Footnote 52. *See* Item 11(g) to Form N-1A.

(n53)Footnote 53. *See id.* at n. 167 and accompanying text.

(n54)Footnote 54. *See id.* at n. 169 and accompanying text.

(n55)Footnote 55. *See* Items 12(b) of Form N-1A; Release 23064, *above*, at n. 170 and accompanying text.

(n56)Footnote 56. *See* Release 23064, *above*, at n. 174 and accompanying text. Item 12(c)(4) of Form N-1A requires a feeder fund to describe briefly the circumstances under which it may change its investment in a master fund; feeder funds that do not have this authority need not include this disclosure. Item 12(c)(3) of Form N-1A only requires disclosure of conversions or exchanges from one class to another if the conversions or exchanges are mandatory or automatic.

(n57)Footnote 57. *See id.* at n. 176 and accompanying text. Investors interested in historical data beyond the 5-year period can look to the bar chart required by Item 4 of Form N-1A.

(n58)Footnote 58. *See id.* at n. 180 and accompanying text.

(n59)Footnote 59. In the past the SEC staff required funds to provide an undertaking to hold a shareholder meeting within 16 months of effectiveness to approve a fund's directors, advisory contract, distribution plan, and other matters. However, the staff no longer requires such a shareholder meeting. *See* Letter from Marianne K. Smythe, Director, SEC Division of Investment Management, to Matthew P. Fink, Investment Company Institute (Nov. 6, 1992); The Calvert Group, 1993 SEC No-Act. LEXIS 27 (Jan. 7, 1993) .



101 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.04

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.04 Form N-2: Registration of Securities of Closed-End Management Investment Companies

Closed-end investment companies register under the Investment Company Act and register their shares under the Securities Act by filing Form N-2.

[1] Introduction

Form N-2 permits closed-end funds to use a disclosure format comparable to that used by mutual funds. Accordingly, a closed-end fund may use a "simplified" prospectus and Statement of Additional Information. As with Form N-1A, Form N-2 is divided into Part A (the prospectus), Part B (the Statement of Additional Information) and Part C (other information required to be in the Registration Statement but not required to be given by the registrant to investors).

Form N-2 incorporates a number of disclosure innovations. For example, funds that may issue senior securities are required to discuss the effects of leveraging. In addition, as long as certain information is included in the annual report, closed-end funds are not required to file annual amendments pursuant to Rule 8b-16. n1

[2] General Instructions

Form N-2 is used by closed-end management investment companies (other than SBICs) for registration statements under both the Securities Act and the Investment Company Act. Fees for registration under the Securities Act are calculated in the manner provided for in Section 6(b) of the Securities Act and Rule 457 thereunder. Regulation C under the Securities Act generally governs filings on Form N-2. However, if the registration statement or an amendment was filed only under the Investment Company Act, the series of rules under Section 8(b) under the Investment Company Act governs. Rule 8b-16 requires an annual amendment to the Investment Company Act registration statement unless specified information is included in the annual report to shareholders.

The SEC's general rules on incorporation by reference of answers to items not required to be included in the prospectus are applicable. Generally speaking, a registrant may incorporate by reference any information contained elsewhere in the registration statement or in other filings with the SEC. In addition, a registrant may incorporate the Statement of Additional Information into the prospectus by reference and deliver it only if the investor requests it. Information may also be incorporated by reference into the Statement of Additional Information but must be provided along with the

Statement of Additional Information unless the requesting person is a shareholder and otherwise has already received the material.

A registration statement, or an amendment thereto, under both the Securities Act and the Investment Company Act or under the Securities Act alone must consist of the facing sheet, Parts A, B & C, signatures, and all other required documents. A registration statement under the Investment Company Act alone must include somewhat more limited information.

Part A of Form N-2 governs the contents of the prospectus and Items 1 through 4 thereof must be set forth in the same order as they appear in the form. The registration statement may include charts, graphs and tables that are not misleading but only the fee table and table of contents may precede the financial highlights (formerly the per share table). Sales literature may be included in the prospectus but should not lengthen the prospectus and should not be placed so as to obscure essential disclosure.

The facing sheet for Form N-2 contains specified information, and as stated above, must be included in any registration statement or amendment thereto. The facing sheet contains boxes to indicate whether the registration statement is under the Securities Act or the Investment Company Act. If no designation is made, the filing will be treated as having been made under both Acts. Amendments must be numbered sequentially. The facing sheet must set forth the exact name of the registrant, the address of its principal executive offices, its telephone number, and the name and address of its agent for service. In addition, registration under the Securities Act must include the approximate date of the proposed public offering and a table setting forth the calculation of the registration fee.

[3] Part A: Information Required in a Prospectus

[a] Item 1. Outside Front Cover. The cover page of the prospectus for a closed-end management company must include all the information specified in Item 1 and may contain other information if it does not impede understanding of the required information. The cover page must include basic identifying information, including identification of the type of fund or a brief statement of the investment objectives. The outside front cover must also describe the offering and must include:

- the type of legend concerning the Statement of Additional Information that is required of mutual funds;
 - the date of the prospectus and Statement of Additional Information;
 - if applicable, a statement that securities are being offered for the account of shareholders;
 - a table showing offering price, sales load and proceeds to the registrant;
 - statements required by Rule 481(b) under the Securities Act;
 - if applicable, a statement that the securities have no history of public trading and a statement describing the tendency of closed-end funds to trade at a discount from net asset value;
 - a cross-reference to any discussion of speculative and high risk factors discussed in the prospectus;
- and
- any other information required by the rules of the SEC or any other governmental authority.

[b] Item 2. Cover Pages: Other Offering Information. The following must be disclosed either on the front cover

or on the inside front or outside back cover: information required by paragraphs (d) through (f) of Rule 481 under the Securities Act and the name of any national Securities Exchange or over-the-counter market on which shares will be listed, as well as the symbol.

[c] Item 3. Fee Table and Synopsis. The prospectus must include a table of shareholder transaction expenses and annual expenses similar to that required under Form N-1A. Form N-2 also adopts the criteria established in Form N-1A for use of a synopsis.

[d] Item 4. Financial Highlights. The "Financial Highlights" section is similar to the section formerly entitled "Condensed Financial Information." It requires a tabular presentation of certain financial information on a per share basis. The most significant substantive change is that the table must include total investment return.

[e] Item 5. Plan of Distribution. The prospectus must show the name and principal business address of each principal underwriter, as well as the nature of any material relationship with the registrant other than that of principal underwriter. The prospectus must also show the amount of securities being underwritten and the nature of the obligation of the underwriter (i.e., whether the principal underwriters are making firm commitments or will use their "best efforts"). The prospectus must also show the price of the securities or, if that is impracticable, the method by which the price will be calculated. There must also be an explanation of all forms of compensation to underwriters. In addition, special circumstances may have to be described (such as offering of securities otherwise than through an underwriter; for the account of security holders; otherwise than for cash; or in conjunction with retirement plans). There must also be a description of any indemnification provisions.

[f] Item 6. Selling Shareholders. If securities are being sold for shareholders, the prospectus must include the information required by Item 507 of Regulation S-K.

[g] Item 7. Use of Proceeds. The prospectus must indicate the use of proceeds. Typically, of course, in the case of an investment company the proceeds will be invested pursuant to the registrant's investment policies. However, any other use for the proceeds, such as paying off indebtedness, would have to be disclosed pursuant to this item. There also must be disclosure about how long it will take to invest the proceeds fully and the consequences of any delay in doing so.

[h] Item 8. General Description of the Registrant. The prospectus must disclose the organization and operation of the Fund, including its date and form and location of organization, as well as its classification and subclassification under Sections 4 and 5 of the Investment Company Act.

The prospectus must also include a concise description of the fund's investment objectives and the policies of the registrant that will "constitute its principal portfolio emphasis." This disclosure must include whether the objectives can be changed without a shareholder vote; the types of securities in which the registrant invests principally; any industry groups in which the fund will concentrate; and any special investment techniques. There must be a discussion of the principal risk factors associated with the fund. If the fund can issue senior securities, there must also be a discussion of the effects of leverage. There should also be disclosure about less important investment policies. The registrant must also include appropriate information about the trading markets for its securities. This item also has special provisions relating to business development companies.

[i] Item 9. Management. The prospectus must include a concise discussion of the role of the board of directors in overseeing the fund's operations. There must be considerable information relating to the investment adviser, including identifying information, the services provided and the compensation paid. The prospectus must also identify the portfolio manager or managers.

There also must be information about services provided by and compensation paid to any person who provides significant administrative or business affairs management services (e.g., an "Administrator" or "Sub-Administrator").

The prospectus must also include basic identifying information about any custodians and transfer agents.

The prospectus also must identify the types of expenses the Fund is responsible for and its practice, if any, of allocating brokerage to affiliates. Finally, the discussion of management must include information about non-residents and control persons.

[j] Item 10. Capital Stock, Long-Term Debt, and Other Securities. The prospectus must include information about the basic attributes of securities outstanding. This item also requires a concise description of the tax consequences of investing in the Fund (i.e., a statement about qualification under Subchapter M of the Internal Revenue Code). Prospectuses relating to senior securities must also describe ratings.

[k] Item 11. Defaults and Arrears on Senior Securities. Such information must be provided, if applicable.

[l] Item 12. Legal Proceedings. The prospectus must include information about any material pending legal proceedings (other than routine litigation incidental to the business) that are likely to have any material adverse effect upon the ability of the investment adviser or principal underwriter to perform its contract or to have a material adverse effect on the fund itself.

[m] Item 13. Table of Contents of the Statement of Additional Information. This item is self-explanatory.

[4] Part B: Information Required in a Statement of Additional Information

[a] Item 14. Cover Page. The outside cover of the Statement of Additional Information must contain the registrant's name; a statement of about the function of the Statement of Additional Information and its relationship with the prospectus; the date of the Statement of Additional Information; the date of the prospectus and statements required by Rule 481(b)(2) under the Securities Act. The cover page may include other information if it does not impede understanding of the required information.

[b] Item 15. Table of Contents. This item requires listing the contents and requires cross-references to related disclosure in the prospectus where appropriate.

[c] Item 16. General Information and History. This item requires information, if applicable, about other businesses in which the fund engaged, name changes and reorganizations or similar proceedings.

[d] Item 17. Investment Objective and Policies. This item requires a concise description of the investment policies but does not require repetition of information in the prospectus. This item also requires listing of all fundamental policies not described in the prospectus which would include so-called "negative" policies (i.e., policies that prohibit a particular type of activity).

[e] Item 18. Management. This item requires a "management table" providing information in tabular form about directors, officers and, if any, advisory board members. The information required includes details about remuneration and retirement benefits. Form N-2 has been amended to require the kind of director information described supra in 7B.03[6][g].

[f] Item 19. Control Persons and Principal Holders of Securities. The registrant must pick a date within 30 days of the filing and identify any persons who control the fund or are known to own of record or beneficially 5 percent or more than any class of outstanding securities. There must also be aggregate information about shareholdings of officers, directors and advisory board members.

[g] Item 20. Investment Advisory and Other Services. This item requires additional information about the investment adviser, including control persons and affiliates that provide services to the fund. There must also be information about the fund's custodian and accountants.

[h] Item 21. Portfolio Managers. This item requires various information to be disclosed if the fund portfolio manager is primarily responsible for the day-to-day management of other accounts, including the number of accounts managed in certain categories and the total assets of such accounts, as well as a description of any material conflicts of interest that may arise in connection with the management of the fund and other accounts.

[i] Item 22. Brokerage Allocation and Other Practices. There must be a description of brokerage practices generally, with particular emphasis on information on brokerage allocated to affiliates.

[j] Item 23. Tax Status. This item calls for information not included in the prospectus that may be of interest to investors.

[k] Item 24. Financial Statements. This item requires inclusion of the financial statements required by Regulation S-X. Certain of the instructions apply to shareholder reports as well.

[5] Part C: Other Information

[a] Item 25. Financial Statements and Exhibits. This item requires a listing of all financial statements and exhibits. Exhibits include articles and by-laws; any voting trust agreements; instruments defining rights of security holders; the dividend reinvestment plan if any; material contracts; and other items if applicable.

[b] Item 26. Marketing Arrangements. This item requires description of any limitations on sales, stabilization activities and responsibilities of underwriters.

[c] Item 27. Other Expenses of Issuance and Distribution. This item requires an itemized statement of expenses other than underwriting discounts and commissions.

[d] Item 28. Persons Controlled by or Under Common Control. This item requires identification of persons in a control relationship with the registrant.

[e] Item 29. Number of Holders of Securities. This item requires identification as of a specified date within 90 days prior to filing as to holders of each class of the fund's securities.

[f] Item 30. Indemnification. This item requires information about indemnification of any director, officer, underwriter or affiliate. Applicable statutory provisions and rules must be noted.

[g] Item 31. Business and Other Connections of Investment Adviser. This item requires information about other businesses of the investment adviser and any of its directors, executive officers or partners.

[h] Item 32. Location of Accounts and Records. This item is self-explanatory.

[i] Item 33. Management Services. This item requires a discussion of management related services not discussed in the prospectus or in the other parts of the Statement of Additional Information.

[j] Item 34. Undertakings. This item enumerates specific undertakings the registrant must include in the registration statement.

[k] Item 35. Signatures. The form specifies the format for including signatures in the registration statement.

FOOTNOTES:

(n1)Footnote 1. A closed-end investment company need not file periodic reports on Form N-SAR if the following is included in its annual report: required information about the dividend reinvestment plan; material changes in investment objectives or policies; changes in the company's charter or by-laws that delay or prevent changes of control; changes in principal risk factors; and changes in portfolio managers.



102 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.05

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.05 Forms N-8B-2 and S-6--Unit Investment Trusts

[1] Introduction

Unit Investment Trusts are distinct from management investment companies (e.g., mutual funds and closed-end management companies) in that they are passive investment vehicles offering interest in:

- one or more underlying mutual funds; or
- a generally fixed portfolio of securities, typically municipal or corporate obligations.

Unit investment trusts of the latter type may offer units in series, each series consisting of a separate portfolio. Unit investment trusts register under the Investment Company Act by filing Form N-8B-2 and register units under the Securities Act by filing Form S-6. n1 As discussed in *Section 7B.05[5]* below, the SEC has proposed, but not adopted, Form N-7 which would permit integrated registration of unit investment trusts under the Investment Company Act and of their securities under the Securities Act. In addition to simplifying the registration process for unit investment trusts, this proposal would adopt a two-part disclosure format similar to that of Form N-1A and N-2.

[2] Coordination of the Requirements of Forms N-8B-2 and S-6

As discussed below, Form N-8B-2 requires detailed disclosure about the unit investment trust, its operations, and the offering of securities. Form S-6 requires that the same information, with a few exceptions, be in the prospectus. However, registrants generally avoid duplication by answering the items of Form N-8B-2 through incorporation by reference to information provided in Form S-6.

[3] General Instructions

[a] Form N-8B-2. The procedural and formal requirements for filing Form N-8B-2 are comparable to those contained in other forms. In some cases the general instructions have been superseded. For example, Form N-8B-2 provides, with respect to incorporation by reference, only that the answers to items 1 through 54 may be incorporated by reference to any of such items. However, other SEC rules, including Rule 411 of Regulation C and Rule 0-4 under the

Investment Company Act, permit broader incorporation by reference. As mentioned above, unit investment trust registrants do not typically fill out Form N-8B-2 completely but respond to the various items, where feasible, by incorporation of the prospectus by reference. Once filed, Form N-8B-2 does not have to be amended.

[b] Form S-6. Form S-6 consists of the facing sheet, the prospectus, a formal undertaking to file certain required information, documents and reports; a list of the papers and documents comprising the registration statement; signatures; written consents; and exhibits. Certain rule references in the general instructions to Form S-6 are out-dated. Specifically, the number of copies of the prospectus is governed by Rule 402 of Regulation C, and written consents are governed by Rules 436 through 439 and Rule 483(c).

[4] Categories of Information Required

Except as noted, the information requirements discussed below are applicable to Form N-8B-2 and Form S-6.

[a] Organization and General Information. The registration statement must include basic identifying information about the trust and each depositor, trustee, or principal underwriter therefor. In addition, the title of each class of securities issued and the state under which the trust is organized must be identified and there must be certain information about the indenture governing operation of the trust. Form N-8B-2 must include information about any name changes and the date on which the fiscal year of the trust ends. Finally, there must be disclosure as to any material litigation.

[b] General Description of Trust and Securities of Trust.

[i] General Information Concerning the Securities of the Trust and the Rights of Holders. Item 10 requires general information about the attributes of the security being offered, including rights of redemption, any voting rights, and, in the case of periodic payment plan certificates, provisions regarding lapses or defaults by security holders in making payments. There must also be disclosure of whether security holders must be given notice of or must consent to any change in the assets of the trust; the terms and conditions of the securities of the trust; the provisions of the trust indenture; and the identity of the depositor, trustee or custodian.

[ii] Information Concerning Portfolio Securities. Item 11 requires a brief description of the types of securities that comprise the corpus of the trust. Special disclosure is required if the trust owns or will own any securities of its regular brokers or dealers. n2

If the trust issues periodic payment plan certificates and invests in securities of another investment company, the following information must be provided: the name of the company; the name and address of the depositor; the principal address of the trustee or custodian; the principal address of the principal underwriter; and the period during which the securities of such company have been the underlying securities.

[iii] Information Concerning Loads, Fees, Charges, and Expenses. Item 13 requires a description of all loads, fees, expenses or charges; the amount thereof; the person to whom the payments are made and his or her relationship to the trust; and the nature of the services performed. In the case of installment payment type periodic payment plan certificates, there must be a table showing the amounts to be paid and certain expenses. In addition, there must be an explanation of any special prices offered to any group, including officers, directors or employees of the depositor, the trustee, the custodian or the principal underwriter. There must also be disclosure as to whether any person may receive profits through the sale or purchase of the trust's securities or its underlying securities. n3

[iv] Information Concerning the Operations of the Trust. Items 14 to 24 of Form N-8B-2 require a brief description of the principal characteristics and method of operation of the trust, including the functions and the duties of the depositor, principal underwriter, custodian or trustee, or other person. There must be a description of the procedures for issuance and authentication of trust securities; payment by purchasers for trust securities; acquisition and disposition

of underlying securities; withdrawal or redemption; handling of income or other funds of the trust; maintaining the books and records of the trust; and reports to security holders. There must also be a description of the major provisions of the trust indenture and of any bonding arrangement regarding the officers, directors, partners or employees of the depositor or principal underwriter.

[c] Organization, Personnel and Affiliated Persons of Depositor.

[i] Organization and Operations of Depositor. In addition to basic identifying information, the form requires a full description of all sales loads or other fees to be received by the depositor and a description of its business activities. If the depositor is involved with any investment companies, the names of those companies, their relationship, if any, to the trust, and the nature of the depositor's activities therewith must be included.

[ii] Officials and Affiliated Persons of Depositor. Extensive information is required about every officer, director, or partner of the depositor and about any 5 percent security holder of the depositor who is a natural person. The form requires disclosure of the name and principal business address of any such person and the nature of his or her relationship with the depositor. There must also be detailed disclosure of his or her ownership of securities of the depositor and of the trust. Finally, there must be a statement of his or her business experience during the last five years and information about other companies which he or she serves as officer, director or partner.

[iii] Companies Owning Securities of Depositor. If any company owns 5 percent or more of the outstanding voting securities of the depositor, there must be disclosure of the name and address of that company and detailed information about its security holdings in the depositor.

[iv] Controlling Persons. If any person, other than an officer, director or partner of the depositor, a 5 percent security holder of the depositor who is a natural person, or a company that owns 5 percent or more of the outstanding securities of the depositor controls the depositor, there must be disclosure of that person's name and address and the nature of its principal business and the basis for his or her control of the depositor.

[v] Compensation of Officers and Directors of Depositor. There must be extensive disclosure of remuneration for services paid by the depositor to its officers, partners, directors, and, in certain cases, employees. "Remuneration for services" for purposes of these requirements includes direct or indirect compensation paid for service rendered to the trust. Disclosure is required as to the three highest paid officers or partners; other officers or partners as a group; directors; and employees or other persons paid more than \$10,000 during the fiscal year.

[d] Distribution and Redemption of Securities.

[i] Distribution of Securities. There must be information about the states in which the trust's securities are sold and whether or not the trust's authority to distribute securities has ever been revoked in any state. In Form N-8B-2, but not in Form S-6, there must be disclosure of whether the trust's sales of securities have been suspended for more than a month.

In addition, there must be a general description of the method of distribution of trust securities, including the substance of any current underwriting and dealer agreements.

[ii] Information Concerning Principal Underwriter. Basic identifying information about the principal underwriter is required, as well as an indication of whether the principal underwriter is a member of the National Association of Securities Dealers. There also must be detailed disclosure of the principal underwriter's fees, including fees received by each principal underwriter from any underlying investment company or any affiliated person or investment adviser thereof. There must be a description of the general business of the principal underwriter, including its relationship with any other investment company. Form N-8B-2 must show every branch office of the underwriter selling securities and the number of individual salesmen of the underwriter through whom securities of the trust were distributed for the last fiscal year. Finally, information about ownership of securities of the trust by the principal

underwriter or its officers, directors or partners and a statement of all brokerage commissions received by any principal underwriter must be disclosed.

[iii] Offering Price. There must be information about how the offering price for trust units is determined and how the underlying securities are valued. n4 In addition, a specimen schedule showing the components of the offering price must be provided. n5

[iv] Suspension of Redemption Rights. If there was any suspension of redemption rights during the three fiscal years covered by the financial statements that must be filed with the registration statement, the circumstances thereof must be detailed.

[v] Redemption Valuation. Disclosure of how the securities of the trust are valued for purposes of withdrawal or redemption is required. Such disclosure is similar to the disclosure required for determination of the offering price.

[e] Information Concerning Trustee or Custodian. In addition to basic identifying information, there must be disclosure of the custodian's or trustee's fees and of whether the custodian or trustee may create a lien on the assets of the trust.

[f] Information Concerning Insurance of Holders of Securities. If there is any insurance covering holders of securities, there must be information about the insuring company and the terms of the policy or policies.

[g] Policy of Registrant. There must be disclosure of any policy of the trust and any provisions of the indenture governing elimination and substitution of portfolio securities. If any investment adviser or other person plays a role in such substitution or elimination, that person must be identified and there must be disclosure of any affiliation to the depositor, trustee or custodian, or principal underwriter, as well as of the remuneration to be received for such services. There must also be detailed disclosure as to any elimination of an underlying security during the last three years. Finally, a description of any fundamental policy of the trust must be provided.

[h] Tax Status. The registration statement must disclose whether the trust is a regulated investment company under Subchapter M of the Internal Revenue Code and, if not, what its taxable status is. Many unit investment trusts are treated as grantor trusts for income tax purposes and, therefore, pay no taxes on amounts distributed.

[i] Financial and Statistical Information. If the trust is not the issuer of periodic payment plan certificates, there must be a table showing, for each of the last ten years, the number of shares or units, net asset value, and dividends paid per share. If the trust is the issuer of periodic payment plan certificates, there must be detailed disclosure as to a hypothetical account with the trust.

If the trust is the issuer of periodic payment plan certificates, there must be additional disclosures in Form N-8B -2, but not in Form S-6, concerning certificates sold and terminated. Form N-8B-2 also requires financial statements prepared in accordance with Regulation S-X, including a statement of condition as of the close of the last fiscal year and statements of income and other distributable funds for three fiscal years. In addition, with respect to the depositor, there must be a balance sheet for the last fiscal year and a profit and loss statement and a statement of surplus for the fiscal year.

[j] Exhibits. Exhibits include the trust indenture; distribution related contracts; form of each type of security; certificate of incorporation or other instrument; any insurance policy; any agreement concerning an underlying investment company; all other material contracts; the form of application for a periodic payment plan certificate; notices sent to security holders pursuant to Section 19 of the Investment Company Act; and annual reports. In addition, the name and address of each dealer to or through whom securities were sold during the last fiscal year must be included.

[5] Proposed Form N-7 for UITs

In 1985, the SEC proposed Form N-7, an integrated registration form for UITs. n6 In addition to integrating disclosure and eliminating the need for two registration forms, the proposed form was designed to provide a more updated format for UIT disclosure, particularly for those organized as series companies. In response to industry criticism, the form was repropoed in 1987 n7 in a format to permit sponsors to prepare a two-part prospectus containing generic information about all series of a trust and specific information about each series. n8 To date, the SEC has not adopted the repropoed form.

FOOTNOTES:

(n1)Footnote 1. Unit investment trusts that are commencing operations benefit from certain "start-up" exemptions. *See* Rule 14a-3, Rule 19b-1 and Rule 22c-1 under the Investment Company Act.

(n2)Footnote 2. *See* Rule 10b-1 under the Investment Company Act for the definition of "regular broker or dealer."

(n3)Footnote 3. The sponsor or depositor of the trust, typically the principal underwriter, assembles the trust's portfolio and deposits it with the trustee, receiving the units of the trust in return. The sponsor bears some market risk in connection with these transactions but may realize underwriter's or dealer's profits.

(n4)Footnote 4. If the underlying securities are securities of a registered investment company, the registration statement of the trust need not duplicate disclosure about valuation that is included in the registration statement for the underlying investment company.

(n5)Footnote 5. The schedule must show a detailed breakdown of assets; liabilities and other charges; net asset value per unit; offering price; and effective sales load.

(n6)Footnote 6. *See Inv. Co. Act Rel. No. 14513, 1985 SEC LEXIS 1048, [1984 -1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,774 (May 14, 1985).*

(n7)Footnote 7. *See Inv. Co. Act Rel. No. 15612, 1987 SEC LEXIS 2420, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,109 (Mar. 9, 1987).*

(n8)Footnote 8. The repropoed form would also eliminate, under certain conditions, the need for UITs to provide annual audited financial statements in prospectuses used in secondary market transactions.



103 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.06

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.06 Form N-14: Certain Business Combinations

A merger by two investment companies involves the issuance of shares by one company (*i.e.*, the acquiring company) to the other company (*i.e.*, the target company) in exchange for the latter's assets. These shares are then distributed to the target company's shareholders in dissolution of the target company. The most common mergers involve public funds with similar investment objectives or a public fund's acquisition of a small, non-public fund. n1

Form N-14--a combined proxy statement/prospectus--is used to register shares under the Securities Act issued in connection with business combinations by management investment companies and to act as the proxy statement for soliciting approval from the target fund's shareholders. n2 Specifically, Form N-14 may be used to register securities in connection with the following transactions:

- Business combinations of the type described in Rule 145 under the Securities Act;
- A merger not requiring shareholder approval under applicable state law;
- An exchange offer;
- A public offering or resale of any securities acquired in an offering registered on Form N-14; and
- Two or more of the transactions listed above registered on one registration statement.

In addition, the SEC staff has indicated that Form N-14 is the appropriate form for registration of reorganization transactions involving variable insurance separate accounts such as the conversion (merger) of management companies into a unit investment trust separate account with an underlying fund or portfolio company. n3

Form N-14 is commonly referred to as a "merger proxy" and generally it follows the three-part approach of Form N-1A. In addition to the preparation of a registration statement and a proxy, Form N-14 requires certain financial information, numerous supporting exhibits, and filing fees, and thus many registrants seek to avoid using it, if possible. n4

The Form N-14 Combined Proxy Statement/Prospectus requires the following general categories of information:

- A synopsis of the key features of the transaction, the acquiring fund and the company being acquired, including comparisons of: advisory and other fees; investment objectives and policies; distribution and purchase procedures and exchange rights; and redemption procedures;
- Principal risks of investing in the acquiring fund as opposed to the acquired company;
- Material features of the transaction, including: summary of terms; description of securities to be issued; reasons for the transaction; federal income tax consequences to security holders; material differences between rights of security holders in the acquiring fund and the acquired company; and a table for existing and *pro forma* capitalization;
- Information about the acquiring fund, including: condensed financial information (*i.e.*, "Financial Highlights"); date, form and place of organization; classification as diversified or non-diversified; description of investment objectives and policies (*i.e.*, types of securities invested in, concentration policies, etc.); principal risk factors of an investment in the acquiring fund; management of the acquiring fund; description of the investment adviser, its services and fees; and pending legal proceedings;
- A discussion of the market conditions, investment strategies and other factors that materially affected the acquiring fund's performance during the most recently completed fiscal year and a line graph comparing the acquiring fund's performance to that of an appropriate index;
- Information about the acquiring company's securities, including: description of their nature and significant attributes; voting rights; restrictions on disposition; material obligations or potential liability; other classes of outstanding securities; dividend and distribution policy; tax consequences of purchasing the securities; procedures for purchasing the securities; procedures for calculating net asset value; imposition of any sales charges; any special purchase methods or plans (*e.g.*, a dividend reinvestment plan); and any minimum initial or subsequent investment;
- A description and information regarding any Rule 12b-1 distribution plans of the acquiring company;
- Information on the revocability of the proxy; persons making the solicitation and the method of solicitation; dissenter's appraisal rights; votes required for approval of proposals and method of counting votes; and effect of abstentions; and
- Names and addresses of controlling persons of either the acquiring company or acquired company.

Form N-14 need not be used for transactions that, while technically a reorganization or merger, do not represent a new investment. For example, when an existing fund reorganizes into a "shell" (*i.e.*, a fund with no assets other than seed capital), no Form N-14 is required. n5 In such a situation, the proxy rules under Section 20 of the Act and Regulation 14A under the Exchange Act would apply. Most importantly, the fund would not be subject to additional Securities Act filings fees, as would likely be the case if it was involved in a transaction subject to Form N-14.

Finally, Rule 488 under the Securities Act specifies automatic effectiveness procedures, analogous to those in Rule 485, discussed above, for open-end investment company registration statements filed on Form N-14. n6 In particular, under Rule 488, a registration statement filed on Form N-14 is automatically effective on the 30th day after the date it was filed or at a later date, designated by the registrant, but not later than 50 days after the registration statement was filed. The SEC staff has cautioned that if filings under Rule 488 exclude required information, such as *pro forma*, audited annual or unaudited semi-annual financial statements, the staff will suspend the automatic effectiveness. n7 An

amendment that is filed to add missing information or exhibits begins a new automatic effective date period, although the SEC staff may be willing to accelerate the effectiveness of the registration statement. n8

FOOTNOTES:

(n1)Footnote 1. Acquisitions of investment advisers and investment companies are discussed more fully in Chapter 24 of Lemke, Lins, and Smith, *above*.

(n2)Footnote 2. 17 *C.F.R.* § 230.488. For an excellent outline of the issues involved in determining when to use Form N-14, see Harman, Podesta, Berueffy, Broadwater & Tait, *Reorganizations and Acquisitions of Investment Companies*, PLI Investment Companies 227 (Aug. 3, 1992), hereinafter cited as "Harman/Podesta."

(n3)Footnote 3. See Letter from Thomas E. Neal, Assistant Chief, Office of Insurance Products and Legal Compliance, SEC, to Industry Registrants (Feb. 8, 1988).

(n4)Footnote 4. See Harman/Podesta, *above*.

(n5)Footnote 5. See Harman/Podesta, *above*.

(n6)Footnote 6. 17 *C.F.R.* § 230.488. Under Rule 488, a registration statement filed on Form N-14 becomes effective automatically on the 30th day after filing with the SEC or on a date between 30 and 50 days after filing as designated by the registrant.

(n7)Footnote 7. See Letter to Chief Financial Officers from John S. Capone, Chief Accountant, SEC Division of Investment Management (Feb. 14, 2001).

(n8)Footnote 8. See Harman/Podesta, *above*, at 238.



104 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.07

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.07 Other Investment Companies

Insurance companies offer variable annuity separate accounts that are registered as investment companies. These separate accounts are generally organized as unit investment trusts investing in underlying vehicles, typically mutual funds. A separate account organized as a unit investment trust registers on Form N-4, and a separate account organized as a management company uses Form N-3. Small business investment companies that are required to register under the Investment Company Act register their securities under the Securities Act use Form N-5. Business development companies are not required to register under the Investment Company Act, although they are regulated by that Act. They register securities under Form N-2.

[1] Variable Insurance Separate Accounts n1

[a] General. At the time Form N-1A was proposed, several commentators urged the SEC to adopt comparable forms for insurance company separate accounts offering variable annuity contracts. n2 The SEC subsequently promulgated integrated forms for these entities in 1985. n3 As a result, both the separate account and the variable annuity contracts it offers are registered on a single form.

Separate accounts organized as open-end management companies use Form N-3. n4 Based on the same three-part disclosure format as Form N-1A, Form N-3 includes a prospectus, an SAI, and other information that is required only in the registration statement filed with the SEC. The SEC has published extensive staff Guidelines for preparing registration statements on Form N-3.

The prospectus requires a concise presentation of material information about the separate account and its variable annuity contracts, including: a per-share table; a general description of the separate account and its sponsoring insurance company; the tax consequences to an investor of an investment in a variable annuity contract; and a general description of the variable annuity contracts, including the annuity options and death benefit available.

The SAI discusses in more detail items in the prospectus and other matters not in the prospectus that may be of interest to investors. For example, an SAI includes general information and history about the insurance company, brokerage allocation practices, and financial statements for the insurance company and the separate account. Finally, Part C of Form N-3 requires other information, similar to that required in Part C of Form N-1A.

Variable annuity separate accounts that are organized as unit investment trusts ("trust accounts") register on Form N-4. n5 Form N-4 follows the three-part format of Form N-3, with similar Guidelines, and requires much of the same disclosure. However, because a trust account typically invests in one or more management companies registered on Form N-1A, a Form N-4 for the annuity contract generally includes disclosure primarily relating to the contract, while the Form N-1A(s) for the underlying fund(s) contains more investment-oriented information. In recent years, administrative advantages have led almost all new variable annuity separate accounts to organize as trust accounts.

Forms N-3 and N-4 also are used by variable annuity separate accounts that fund tax-qualified pension plans but are excepted from the Act by Section 3(c)(11). n6 As is the case with Form N-1A, the SEC staff has encouraged registrants using Forms N-3 and N-4 to improve prospectuses by making them more concise, direct, and understandable. The staff has stated that a fund that chooses to make its prospectus more understandable and user-friendly, by making form and content changes, may submit a draft prospectus to the staff for informal review. n7 In 2002 the SEC adopted Form N-6, which is specifically tailored to variable life insurance.

[b] Form N-3 (Management Companies).

[i] General Requirements. Form N-3 is available for separate accounts that offer variable annuity contracts and that are organized as management investment companies under the Investment Company Act and may also be used by certain separate accounts that offer variable annuity contracts but which are not registered investment companies. The form consists of Part A (the prospectus); Part B (the Statement of Additional Information); and Part C (other information that must be filed with the SEC, but, with the exception of certain financial information, does not have to be made available to investors). The requirements of Form N-3, insofar as they relate to the operations of the separate account as an investment company, are comparable to those of Form N-1A.

[iii] Particular Disclosures About Insurance Features. Form N-3 requires considerable disclosure, particularly in the prospectus, as to the insurance aspects of the separate account. The insurance company must be identified and described, as must the types of variable annuity contracts offered pursuant to the registration statement (e.g., group, individual, single premium immediate, flexible premium deferred). The prospectus also must define special terms, such as accumulation unit, contract-owner, participant, sub-account, etc., in a glossary or index. Certain aspects of the annuity contract must be highlighted, particularly assessment of a portion of the sales load upon redemption or annuitization; assessment of a penalty tax upon withdrawal; and any revocation right, such as a ten-day free look provision. A discussion of the relationship of the separate account to the insurance company and a general description of variable annuity contracts must be included. The prospectus must discuss options during the annuity period and the death benefit, as well as all deductions from purchase payments. Certain tax aspects of the separate account must also be described.

Similar to the information required in a prospectus on Form N-1A, the Form N-3 prospectus must contain a table showing pre-accumulation unit income and capital changes. The Statement of Additional Information must have all financial statements of the separate account, as well as a two-year comparative balance sheet of the sponsoring insurance company. The remainder of the insurance company's financial statements may be placed in Part C but, whether or not such financial statements are in Part C, they must be made available to investors free of charge.

[c] Form N-4 (Unit Investment Trusts).

[i] General Requirements. Most, if not all, modern variable annuity separate accounts are organized as unit investment trusts. Form N-4 permits them to combine their registration statements under the Securities Act with their full registration statement under the Investment Company Act. n8 Form N-4 has the same three-part format as Form N-3 and Form N-1A. n9

Prospectuses of separate accounts that are unit investment trusts must, in addition to providing information comparable

to that required in Form N-3, describe the portfolio companies of the trust. The information that must be included is the name of the fund or portfolio, its type (e.g., money market fund, bond fund, balanced fund) or a brief statement of its investment objectives and its investment adviser. Separate account contract owners must receive, in addition, the prospectus for the fund or funds in which they invest.

[ii] Particular Disclosures About Insurance Features. These disclosures are comparable to those required by Form N-3.

[d] Form N-6 (Variable Life Insurance). In 2002, the SEC adopted a registration form specifically tailored to variable life insurance. n10 Form N-6 focuses on disclosure of information that is relevant to variable life investors such as premium payments, death benefits, surrenders and loans, and eliminates requirements of the prior registration forms (Form N-8B-2 under the Investment Company Act and Form S-6 under the Securities Act) that produced lengthy prospectuses and disclosure of unhelpful information. Like the Form N-4 (variable annuity) and Form N-1A (mutual fund) registration forms, Form N-6 has a two-part format: a simplified prospectus and a Statement of Additional Information (SAI).

Among other features, Form N-6 utilizes a fee table that shows all costs associated with a variable life policy, including cost of insurance charges. Costs of insurance charges are presented in two ways: (1) as a range from minimum to maximum; and (2) as the actual charge for a representative policy owner. The fee table also requires maximum charges to be shown, though a fund can disclose current charges if desired.

Form N-6 does not require hypothetical illustrations, but if included, they can appear in either the prospectus or SAI and, among other things, must be preceded by a clear and concise explanation, must show values based on three gross rates of return (zero percent, six percent and some other percentage not to exceed 12 percent), and must reflect an arithmetic average of the total expenses of all available underlying funds. Form N-6 allows the separate account's financial statements and the insurer's balance sheets to appear in the SAI with the remainder of the insurer's financial statements appearing in Part C. Further, the insurer's financial statements can be prepared in accordance with statutory requirements rather than generally accepted accounting principles (GAAP), provided that the insurer does not otherwise prepare financial statements in accordance with GAAP for its SEC filings or those of its parent.

[2] Small Business Investment Companies--Form N-5

[a] General Requirements. Form N-5 is used for Securities Act and Investment Company Act registration by any small business investment company ("SBIC") registered under the Investment Company Act. n11 Relatively few SBICs are so registered. n12

[b] Information Required for Registration Under the Investment Company Act. Part I of Form N-5 requires extensive information about the SBIC and its fundamental and other policies; financial information; information about security holders and service contractors; information about indemnification of directors and officers; information about the interest of affiliated persons in certain transactions; information about other securities; and financial statements.

[c] Information Required for Registration Under the Securities Act. Part II of Form N-5 requires incorporation of most of the information required by Part I into the prospectus. In addition, information must be included in the prospectus about the plan of distribution, underwriting commissions and compensation; use of proceeds; and sales otherwise than for cash.

[3] Business Development Companies--Form N-2

[a] General Requirements. Business development companies use Form N-2, the registration form for closed-end funds, for registering their securities. n13

[b] Special Disclosures. In addition to satisfying the requirements of Form N-2, business development companies

are required by the SEC to make additional disclosures. One area of additional disclosure is the special risk associated with investing in securities of small and developing or financially troubled business. Business development companies are also required to include disclosure comparable to that provided by operating companies pursuant to Items 301 (Selected Financial Data) and 303 (Management's Discussion and Analysis of Financial Conditions and Results of Operation) of Regulation S-K (however, business development companies need not include the per share condensed financial information required by Form N-2). In addition to the foregoing, business development companies have to make more disclosure than do closed-end funds about their portfolio companies. Also, business development companies are expected to provide enough information to demonstrate their compliance with the Investment Company Act, in the registration statement, although not necessarily in the prospectus.

FOOTNOTES:

(n1)Footnote 1. For further discussion of variable annuity accounts, *see* Lemke, Lins & Smith § 9.06.

(n2)Footnote 2. *See Inv. Co. Act Rel. No. 13436, 1983 SEC LEXIS 1030, [1983 -1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,413, at 86,154 n. 3 (Aug. 12, 1983).*

(n3)Footnote 3. *See Inv. Co. Act Rel. No. 14575, 1985 SEC LEXIS 1312, [1984 -1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,783 (June 14, 1985).*

(n4)Footnote 4. *17 C.F.R. § 274.11b.*

(n5)Footnote 5. *17 C.F.R. § 274.11c.*

(n6)Footnote 6. *See Inv. Co. Act Rel. No. 14575, 1985 SEC LEXIS 1312, [1984 -1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,783 (June 14, 1985).* Section 3(c)(11) excepts certain pension and profit-sharing plans from the Act and is discussed in § 3.07[1][k] above.

(n7)Footnote 7. *See SEC Staff Generic Comment Letter (Nov. 7, 1996).*

(n8)Footnote 8. Form N-4 is also available for certain separate accounts that offer variable annuity contracts but which are not registered investment companies. These entities have previously filed registration statements under the Securities Act on Form S-1.

(n9)Footnote 9. *See § 7B.05 below.*

(n10)Footnote 10. *See Inv. Co. Act Rel. No. 25522, 2002 SEC LEXIS 956 (Apr. 12, 2002) .*

(n11)Footnote 11. An SBIC is a company that is licensed as a small business investment company under the Small Business Investment Act of 1958 or that has received the preliminary approval of the SBA and has been notified that it may submit a license application.

(n12)Footnote 12. Many SBICs rely on Section 3(c)(1) of the Investment Company Act. *See § 7B.01[3][b] below.* In addition, Rule 3c-2 under the Investment Company Act limits applicability of the attribution rule in Section 3(c)(1) in respect of small business investment companies, and Rule 3c-3 under the Investment Company Act excludes from the definition of a public offering for purposes of Section 3(c)(1) non-convertible debt of an SBIC that is guaranteed by the SBA.

(n13)Footnote 13. Section 2(a)(48) of the Investment Company Act defines business development companies to include domestic closed-end companies organized for the purpose of investing in and offering significant managerial assistance to small, developing or financially troubled businesses. Since business development companies are not registered under the Investment Company Act, they must register their securities under the Exchange Act.



105 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 7B Registration Of Investment Company Securities

2-7B Federal Securities Act of 1933 § 7B.08

AUTHOR: Thomas P. Lemke Gerald T. Lins

§ 7B.08 Other Prospectus Disclosure Issues

One of the most significant challenges facing regulators and the fund industry is the nature and extent of the disclosure that funds should make in their prospectuses. Although SEC registration statements are fairly precise in terms of the topics that need to be covered in a prospectus, by necessity each fund generally must determine the quality and quantity of the disclosure needed to describe its unique characteristics.

Because the fund marketplace is in a constant state of flux, and because a fund itself may change or introduce new investment strategies or policies, the SEC staff has emphasized that funds cannot rely on the SEC or its staff to identify these changing areas or to assess whether, and to what extent, changes in prospectus disclosure are needed (although over the years regulators have not hesitated to require additional disclosure about areas of concern to them). n1 Rather, it is a fund's responsibility on an ongoing basis to analyze fund risk and review prospectus risk disclosure, and to update prospectus disclosure when appropriate. n2

[1] High Yield Bond Fund Disclosure

Since the 1980s, investment companies have acquired substantial amounts of non-investment grade debt securities (e.g., bonds rated lower than BBB by Standard and Poor's Corporation or lower than Baa by Moody's Investor's Service, Inc.), commonly known as "high yield" or "junk" bonds. Today there are many bond funds specializing in such securities. Periodic difficulties in the market for these securities have heightened SEC concern about the adequacy of disclosure regarding junk bond investments. To address these concerns, the SEC staff issued two letters (in 1989, and again in 1990) setting forth fairly extensive disclosure requirements for funds that invest in these instruments. n3 These Letters, along with the five other Generic Comment Letters issued by the SEC's Division of Investment Management over the years, were rescinded by the SEC as part of the 1998 Form N-1A Amendments. Although the specific conditions (e.g., percentage limitations) outlined in these Letters no longer apply, it appears the general disclosure principles announced in the Letters have been built into Form N-1A as part of the 1998 Form N-1A Amendments.

[2] Disclosure Cases

Fund disclosure cases usually involve an allegation under the Securities Act that disclosure about a matter was either misleading or insufficient.

[a] Adequacy of Comparisons. *Lucia v. Prospect Street High Income Portfolio, Inc.* n4 involved a closed-end fund whose objective was to invest in a diversified portfolio of junk bonds. The fund's shares declined due to the collapse of the junk bond market in 1989. At issue was certain disclosure in the fund's prospectus that presented favorable performance of junk bonds as compared to U.S. Treasury securities for the ten-year period prior to the initial public offering. The plaintiffs alleged that the fund's disclosure was inadequate because the fund's prospectus omitted a shorter, six-year comparison showing that U.S. Treasury securities performed better than junk bonds. The district court ruled that the prospectus' comparison to Treasury securities was not misleading.

However, the Court of Appeals concluded that because the prospectus contained the favorable ten-year comparison, a jury might determine that the unfavorable six-year comparison would have been material and that the omission of the six-year comparison might have rendered the ten-year comparison misleading. The court also stated that while a one-or two-year period favoring Treasury securities may not constitute a trend, a six-year period favoring Treasury securities is "substantial enough to cast some doubt on the reliability of the reported ten-year figure." n5

[b] Adequacy of Disclosure.

[i] Fund Risk Category. In *Tabankin v. Kemper Short-Term Global Income Fund*, n6 a district court dismissed a class action suit brought by shareholders who suffered losses when two global income funds' net asset values decreased approximately 20 percent. The plaintiffs claimed that the funds' prospectuses and sales literature misrepresented the true risks of investing in the funds, by characterizing the funds as being "conservative" and using "prudent" investment strategies when in fact the portfolio managers pursued a risky course of investment. Because the sales literature contained risk disclosure and referred the reader to the prospectuses, the court focused on the prospectus disclosure. n7

Among other things, the court found that the objective of each fund, to "provide as high a level of current income as is consistent with prudent investment management from a portfolio of high-quality money market instruments," was not misleading because, in effect, other statements in the prospectus defined the term "prudent investment management." n8 The court also found that the plaintiffs had failed to identify any material misrepresentations or omissions, and that the "total mix" of information available in the prospectuses identified the risks that came to pass.

In *Young v. Nationwide Life Insurance Co.*, n9 a district court denied the defendants' motion to dismiss a case involving policyowners who purchased variable life insurance policies and who alleged that the issuers' marketing and other materials misrepresented the nature of these policies. Specifically, the plaintiffs alleged that the variable contracts' sub-accounts (i.e., mutual funds that are the underlying investments for the contracts and are available only to policyowners and not to the public at large) were misrepresented as clones or replicas of well-known, publicly-offered retail mutual funds with the same or similar names that would track the performance of the retail funds, which they did not do.

In denying the defendants' motion, the court noted that: 1) the sub-account fund names were very nearly identical to the names of the retail funds, giving rise to potential investor confusion; 2) the initial registration statement (although subsequently amended before effectiveness) stated that two of the sub-account funds would be managed in the same style as their corresponding retail funds and would include many of the same securities; 3) some confirmation statements consistently referred to the investment as the retail fund; and 4) marketing material for the variable contracts referred to certain sub-accounts using the name of the retail funds and included performance figures for the retail funds.

[ii] Fund Investments.

[A] Unauthorized Investments. In *In re Alliance North American Government Income Trust, Inc. Securities Litigation*, n10 a district court dismissed a class action alleging inadequate disclosure filed by investors in a fund whose net asset value declined substantially when the Mexican government devalued the peso in December 1994. The court stated that the key inquiry in determining whether a prospectus is materially misleading is whether the defendant's representations, taken together and in context, would have misled a reasonable investor about the nature of the

investment. n11

Among others, the court addressed the plaintiff's claim that the fund's hedging practices and the availability of hedging devices were misrepresented. The plaintiff charged that the fund falsely reassured investors that the fund would protect itself from significant harm to its assets from currency fluctuations by using hedging techniques. The defendants countered, stating that: (1) the fund never made any assurance that it would use hedging devices (e.g., futures, options or forward contracts) to protect against currency fluctuations; and (2) the prospectus only referred to the possibility of hedging the fund's foreign investments but clearly stated there was no certainty such devices would be used. The court stated that phrasing an investment strategy in terms of possibilities, standing alone, is insufficient warning to shareholders of the risk of whether hedging devices would be used. However, the court ruled against the plaintiff, based on its finding that, in combination with other warnings contained in the prospectus and SAI, a reasonable investor should have been fully apprised of the risks that the fund would be unable to hedge effectively foreign currency risk.

On appeal, the Second Circuit Court of Appeals agreed that the fund's representations concerning the availability of hedging devices, taken together and in context, could have misled a reasonable investor. According to the court, cautionary language in the prospectus warned only that the fund's hedging maneuvers might fail, not that the fund would have no opportunity to use hedging maneuvers under the economic conditions then prevailing. On remand, the district court granted the fund's motion for summary judgment, finding that plaintiff's assertion that the fund had no opportunity to use hedging maneuvers was untenable.

[B] Mortgage-Backed Securities. In *Schaefer v. Overland Express Family of Funds* n12 the plaintiffs alleged that a mutual fund's investments in collateralized mortgage obligations ("CMOs") were based on false and misleading prospectus disclosure. Specifically, the plaintiffs claimed the fund failed to disclose that it could sell CMOs and incur a permanent loss, or that the fund's investments bore, among others, liquidity risk (the risk that CMO values, and their marketability, become impaired if interest rates rise), and extension risk (the possibility that rising interest rates may cause prepayments of underlying mortgages to occur at a slower than expected rate, thereby causing shorter-term securities to convert to longer-term securities that have greater price fluctuations).

In dismissing the plaintiffs' claims, the district court concluded that the alleged omissions and misrepresentations, when compared to the prospectus's risk disclosures, were immaterial under the "bespeaks caution" doctrine. n13 In particular, the court noted that the prospectus had warned of the risks of principal loss and that the fund had the ability to sell securities at a loss. The court also pointed out that disclosure of the fund's annual turnover rate of up to 250 percent put the plaintiffs on notice that the fund would be buying and selling securities (including CMOs). Moreover, the court reasoned that the possibility that a fund might and would sell certain securities at a loss is a fact that any reasonable investor would know and even presume. As to the allegations of inadequate disclosure about specific types of interest rate risk, the court concluded that such disclosure was immaterial because the alleged omitted risks are merely a subset of the primary risk attendant with these types of investments: namely, interest rate risk. The court noted that the fund's prospectus disclosed in detail the risks associated with interest rate fluctuations and limitations on interest rate adjustments, including the affect interest rate caps and adjustable rates have on the value of CMOs. n14

In *In re TCW/DW North American Government Income Trust Securities Litigation*, n15 shareholders of an open-end mutual fund brought a class action alleging that the defendants' prospectus was misleading. The plaintiffs claimed that, with respect to the fund's investments in mortgage-backed securities, the prospectus failed to alert investors of "extension risk" and the effect it might have on the fund's policy of generally maintaining a market value dollar-weighted average portfolio life of no greater than three years.

The defendants sought to dismiss the complaint on the basis that, even though the term "extension risk" was not used, the prospectus disclosed the nature, causes and consequences of such risk and that the prospectus "bespoke caution" about the various risks arising from a change in interest rates. The court held that the extension risk disclosure could be important to a reasonable investor and, therefore, dismissed the defendants' motion to dismiss. The court explained that

even though the prospectus disclosed the fact that prepayments may slow when interest rates rise, the prospectus did not disclose the consequences of this statement--namely, that this event could change a short-term security into a longer-term security with the potential for greater price fluctuation. n16 In the court's view, extension risk is apparently limited to, and therefore relevant to a discussion about, mortgage-backed securities.

In *Sheppard v. TCW/DW Term Trust 2000*, n17 the court granted a defendant's motion to dismiss a class action suit brought against a closed-end fund alleging inadequate disclosure about the extent of the fund's reliance on mortgage-backed securities and the magnitude of the risk related to an increase in interest rates. The court found the prospectus to be adequate, warning potential investors of a rise in interest rates--the very risk that came to pass.

In *Olkey v. Hyperion 1999 Term Trust, Inc.*, n18 plaintiffs appealed a lower court's dismissal of their class action against a group of closed-end investment companies investing primarily in mortgage-backed securities. The plaintiffs claimed that the defendants had misstated the fund's investment strategy by purporting to design a balanced portfolio that would attempt to remain interest rate-neutral, when in fact the portfolio favored rising interest rates. The plaintiffs also claimed that the defendants had failed to disclose the limitations of the use of mortgage-backed securities, which tend to go down when interest rates go up, as a hedge against investments in interest-only strips of mortgages ("IOs"), which tend to go up with interest rates, when rates decline. Finally, the plaintiffs claimed that the defendants had misrepresented the riskiness of the funds in "roadshow" presentations given to potential broker-dealers. During the period of time in which the misrepresentations were alleged to occur, interest rates declined to historic lows, resulting in a drop in the value of the funds' shares.

The appellate court affirmed dismissal of each of the plaintiffs' claims, concluding that when cautionary language contained in the prospectus is read together, the prospectus disclosure "bespeaks caution."

The court also found that, although not disclosed expressly, the prospectus implicitly and clearly communicated a bias in favor of rising interest rates. The court noted extensive prospectus disclosure about the nature and risks of mortgage-backed securities, including disclosure clearly indicating that, unlike traditional debt securities, a drop in interest rates may have a negative affect on the value of mortgage-backed securities (as well as increasing price and yield volatility) because of the likely increase in prepayment rates.

Based on this disclosure taken as a whole, the court determined a reasonable investor would have concluded that the investment objectives could only be achieved if interest rates rose more than they fell. Regarding the claim of inadequate hedging strategy disclosure, the court referenced prospectus disclosure, under the heading "Risk Factors," that precisely described the scenario that occurred. Furthermore, the court concluded that the representations made at "roadshows" were immaterial because they were contradicted by the plain and prominently displayed language in the prospectuses.

Finally, implying that the plaintiffs appeared to have brought suit merely because their investments had turned out badly, the court stated that the fact that a fund's investment manager makes a wrong call on the direction of the markets is not, in and of itself, a basis for a federal securities law claim. n19

In *In re Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Service Corporation*, n20 a SEC administrative law judge, among others, found in an initial decision that respondents violated the antifraud provisions of the federal securities laws by marketing shares of a government bond fund as a safe, stable investment when in fact the fund was invested heavily in volatile inverse floating collateralized mortgage obligations that exposed the fund to significant losses when interest rates rose in 1994. The Fundamental U.S. Government Strategic Income Fund (the "Fund") is a no-load, open-end mutual fund created in early 1992. According to the Fund's original prospectus, and the way in which the Fund was marketed, the Fund's investment objective was designed to achieve high current income with minimum risk of principal and relative stability of net asset value. The prospectus further disclosed that the Fund would seek its objective by investing in securities issued or guaranteed by the U.S. Government having high current

yields, and by limiting the duration of the Fund's portfolio to three years or less through hedging, including investments and options. The sales brochures for the Fund emphasized safety, containing for example statements in large, boldface type such as "Earn High Yields With Maximum Safety" and frequent references to the safety of U.S. Government securities. The Fund's three-year duration was emphasized as well as an important means for reducing volatility caused by interest rate fluctuations.

Faced with poor performance, the Fund's management caused the Fund to invest up to approximately 30 percent of the Fund's assets in inverse floaters, for the period from approximately March 1993 through 1994. Although these investments initially had a positive impact on the Fund's performance, in February 1994, when the Federal Reserve Board raised interest rates, the Fund's investment in inverse floaters (the coupon for which decreases as interest rates increase) contributed significantly to an approximate 32 percent drop in the Fund's net asset value. Prior to May 1994, the Fund's prospectus did not contain any risk disclosure concerning inverse floaters.

The administrative law judge found that, as a result of the Fund's inverse floater investments, the Fund's duration materially exceeded what was represented as the safe, stable figure of three, and that the standard the Fund's management used to determine duration did not measure the interest rate volatility of the Fund's portfolio, a fact known to management. The judge also found that, contrary to the prospectus, the Fund was unable to hedge the Fund's inverse floater investments using futures and options. Because the Fund's management could not quantify the sensitivity of floaters to the changes in interest rates and prepayments, the management could not determine the proper hedge position. Notwithstanding, the Fund's management knowingly continued to use misleading sales materials to market the Fund that emphasized high returns with maximum safety, supported by the claim of the Fund's three-year duration level. Based on these findings, the judge ordered the respondents to cease and desist from violations of the antifraud provisions, barred the named individual from association with an investment adviser or broker-dealer, revoked the investment adviser and broker-dealer registrations of the two registered entities and fined the individual \$250,000 and the two other respondents \$500,000 each.

[iii] Conversion of a Closed-End Fund to an Open-End Fund. In *Finkel v. Putnam Convertible Opportunities and Income Trust*,ⁿ²¹ the district court denied a plaintiff's motion to reargue the court's earlier dismissal of a suit alleging that a closed-end fund's prospectus essentially guaranteed that the fund would commence a share repurchase program or put the issue of converting to an open-end fund to shareholder vote in certain circumstances.

Because the fund's prospectus provided that the fund merely will consider conversion and warned that the fund has no present intention of taking such actions, the court found that no reasonable investor would have believed the prospectus to guarantee either that a share repurchase program would be recommended or that a shareholder vote to convert would occur.ⁿ²²

One of the most significant challenges facing regulators and the fund industry is the nature and extent of the disclosure that funds should make in their prospectuses. Although SEC registration statements are fairly precise in terms of the topics that need to be covered in a prospectus, by necessity each fund generally must determine the quality and quantity of the disclosure needed to describe its unique characteristics.

Because the fund marketplace is in a constant state of flux, and because a fund itself may change or introduce new investment strategies or policies, the SEC staff has emphasized that funds cannot rely on the SEC or its staff to identify these changing areas or to assess whether, and to what extent, changes in prospectus disclosure are needed (although over the years regulators have not hesitated to require additional disclosure about areas of concern to them).ⁿ²³ Rather, it is a fund's responsibility on an ongoing basis to analyze fund risk and review prospectus risk disclosure, and to update prospectus disclosure when appropriate.ⁿ²⁴

FOOTNOTES:

(n1)Footnote 1. See Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, SEC, to

Investment Company Registrants (Feb. 3, 1995) [hereinafter cited as "1995 Generic Comment Letter"].

(n2)Footnote 2. *Id.*

(n3)Footnote 3. *See* Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, SEC to Investment Company Registrants (Oct. 3, 1989); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, SEC to Matthew B. Fink, General Counsel, Investment Company Institute (Feb. 23, 1990).

In a 1990 letter to funds, the staff stated that, in light of the substantial decline in high-yield bond prices during the preceding weeks, the staff believed it would be misleading for a fund whose yield reflected a substantial risk premium to promote the sale of fund shares without providing a thorough explanation of the reason for the high yields. *See* Letter from Gene A. Gohlke, Acting Director, Division of Investment Management, SEC, to Investment Company Registrants (Oct. 16, 1990). The staff observed that the higher yields resulting from these price declines reflected the risk of principal loss rather than the income stream that investors could expect. The staff expressed concern that bond fund investors might make investment decisions by comparing junk bond yields to those of bank instruments, money market funds, and funds investing in investment grade debt and suggested, among other things, that junk bond funds that use advertisements consider excluding yield quotations or prominently accompanying them with an explanation of the limitations and risks involved. *See* Letter from Gene A. Gohlke, Acting Director, Division of Investment Management, SEC, to Investment Company Registrants (Oct. 16, 1990).

(n4)Footnote 4. *36 F.3d 170 (1st Cir. 1994)* .

(n5)Footnote 5. *Id.* at 176 .

(n6)Footnote 6. 1994 U.S. Dist. LEXIS 965 (N.D. Ill. Jan. 31, 1994) [hereinafter cited as "Tabankin"].

(n7)Footnote 7. With respect to the supplemental sales literature, the court held that failure to disclose material information in sales literature is not a fraud if that information is contained in the prospectus. *Tabankin*, 1994 U.S. Dist. LEXIS 965, at *10 (*citing Eckstein v. Balcors Film Investors*, 8 F.3d 1121 (7th Cir. 1993)).

(n8)Footnote 8. *Tabankin* , *above*. In sum, the court held:

It is not tenable to base a securities fraud claim on a general statement of the Fund's objective when the Prospectus clearly states that there is no assurance that the objective will be achieved, goes on to list specific risks associated with the particular Fund, and the plaintiffs' loss results from those very risks.

Id. at *13.

(n9)Footnote 9. *2 F. Supp. 2d 914, 1998 U.S. Dist. LEXIS 6203 (S.D. Tex. Apr. 27, 1998)* .

(n10)Footnote 10. 1996 U.S. Dist. LEXIS 14209 (S.D.N.Y. Sept. 26, 1996) . This court, for the same reasons it dismissed the original complaint, subsequently denied the plaintiffs' motion for leave to file an amended complaint. *See In re Alliance N. Am. Gov't Income Trust, Inc. Sec. Litig.*, 1997 U.S. Dist. LEXIS 10344 (S.D.N.Y. July 18, 1997) , *aff'd in part and rev'd in part*, *Robert B. Hunt, IRA v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 1998 U.S. App. LEXIS 26065 (2d Cir. Oct. 15, 1998) .

(n11)Footnote 11. *Id.* at *8 (*citing McMahan & Co. v. Warehouse Entertainment, Inc.*, 900 F.2d 576, 579 (2d Cir. 1991) , *cert. denied*, 501 U.S. 1249, 111 S. Ct. 2887, 115 L. Ed. 2d 1052 (1991)).

(n12)Footnote 12. *169 F.R.D. 124 (S.D. Cal. Oct. 24, 1995)* .

(n13)Footnote 13. Under the "bespeaks caution" doctrine, a court may rule that as a matter of law the defendant's

forward-looking representations--if qualified by specific cautionary language--are not material.

(n14)Footnote 14. On this point, the court stated:

[N]o fund prospectus can begin to describe all the myriad risks to which investments may be subject. To require lengthy, extensive and detailed disclosures of every potential risk an investor faces would be to encourage excessive and possibly mind-numbing disclosures that lose their informative value in the eyes of the market place and the investor. Too much disclosure would be as much of an evil as too little.

(n15)Footnote 15. 941 F. Supp. 326 (S.D.N.Y. May 8, 1996) [hereinafter cited as "TCW"].

(n16)Footnote 16. *But cf.* 169 F.R.D. 124 (S.D. Cal. Oct. 24, 1995) [hereinafter cited as "Schaefer"] (where the Southern District Court of California granted, on very similar facts, defendant's motion to dismiss on the issue of whether failure to disclose extension risk in the fund's prospectus was a material omission). *Cf. also* *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F. 3d 2 (2nd Cir. 1996) [hereinafter cited as "Hyperion 1999 Term Trust"]. Based on the decision in *Hyperion 1999 Term Trust*, a Second Circuit decision affirming the dismissal of a complaint against another mortgage-backed securities fund involving alleged inadequate risk disclosure (discussed below), the TCW court considered, but denied, a renewed motion to dismiss the TCW class action. *See In re TCW/DW North American Government Income Trust Securities Litigation* (S.D.N.Y. 1997). The TCW court distinguished the facts of this case from the facts in *Hyperion 1999 Term Trust* and *Schaefer*, concluding that extension risk disclosure was more important in TCW than in the other two cases because of the TCW fund's policy of maintaining a portfolio of securities with a short average life. The court stated that it could be a material omission to fail to disclose that a fund expecting to maintain a portfolio of short-term securities could, during a time of rising interest rates, have a portfolio of securities with a much longer life.

(n17)Footnote 17. 938 F. Supp. 171 (S.D.N.Y. Aug. 16, 1996) . *But cf.* TCW, *above*, and accompanying text.

(n18)Footnote 18. *See.* *Hyperion 1999 Term Trust* , *above*. *But cf.* TCW, *above*, and accompanying text.

(n19)Footnote 19. *See* *Hyperion 1999 Term Trust* , *above*, at 8-9.

(n20)Footnote 20. Adm. Pro. File No. 3-9461, 2001 SEC Lexis 156 (Jan. 29, 2001) . *See also* Chapter 19.02[6][b] of Lemke, Lins, and Smith, *above* (discussion of NASD action against Fundamental Service Corporation for the use of misleading mutual fund advertising).

(n21)Footnote 21. 1997 U.S. Dist. LEXIS 9420 (S.D.N.Y. July 3, 1997) .

(n22)Footnote 22. The court relied on the Second Circuit's decision in *Hyperion 1999 Term Trust*, *above*, at 9 (misleading disclosure claims should be dismissed if they are contradicted by disclosures made on the face of the prospectus).

(n23)Footnote 23. *See* 1995 Generic Comment Letter, *above*.

(n24)Footnote 24. *See* 1995 Generic Comment Letter, *above*.



106 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 7B Investment Company Act Forms

2-7B Federal Securities Act of 1933 APPENDIX 7B.syn

§ 7B.syn Synopsis to Appendix 7B: Investment Company Act Forms

FORM N-1A

GENERAL INSTRUCTIONS

PART A INFORMATION REQUIRED IN A PROSPECTUS

PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION

PART C OTHER INFORMATION

SIGNATURES



107 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 7B Investment Company Act Forms

2-7B Federal Securities Act of 1933 Scope

FORM N-1A

OMB APPROVAL

OMB Num-
ber:.....3235-030
7

Ex-
pires:.....Novemb
er 30, 2010

Estimated average burden
hours per re-
sponse..... 657.0

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM N-1A

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933 ☐

Pre-Effective Amendment No. ☐

Post-Effective Amendment No. ☐

and/or

REGISTRATION STATEMENT UNDER THE INVESTMENT COMPANY
ACT OF 1940 ☐

2-7B Federal Securities Act of 1933 Scope

Amendment No. _____ ☐

(Check appropriate box or boxes.)

(Exact Name of Registrant as Specified in
Charter)

(Address of Principal Executive Offices)

(Zip Code)

Registrant's Telephone Number, including Area
Code

(Name and Address of Agent for Service)

Approximate Date of Proposed Public Offer-
ing

It is proposed that this filing will become effective (check appropriate box)

☐ immediately upon filing pursuant to paragraph (b)

☐ on (date) pursuant to paragraph (b)

☐ 60 days after filing pursuant to paragraph (a)(1)

☐ on (date) pursuant to paragraph (a)(1)

☐ 75 days after filing pursuant to paragraph (a)(2)

☐ on (date) pursuant to paragraph (a)(2) of rule 485.

If appropriate, check the following box:

☐ this post-effective amendment designates a new effective date for a previously filed post-effective amendment.

Omit from the facing sheet reference to the other Act if the Registration Statement or amendment is filed under only one of the Acts. Include the "Approximate Date of Proposed Public Offering" and "Title of Securities Being Registered" only where securities are being registered under the Securities Act of 1933.

Form N-1A is to be used by open-end management investment companies, except insurance company separate accounts and small business investment companies licensed under the United States Small Business Administration, to register under the Investment Company Act of 1940 and to offer their shares under the Securities Act of 1933. The Commission has designed Form N-1A to provide investors with information that will assist them in making a decision about

2-7B Federal Securities Act of 1933 Scope

investing in an investment company eligible to use the Form. The Commission also may use the information provided on Form N-1A in its regulatory, disclosure review, inspection, and policy making roles.

A Registrant is required to disclose the information specified by Form N-1A, and the Commission will make this information public. A Registrant is not required to respond to the collection of information contained in Form N-1A unless the Form displays a currently valid Office of Management and Budget ("OMB") control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to Secretary, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549-1090. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. § 3507.



108 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 7B Investment Company Act Forms

2-7B Federal Securities Act of 1933 Scope

GENERAL INSTRUCTIONS

A. Definitions

References to sections and rules in this Form N-1A are to the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq.*] (the "Investment Company Act"), unless otherwise indicated. Terms used in this Form N-1A have the same meaning as in the Investment Company Act or the related rules, unless otherwise indicated. As used in this Form N-1A, the terms set out below have the following meanings:

"Class" means a class of shares issued by a Multiple Class Fund that represents interests in the same portfolio of securities under rule 18f-3 [17 CFR 270.18f-3] or under an order exempting the Multiple Class Fund from sections 18(f), 18(g), and 18(i) [15 U.S.C. 80a-18(f), 18(g), and 18(i)].

"Exchange-Traded Fund" means a Fund or Class, the shares of which are traded on a national securities exchange, and that has formed and operates pursuant to an exemptive order granted by the Commission or in reliance on an exemptive rule adopted by the Commission.

"Fund" means the Registrant or a separate Series of the Registrant. When an item of Form N-1A specifically applies to a Registrant or a Series, those terms will be used.

"Market Price" refers to the last reported sale price at which Exchange-Traded Fund shares trade on the principal U.S. market on which the Fund's shares are traded during a regular trading session or, if it more accurately reflects the current market value of the Fund's shares at the time the Fund uses to calculate its net asset value, a price within the range of the highest bid and lowest offer on the principal U.S. market on which the Fund's shares are traded during a regular trading session.

"Master-Feeder Fund" means a two-tiered arrangement in which one or more Funds (each a "Feeder Fund") holds shares of a single Fund (the "Master Fund") in accordance with section 12(d)(1)(E) [15 U.S.C. 80a-12(d)(1)(E)].

"Money Market Fund" means a Fund that holds itself out as money market fund and meets the maturity, quality, and diversification requirements of rule 2a-7 [17 CFR 270.2a-7].

"Multiple Class Fund" means a Fund that has more than one Class.

2-7B Federal Securities Act of 1933 Scope

"Registrant" means an open-end management investment company registered under the Investment Company Act.

"SAI" means the Statement of Additional Information required by Part B of this Form.

"Securities Act" means the Securities Act of 1933 [15 U.S.C. 77a *et seq.*].

"Securities Exchange Act" means the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq.*].

"Series" means shares offered by a Registrant that represent undivided interests in a portfolio of investments and that are preferred over all other series of shares for assets specifically allocated to that series in accordance with rule 18f-2(a) [17 CFR 270.18f-2(a)].

B. Filing and Use of Form N-1A

1. What is Form N-1A used for?

Form N-1A is used by Funds, except insurance company separate accounts and small business investment companies licensed under the United States Small Business Administration, to file:

(a) An initial registration statement under the Investment Company Act and amendments to the registration statement, including amendments required by rule 8b-16 [17 CFR 270.8b-16];

(b) An initial registration statement under the Securities Act and amendments to the registration statement, including amendments required by section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)]; or

(c) Any combination of the filings in paragraph (a) or (b).

2. What is included in the registration statement?

(a) For registration statements or amendments filed under both the Investment Company Act and the Securities Act or only under the Securities Act, include the facing sheet of the Form, Parts A, B, and C, and the required signatures.

(b) For registration statements or amendments filed only under the Investment Company Act, include the facing sheet of the Form, responses to all Items of Parts A (except Items 1, 2, 3, 4 and 13), B, and C (except Items 28(e) and (i) - (k)), and the required signatures.

3. What are the fees for Form N-1A?

No registration fees are required with the filing of Form N-1A to register as an investment company under the Investment Company Act or to register securities under the Securities Act. See section 24(f) [15 U.S.C. 80a-24f-2] and related rule 24f-2 [17 CFR 270.24f-2].

4. What rules apply to the filing of a registration statement on Form N-1A?

(a) For registration statements and amendments filed under both the Investment Company Act and the Securities Act or only under the Securities Act, the general rules regarding the filing of registration statements in Regulation C under the Securities Act [17 CFR 230.400 - 230.497] apply to the filing of Form N-1A. Specific requirements concerning Funds appear in rules 480 - 485 and 495 - 497 of Regulation C.

(b) For registration statements and amendments filed only under the Investment Company Act, the general provisions in rules 8b-1 - 8b-33 [17 CFR 270.8b-1 - 270.8b-33] apply to the filing of Form N-1A.

(c) The plain English requirements of rule 421 under the Securities Act [17 CFR 230.421] apply to prospectus disclosure in Part A of Form N-1A. The information required by Items 2 through 8 must be provided in plain English under rule 421(d) under the Securities Act.

(d) Regulation S-T [17 CFR 232.10 - 232.903] applies to all filings on the Commission's Electronic Data Gathering, Analysis, and Retrieval system ("EDGAR").

C. Preparation of the Registration Statement**1. Administration of the Form N-1A requirements:**

(a) The requirements of Form N-1A are intended to promote effective communication between the Fund and prospective investors. A Fund's prospectus should clearly disclose the fundamental characteristics and investment risks of the Fund, using concise, straightforward, and easy to understand language. A Fund should use document design techniques that promote effective communication. The prospectus should emphasize the Fund's overall investment approach and strategy.

(b) The prospectus disclosure requirements in Form N-1A are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters. The prospectus should help investors to evaluate the risks of an investment and to decide whether to invest in a Fund by providing a balanced disclosure of positive and negative factors. Disclosure in the prospectus should be designed to assist an investor in comparing and contrasting the Fund with other funds.

(c) Responses to the Items in Form N-1A should be as simple and direct as reasonably possible and should include only as much information as is necessary to enable an average or typical investor to understand the particular characteristics of the Fund. The prospectus should avoid: including lengthy legal and technical discussions; simply

2-7B Federal Securities Act of 1933 Scope

restating legal or regulatory requirements to which Funds generally are subject; and disproportionately emphasizing possible investments or activities of the Fund that are not a significant part of the Fund's investment operations. Brevity is especially important in describing the practices or aspects of the Fund's operations that do not differ materially from those of other investment companies. Avoid excessive detail, technical or legal terminology, and complex language. Also avoid lengthy sentences and paragraphs that may make the prospectus difficult for many investors to understand and detract from its usefulness.

(d) The requirements for prospectuses included in Form N-1A will be administered by the Commission in a way that will allow variances in disclosure or presentation if appropriate for the circumstances involved while remaining consistent with the objectives of Form N-1A.

2. Form N-1A is divided into three parts:

(a) *Part A.* Part A includes the information required in a Fund's prospectus under section 10(a) of the Securities Act. The purpose of the prospectus is to provide essential information about the Fund in a way that will help investors to make informed decisions about whether to purchase the Fund's shares described in the prospectus. In responding to the Items in Part A, avoid cross-references to the SAI or shareholder reports. Cross-references within the prospectus are most useful when their use assists investors in understanding the information presented and does not add complexity to the prospectus.

(b) *Part B.* Part B includes the information required in a Fund's SAI. The purpose of the SAI is to provide additional information about the Fund that the Commission has concluded is not necessary or appropriate in the public interest or for the protection of investors to be in the prospectus, but that some investors may find useful. Part B affords the Fund an opportunity to expand discussions of the matters described in the prospectus by including additional information that the Fund believes may be of interest to some investors. The Fund should not duplicate in the SAI information that is provided in the prospectus, unless necessary to make the SAI comprehensible as a document independent of the prospectus.

(c) *Part C.* Part C includes other information required in a Fund's registration statement.

3. Additional Matters:

(a) *Organization of Information.* Organize the information in the prospectus and SAI to make it easy for investors to understand. Notwithstanding rule 421(a) under the Securities Act regarding the order of information required in a prospectus, disclose the information required by Items 2 through 8 in numerical order at the front of the prospectus. Do not precede these Items with any other Item except the Cover Page (Item 1) or a table of contents meeting the requirements of rule 481(c) under the Securities Act. Information that is included in response to Items 2 through 8 need not be repeated elsewhere in the prospectus. Disclose the information required by Item 12 (Distribution Arrangements) in one place in the prospectus.

2-7B Federal Securities Act of 1933 Scope

(b) *Other Information.* A Fund may include, except in response to Items 2 through 8, information in the prospectus or the SAI that is not otherwise required. For example, a Fund may include charts, graphs, or tables so long as the information is not incomplete, inaccurate, or misleading and does not, because of its nature, quantity, or manner of presentation, obscure or impede understanding of the information that is required to be included. Items 2 through 8 may not include disclosure other than that required or permitted by those Items.

(c) *Use of Form N-1A by More Than One Registrant, Series, or Class.* Form N-1A may be used by one or more Registrants, Series, or Classes.

(i) When disclosure is provided for more than one Fund or Class, the disclosure should be presented in a format designed to communicate the information effectively. Except as required by paragraph (c)(ii) for Items 2 through 8, Funds may order or group the response to any Item in any manner that organizes the information into readable and comprehensible segments and is consistent with the intent of the prospectus to provide clear and concise information about the Funds or Classes. Funds are encouraged to use, as appropriate, tables, side-by-side comparisons, captions, bullet points, or other organizational techniques when presenting disclosure for multiple Funds or Classes.

(ii) Paragraph (a) requires Funds to disclose the information required by Items 2 through 8 in numerical order at the front of the prospectus and not to precede Items 2 through 8 with other information. Except as permitted by paragraph (c)(iii), a prospectus that contains information about more than one Fund must present all of the information required by Items 2 through 8 for each Fund sequentially and may not integrate the information for more than one Fund together. That is, a prospectus must present all of the information for a particular Fund that is required by Items 2 through 8 together, followed by all of the information for each additional Fund, and may not, for example, present all of the Item 2 (Risk/Return Summary: Investment Objectives/Goals) information for several Funds followed by all of the Item 3 (Risk/Return Summary: Fee Table) information for several Funds. If a prospectus contains information about multiple Funds, clearly identify the name of the relevant Fund at the beginning of the information for the Fund that is required by Items 2 through 8. A Multiple Class Fund may present the information required by Items 2 through 8 separately for each Class or may integrate the information for multiple Classes, although the order of the information must be as prescribed in Items 2 through 8. For example, the prospectus may present all of the Item 2 (Risk/Return Summary: Investment Objectives/Goals) information for several Classes followed by all of the Item 3 (Risk/Return Summary: Fee Table) information for the Classes, or may present Items 2 and 3 for each of several Classes sequentially. Other presentations of multiple Class information also would be acceptable if they are consistent with the Form's intent to disclose the information required by Items 2 through 8 in a standard order at the beginning of the prospectus. For a Multiple Class Fund, clearly identify the relevant Classes at the beginning of the Items 2 through 8 information for those Classes.

(iii) A prospectus that contains information about more than one Fund may integrate the information required by any of Items 6 through 8 for all of the Funds together, provided that the information contained in any Item that is integrated is identical for all Funds covered in the prospectus. If the information required by any of Items 6 through 8 is integrated pursuant to this paragraph, the integrated information should be presented immediately following the separate presentations of Item 2 through 8 information for individual Funds. In addition, include a statement containing the following information in each Fund's separate presentation of Item 2 through 8 information, in the location where the integrated information is omitted: "For important information about [purchase and sale of fund shares,] [tax

information,] and [financial intermediary compensation], please turn to [identify section heading and page number of prospectus]."

(d) *Modified Prospectuses for Certain Funds.*

(i) A Fund may modify or omit, if inapplicable, the information required by Items 6, 11(b)-(d) and 12(a)(2)-(5) for funds used as investment options for:

(A) a defined contribution plan that meets the requirements for qualification under section 401(k) of the Internal Revenue Code (26 U.S.C. 401(k));

(B) a tax-deferred arrangement under sections 403(b) or 457 of the Internal Revenue Code (26 U.S.C. 403(b) and 457); and

(C) a variable contract as defined in section 817(d) of the Internal Revenue Code (26 U.S.C. 817(d)), if covered in a separate account prospectus.

(ii) A Fund that uses a modified prospectus under Instruction (d)(i) may:

(A) alter the legend required on the back cover page by Item 1(b)(1) to state, as applicable, that the prospectus is intended for use in connection with a defined contribution plan, tax-deferred arrangement, or variable contract; and

(B) modify other disclosure in the prospectus consistent with offering the Fund as a specific investment option for a defined contribution plan, tax-deferred arrangement, or variable contract.

(iii) A Fund may omit the information required by Items 4(b)(2)(iii)(B) and (C) and 4(b)(2)(iv) if the Fund's prospectus will be used exclusively to offer Fund shares as investment options for one or more of the following:

(A) a defined contribution plan that meets the requirements for qualification under section 401(k) of the Internal Revenue Code (26 U.S.C. 401(k)), a tax-deferred arrangement under section 403(b) or 457 of the Internal Revenue Code (26 U.S.C. 403(b) or 457), a variable contract as defined in section 817(d) of the Internal Revenue Code (26 U.S.C. 817(d)), or a similar plan or arrangement pursuant to which an investor is not taxed on his or her investment in

the Fund until the investment is sold; or

(B) persons that are not subject to the federal income tax imposed under section 1 of the Internal Revenue Code (26 U.S.C. 1), or any successor to that section.

(iv) A Fund that omits information under Instruction (d)(iii) may alter the legend required on the back cover page by Item 1(b)(1) to state, as applicable, that the prospectus is intended for use in connection with a defined contribution plan, tax-deferred arrangement, variable contract, or similar plan or arrangement, or persons described in Instruction (d)(iii)(B).

(e) *Dates.* Rule 423 under the Securities Act [17 CFR 230.423] applies to the dates of the prospectus and the SAI. The SAI should be made available at the same time that the prospectus becomes available for purposes of rules 430 and 460 under the Securities Act [17 CFR 230.430 and 230.460].

(f) *Sales Literature.* A Fund may include sales literature in the prospectus so long as the amount of this information does not add substantial length to the prospectus and its placement does not obscure essential disclosure.

D. Incorporation by Reference

1. Specific rules for incorporation by reference in Form N-1A:

(a) A Fund may not incorporate by reference into a prospectus information that Part A of this Form requires to be included in a prospectus, except as specifically permitted by Part A of the Form.

(b) A Fund may incorporate by reference any or all of the SAI into the prospectus (but not to provide any information required by Part A to be included in the prospectus) without delivering the SAI with the prospectus.

(c) A Fund may incorporate by reference into the SAI or its response to Part C, information that Parts B and C require to be included in the Fund's registration statement.

2. General Requirements:

All incorporation by reference must comply with the requirements of this Form and the following rules on incorporation by reference: rule 10(d) of Regulation S-K under the Securities Act [17 CFR 229.10(d)] (general rules on incorporation by reference, which, among other things, prohibit, unless specifically required by this Form, incorporating by reference a document that includes incorporation by reference to another document, and limits incorporation to

2-7B Federal Securities Act of 1933 Scope

documents filed within the last 5 years, with certain exceptions); rule 411 under the Securities Act [17 CFR 230.411] (general rules on incorporation by reference in a prospectus); rule 303 of Regulation S-T [17 CFR 232.303] (specific requirements for electronically filed documents); and rules 0-4, 8b-23 and 8b-32 [17 CFR 270.0-4, 270.8b-23 and 270.8b-32] (additional rules on incorporation by reference for Funds).



109 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 7B Investment Company Act Forms

2-7B Federal Securities Act of 1933 PART A

PART A INFORMATION REQUIRED IN A PROSPECTUS

Item 1. Front and Back Cover Pages

(a) *Front Cover Page.* Include the following information, in plain English under rule 421(d) under the Securities Act, on the outside front cover page of the prospectus:

(1) The Fund's name and the Class or Classes, if any, to which the prospectus relates.

(2) The exchange ticker symbol of the Fund's shares or, if the prospectus relates to one or more Classes of the Fund's shares, adjacent to each such Class, the exchange ticker symbol of such Class of the Fund's shares. If the Fund is an Exchange-Traded Fund, also identify the principal U.S. market or markets on which the Fund shares are traded.

(3) The date of the prospectus.

(4) The statement required by rule 481(b)(1) under the Securities Act.

Instruction. A Fund may include on the front cover page a statement of its investment objectives, a brief (*e.g.*, one sentence) description of its operations, or any additional information, subject to the requirement set out in General Instruction C.3(b).

2-7B Federal Securities Act of 1933 PART A

(b) *Back Cover Page*. Include the following information, in plain English under rule 421(d) under the Securities Act, on the outside back cover page of the prospectus:

(1) A statement that the SAI includes additional information about the Fund, and a statement to the following effect:

Additional information about the Fund's investments is available in the Fund's annual and semi-annual reports to shareholders. In the Fund's annual report, you will find a discussion of the market conditions and investment strategies that significantly affected the Fund's performance during its last fiscal year.

Explain that the SAI and the Fund's annual and semi-annual reports are available, without charge, upon request, and explain how shareholders in the Fund may make inquiries to the Fund. Provide a toll-free (or collect) telephone number for investors to call: to request the SAI; to request the Fund's annual report; to request the Fund's semi-annual report; to request other information about the Fund; and to make shareholder inquiries. Also, state whether the Fund makes available its SAI and annual and semi-annual reports, free of charge, on or through the Fund's Web site at a specified Internet address. If the Fund does not make its SAI and shareholder reports available in this manner, disclose the reasons why it does not do so (including, where applicable, that the Fund does not have an Internet Web site).

Instructions.

1. A Fund may indicate, if applicable, that the SAI, annual and semi-annual reports, and other information are available by E-mail request.

2. A Fund may indicate, if applicable, that the SAI and other information are available from a financial intermediary (such as a broker-dealer or bank) through which shares of the Fund may be purchased or sold.

3. When a Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for the SAI, the annual report, or the semi-annual report, the Fund (or financial intermediary) must send the requested document within 3 business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery.

4. A Fund that has not yet been required to deliver an annual or semi-annual report to shareholders under rule 30e-1 [17 CFR 270.30e-1] may omit the statements required by this paragraph regarding the reports.

5. A Money Market Fund may omit the sentence indicating that a reader will find in the Fund's annual report a discussion of the market conditions and investment strategies that significantly affect the Fund's performance during its last fiscal year.

2-7B Federal Securities Act of 1933 PART A

(2) A statement whether and from where information is incorporated by reference into the prospectus as permitted by General Instruction D. Unless the information is delivered with the prospectus, explain that the Fund will provide the information without charge, upon request (referring to the telephone number provided in response to paragraph (b)(1)).

Instruction. The Fund may combine the information about incorporation by reference with the statements required under paragraph (b)(1).

(3) A statement that information about the Fund (including the SAI) can be reviewed and copied at the Commission's Public Reference Room in Washington, D.C., and that information on the operation of the Public Reference Room may be obtained by calling the Commission at 1-202-551-8090. State that reports and other information about the Fund are available on the EDGAR Database on the Commission's Internet site at <http://www.sec.gov>, and that copies of this information may be obtained, after paying a duplicating fee, by electronic request at the following E-mail address: publicinfo@sec.gov, or by writing the Commission's Public Reference Section, Washington, D.C. 20549-1520.

(4) The Fund's Investment Company Act file number on the bottom of the back cover page in type size smaller than that generally used in the prospectus (*e.g.*, 8-point modern type).

Item 2. Risk/Return Summary: Investment Objectives/Goals

Disclose the Fund's investment objectives or goals. A Fund also may identify its type or category (*e.g.*, that it is a Money Market Fund or a balanced fund).

Item 3. Risk/Return Summary: Fee Table

Include the following information, in plain English under rule 421(d) under the Securities Act, after Item 2:

Fees and expenses of the Fund

This table describes the fees and expenses that you may pay if you buy and hold shares of the Fund. You may qualify for sales charge discounts if you and your family invest, or agree to invest in the future, at least \$[

_____] in [name of fund family] funds. More information about these and other discounts is available from your financial professional and in [identify section heading and page number] of the Fund's prospectus and [identify section heading and page number] of the Fund's statement of additional information.

Shareholder Fees (fees paid directly from your investment)

Maximum Sales Charge (Load) Imposed on Purchases (as a percentage of offering price)	_____ %
Maximum Deferred Sales Charge (Load) (as a percentage of _)	_____ %

2-7B Federal Securities Act of 1933 PART A

Maximum Sales Charge (Load) Imposed
on Reinvested Dividends

[and other Distributions] (as a percent-
age of _____) _____%

Redemption Fee (as a percentage of
amount redeemed, if applicable) _____%

Exchange Fee _____%

Maximum Account Fee _____%

Annual Fund Operating Expenses (expenses that you pay each
year as a percentage of the value of your investment)

Management Fees _____%

Distribution [and/or
Service] (12b-1)
Fees _____%

Other Expenses _____%

_____ %

_____ %

_____ %

Total Annual Fund
Operating Ex-
penses _____%

Example

This Example is intended to help you compare the cost of investing in the Fund with the cost of investing in other mutual funds.

The Example assumes that you invest \$10,000 in the Fund for the time periods indicated and then redeem all of your shares at the end of those periods. The Example also assumes that your investment has a 5% return each year and that the Fund's operating expenses remain the same. Although your actual costs may be higher or lower, based on these assumptions your costs would be:

1 year	3 years	5 years	10 years
\$	\$	\$	\$
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

You would pay the following expenses if you did not redeem your shares:

1 year	3 years	5 years	10 years
\$	\$	\$	\$
_____	_____	_____	_____

_____ — — — — —

 —

The Example does not reflect sales charges (loads) on reinvested dividends [and other distributions]. If these sales charges (loads) were included, your costs would be higher.

Portfolio Turnover

The Fund pays transaction costs, such as commissions, when it buys and sells securities (or "turns over" its portfolio). A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when Fund shares are held in a taxable account. These costs, which are not reflected in annual fund operating expenses or in the example, affect the Fund's performance. During the most recent fiscal year, the Fund's portfolio turnover rate was _____ % of the average value of its portfolio.

Instructions.

1. General.

(a) Round all dollar figures to the nearest dollar and all percentages to the nearest hundredth of one percent.

(b) Include the narrative explanations in the order indicated. A Fund may modify the narrative explanations if the explanation contains comparable information to that shown. The narrative explanation regarding sales charge discounts is only required by a Fund that offers such discounts and should specify the minimum level of investment required to qualify for a discount as disclosed in the table required by Item 12(a)(1).

(c) Include the caption "Maximum Account Fees" only if the Fund charges these fees. A Fund may omit other captions if the Fund does not charge the fees or expenses covered by the captions.

(d)

(i) If the Fund is a Feeder Fund, reflect the aggregate expenses of the Feeder Fund and the Master Fund in a single fee table using the captions provided. In a footnote to the fee table, state that the table and Example reflect the expenses of both the Feeder and Master Funds.

(ii) If the prospectus offers more than one Class of a Multiple Class Fund or more than one Feeder Fund that invests in the same Master Fund, provide a separate response for each Class or Feeder Fund.

(e) If the Fund is an Exchange-Traded Fund,

(i) Modify the narrative explanation to state that investors may pay brokerage commissions on their purchases and sales of Exchange-Traded Fund shares, which are not reflected in the example; and

(ii) If the Fund issues or redeems shares in creation units of not less than 25,000 shares each, exclude any fees charged for the purchase and redemption of the Fund's creation units.

2. Shareholder Fees.

(a)

(i) "Maximum Deferred Sales Charge (Load)" includes the maximum total deferred sales charge (load) payable upon redemption, in installments, or both, expressed as a percentage of the amount or amounts stated in response to Item 12(a), except that, for a sales charge (load) based on net asset value at the time of purchase, show the sales charge (load) as a percentage of the *offering price* at the time of purchase. A Fund may include in a footnote to the table, if applicable, a tabular presentation showing the amount of deferred sales charges (loads) over time or a narrative explanation of the sales charges (loads) (*e.g.*, _____% in the first year after purchase, declining to _____% in the _____ year and eliminated thereafter).

(ii) If more than one type of sales charge (load) is imposed (*e.g.*, a deferred sales charge (load) and a front-end sales charge (load)), the first caption in the table should read "Maximum Sales Charge (Load)" and show the maximum cumulative percentage. Show the percentage amounts and the terms of each sales charge (load) comprising that figure on separate lines below.

(iii) If a sales charge (load) is imposed on shares purchased with reinvested capital gains distributions or returns of capital, include the bracketed words in the third caption.

(b) "Redemption Fee" includes a fee charged for any redemption of the Fund's shares, but does not include a deferred sales charge (load) imposed upon redemption.

(c) "Exchange Fee" includes the maximum fee charged for any exchange or transfer of interest from the Fund to another fund. The Fund may include in a footnote to the table, if applicable, a tabular presentation of the range of exchange fees or a narrative explanation of the fees.

(d) "Maximum Account Fees." Disclose account fees that may be charged to a typical investor in the Fund; fees that apply to only a limited number of shareholders based on their particular circumstances need not be disclosed. Include a

caption describing the maximum account fee (*e.g.*, "Maximum Account Maintenance Fee" or "Maximum Cash Management Fee"). State the maximum annual account fee as either a fixed dollar amount or a percentage of assets. Include in a parenthetical to the caption the basis on which any percentage is calculated. If an account fee is charged only to accounts that do not meet a certain threshold (*e.g.*, accounts under \$5,000), the Fund may include the threshold in a parenthetical to the caption or footnote to the table. The Fund may include an explanation of any non-recurring account fee in a parenthetical to the caption or in a footnote to the table.

3. Annual Fund Operating Expenses.

(a) "Management Fees" include investment advisory fees (including any fees based on the Fund's performance), any other management fees payable to the investment adviser or its affiliates, and administrative fees payable to the investment adviser or its affiliates that are not included as "Other Expenses."

(b) "Distribution [and/or Service] (12b-1) Fees" include all distribution or other expenses incurred during the most recent fiscal year under a plan adopted pursuant to rule 12b-1 [17 CFR 270.12b-1]. Under an appropriate caption or a subcaption of "Other Expenses," disclose the amount of any distribution or similar expenses deducted from the Fund's assets other than pursuant to a rule 12b-1 plan.

(c)

(i) "Other Expenses" include all expenses not otherwise disclosed in the table that are deducted from the Fund's assets or charged to all shareholder accounts. The amount of expenses deducted from the Fund's assets are the amounts shown as expenses in the Fund's statement of operations (including increases resulting from complying with paragraph 2(g) of rule 6-07 of Regulation S-X [17 CFR 210.6-07]).

(ii) "Other Expenses" do not include extraordinary expenses as determined under generally accepted accounting principles (*see* Accounting Principles Board Opinion No. 30). If extraordinary expenses were incurred that materially affected the Fund's "Other Expenses," disclose in a footnote to the table what "Other Expenses" would have been had the extraordinary expenses been included.

(iii) The Fund may subdivide this caption into no more than three subcaptions that identify the largest expense or expenses comprising "Other Expenses," but must include a total of all "Other Expenses." Alternatively, the Fund may include the components of "Other Expenses" in a parenthetical to the caption.

(d)

(i) Base the percentages of "Annual Fund Operating Expenses" on amounts incurred during the Fund's most recent fiscal year, but include in expenses amounts that would have been incurred absent expense reimbursement or fee waiver arrangements. If the Fund has changed its fiscal year and, as a result, the most recent fiscal year is less than three

months, use the fiscal year prior to the most recent fiscal year as the basis for determining "Annual Fund Operating Expenses."

(ii) If there have been any changes in "Annual Fund Operating Expenses" that would materially affect the information disclosed in the table:

(A) Restate the expense information using the current fees as if they had been in effect during the previous fiscal year; and

(B) In a footnote to the table, disclose that the expense information in the table has been restated to reflect current fees.

(iii) A change in "Annual Fund Operating Expenses" means either an increase or a decrease in expenses that occurred during the most recent fiscal year or that is expected to occur during the current fiscal year. A change in "Annual Fund Operating Expenses" does not include a decrease in operating expenses as a percentage of assets due to economies of scale or breakpoints in a fee arrangement resulting from an increase in the Fund's assets.

(e) If there are expense reimbursement or fee waiver arrangements that will reduce any Fund operating expenses for no less than one year from the effective date of the Fund's registration statement, a Fund may add two captions to the table: one caption showing the amount of the expense reimbursement or fee waiver, and a second caption showing the Fund's net expenses after subtracting the fee reimbursement or expense waiver from the total fund operating expenses. The Fund should place these additional captions directly below the "Total Annual Fund Operating Expenses" caption of the table and should use appropriate descriptive captions, such as "Fee Waiver [and/or Expense Reimbursement]" and "Total Annual Fund Operating Expenses After Fee Waiver [and/or Expense Reimbursement]," respectively. If the Fund provides this disclosure, also disclose the period for which the expense reimbursement or fee waiver arrangement is expected to continue, including the expected termination date, and briefly describe who can terminate the arrangement and under what circumstances.

(f)

(i) If the Fund (unless it is a Feeder Fund) invests in shares of one or more Acquired Funds, add a subcaption to the "Annual Fund Operating Expenses" portion of the table directly above the subcaption titled "Total Annual Fund Operating Expenses." Title the additional subcaption: "Acquired Fund Fees and Expenses." Disclose in the subcaption fees and expenses incurred indirectly by the Fund as a result of investment in shares of one or more Acquired Funds. For purposes of this item, an "Acquired Fund" means any company in which the Fund invests or has invested during the relevant fiscal period that (A) is an investment company or (B) would be an investment company under section 3(a) of the Investment Company Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided for in sections

2-7B Federal Securities Act of 1933 PART A

3(c)(1) and 3(c)(7) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)). If a Fund uses another term in response to other requirements of this Form to refer to Acquired Funds, it may include that term in parentheses following the subcaption title. In the event the fees and expenses incurred indirectly by the Fund as a result of investment in shares of one or more Acquired Funds do not exceed 0.01 percent (one basis point) of average net assets of the Fund, the Fund may include these fees and expenses under the subcaption "Other Expenses" in lieu of this disclosure requirement.

(ii) Determine the "Acquired Fund Fees and Expenses" according to the following formula:

$$\text{AFFE} = [(F1/FY)*AI1 * D1] + [(F2/FY)*AI2* D2] + [(F3/FY)*AI3* D3] + \text{Transaction Fees} + \text{Incentive Allocations}$$

Average Net Assets of the Fund

Where:

AFFE = Acquired Fund fees and expenses;

F1, F2, F3, ... = Total annual operating expense ratio for each Acquired Fund;

FY = Number of days in the relevant fiscal year.

AI1, AI2, AI3, ... = Average invested balance in each Acquired Fund;

D1, D2, D3, ... = Number of days invested in each Acquired Fund; and

"Transaction Fees" = The total amount of sales loads, redemption fees, or other transaction fees paid by the Fund in connection with acquiring or disposing of shares in any Acquired Funds during the most recent fiscal year.

"Incentive Allocations" = Any allocation of capital from the Acquiring Fund to the adviser of the Acquired Fund (or its affiliate) based on a percentage of the Acquiring Fund's income, capital gains and/or appreciation in the Acquired Fund.

(iii) Calculate the average net assets of the Fund for the most recent fiscal year, as provided in Item 13(a) (see Instruction 4 to Item 13(a)).

(iv) The total annual operating expense ratio used for purposes of this calculation (F1) is the annualized ratio of operating expenses to average net assets for the Acquired Fund's most recent fiscal period as disclosed in the Acquired Fund's most recent shareholder report. If the ratio of expenses to average net assets is not included in the most recent shareholder report or the Acquired Fund is a newly formed fund that has not provided a shareholder report, then the ratio of expenses to average net assets of the Acquired Fund is the ratio of total annual operating expenses to average annual net assets of the Acquired Fund for its most recent fiscal period as disclosed in the most recent communication from the Acquired Fund to the Fund. For purposes of this instruction: (i) Acquired Fund expenses include increases resulting from brokerage service and expense offset arrangements and reductions resulting from fee waivers or reimbursements by the Acquired Funds' investment advisers or sponsors; and (ii) Acquired Fund expenses do not include expenses (i.e., performance fees) that are incurred solely upon the realization and/or distribution of a gain. If an Acquired Fund has no operating history, include in the Acquired Funds' expenses any fees payable to the Acquired

Fund's investment adviser or its affiliates stated in the Acquired Fund's registration statement, offering memorandum or other similar communication without giving effect to any performance.

(v) To determine the average invested balance (AI1), the numerator is the sum of the amount initially invested in an Acquired Fund during the most recent fiscal year (if the investment was held at the end of the previous fiscal year, use the amount invested as of the end of the previous fiscal year) and the amounts invested in the Acquired Fund no less frequently than monthly during the period the investment is held by the Fund (if the investment was held through the end of the fiscal year, use each month-end through and including the fiscal yearend). Divide the numerator by the number of measurement points included in the calculation of the numerator (i.e., if an investment is made during the fiscal year and held for 3 succeeding months, the denominator would be 4).

(vi) A New Fund should base the Acquired Fund fees and expenses on assumptions as to the specific Acquired Funds in which the New Fund expects to invest. Disclose in a footnote to the table that Acquired Fund fees and expenses are based on estimated amounts for the current fiscal year.

(vii) The Fund may clarify in a footnote to the fee table that the total annual fund operating expenses under Item 3 do not correlate to the ratio of expenses to average net assets given in response to Item 13, which reflects the operating expenses of the Fund and does not include Acquired Fund fees and expenses.

4. Example.

(a) Assume that the percentage amounts listed under "Total Annual Fund Operating Expenses" remain the same in each year of the 1-, 3-, 5-, and 10-year periods, except that an adjustment may be made to reflect any expense reimbursement or fee waiver arrangements that will reduce any Fund operating expenses for no less than one year from the effective date of the Fund's registration statement. An adjustment to reflect any expense reimbursement or fee waiver arrangement may be reflected only in the period(s) for which the expense reimbursement or fee waiver arrangement is expected to continue.

(b) For any breakpoint in any fee, assume that the amount of the Fund's assets remains constant as of the level at the end of the most recently completed fiscal year.

(c) Assume reinvestment of all dividends and distributions.

(d) Reflect recurring and non-recurring fees charged to all investors other than any exchange fees or any sales charges (loads) on shares purchased with reinvested dividends or other distributions. If sales charges (loads) are imposed on reinvested dividends or other distributions, include the narrative explanation following the Example and include the bracketed words when sales charges (loads) are charged on reinvested capital gains distributions or returns

2-7B Federal Securities Act of 1933 PART A

of capital. Reflect any shareholder account fees collected by more than one Fund by dividing the total amount of the fees collected during the most recent fiscal year for all Funds whose shareholders are subject to the fees by the total average net assets of the Funds. Add the resulting percentage to "Annual Fund Operating Expenses" and assume that it remains the same in each of the 1-, 3-, 5-, and 10-year periods. A Fund that charges account fees based on a minimum account requirement exceeding \$10,000 may adjust its account fees based on the amount of the fee in relation to the Fund's minimum account requirement.

(e) Reflect any deferred sales charge (load) by assuming redemption of the entire account at the end of the year in which the sales charge (load) is due. In the case of a deferred sales charge (load) that is based on the Fund's net asset value at the time of payment, assume that the net asset value at the end of each year includes the 5% annual return for that and each preceding year.

(f) Include the second 1-, 3-, 5-, and 10-year periods and related narrative explanation only if a sales charge (load) or other fee is charged upon redemption.

5. *Portfolio Turnover*. Disclose the portfolio turnover rate provided in response to Item 13(a) for the most recent fiscal year (or for such shorter period as the Fund has been in operation). Disclose the period for which the information is provided if less than a full fiscal year. A Fund that is a Money Market Fund may omit the portfolio turnover information required by this Item.

6. *New Funds*. For purposes of this Item, a "New Fund" is a Fund that does not include in Form N-1A financial statements reporting operating results or that includes financial statements for the Fund's initial fiscal year reporting operating results for a period of 6 months or less. The following Instructions apply to New Funds.

(a) Base the percentages expressed in "Annual Fund Operating Expenses" on payments that will be made, but include in expenses, amounts that will be incurred without reduction for expense reimbursement or fee waiver arrangements, estimating amounts of "Other Expenses." Disclose in a footnote to the table that "Other Expenses" are based on estimated amounts for the current fiscal year.

(b) Complete only the 1- and 3-year period portions of the Example and estimate any shareholder account fees collected.

Item 4. Risk/Return Summary: Investments, Risks, and Performance

Include the following information, in plain English under rule 421(d) under the Securities Act, in the order and subject matter indicated:

(a) *Principal investment strategies of the Fund*.

Based on the information given in response to Item 9(b), summarize how the Fund intends to achieve its investment

objectives by identifying the Fund's principal investment strategies (including the type or types of securities in which the Fund invests or will invest principally) and any policy to concentrate in securities of issuers in a particular industry or group of industries.

(b) *Principal risks of investing in the Fund.*

(1) *Narrative Risk Disclosure.*

(i) Based on the information given in response to Item 9(c), summarize the principal risks of investing in the Fund, including the risks to which the Fund's portfolio as a whole is subject and the circumstances reasonably likely to affect adversely the Fund's net asset value, yield, and total return. Unless the Fund is a Money Market Fund, disclose that loss of money is a risk of investing in the Fund.

Instruction. A Fund may, in responding to this Item, describe the types of investors for whom the Fund is intended or the types of investment goals that may be consistent with an investment in the Fund.

(ii) If the Fund is a Money Market Fund, state that:

An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the Fund.

(iii) If the Fund is advised by or sold through an insured depository institution, state that:

An investment in the Fund is not a deposit of the bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

Instruction. A Money Market Fund that is advised by or sold through an insured depository institution should combine the disclosure required by Items 4(b)(1)(ii) and (iii) in a single statement.

(iv) If applicable, state that the Fund is non-diversified, describe the effect of non-diversification (*e.g.*, disclose that, compared with other funds, the Fund may invest a greater percentage of its assets in a particular issuer), and summarize the risks of investing in a non-diversified fund.

(2) *Risk/Return Bar Chart and Table.*

2-7B Federal Securities Act of 1933 PART A

(i) Include the bar chart and table required by paragraphs (b)(2)(ii) and (iii) of this section. Provide a brief explanation of how the information illustrates the variability of the Fund's returns (*e.g.*, by stating that the information provides some indication of the risks of investing in the Fund by showing changes in the Fund's performance from year to year and by showing how the Fund's average annual returns for 1, 5, and 10 years compare with those of a broad measure of market performance). Provide a statement to the effect that the Fund's past performance (before and after taxes) is not necessarily an indication of how the Fund will perform in the future. If applicable, include a statement explaining that updated performance information is available and providing a Web site address and/or toll-free (or collect) telephone number where the updated information may be obtained.

(ii) If the Fund has annual returns for at least one calendar year, provide a bar chart showing the Fund's annual total returns for each of the last 10 calendar years (or for the life of the Fund if less than 10 years), but only for periods subsequent to the effective date of the Fund's registration statement. Present the corresponding numerical return adjacent to each bar. If the Fund's fiscal year is other than a calendar year, include the year-to-date return information as of the end of the most recent quarter in a footnote to the bar chart. Following the bar chart, disclose the Fund's highest and lowest return for a quarter during the 10 years or other period of the bar chart.

(iii) If the Fund has annual returns for at least one calendar year, provide a table showing the Fund's (A) average annual total return; (B) average annual total return (after taxes on distributions); and (C) average annual total return (after taxes on distributions and redemption). A Money Market Fund should show only the returns described in clause (A) of the preceding sentence. All returns should be shown for 1-, 5-, and 10- calendar year periods ending on the date of the most recently completed calendar year (or for the life of the Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. The table also should show the returns of an appropriate broad-based securities market index as defined in Instruction 5 to Item 27(b)(7) for the same periods. A Fund that has been in existence for more than 10 years also may include returns for the life of the Fund. A Money Market Fund may provide the Fund's 7-day yield ending on the date of the most recent calendar year or disclose a toll-free (or collect) telephone number that investors can use to obtain the Fund's current 7-day yield. For a Fund (other than a Money Market Fund or a Fund described in General Instruction C.3.(d)(iii)), provide the information in the following table with the specified captions:

AVERAGE ANNUAL TOTAL RETURNS

(For the periods
ended December
31,

_____))

	1 year	5 years [or Life of Fund]	10 years [or Life of Fund]
Return Before Taxes	____%	____%	____%
Return After Taxes on Distributions	____%	____%	____%
Return After Taxes on Distributions and Sale of Fund Shares	____%	____%	____%

2-7B Federal Securities Act of 1933 PART A

Index _____% _____% _____%
 (reflects no de-
 duction for [fees,
 expenses, or
 taxes])

(iv) Adjacent to the table required by paragraph 4(b)(2)(iii), provide a brief explanation that:

(A) After-tax returns are calculated using the historical highest individual federal marginal income tax rates and do not reflect the impact of state and local taxes;

(B) Actual after-tax returns depend on an investor's tax situation and may differ from those shown, and after-tax returns shown are not relevant to investors who hold their Fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts;

(C) If the Fund is a Multiple Class Fund that offers more than one Class in the prospectus, after-tax returns are shown for only one Class and after-tax returns for other Classes will vary; and

(D) If average annual total return (after taxes on distributions and redemption) is higher than average annual total return, the reason for this result may be explained.

Instructions.

1. *Bar Chart.*

(a) Provide annual total returns beginning with the earliest calendar year. Calculate annual returns using the Instructions to Item 13(a), except that the calculations should be based on calendar years. If a Fund's shares are sold subject to a sales load or account fees, state that sales loads or account fees are not reflected in the bar chart and that, if these amounts were reflected, returns would be less than those shown.

(b) For a Fund that provides annual total returns for only one calendar year or for a Fund that does not include the bar chart because it does not have annual returns for a full calendar year, modify, as appropriate, the narrative explanation required by paragraph (b)(2)(i) (*e.g.*, by stating that the information gives some indication of the risks of an investment in the Fund by comparing the Fund's performance with a broad measure of market performance).

2. *Table.*

2-7B Federal Securities Act of 1933 PART A

(a) Calculate a Money Market Fund's 7-day yield under Item 26(a); the Fund's average annual total return under Item 26(b)(1); and the Fund's average annual total return (after taxes on distributions) and average annual total return (after taxes on distributions and redemption) under Items 26(b)(2) and (3), respectively.

(b) A Fund may include, in addition to the required broad-based securities market index, information for one or more other indexes as permitted by Instruction 6 to Item 27(b)(7). If an additional index is included, disclose information about the additional index in the narrative explanation accompanying the bar chart and table (*e.g.*, by stating that the information shows how the Fund's performance compares with the returns of an index of funds with similar investment objectives).

(c) If the Fund selects an index that is different from the index used in a table for the immediately preceding period, explain the reason(s) for the selection of a different index and provide information for both the newly selected and the former index.

(d) A Fund (other than a Money Market Fund) may include the Fund's yield calculated under Item 26(b)(2). Any Fund may include its tax-equivalent yield calculated under Item 26. If a Fund's yield is included, provide a toll-free (or collect) telephone number that investors can use to obtain current yield information.

(e) Returns required by paragraphs 4(b)(2)(iii)(A), (B), and (C) for a Fund or Series must be adjacent to one another and appear in that order. The returns for a broad-based securities market index, as required by paragraph 4(b)(2)(iii), must precede or follow all of the returns for a Fund or Series rather than be interspersed with the returns of the Fund or Series.

3. *Multiple Class Funds.*

(a) When a Multiple Class Fund presents information for more than one Class together in response to Item 4(b)(2), provide annual total returns in the bar chart for only one of those Classes. The Fund can select which Class to include (*e.g.*, the oldest Class, the Class with the greatest net assets) if the Fund:

(i) Selects the Class with 10 or more years of annual returns if other Classes have fewer than 10 years of annual returns;

(ii) Selects the Class with the longest period of annual returns when the Classes all have fewer than 10 years of returns; and

2-7B Federal Securities Act of 1933 PART A

(iii) If the Fund provides annual total returns in the bar chart for a Class that is different from the Class selected for the most immediately preceding period, explain in a footnote to the bar chart the reasons for the selection of a different Class.

(b) When a Multiple Class Fund offers a new Class in a prospectus and separately presents information for the new Class in response to Item 4(b)(2), include the bar chart with annual total returns for any other existing Class for the first year that the Class is offered. Explain in a footnote that the returns are for a Class that is not presented that would have substantially similar annual returns because the shares are invested in the same portfolio of securities and the annual returns would differ only to the extent that the Classes do not have the same expenses. Include return information for the other Class reflected in the bar chart in the performance table.

(c) When a Multiple Class Fund presents information for more than one Class together in response to Item 4(b)(2):
(i) Provide the returns required by paragraph 4(b)(2)(iii)(A) of this Item for each of the Classes;

(ii) Provide the returns required by paragraphs 4(b)(2)(iii)(B) and (C) of this Item for only one of those Classes. The Fund may select the Class for which it provides the returns required by paragraphs 4(b)(2)(iii)(B) and (C) of this Item, provided that the Fund:

(A) Selects a Class that has been offered for use as an investment option for accounts other than those described in General Instruction C.3.(d)(iii)(A);

(B) Selects a Class described in paragraph (c)(ii)(A) of this instruction with 10 or more years of annual returns if other Classes described in paragraph (c)(ii)(A) of this instruction have fewer than 10 years of annual returns;

(C) Selects the Class described in paragraph (c)(ii)(A) of this instruction with the longest period of annual returns if the Classes described in paragraph (c)(ii)(A) of this instruction all have fewer than 10 years of returns; and

(D) If the Fund provides the returns required by paragraphs 4(b)(2)(iii)(B) and (C) of this Item for a Class that is different from the Class selected for the most immediately preceding period, explain in a footnote to the table the reasons for the selection of a different Class;

(iii) The returns required by paragraphs 4(b)(2)(iii)(A), (B), and (C) of this Item for the Class described in paragraph (c)(ii) of this instruction should be adjacent and should not be interspersed with the returns of other Classes; and

(iv) All returns shown should be identified by Class.

(d) If a Multiple Class Fund offers a Class in the prospectus that converts into another Class after a stated period, compute average annual total returns in the table by using the returns of the other Class for the period after conversion.

4. *Change in Investment Adviser*: If the Fund has not had the same investment adviser during the last 10 calendar years, the Fund may begin the bar chart and the performance information in the table on the date that the current adviser began to provide advisory services to the Fund subject to the conditions in Instruction 11 of Item 27(b)(7).

Item 5. Management

(a) *Investment Adviser(s)*. Provide the name of each investment adviser of the Fund, including sub-advisers. *Instructions.*

1. A Fund need not identify a sub-adviser whose sole responsibility for the Fund is limited to day-to-day management of the Fund's holdings of cash and cash equivalent instruments, unless the Fund is a Money Market Fund or other Fund with a principal investment strategy of regularly holding cash and cash equivalent instruments.

2. A Fund having three or more sub-advisers, each of which manages a portion of the Fund's portfolio, need not identify each such sub-adviser, except that the Fund must identify any sub-adviser that is (or is reasonably expected to be) responsible for the management of a significant portion of the Fund's net assets. For purposes of this paragraph, a significant portion of a Fund's net assets generally will be deemed to be 30% or more of the Fund's net assets.

(b) *Portfolio Manager(s)*. State the name, title, and length of service of the person or persons employed by or associated with the Fund or an investment adviser of the Fund who are primarily responsible for the day-to-day management of the Fund's portfolio ("Portfolio Manager").

Instructions.

1. This requirement does not apply to a Money Market Fund.

2. If a committee, team, or other group of persons associated with the Fund or an investment adviser of the Fund is jointly and primarily responsible for the day-to-day management of the Fund's portfolio, information in response to this Item is required for each member of such committee, team, or other group. If more than five persons are jointly and

primarily responsible for the day-to-day management of the Fund's portfolio, the Fund need only provide information for the five persons with the most significant responsibility for the day-to-day management of the Fund's portfolio.

Item 6. Purchase and Sale of Fund Shares

(a) *Purchase of Fund Shares.* Disclose the Fund's minimum initial or subsequent investment requirements.

(b) *Sale of Fund Shares.* Also disclose that the Fund's shares are redeemable and briefly identify the procedures for redeeming shares (*e.g.*, on any business day by written request, telephone, or wire transfer).

(c) *Exchange-Traded Funds.* If the Fund is an Exchange-Traded Fund,

(i) Specify the number of shares that the Fund will issue (or redeem) in exchange for the deposit or delivery of basket assets (*i.e.*, the securities or other assets the Fund specifies each day in name and number as the securities or assets in exchange for which it will issue or in return for which it will redeem Fund shares) and explain that:

(A) Individual Fund shares may only be purchased and sold on a national securities exchange through a broker-dealer; and

(B) The price of Fund shares is based on market price, and because Exchange-Traded Fund shares trade at market prices rather than net asset value, shares may trade at a price greater than net asset value (premium) or less than net asset value (discount); and

(ii) If the Fund issues shares in creation units of not less than 25,000 shares each, the Fund may omit the information required by Items 6(a) and 6(b).

Item 7. Tax Information

State, as applicable, that the Fund intends to make distributions that may be taxed as ordinary income or capital gains or that the Fund intends to distribute tax-exempt income. For a Fund that holds itself out as investing in securities generating tax-exempt income, provide, as applicable, a general statement to the effect that a portion of the Fund's distributions may be subject to federal income tax.

Item 8. Financial Intermediary Compensation

Include the following statement. A Fund may modify the statement if the modified statement contains comparable information. A Fund may omit the statement if neither the Fund nor any of its related companies pay financial intermediaries for the sale of Fund shares or related services.

Payments to Broker-Dealers and Other Financial Intermediaries.

If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information.

Item 9. Investment Objectives, Principal Investment Strategies, Related Risks, and Disclosure of Portfolio Holdings

(a) *Investment Objectives.* State the Fund's investment objectives and, if applicable, state that those objectives may be changed without shareholder approval.

(b) *Implementation of Investment Objectives.* Describe how the Fund intends to achieve its investment objectives. In the discussion:

(1) Describe the Fund's principal investment strategies, including the particular type or types of securities in which the Fund principally invests or will invest.

Instructions.

1. A strategy includes any policy, practice, or technique used by the Fund to achieve its investment objectives.

2. Whether a particular strategy, including a strategy to invest in a particular type of security, is a principal investment strategy depends on the strategy's anticipated importance in achieving the Fund's investment objectives, and how the strategy affects the Fund's potential risks and returns. In determining what is a principal investment strategy, consider, among other things, the amount of the Fund's assets expected to be committed to the strategy, the amount of the Fund's assets expected to be placed at risk by the strategy, and the likelihood of the Fund's losing some or all of those assets from implementing the strategy.

3. A negative strategy (*e.g.*, a strategy not to invest in a particular type of security or not to borrow money) is

not a principal investment strategy.

4. Disclose any policy to concentrate in securities of issuers in a particular industry or group of industries (i. e., investing more than 25% of a Fund's net assets in a particular industry or group of industries).

5. Disclose any other policy specified in Item 16(c)(1) that is a principal investment strategy of the Fund.

6. Disclose, if applicable, that the Fund may, from time to time, take temporary defensive positions that are inconsistent with the Fund's principal investment strategies in attempting to respond to adverse market, economic, political, or other conditions. Also disclose the effect of taking such a temporary defensive position (*e.g.*, that the Fund may not achieve its investment objective).

7. Disclose whether the Fund (if not a Money Market Fund) may engage in active and frequent trading of portfolio securities to achieve its principal investment strategies. If so, explain the tax consequences to shareholders of increased portfolio turnover, and how the tax consequences of, or trading costs associated with, a Fund's portfolio turnover may affect the Fund's performance.

(2) Explain in general terms how the Fund's adviser decides which securities to buy and sell (*e.g.*, for an equity fund, discuss, if applicable, whether the Fund emphasizes value or growth or blends the two approaches).

(c) *Risks*. Disclose the principal risks of investing in the Fund, including the risks to which the Fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the Fund's net asset value, yield, or total return.

(d) *Portfolio Holdings*. State that a description of the Fund's policies and procedures with respect to the disclosure of the Fund's portfolio securities is available (i) in the Fund's SAI; and (ii) on the Fund's website, if applicable.

Item 10. Management, Organization, and Capital Structure

(a) *Management*.

(1) *Investment Adviser*.

2-7B Federal Securities Act of 1933 PART A

(i) Provide the name and address of each investment adviser of the Fund, including sub advisers. Describe the investment adviser's experience as an investment adviser and the advisory services that it provides to the Fund.

(ii) Describe the compensation of each investment adviser of the Fund as follows:

(A) If the Fund has operated for a full fiscal year, state the aggregate fee paid to the adviser for the most recent fiscal year as a percentage of average net assets. If the Fund has not operated for a full fiscal year, state what the adviser's fee is as a percentage of average net assets, including any breakpoints.

(B) If the adviser's fee is not based on a percentage of average net assets (*e.g.*, the adviser receives a performance-based fee), describe the basis of the adviser's compensation.

(iii) Include a statement, adjacent to the disclosure required by paragraph (a)(1)(ii) of this Item, that a discussion regarding the basis for the board of directors approving any investment advisory contract of the Fund is available in the Fund's annual or semi-annual report to shareholders, as applicable, and providing the period covered by the relevant annual or semi-annual report.

Instructions.

1. If the Fund changed advisers during the fiscal year, describe the compensation and the dates of service for each adviser.

2. Explain any changes in the basis of computing the adviser's compensation during the fiscal year.

3. If a Fund has more than one investment adviser, disclose the aggregate fee paid to all of the advisers, rather than the fees paid to each adviser, in response to this Item.

(2) *Portfolio Manager.* For each Portfolio Manager identified in response to Item 5(b), state the Portfolio Manager's business experience during the past 5 years. Include a statement, adjacent to the foregoing disclosure, that the SAI provides additional information about the Portfolio Manager's(s') compensation, other accounts managed by the Portfolio Manager(s), and the Portfolio Manager's(s') ownership of securities in the Fund. If a Portfolio Manager is a member of a committee, team, or other group of persons associated with the Fund or an investment adviser of the Fund that is jointly and primarily responsible for the day-to-day management of the Fund's portfolio, provide a brief description of the person's role on the committee, team, or other group (*e.g.*, lead member), including a description of

2-7B Federal Securities Act of 1933 PART A

any limitations on the person's role and the relationship between the person's role and the roles of other persons who have responsibility for the day-to-day management of the Fund's portfolio.

(3) *Legal Proceedings.* Describe any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the Fund or the Fund's investment adviser or principal underwriter is a party. Include the name of the court in which the proceedings are pending, the date instituted, the principal parties involved, a description of the factual basis alleged to underlie the proceeding, and the relief sought. Include similar information as to any legal proceedings instituted, or known to be contemplated, by a governmental authority.

Instruction. For purposes of this requirement, legal proceedings are material only to the extent that they are likely to have a material adverse effect on the Fund or the ability of the investment adviser or principal underwriter to perform its contract with the Fund.

(b) *Capital Stock.* Disclose any unique or unusual restrictions on the right freely to retain or dispose of the Fund's shares or material obligations or potential liabilities associated with holding the Fund's shares (not including investment risks) that may expose investors to significant risks.

Item 11. Shareholder Information

(a) *Pricing of Fund Shares.* Describe the procedures for pricing the Fund's shares, including:

(1) An explanation that the price of Fund shares is based on the Fund's net asset value and the method used to value Fund shares (market price, fair value, or amortized cost); except that if the Fund is an Exchange-Traded Fund, an explanation that the price of Fund shares is based on market price.

Instruction. A Fund (other than a Money Market Fund) must provide a brief explanation of the circumstances under which it will use fair value pricing and the effects of using fair value pricing. With respect to any portion of a Fund's assets that are invested in one or more open-end management investment companies that are registered under the Investment Company Act, the Fund may briefly explain that the Fund's net asset value is calculated based upon the net asset values of the registered open-end management investment companies in which the Fund invests, and that the prospectuses for these companies explain the circumstances under which those companies will use fair value pricing and the effects of using fair value pricing.

(2) A statement as to when calculations of net asset value are made and that the price at which a purchase or redemption is effected is based on the next calculation of net asset value after the order is placed.

(3) A statement identifying in a general manner any national holidays when shares will not be priced and specifying any additional local or regional holidays when the Fund shares will not be priced.

Instructions.

1. In responding to this Item, a Fund may use a list of specific days or any other means that effectively communicates the information (*e.g.*, explaining that shares will not be priced on the days on which the New York Stock Exchange is closed for trading).

2. If the Fund has portfolio securities that are primarily listed on foreign exchanges that trade on weekends or other days when the Fund does not price its shares, disclose that the net asset value of the Fund's shares may change on days when shareholders will not be able to purchase or redeem the Fund's shares.

(b) *Purchase of Fund Shares.* Describe the procedures for purchasing the Fund's shares.

(c) *Redemption of Fund Shares.* Describe the procedures for redeeming the Fund's shares, including:

(1) Any restrictions on redemptions.

(2) Any redemption charges, including how these charges will be collected and under what circumstances the charges will be waived.

(3) If the Fund has reserved the right to redeem in kind.

(4) Any procedure that a shareholder can use to sell the Fund's shares to the Fund or its underwriter through a broker-dealer, noting any charges that may be imposed for such service.

Instruction. The specific fees paid through the broker-dealer for such service need not be disclosed.

(5) The circumstances, if any, under which the Fund may redeem shares automatically without action by the shareholder in accounts below a certain number or value of shares.

(6) The circumstances, if any, under which the Fund may delay honoring a request for redemption for a certain time after a shareholder's investment (*e.g.*, whether a Fund does not process redemptions until clearance of the check for the initial investment).

(7) Any restrictions on, or costs associated with, transferring shares held in street name accounts.

(d) *Dividends and Distributions.* Describe the Fund's policy with respect to dividends and distributions, including any options that shareholders may have as to the receipt of dividends and distributions.

(e) *Frequent Purchases and Redemptions of Fund Shares.*

(1) Describe the risks, if any, that frequent purchases and redemptions of Fund shares by Fund shareholders may present for other shareholders of the Fund.

(2) State whether or not the Fund's board of directors has adopted policies and procedures with respect to frequent purchases and redemptions of Fund shares by Fund shareholders.

(3) If the Fund's board of directors has not adopted any such policies and procedures, provide a statement of the specific basis for the view of the board that it is appropriate for the Fund not to have such policies and procedures.

(4) If the Fund's board of directors has adopted any such policies and procedures, describe those policies and procedures, including:

(i) Whether or not the Fund discourages frequent purchases and redemptions of Fund shares by Fund shareholders;

(ii) Whether or not the Fund accommodates frequent purchases and redemptions of Fund shares by Fund shareholders; and

(iii) Any policies and procedures of the Fund for deterring frequent purchases and redemptions of Fund shares by Fund shareholders, including any restrictions imposed by the Fund to prevent or minimize frequent purchases and redemptions. Describe each of these policies, procedures, and restrictions with specificity. Indicate whether each of these restrictions applies uniformly in all cases or whether the restriction will not be imposed under certain circumstances, including whether each of these restrictions applies to trades that occur through omnibus accounts at intermediaries, such as investment advisers, broker-dealers, transfer agents, third party administrators, and insurance companies. Describe with specificity the circumstances under which any restriction will not be imposed. Include a

description of the following restrictions, if applicable:

(A) Any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period;

(B) Any exchange fee or redemption fee;

(C) Any costs or administrative or other fees or charges that are imposed on shareholders deemed to be engaged in frequent purchases and redemptions of Fund shares, together with a description of the circumstances under which such costs, fees, or charges will be imposed;

(D) Any minimum holding period that is imposed before an investor may make exchanges into another Fund;

(E) Any restrictions imposed on exchange or purchase requests submitted by overnight delivery, electronically, or via facsimile or telephone; and

(F) Any right of the Fund to reject, limit, delay, or impose other conditions on exchanges or purchases or to close or otherwise limit accounts based on a history of frequent purchases and redemptions of Fund shares, including the circumstances under which such right will be exercised.

(5) If applicable, include a statement, adjacent to the disclosure required by paragraphs (e)(1) through (e)(4) of this Item, that the SAI includes a description of all arrangements with any person to permit frequent purchases and redemptions of Fund shares.

(f) *Tax Consequences.*

(1) Describe the tax consequences to shareholders of buying, holding, exchanging and selling the Fund's shares, including, as applicable, that:

(i) The Fund intends to make distributions that may be taxed as ordinary income and capital gains (which may be taxable at different rates depending on the length of time the Fund holds its assets). If the Fund expects that its distributions, as a result of its investment objectives or strategies, will consist primarily of ordinary income or capital

gains, provide disclosure to that effect.

(ii) The Fund's distributions, whether received in cash or reinvested in additional shares of the Fund, may be subject to federal income tax.

(iii) An exchange of the Fund's shares for shares of another fund will be treated as a sale of the Fund's shares and any gain on the transaction may be subject to federal income tax.

(2) For a Fund that holds itself out as investing in securities generating tax-exempt income:

(i) Modify the disclosure required by paragraph (f)(1) to reflect that the Fund intends to distribute tax-exempt income.

(ii) Also disclose, as applicable, that:

(A) The Fund may invest a portion of its assets in securities that generate income that is not exempt from federal or state income tax;

(B) Income exempt from federal tax may be subject to state and local income tax; and

(C) Any capital gains distributed by the Fund may be taxable.

(3) If the Fund does not expect to qualify as a regulated investment company under Subchapter M of the Internal Revenue Code [I.R.C. 851 *et seq.*], explain the tax consequences. If the Fund expects to pay an excise tax under the Internal Revenue Code [I.R.C. 4982] with respect to its distributions, explain the tax consequences.

(g) *Exchange-Traded Funds.* If the Fund is an Exchange-Traded Fund:

(1) The Fund may omit from the prospectus the information required by Items 11(a)(2), (b), and (c) if the Fund issues or redeems Fund shares in creation units of not less than 25,000 shares each; and

(2) Provide a table showing the number of days the Market Price of the Fund shares was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value (*i.e.*, premium or discount) for the most recently completed calendar year, and the most recently completed calendar quarters since that year (or the life of the Fund, if shorter). The Fund may omit this table if the Fund provides an Internet address at the Fund's Web site, which is publicly accessible, free of charge, that investors can use to obtain the premium/discount information required in this Item.

Instruction.

1. Provide the information in tabular form.
2. Express the information as a percentage of the net asset value of the Fund, using separate columns for the number of days the Market Price was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value. Round all percentages to the nearest hundredth of one percent.
3. Adjacent to the table, provide a brief explanation that: shareholders may pay more than net asset value when they buy Fund shares and receive less than net asset value when they sell those shares, because shares are bought and sold at current market prices.
4. Include a statement that the data presented represents past performance and cannot be used to predict future results.

Item 12. Distribution Arrangements

(a) Sales Loads.

(1) Describe any sales loads, including deferred sales loads, applied to purchases of the Fund's shares. Include in a table any front-end sales load (and each breakpoint in the sales load, if any) as a percentage of both the offering price and the net amount invested.

Instructions.

1. If the Fund's shares are sold subject to a front-end sales load, explain that the term "offering price" includes the front-end sales load.

2-7B Federal Securities Act of 1933 PART A

2. Disclose, if applicable, that sales loads are imposed on shares, or amounts representing shares, that are purchased with reinvested dividends or other distributions.

3. Discuss, if applicable, how deferred sales loads are imposed and calculated, including:

(a) Whether the specified percentage of the sales load is based on the offering price, or the lesser of the offering price or net asset value at the time the sales load is paid.

(b) The amount of the sales load as a percentage of both the offering price and the net amount invested.

(c) A description of how the sales load is calculated (*e.g.*, in the case of a partial redemption, whether or not the sales load is calculated as if shares or amounts representing shares not subject to a sales load are redeemed first, and other shares or amounts representing shares are then redeemed in the order purchased).

(d) If applicable, the method of paying an installment sales load (*e.g.*, by withholding of dividend payments, involuntary redemptions, or separate billing of a shareholder's account).

(2) Unless disclosed in response to paragraph (a)(1), briefly describe any arrangements that result in breakpoints in, or elimination of, sales loads (*e.g.*, letters of intent, accumulation plans, dividend reinvestment plans, withdrawal plans, exchange privileges, employee benefit plans, redemption reinvestment plans, and waivers for particular classes of investors). Identify each class of individuals or transactions to which the arrangements apply and state each different breakpoint as a percentage of both the offering price and the net amount invested. If applicable, state that additional information concerning sales load breakpoints is available in the Fund's SAI.

Instructions.

1. The description, pursuant to paragraph (a)(1) or (a)(2) of this Item 12, of arrangements that result in breakpoints in, or elimination of, sales loads must include a brief summary of shareholder eligibility requirements, including a description or list of the types of accounts (*e.g.*, retirement accounts, accounts held at other financial intermediaries), account holders (*e.g.*, immediate family members, family trust accounts, solely-controlled business accounts), and fund holdings (*e.g.*, funds held within the same fund complex) that may be aggregated for purposes of determining eligibility for sales load breakpoints.

2. The description pursuant to paragraph (a)(2) of this Item 12 need not contain any information required by Items

17(d) and 22(b).

(3) Describe, if applicable, the methods used to value accounts in order to determine whether a shareholder has met sales load breakpoints, including the circumstances in which and the classes of individuals to whom each method applies. Methods that should be described, if applicable, include historical cost, net amount invested, and offering price.

(4)

(i) State, if applicable, that, in order to obtain a breakpoint discount, it may be necessary at the time of purchase for a shareholder to inform the Fund or his or her financial intermediary of the existence of other accounts in which there are holdings eligible to be aggregated to meet sales load breakpoints. Describe any information or records, such as account statements, that it may be necessary for a shareholder to provide to the Fund or his or her financial intermediary in order to verify his or her eligibility for a breakpoint discount. This description must include, if applicable:

(A) Information or records regarding shares of the Fund or other funds held in all accounts (*e.g.*, retirement accounts) of the shareholder at the financial intermediary;

(B) Information or records regarding shares of the Fund or other funds held in any account of the shareholder at another financial intermediary; and

(C) Information or records regarding shares of the Fund or other funds held at any financial intermediary by related parties of the shareholder, such as members of the same family or household.

(ii) If the Fund permits eligibility for breakpoints to be determined based on historical cost, state that a shareholder should retain any records necessary to substantiate historical costs because the Fund, its transfer agent, and financial intermediaries may not maintain this information.

(5) State whether the Fund makes available free of charge, on or through the Fund's Web site at a specified Internet address, and in a clear and prominent format, the information required by paragraphs (a)(1) through (a)(4) and Item 22(a), including whether the Web site includes hyperlinks that facilitate access to the information. If the Fund does not make the information required by paragraphs (a)(1) through (a)(4) and Item 22(a) available in this manner, disclose the reasons why it does not do so (including, where applicable, that the Fund does not have an Internet Web site).

Instruction. All information required by paragraph (a) of this Item 12 must be adjacent to the table required by paragraph (a)(1) of this Item 12; must be presented in a clear, concise, and understandable manner; and must include tables, schedules, and charts as expressly required by paragraph (a)(1) of this Item 12 or where doing so would facilitate understanding.

(b) *Rule 12b-1 Fees.* If the Fund has adopted a plan under rule 12b-1, state the amount of the distribution fee payable under the plan and provide disclosure to the following effect:

(1) The Fund has adopted a plan under rule 12b-1 that allows the Fund to pay distribution fees for the sale and distribution of its shares; and

(2) Because these fees are paid out of the Fund's assets on an on-going basis, over time these fees will increase the cost of your investment and may cost you more than paying other types of sales charges.

Instruction. If the Fund pays service fees under its rule 12b-1 plan, modify this disclosure to reflect the payment of these fees (*e.g.*, by indicating that the Fund pays distribution and other fees for the sale of its shares and for services provided to shareholders). For purposes of this paragraph, service fees have the same meaning given that term under rule 2830(b)(9) of the NASD Conduct Rules [NASD Manual (CCH) 4622].

(c) *Multiple Class and Master-Feeder Funds.*

(1) Describe the main features of the structure of the Multiple Class Fund or Master-Feeder Fund.

(2) If more than one Class of a Multiple Class Fund is offered in the prospectus, provide the information required by paragraphs (a) and (b) for each of those Classes.

(3) If a Multiple Class Fund offers in the prospectus shares that provide for mandatory or automatic conversions or exchanges from one Class to another Class, provide the information required by paragraphs (a) and (b) for both the shares offered and the Class into which the shares may be converted or exchanged.

(4) If a Feeder Fund has the ability to change the Master Fund in which it invests, describe briefly the circumstances under which the Feeder Fund can do so.

Instruction. A Feeder Fund that does not have the authority to change its Master Fund need not disclose the possibility and consequences of its no longer investing in the Master Fund.

Item 13. Financial Highlights Information

(a) Provide the following information for the Fund, or for the Fund and its subsidiaries, audited for at least the latest 5 years and consolidated as required in Regulation S-X [17 CFR 210].

Financial Highlights

The financial highlights table is intended to help you understand the Fund's financial performance for the past 5 years [or, if shorter, the period of the Fund's operations]. Certain information reflects financial results for a single Fund share. The total returns in the table represent the rate that an investor would have earned [or lost] on an investment in the Fund (assuming reinvestment of all dividends and distributions). This information has been audited by _____, whose report, along with the Fund's financial statements, are included in [the SAI or annual report], which is available upon request.

Net Asset Value, Beginning of Period

Income From Investment Operations

Net Investment Income

Net Gains or Losses on Securities (both realized and unrealized)

Total From Investment Operations

Less Distributions

Dividends (from net investment income)

Distributions (from capital gains)

Returns of Capital

Total Distributions

Net Asset Value, End of Period

Total Return

.....

Ratios/Supplemental Data

Net Assets, End of Period

Ratio of Expenses to Average Net Assets

Ratio of Net Income to Average Net Assets

Portfolio Turnover Rate

Instructions.

1. General.

2-7B Federal Securities Act of 1933 PART A

(a) Present the information in comparative columnar form for each of the last 5 fiscal years of the Fund (or for such shorter period as the Fund has been in operation), but only for periods subsequent to the effective date of the Fund's registration statement. Also present the information for the period between the end of the latest fiscal year and the date of the latest balance sheet or statement of assets and liabilities. When a period in the table is for less than a full fiscal year, a Fund may annualize ratios in the table and disclose that the ratios are annualized in a note to the table.

(b) List per share amounts at least to the nearest cent. If the offering price is expressed in tenths of a cent or more, then state the amounts in the table in tenths of a cent. Present the information using a consistent number of decimal places.

(c) Include the narrative explanation before the financial information. A Fund may modify the explanation if the explanation contains comparable information to that shown.

2. Per Share Operating Performance.

(a) Derive net investment income data by adding (deducting) the increase (decrease) per share in undistributed net investment income for the period to (from) dividends from net investment income per share for the period. The increase (decrease) per share may be derived by comparing the per share figures obtained by dividing undistributed net investment income at the beginning and end of the period by the number of shares outstanding on those dates. Other methods of computing net investment income may be acceptable. Provide an explanation in a note to the table of any other method used to compute net investment income.

(b) The amount shown at the Net Gains or Losses on Securities caption is the balancing figure derived from the other amounts in the statement. The amount shown at this caption for a share outstanding throughout the year may not agree with the change in the aggregate gains and losses in the portfolio securities for the year because of the timing of sales and repurchases of the Fund's shares in relation to fluctuating market values for the portfolio.

(c) For any distributions made from sources other than net investment income and capital gains, state the per share amounts separately at the Returns of Capital caption and note the nature of the distributions.

3. Total Return.

(a) Assume an initial investment made at the net asset value calculated on the last business day before the first day of each period shown.

(b) Do not reflect sales loads or account fees in the initial investment, but, if sales loads or account fees are imposed, note that they are not reflected in total return.

2-7B Federal Securities Act of 1933 PART A

(c) Reflect any sales load assessed upon reinvestment of dividends or distributions.

(d) Assume a redemption at the price calculated on the last business day of each period shown.

(e) For a period less than a full fiscal year, state the total return for the period and disclose that total return is not annualized in a note to the table.

4. Ratios/Supplemental Data.

(a) Calculate "average net assets" based on the value of the net assets determined no less frequently than the end of each month.

(b) Calculate the Ratio of Expenses to Average Net Assets using the amount of expenses shown in the Fund's statement of operations for the relevant fiscal period, including increases resulting from complying with paragraph 2(g) of rule 6-07 of Regulation S-X and reductions resulting from complying with paragraphs 2(a) and (f) of rule 6-07 regarding fee waivers and reimbursements. If a change in the methodology for determining the ratio of expenses to average net assets results from applying paragraph 2(g) of rule 6-07, explain in a note that the ratio reflects fees paid with brokerage commissions and fees reduced in connection with specific agreements only for periods ending after September 1, 1995.

(c) A Fund that is a Money Market Fund may omit the Portfolio Turnover Rate.

(d) Calculate the Portfolio Turnover Rate as follows:

(i) Divide the lesser of amounts of purchases or sales of portfolio securities for the fiscal year by the monthly average of the value of the portfolio securities owned by the Fund during the fiscal year. Calculate the monthly average by totaling the values of portfolio securities as of the beginning and end of the first month of the fiscal year and as of the end of each of the succeeding 11 months and dividing the sum by 13.

(ii) Exclude from both the numerator and the denominator amounts relating to all securities, including options, whose maturities or expiration dates at the time of acquisition were one year or less. Include all long-term securities, including long-term U.S. Government securities. Purchases include any cash paid upon the conversion of one portfolio security into another and the cost of rights or warrants. Sales include net proceeds of the sale of rights and warrants and net proceeds of portfolio securities that have been called or for which payment has been made through redemption or

maturity.

(iii) If the Fund acquired the assets of another investment company or of a personal holding company in exchange for its own shares during the fiscal year in a purchase-of-assets transaction, exclude the value of securities acquired from purchases and securities sold from sales to realign the Fund's portfolio. Adjust the denominator of the portfolio turnover computation to reflect these excluded purchases and sales and disclose them in a footnote.

(iv) Include in purchases and sales any short sales that the Fund intends to maintain for more than one year and put and call options with expiration dates more than one year from the date of acquisition. Include proceeds from a short sale in the value of the portfolio securities sold during the period; include the cost of covering a short sale in the value of portfolio securities purchased during the period. Include premiums paid to purchase options in the value of portfolio securities purchased during the reporting period; include premiums received from the sale of options in the value of the portfolio securities sold during the period.

(b) A Fund may incorporate by reference the Financial Highlights Information from a report to shareholders under rule 30e-1 into the prospectus in response to this Item if the Fund delivers the shareholder report with the prospectus or, if the report has been previously delivered (*e.g.*, to a current shareholder), the Fund includes the statement required by Item 1(b)(1).



110 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 7B Investment Company Act Forms

2-7B Federal Securities Act of 1933 PART B

PART B INFORMATION REQUIRED IN A STATEMENT OF ADDITIONAL INFORMATION

Item 14. Cover Page and Table of Contents

(a) *Front Cover Page.* Include the following information on the outside front cover page of the SAI:

(1) The Fund's name and the Class or Classes, if any, to which the SAI relates. If the Fund is a Series, also provide the Registrant's name.

(2) The exchange ticker symbol of the Fund's securities or, if the SAI relates to one or more Classes of the Fund's securities, adjacent to each such Class, the exchange ticker symbol of such Class of the Fund's securities. If the Fund is an Exchange-Traded Fund, also identify the principal U.S. market or markets on which the Fund shares are traded.

(3) A statement or statements:

(i) That the SAI is not a prospectus;

(ii) How the prospectus may be obtained; and

(iii) Whether and from where information is incorporated by reference into the SAI, as permitted by General Instruction D.

Instruction. Any information incorporated by reference into the SAI must be delivered with the SAI unless the information has been previously delivered in a shareholder report (*e.g.*, to a current shareholder), and the Fund states that the shareholder report is available, without charge, upon request. Provide a toll-free (or collect) telephone number to call to request the report.

(4) The date of the SAI and of the prospectus to which the SAI relates.

(b) *Table of Contents.* Include under appropriate captions (and subcaptions) a list of the contents of the SAI and, when useful, provide cross-references to related disclosure in the prospectus.

Item 15. Fund History

(a) Provide the date and form of organization of the Fund and the name of the state or other jurisdiction in which the Fund is organized.

(b) If the Fund has engaged in a business other than that of an investment company during the past 5 years, state the nature of the other business and give the approximate date on which the Fund commenced business as an investment company. If the Fund's name was changed during that period, state its former name and the approximate date on which it was changed. Briefly describe the nature and results of any change in the Fund's business or name that occurred in connection with any bankruptcy, receivership, or similar proceeding, or any other material reorganization, readjustment or succession.

Item 16. Description of the Fund and Its Investments and Risks

(a) *Classification.* State that the Fund is an open-end, management investment company and indicate, if applicable, that the Fund is diversified.

(b) *Investment Strategies and Risks.* Describe any investment strategies, including a strategy to invest in a particular type of security, used by an investment adviser of the Fund in managing the Fund that are not principal strategies and the risks of those strategies.

(c) *Fund Policies.*

(1) Describe the Fund's policy with respect to each of the following:

(i) Issuing senior securities;

(ii) Borrowing money, including the purpose for which the proceeds will be used;

(iii) Underwriting securities of other issuers;

(iv) Concentrating investments in a particular industry or group of industries;

(v) Purchasing or selling real estate or commodities;

(vi) Making loans; and

(vii) Any other policy that the Fund deems fundamental or that may not be changed without shareholder approval, including, if applicable, the Fund's investment objectives.

Instruction. If the Fund reserves freedom of action with respect to any practice specified in paragraph (c)(1), state the maximum percentage of assets to be devoted to the practice and disclose the risks of the practice.

(2) State whether shareholder approval is necessary to change any policy specified in paragraph (c)(1). If so, describe the vote required to obtain this approval.

(d) *Temporary Defensive Position.* Disclose, if applicable, the types of investments that a Fund may make while assuming a temporary defensive position described in response to Item 9(b).

(e) *Portfolio Turnover.* Explain any significant variation in the Fund's portfolio turnover rates over the two most

recently completed fiscal years or any anticipated variation in the portfolio turnover rate from that reported for the last fiscal year in response to Item 13.

Instruction. This paragraph does not apply to a Money Market Fund.

(f) *Disclosure of Portfolio Holdings.*

(1) Describe the Fund's policies and procedures with respect to the disclosure of the Fund's portfolio securities to any person, including:

(i) How the policies and procedures apply to disclosure to different categories of persons, including individual investors, institutional investors, intermediaries that distribute the Fund's shares, third-party service providers, rating and ranking organizations, and affiliated persons of the Fund;

(ii) Any conditions or restrictions placed on the use of information about portfolio securities that is disclosed, including any requirement that the information be kept confidential or prohibitions on trading based on the information, and any procedures to monitor the use of this information;

(iii) The frequency with which information about portfolio securities is disclosed, and the length of the lag, if any, between the date of the information and the date on which the information is disclosed;

(iv) Any policies and procedures with respect to the receipt of compensation or other consideration by the Fund, its investment adviser, or any other party in connection with the disclosure of information about portfolio securities;

(v) The individuals or categories of individuals who may authorize disclosure of the Fund's portfolio securities (*e.g.*, executive officers of the Fund);

(vi) The procedures that the Fund uses to ensure that disclosure of information about portfolio securities is in the best interests of Fund shareholders, including procedures to address conflicts between the interests of Fund shareholders, on the one hand, and those of the Fund's investment adviser; principal underwriter; or any affiliated person of the Fund, its investment adviser, or its principal underwriter, on the other; and

(vii) The manner in which the board of directors exercises oversight of disclosure of the Fund's portfolio securities.

2-7B Federal Securities Act of 1933 PART B

Instruction. Include any policies and procedures of the Fund's investment adviser, or any other third party, that the Fund uses, or that are used on the Fund's behalf, with respect to the disclosure of the Fund's portfolio securities to any person.

(2) Describe any ongoing arrangements to make available information about the Fund's portfolio securities to any person, including the identity of the persons who receive information pursuant to such arrangements. Describe any compensation or other consideration received by the Fund, its investment adviser, or any other party in connection with each such arrangement, and provide the information described by paragraphs (f)(1)(ii), (iii), and (v) of this Item with respect to such arrangements.

Instructions.

1. The consideration required to be disclosed by Item 16(f)(2) includes any agreement to maintain assets in the Fund or in other investment companies or accounts managed by the investment adviser or by any affiliated person of the investment adviser.

2. The Fund is not required to describe an ongoing arrangement to make available information about the Fund's portfolio securities pursuant to this Item, if, not later than the time that the Fund makes the portfolio securities information available to any person pursuant to the arrangement, the Fund discloses the information in a publicly available filing with the Commission that is required to include the information.

3. The Fund is not required to describe an ongoing arrangement to make available information about the Fund's portfolio securities pursuant to this Item if:

(a) the Fund makes the portfolio securities information available to any person pursuant to the arrangement no earlier than the day next following the day on which the Fund makes the information available on its website in the manner specified in its prospectus pursuant to paragraph (b); and

(b) the Fund has disclosed in its current prospectus that the portfolio securities information will be available on its website, including (1) the nature of the information that will be available, including both the date as of which the information will be current (e.g., month-end) and the scope of the information (e.g., complete portfolio holdings, Fund's largest 20 holdings); (2) the date when the information will first become available and the period for which the information will remain available, which shall end no earlier than the date on which the Fund files its Form N-CSR or Form N-Q with the Commission for the period that includes the date as of which the website information is current; and (3) the location on the Fund's website where either the information or a prominent hyperlink (or series of prominent hyperlinks) to the information will be available.

Item 17. Management of the Fund

Instructions.

1. For purposes of this Item 17, the terms below have the following meanings:

(a) The term "family of investment companies" means any two or more registered investment companies that:

(1) Share the same investment adviser or principal underwriter; and

(2) Hold themselves out to investors as related companies for purposes of investment and investor services.

(b) The term "fund complex" means two or more registered investment companies that:

(1) Hold themselves out to investors as related companies for purposes of investment and investor services; or

(2) Have a common investment adviser or have an investment adviser that is an affiliated person of the investment adviser of any of the other registered investment companies.

(c) The term "immediate family member" means a person's spouse; child residing in the person's household (including step and adoptive children); and any dependent of the person, as defined in section 152 of the Internal Revenue Code (26 U.S.C. 152).

(d) The term "officer" means the president, vice-president, secretary, treasurer, controller, or any other officer who performs policy-making functions.

2. When providing information about directors, furnish information for directors who are interested persons of the Fund separately from the information for directors who are not interested persons of the Fund. For example, when furnishing information in a table, you should provide separate tables (or separate sections of a single table) for directors who are interested persons and for directors who are not interested persons. When furnishing information in narrative form, indicate by heading or otherwise the directors who are interested persons and the directors who are not interested persons.

2-7B Federal Securities Act of 1933 PART B

(a) *Management Information.*

(1) Provide the information required by the following table for each director and officer of the Fund, and, if the Fund has an advisory board, member of the board. Explain in a footnote to the table any family relationship between the persons listed.

(1)	(2)	(3)	(4)	(5)	(6)
Name, Address, and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation(s) During Past 5 Years	Number of Portfolios in Fund Complex Overseen by Director	Other Directorships Held by Director

Instructions.

1. For purposes of this paragraph, the term "family relationship" means any relationship by blood, marriage, or adoption, not more remote than first cousin.
2. For each director who is an interested person of the Fund, describe, in a footnote or otherwise, the relationship, events, or transactions by reason of which the director is an interested person.
3. State the principal business of any company listed under column (4) unless the principal business is implicit in its name.
4. Indicate in column (6) directorships not included in column (5) that are held by a director in any company with a class of securities registered pursuant to section 12 of the Securities Exchange Act (15 U.S.C. 78l) or subject to the requirements of section 15(d) of the Securities Exchange Act (15 U.S.C. 78o(d)) or any company registered as an investment company under the Investment Company Act, and name the companies in which the directorships are held. Where the other directorships include directorships overseeing two or more portfolios in the same fund complex, identify the fund complex and provide the number of portfolios overseen as a director in the fund complex rather than listing each portfolio separately.

(2) For each individual listed in column (1) of the table required by paragraph (a)(1) of this Item 17, except for any director who is not an interested person of the Fund, describe any positions, including as an officer, employee, director, or general partner, held with affiliated persons or principal underwriters of the Fund.

Instruction. When an individual holds the same position(s) with two or more registered investment companies that are part of the same fund complex, identify the fund complex and provide the number of registered investment companies for which the position(s) are held rather than listing each registered investment company separately.

2-7B Federal Securities Act of 1933 PART B

(3) Describe briefly any arrangement or understanding between any director or officer and any other person(s) (naming the person(s)) pursuant to which he was selected as a director or officer.

Instruction. Do not include arrangements or understandings with directors or officers acting solely in their capacities as such.

(b) *Board of Directors.*

(1) Briefly describe the responsibilities of the board of directors with respect to the Fund's management.

Instruction. A Fund may respond to this paragraph by providing a general statement as to the responsibilities of the board of directors with respect to the Fund's management under the applicable laws of the state or other jurisdiction in which the Fund is organized.

(2) Identify the standing committees of the Fund's board of directors, and provide the following information about each committee:

(i) A concise statement of the functions of the committee;

(ii) The members of the committee;

(iii) The number of committee meetings held during the last fiscal year; and

(iv) If the committee is a nominating or similar committee, state whether the committee will consider nominees recommended by security holders and, if so, describe the procedures to be followed by security holders in submitting recommendations.

(3) Unless disclosed in the table required by paragraph (a)(1) of this Item 17, describe any positions, including as an officer, employee, director, or general partner, held by any director who is not an interested person of the Fund, or immediate family member of the director, during the two most recently completed calendar years with:

(i) The Fund;

2-7B Federal Securities Act of 1933 PART B

(ii) An investment company, or a person that would be an investment company but for the exclusions provided by sections 3(c)(1) and 3(c)(7) (15 U.S.C. 80a-3(c)(1) and (c)(7)), having the same investment adviser or principal underwriter as the Fund or having an investment adviser or principal underwriter that directly or indirectly controls, is controlled by, or is under common control with an investment adviser or principal underwriter of the Fund;

(iii) An investment adviser, principal underwriter, or affiliated person of the Fund; or

(iv) Any person directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter of the Fund.

Instruction. When an individual holds the same position(s) with two or more portfolios that are part of the same fund complex, identify the fund complex and provide the number of portfolios for which the position(s) are held rather than listing each portfolio separately.

(4) For each director, state the dollar range of equity securities beneficially owned by the director as required by the following table:

(i) In the Fund; and

(ii) On an aggregate basis, in any registered investment companies overseen by the director within the same family of investment companies as the Fund.

(1)	(2)	(3)
Name of Director	Dollar Range of Equity Securities in the Fund	Aggregate Dollar Range of Equity Securities in All Registered Investment Companies Overseen by Director in Family of Investment Companies

Instructions.

1. Information should be provided as of the end of the most recently completed calendar year. Specify the valuation date by footnote or otherwise.

2. Determine "beneficial ownership" in accordance with rule 16a-1(a)(2) under the Exchange Act (17 CFR 240.16a-1(a)(2)).

2-7B Federal Securities Act of 1933 PART B

3. If the SAI covers more than one Fund or Series, disclose in column (2) the dollar range of equity securities beneficially owned by a director in each Fund or Series overseen by the director.

4. In disclosing the dollar range of equity securities beneficially owned by a director in columns (2) and (3), use the following ranges: none, \$1-\$10,000, \$10,001-\$50,000, \$50,001-\$100,000, or over \$100,000.

(5) For each director who is not an interested person of the Fund, and his immediate family members, furnish the information required by the following table as to each class of securities owned beneficially or of record in:

(i) An investment adviser or principal underwriter of the Fund; or

(ii) A person (other than a registered investment company) directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter of the Fund:

(1)	(2)	(3)	(4)	(5)	(6)
Name of Director	Name of Owners and Relationships to Director	Company	Title of Class	Value of Securities	Percent of Class

Instructions.

1. Information should be provided as of the end of the most recently completed calendar year. Specify the valuation date by footnote or otherwise.

2. An individual is a "beneficial owner" of a security if he is a "beneficial owner" under either rule 13d-3 or rule 16a-1(a)(2) under the Exchange Act (17 CFR 240.13d-3 or 240.16a-1(a)(2)).

3. Identify the company in which the director or immediate family member of the director owns securities in column (3). When the company is a person directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter, describe the company's relationship with the investment adviser or principal underwriter.

4. Provide the information required by columns (5) and (6) on an aggregate basis for each director and his

immediate family members.

(6) Unless disclosed in response to paragraph (b)(5) of this Item 17, describe any direct or indirect interest, the value of which exceeds \$120,000, of each director who is not an interested person of the Fund, or immediate family member of the director, during the two most recently completed calendar years, in:

(i) An investment adviser or principal underwriter of the Fund; or

(ii) A person (other than a registered investment company) directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter of the Fund.

Instructions.

1. A director or immediate family member has an interest in a company if he is a party to a contract, arrangement, or understanding with respect to any securities of, or interest in, the company.

2. The interest of the director and the interests of his immediate family members should be aggregated in determining whether the value exceeds \$120,000.

(7) Describe briefly any material interest, direct or indirect, of any director who is not an interested person of the Fund, or immediate family member of the director, in any transaction, or series of similar transactions, during the two most recently completed calendar years, in which the amount involved exceeds \$120,000 and to which any of the following persons was a party:

(i) The Fund;

(ii) An officer of the Fund;

(iii) An investment company, or a person that would be an investment company but for the exclusions provided by sections 3(c)(1) and 3(c)(7) (15 U.S.C. 80a-3(c)(1) and (c)(7)), having the same investment adviser or principal underwriter as the Fund or having an investment adviser or principal underwriter that directly or indirectly controls, is controlled by, or is under common control with an investment adviser or principal underwriter of the Fund;

2-7B Federal Securities Act of 1933 PART B

(iv) An officer of an investment company, or a person that would be an investment company but for the exclusions provided by sections 3(c)(1) and 3(c)(7) (15 U.S.C. 80a-3(c)(1) and (c)(7)), having the same investment adviser or principal underwriter as the Fund or having an investment adviser or principal underwriter that directly or indirectly controls, is controlled by, or is under common control with an investment adviser or principal underwriter of the Fund;

(v) An investment adviser or principal underwriter of the Fund;

(vi) An officer of an investment adviser or principal underwriter of the Fund;

(vii) A person directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter of the Fund; or

(viii) An officer of a person directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter of the Fund.

Instructions.

1. Include the name of each director or immediate family member whose interest in any transaction or series of similar transactions is described and the nature of the circumstances by reason of which the interest is required to be described.

2. State the nature of the interest, the approximate dollar amount involved in the transaction, and, where practicable, the approximate dollar amount of the interest.

3. In computing the amount involved in the transaction or series of similar transactions, include all periodic payments in the case of any lease or other agreement providing for periodic payments.

4. Compute the amount of the interest of any director or immediate family member of the director without regard to the amount of profit or loss involved in the transaction(s).

5. As to any transaction involving the purchase or sale of assets, state the cost of the assets to the purchaser and, if acquired by the seller within two years prior to the transaction, the cost to the seller. Describe the method used in determining the purchase or sale price and the name of the person making the determination.

2-7B Federal Securities Act of 1933 PART B

6. Disclose indirect, as well as direct, material interests in transactions. A person who has a position or relationship with, or interest in, a company that engages in a transaction with one of the persons listed in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 may have an indirect interest in the transaction by reason of the position, relationship, or interest. The interest in the transaction, however, will not be deemed "material" within the meaning of paragraph (b)(7) of this Item 17 where the interest of the director or immediate family member arises solely from the holding of an equity interest (including a limited partnership interest, but excluding a general partnership interest) or a creditor interest in a company that is a party to the transaction with one of the persons specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17, and the transaction is not material to the company.

7. The materiality of any interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case. The importance of the interest to the person having the interest, the relationship of the parties to the transaction with each other, and the amount involved in the transaction are among the factors to be considered in determining the significance of the information to investors.

8. No information need be given as to any transaction where the interest of the director or immediate family member arises solely from the ownership of securities of a person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 and the director or immediate family member receives no extra or special benefit not shared on a pro rata basis by all holders of the class of securities.

9. Transactions include loans, lines of credit, and other indebtedness. For indebtedness, indicate the largest aggregate amount of indebtedness outstanding at any time during the period, the nature of the indebtedness and the transaction in which it was incurred, the amount outstanding as of the end of the most recently completed calendar year, and the rate of interest paid or charged.

10. No information need be given as to any routine, retail transaction. For example, the Fund need not disclose that a director has a credit card, bank or brokerage account, residential mortgage, or insurance policy with a person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 unless the director is accorded special treatment.

(8) Describe briefly any direct or indirect relationship, in which the amount involved exceeds \$120,000, of any director who is not an interested person of the Fund, or immediate family member of the director, that existed at any time during the two most recently completed calendar years with any of the persons specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17. Relationships include:

(i) Payments for property or services to or from any person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17;

2-7B Federal Securities Act of 1933 PART B

(ii) Provision of legal services to any person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17;

(iii) Provision of investment banking services to any person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17, other than as a participating underwriter in a syndicate; and

(iv) Any consulting or other relationship that is substantially similar in nature and scope to the relationships listed in paragraphs (b)(8)(i) through (b)(8)(iii) of this Item 17.

Instructions.

1. Include the name of each director or immediate family member whose relationship is described and the nature of the circumstances by reason of which the relationship is required to be described.

2. State the nature of the relationship and the amount of business conducted between the director or immediate family member and the person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 as a result of the relationship during the two most recently completed calendar years.

3. In computing the amount involved in a relationship, include all periodic payments in the case of any agreement providing for periodic payments.

4. Disclose indirect, as well as direct, relationships. A person who has a position or relationship with, or interest in, a company that has a relationship with one of the persons listed in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 may have an indirect relationship by reason of the position, relationship, or interest.

5. In determining whether the amount involved in a relationship exceeds \$120,000, amounts involved in a relationship of the director should be aggregated with those of his immediate family members.

6. In the case of an indirect interest, identify the company with which a person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 has a relationship; the name of the director or immediate family member affiliated with the company and the nature of the affiliation; and the amount of business conducted between the company and the person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 during the two most recently completed calendar years.

2-7B Federal Securities Act of 1933 PART B

7. In calculating payments for property and services for purposes of paragraph (b)(8)(i) of this Item 17, the following may be excluded:

A. Payments where the transaction involves the rendering of services as a common contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority; or

B. Payments that arise solely from the ownership of securities of a person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 and no extra or special benefit not shared on a pro rata basis by all holders of the class of securities is received.

8. No information need be given as to any routine, retail relationship. For example, the Fund need not disclose that a director has a credit card, bank or brokerage account, residential mortgage, or insurance policy with a person specified in paragraphs (b)(7)(i) through (b)(7)(viii) of this Item 17 unless the director is accorded special treatment.

(9) If an officer of an investment adviser or principal underwriter of the Fund, or an officer of a person directly or indirectly controlling, controlled by, or under common control with an investment adviser or principal underwriter of the Fund, served during the two most recently completed calendar years, on the board of directors of a company where a director of the Fund who is not an interested person of the Fund, or immediate family member of the director, was during the two most recently completed calendar years, an officer, identify:

(i) The company;

(ii) The individual who serves or has served as a director of the company and the period of service as director;

(iii) The investment adviser or principal underwriter or person controlling, controlled by, or under common control with the investment adviser or principal underwriter where the individual named in paragraph (b)(9)(ii) of this Item 17 holds or held office and the office held; and

(iv) The director of the Fund or immediate family member who is or was an officer of the company; the office held; and the period of holding the office.

(c) *Compensation.* For all directors of the Fund and for all members of any advisory board who receive compensation from the Fund, and for each of the three highest paid officers or any affiliated person of the Fund who received aggregate compensation from the Fund for the most recently completed fiscal year exceeding \$60,000

2-7B Federal Securities Act of 1933 PART B

("Compensated Persons"):

(1) Provide the information required by the following table:

Compensation Table				
(1)	(2)	(3)	(4)	(5)
Name of Person, Position	Aggregate Com- pensation From Fund	Pension or Retire- ment Benefits Ac- crued As Part of Funds Expenses	Estimated An- nual Benefits Upon Retire- ment	Total Compensa- tion From Fund and Fund Complex Paid to Directors

Instructions.

1. For column (1), indicate, as necessary, the capacity in which the remuneration is received. For Compensated Persons who are directors of the Fund, compensation is amounts received for service as a director.

2. If the Fund has not completed its first full year since its organization, provide the information for the current fiscal year, estimating future payments that would be made under an existing agreement or understanding. Disclose in a footnote to the Compensation Table the period for which the information is given.

3. Include in column (2) amounts deferred at the election of the Compensated Person, whether under a plan established under section 401(k) of the Internal Revenue Code [I.R.C. 401(k)] or otherwise, for the fiscal year in which earned. Disclose in a footnote to the Compensation Table the total amount of deferred compensation (including interest) payable to or accrued for any Compensated Person.

4. Include in columns (3) and (4) all pension or retirement benefits proposed to be paid under any existing plan in the event of retirement at normal retirement date, directly or indirectly, by the Fund, any of its subsidiaries, or other investment companies in the Fund Complex. Omit column (4) when retirement benefits are not determinable.

5. For any defined benefit or actuarial plan under which benefits are determined primarily by final compensation (or average final compensation) and years of service, provide the information required in column (4) in a separate table showing estimated annual benefits payable upon retirement (including amounts attributable to any defined benefit supplementary or excess pension award plans) in specified compensation and years of service classifications. Also provide the estimated credited years of service for each Compensated Person.

6. Include in column (5) only aggregate compensation paid to a director for service on the board and all other boards of investment companies in a Fund Complex specifying the number of any other investment companies.

2-7B Federal Securities Act of 1933 PART B

(2) Describe briefly the material provisions of any pension, retirement, or other plan or any arrangement, other than fee arrangements disclosed in paragraph (d)(1), under which the Compensated Persons are or may be compensated for services provided, including amounts paid, if any, to the Compensated Person under these arrangements during the most recently completed fiscal year. Specifically include the criteria used to determine amounts payable under the plan, the length of service or vesting period required by the plan, the retirement age or other event that gives rise to payment under the plan, and whether the payment of benefits is secured or funded by the Fund.

(d) *Sales Loads*. Disclose any arrangements that result in breakpoints in, or elimination of, sales loads for directors and other affiliated persons of the Fund. Identify each class of individuals and transactions to which the arrangements apply and state each different breakpoint as a percentage of both the offering price and the net amount invested of the Fund's shares. Explain, as applicable, the reasons for the difference in the price at which securities are offered generally to the public, and the prices at which securities are offered to directors and other affiliated persons of the Fund.

(e) *Codes of Ethics*. Provide a brief statement disclosing whether the Fund and its investment adviser and principal underwriter have adopted codes of ethics under rule 17j-1 of the Investment Company Act [17 CFR 270.17j-1] and whether these codes of ethics permit personnel subject to the codes to invest in securities, including securities that may be purchased or held by the Fund.

Instruction: A Fund that is not required to adopt a code of ethics under rule 17j-1 of the Investment Company Act is not required to respond to this item.

(f) *Proxy Voting Policies*. Unless the Fund invests exclusively in non-voting securities, describe the policies and procedures that the Fund uses to determine how to vote proxies relating to portfolio securities, including the procedures that the Fund uses when a vote presents a conflict between the interests of Fund shareholders, on the one hand, and those of the Fund's investment adviser; principal underwriter; or any affiliated person of the Fund, its investment adviser, or its principal underwriter, on the other. Include any policies and procedures of the Fund's investment adviser, or any other third party, that the Fund uses, or that are used on the Fund's behalf, to determine how to vote proxies relating to portfolio securities. Also, state that information regarding how the Fund voted proxies relating to portfolio securities during the most recent 12-month period ended June 30 is available (1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; or on or through the Fund's website at a specified Internet address; or both; and (2) on the Commission's website at <http://www.sec.gov>.

Instructions.

1. A Fund may satisfy the requirement to provide a description of the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities by including a copy of the policies and procedures themselves.

2. If a Fund discloses that the Fund's proxy voting record is available by calling a toll-free (or collect) telephone

2-7B Federal Securities Act of 1933 PART B

number, and the Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for this information, the Fund (or financial intermediary) must send the information disclosed in the Fund's most recently filed report on Form N-PX, within three business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery.

3. If a Fund discloses that the Fund's proxy voting record is available on or through its website, the Fund must make available free of charge the information disclosed in the Fund's most recently filed report on Form N-PX on or through its website as soon as reasonably practicable after filing the report with the Commission. The information disclosed in the Fund's most recently filed report on Form N-PX must remain available on or through the Fund's website for as long as the Fund remains subject to the requirements of Rule 30b1-4 (17 CFR 270.30b1-4) and discloses that the Fund's proxy voting record is available on or through its website.

Item 18. Control Persons and Principal Holders of Securities

Provide the following information as of a specified date no more than 30 days prior to the date of filing the registration statement or an amendment.

(a) *Control Persons.* State the name and address of each person who controls the Fund and explain the effect of that control on the voting rights of other security holders. For each control person, state the percentage of the Fund's voting securities owned or any other basis of control. If the control person is a company, give the jurisdiction under the laws of which it is organized. List all parents of the control person.

Instruction. For purposes of this paragraph, "control" means (i) the beneficial ownership, either directly or through one or more controlled companies, of more than 25% of the voting securities of a company; (ii) the acknowledgment or assertion by either the controlled or controlling party of the existence of control; or (iii) an adjudication under section 2(a)(9), which has become final, that control exists.

(b) *Principal Holders.* State the name, address, and percentage of ownership of each person who owns of record or is known by the Fund to own beneficially 5% or more of any Class of the Fund's outstanding equity securities.

Instructions.

1. Calculate the percentages based on the amount of securities outstanding.

2. If securities are being registered under or in connection with a plan of acquisition, reorganization, readjustment or succession, indicate, as far as practicable, the ownership that would result from consummation of the plan based on present holdings and commitments.

3. Indicate whether the securities are owned of record, beneficially, or both. Show the respective percentage owned in each manner.

(c) *Management Ownership.* State the percentage of the Fund's equity securities owned by all officers, directors, and members of any advisory board of the Fund as a group. If the amount owned by directors and officers as a group is less than 1% of the Class, provide a statement to that effect.

Item 19. Investment Advisory and Other Services

(a) *Investment Advisers.* Disclose the following information with respect to each investment adviser:

(1) The name of any person who controls the adviser, the basis of the person's control, and the general nature of the person's business. Also disclose, if material, the business history of any organization that controls the adviser.

(2) The name of any affiliated person of the Fund who also is an affiliated person of the adviser, and a list of all capacities in which the person is affiliated with the Fund and with the adviser.

Instruction. If an affiliated person of the Fund alone or together with others controls the adviser, state that fact. It is not necessary to provide the amount or percentage of the outstanding voting securities owned by the controlling person.

(3) The method of calculating the advisory fee payable by the Fund including:

(i) The total dollar amounts that the Fund paid to the adviser (aggregated with amounts paid to affiliated advisers, if any), and any advisers who are not affiliated persons of the adviser, under the investment advisory contract for the last three fiscal years;

(ii) If applicable, any credits that reduced the advisory fee for any of the last three fiscal years; and

(iii) Any expense limitation provision.

Instructions.

2-7B Federal Securities Act of 1933 PART B

1. If the advisory fee payable by the Fund varies depending on the Fund's investment performance in relation to a standard, describe the standard along with a fee schedule in tabular form. The Fund may include examples showing the fees that the adviser would earn at various levels of performance as long as the examples include calculations showing the maximum and minimum fee percentages that could be earned under the contract.

2. State separately each type of credit or offset.

3. When a Fund is subject to more than one expense limitation provision, describe only the most restrictive provision.

4. For a Registrant with more than one Series, or a Multiple Class Fund, describe the methods of allocation and payment of advisory fees for each Series or Class.

(b) *Principal Underwriter*. State the name and principal business address of any principal underwriter for the Fund. Disclose, if applicable, that an affiliated person of the Fund is an affiliated person of the principal underwriter and identify the affiliated person.

(c) *Services Provided by Each Investment Adviser and Fund Expenses Paid by Third Parties*.

(1) Describe all services performed for or on behalf of the Fund supplied or paid for wholly or in substantial part by each investment adviser.

(2) Describe all fees, expenses, and costs of the Fund that are to be paid by persons other than an investment adviser or the Fund, and identify those persons.

(d) *Service Agreements*. Summarize the substantive provisions of any other management-related service contract that may be of interest to a purchaser of the Fund's shares, under which services are provided to the Fund, indicating the parties to the contract, and the total dollars paid and by whom for the past three years.

Instructions.

1. The term "management-related service contract" includes any contract with the Fund to keep, prepare, or file accounts, books, records, or other documents required under federal or state law, or to provide any similar services with respect to the daily administration of the Fund, but does not include the following:

2-7B Federal Securities Act of 1933 PART B

- (a) Any contract with the Fund to provide investment advice;
- (b) Any agreement with the Fund to perform as custodian, transfer agent, or dividend-paying agent for the Fund;
and
- (c) Any contract with the Fund for outside legal or auditing services, or contract for personal employment entered into with the Fund in the ordinary course of business.

2. No information need be given in response to this paragraph with respect to the service of mailing proxies or periodic reports to the Fund's shareholders.

3. In summarizing the substantive provisions of any management-related service contract, include the following:

- (a) The name of the person providing the service;
 - (b) The direct or indirect relationships, if any, of the person with the Fund, an investment adviser of the Fund or the Fund's principal underwriter; and
 - (c) The nature of the services provided, and the basis of the compensation paid for the services for the last three fiscal years.
- (e) *Other Investment Advice.* If any person (other than a director, officer, member of an advisory board, employee, or investment adviser of the Fund), through any understanding, whether formal or informal, regularly advises the Fund or the Fund's investment adviser with respect to the Fund's investing in, purchasing, or selling securities or other property, or has the authority to determine what securities or other property should be purchased or sold by the Fund, and receives direct or indirect remuneration, provide the following information:

- (1) The person's name;
- (2) A description of the nature of the arrangement, and the advice or information provided; and

2-7B Federal Securities Act of 1933 PART B

(3) Any remuneration (including, for example, participation, directly or indirectly, in commissions or other compensation paid in connection with transactions in the Fund's portfolio securities) paid for the advice or information, and a statement as to how the remuneration was paid and by whom it was paid for the last three fiscal years.

Instruction. Do not include information for the following:

(a) Persons who advised the investment adviser or the Fund solely through uniform publications distributed to subscribers;

(b) Persons who provided the investment adviser or the Fund with only statistical and other factual information, advice about economic factors and trends, or advice as to occasional transactions in specific securities, but without generally advising about the purchase or sale of securities by the Fund;

(c) A company that is excluded from the definition of "investment adviser" of an investment company under section 2(a)(20)(iii) [15 U.S.C. 80a-2(a)(20)(iii)];

(d) Any person the character and amount of whose compensation for these services must be approved by a court;
or

(e) Other persons as the Commission has by rule or order determined not to be an "investment adviser" of an investment company.

(f) *Dealer Reallowances.* Disclose any front-end sales load reallowed to dealers as a percentage of the offering price of the Fund's shares.

(g) *Rule 12b-1 Plans.* If the Fund has adopted a plan under rule 12b-1, describe the material aspects of the plan, and any agreements relating to the implementation of the plan, including:

(1) A list of the principal types of activities for which payments are or will be made, including the dollar amount and the manner in which amounts paid by the Fund under the plan during the last fiscal year were spent on:

(i) Advertising;

2-7B Federal Securities Act of 1933 PART B

(ii) Printing and mailing of prospectuses to other than current shareholders;

(iii) Compensation to underwriters;

(iv) Compensation to broker-dealers;

(v) Compensation to sales personnel;

(vi) Interest, carrying, or other financing charges; and

(vii) Other (specify).

(2) The relationship between amounts paid to the distributor and the expenses that it incurs (*e.g.*, whether the plan reimburses the distributor only for expenses incurred or compensates the distributor regardless of its expenses).

(3) The amount of any unreimbursed expenses incurred under the plan in a previous year and carried over to future years, in dollars and as a percentage of the Fund's net assets on the last day of the previous year.

(4) Whether the Fund participates in any joint distribution activities with another Series or investment company. If so, disclose, if applicable, that fees paid under the Fund's rule 12b-1 plan may be used to finance the distribution of the shares of another Series or investment company, and state the method of allocating distribution costs (*e.g.*, relative net asset size, number of shareholder accounts).

(5) Whether any of the following persons had a direct or indirect financial interest in the operation of the plan or related agreements:

(i) Any interested person of the Fund; or

2-7B Federal Securities Act of 1933 PART B

(ii) Any director of the Fund who is not an interested person of the Fund.

(6) The anticipated benefits to the Fund that may result from the plan.

(h) *Other Service Providers.*

(1) Unless disclosed in response to paragraph (d), identify any person who provides significant administrative or business affairs management services for the Fund (*e.g.*, an "administrator"), describe the services provided, and the compensation paid for the services.

(2) State the name and principal business address of the Fund's transfer agent and the dividend-paying agent.

(3) State the name and principal business address of the Fund's custodian and independent public accountant and describe generally the services performed by each. If the Fund's portfolio securities are held by a person other than a commercial bank, trust company, or depository registered with the Commission as custodian, state the nature of the business of that person or persons.

(4) If an affiliated person of the Fund, or an affiliated person of the affiliated person, acts as custodian, transfer agent, or dividend-paying agent for the Fund, describe the services that the person performs and the basis for remuneration.

Item 20. Portfolio Managers

(a) *Other Accounts Managed.* If a Portfolio Manager required to be identified in response to Item 5(b) is primarily responsible for the day-to-day management of the portfolio of any other account, provide the following information:

(1) The Portfolio Manager's name;

(2) The number of other accounts managed within each of the following categories and the total assets in the accounts managed within each category:

2-7B Federal Securities Act of 1933 PART B

(A) Registered investment companies;

(B) Other pooled investment vehicles; and

(C) Other accounts.

(3) For each of the categories in paragraph (a)(2) of this Item, the number of accounts and the total assets in the accounts with respect to which the advisory fee is based on the performance of the account; and

(4) A description of any material conflicts of interest that may arise in connection with the Portfolio Manager's management of the Fund's investments, on the one hand, and the investments of the other accounts included in response to paragraph (a)(2) of this Item, on the other. This description would include, for example, material conflicts between the investment strategy of the Fund and the investment strategy of other accounts managed by the Portfolio Manager and material conflicts in allocation of investment opportunities between the Fund and other accounts managed by the Portfolio Manager.

Instructions.

1. Provide the information required by this paragraph as of the end of the Fund's most recently completed fiscal year, except that, in the case of an initial registration statement or an update to the Fund's registration statement that discloses a new Portfolio Manager, information with respect to any newly identified Portfolio Manager must be provided as of the most recent practicable date. Disclose the date as of which the information is provided.

2. If a committee, team, or other group of persons that includes the Portfolio Manager is jointly and primarily responsible for the day-to-day management of the portfolio of an account, include the account in responding to paragraph (a) of this Item.

(b) *Compensation.* Describe the structure of, and the method used to determine, the compensation of each Portfolio Manager required to be identified in response to Item 5(b). For each type of compensation (*e.g.*, salary, bonus, deferred compensation, retirement plans and arrangements), describe with specificity the criteria on which that type of compensation is based, for example, whether compensation is fixed, whether (and, if so, how) compensation is based on Fund pre- or after-tax performance over a certain time period, and whether (and, if so, how) compensation is based on the value of assets held in the Fund's portfolio. For example, if compensation is based solely or in part on performance, identify any benchmark used to measure performance and state the length of the period over which performance is measured.

Instructions.

2-7B Federal Securities Act of 1933 PART B

1. Provide the information required by this paragraph as of the end of the Fund's most recently completed fiscal year, except that, in the case of an initial registration statement or an update to the Fund's registration statement that discloses a new Portfolio Manager, information with respect to any newly identified Portfolio Manager must be provided as of the most recent practicable date. Disclose the date as of which the information is provided.

2. Compensation includes, without limitation, salary, bonus, deferred compensation, and pension and retirement plans and arrangements, whether the compensation is cash or non-cash. Group life, health, hospitalization, medical reimbursement, relocation, and pension and retirement plans and arrangements may be omitted, provided that they do not discriminate in scope, terms, or operation in favor of the Portfolio Manager or a group of employees that includes the Portfolio Manager and are available generally to all salaried employees. The value of compensation is not required to be disclosed under this Item.

3. Include a description of the structure of, and the method used to determine, any compensation received by the Portfolio Manager from the Fund, the Fund's investment adviser, or any other source with respect to management of the Fund and any other accounts included in the response to paragraph (a)(2) of this Item. This description must clearly disclose any differences between the method used to determine the Portfolio Manager's compensation with respect to the Fund and other accounts, *e.g.*, if the Portfolio Manager receives part of an advisory fee that is based on performance with respect to some accounts but not the Fund, this must be disclosed.

(c) *Ownership of Securities.* For each Portfolio Manager required to be identified in response to Item 5(b), state the dollar range of equity securities in the Fund beneficially owned by the Portfolio Manager using the following ranges: none, \$1- \$10,000, \$10,001-\$50,000, \$50,001-\$100,000, \$100,001-\$500,000, \$500,001-\$1,000,000, or over \$1,000,000.

Instructions.

1. Provide the information required by this paragraph as of the end of the Fund's most recently completed fiscal year, except that, in the case of an initial registration statement or an update to the Fund's registration statement that discloses a new Portfolio Manager, information with respect to any newly identified Portfolio Manager must be provided as of the most recent practicable date. Specify the valuation date.

2. Determine "beneficial ownership" in accordance with rule 16a-1(a)(2) under the Exchange Act (17 CFR 240.16a-1(a)(2)).

Item 21. Brokerage Allocation and Other Practices

2-7B Federal Securities Act of 1933 PART B

(a) *Brokerage Transactions.* Describe how transactions in portfolio securities are effected, including a general statement about brokerage commissions, markups, and markdowns on principal transactions and the aggregate amount of any brokerage commissions paid by the Fund during its three most recent fiscal years. If, during either of the two years preceding the Fund's most recent fiscal year, the aggregate dollar amount of brokerage commissions paid by the Fund differed materially from the amount paid during the most recent fiscal year, state the reason(s) for the difference(s).

(b) *Commissions.*

(1) Identify, disclose the relationship, and state the aggregate dollar amount of brokerage commissions paid by the Fund during its three most recent fiscal years to any broker:

(i) That is an affiliated person of the Fund or an affiliated person of that person; or

(ii) An affiliated person of which is an affiliated person of the Fund, its investment adviser, or principal underwriter.

(2) For each broker identified in response to paragraph (b)(1), state:

(i) The percentage of the Fund's aggregate brokerage commissions paid to the broker during the most recent fiscal year; and

(ii) The percentage of the Fund's aggregate dollar amount of transactions involving the payment of commissions effected through the broker during the most recent fiscal year.

(3) State the reasons for any material difference in the percentage of brokerage commissions paid to, and the percentage of transactions effected through, a broker disclosed in response to paragraph (b)(1).

(c) *Brokerage Selection.* Describe how the Fund will select brokers to effect securities transactions for the Fund and how the Fund will evaluate the overall reasonableness of brokerage commissions paid, including the factors that the Fund will consider in making these determinations.

Instructions.

2-7B Federal Securities Act of 1933 PART B

1. If the Fund will consider the receipt of products or services other than brokerage or research services in selecting brokers, specify those products and services.

2. If the Fund will consider the receipt of research services in selecting brokers, identify the nature of those research services.

3. State whether persons acting on the Fund's behalf are authorized to pay a broker a higher brokerage commission than another broker might have charged for the same transaction in recognition of the value of (a) brokerage or (b) research services provided by the broker.

4. If applicable, explain that research services provided by brokers through which the Fund effects securities transactions may be used by the Fund's investment adviser in servicing all of its accounts and that not all of these services may be used by the adviser in connection with the Fund. If other policies or practices are applicable to the Fund with respect to the allocation of research services provided by brokers, explain those policies and practices.

(d) *Directed Brokerage*. If, during the last fiscal year, the Fund or its investment adviser, through an agreement or understanding with a broker, or otherwise through an internal allocation procedure, directed the Fund's brokerage transactions to a broker because of research services provided, state the amount of the transactions and related commissions.

(e) *Regular Broker-Dealers*. If the Fund has acquired during its most recent fiscal year or during the period of time since organization, whichever is shorter, securities of its regular brokers or dealers as defined in rule 10b-1 [17 CFR 270.10b-1] or of their parents, identify those brokers or dealers and state the value of the Fund's aggregate holdings of the securities of each issuer as of the close of the Fund's most recent fiscal year.

Instruction. The Fund need only disclose information about an issuer that derived more than 15% of its gross revenues from the business of a broker, a dealer, an underwriter, or an investment adviser during its most recent fiscal year.

Item 22. Capital Stock and Other Securities

(a) *Capital Stock*. For each class of capital stock of the Fund, provide:

(1) The title of each class; and

(2) A full discussion of the following provisions or characteristics of each class, if applicable:

- (i) Restrictions on the right freely to retain or dispose of the Fund's shares;
- (ii) Material obligations or potential liabilities associated with owning the Fund's shares (not including investment risks);
- (iii) Dividend rights;
- (iv) Voting rights (including whether the rights of shareholders can be modified by other than a majority vote);
- (v) Liquidation rights;
- (vi) Preemptive rights;
- (vii) Conversion rights;
- (viii) Redemption provisions;
- (ix) Sinking fund provisions; and
- (x) Liability to further calls or to assessment by the Fund.

Instructions.

1. If any class described in response to this paragraph possesses cumulative voting rights, disclose the existence of those rights and explain the operation of cumulative voting.

2. If the rights evidenced by any class described in response to this paragraph are materially limited or qualified by the rights of any other class, explain those limitations or qualifications.

(b) *Other Securities*. Describe the rights of any authorized securities of the Fund other than capital stock. If the securities are subscription warrants or rights, state the title and amount of securities called for, and the period during which and the prices at which the warrants or rights are exercisable.

Item 23 Purchase, Redemption, and Pricing of Shares

(a) *Purchase of Shares*. To the extent that the prospectus does not do so, describe how the Fund's shares are offered to the public. Include any special purchase plans or methods not described in the prospectus or elsewhere in the SAI, including letters of intent, accumulation plans, dividend reinvestment plans, withdrawal plans, exchange privileges, employee benefit plans, redemption reinvestment plans, and waivers for particular classes of shareholders.

(b) *Fund Reorganizations*. Disclose any arrangements that result in breakpoints in, or elimination of, sales loads in connection with the terms of a merger, acquisition, or exchange offer made under a plan of reorganization. Identify each class of individuals to which the arrangements apply and state each different sales load available as a percentage of both the offering price and the net amount invested.

(c) *Offering Price*. Describe the method followed or to be followed by the Fund in determining the total offering price at which its shares may be offered to the public and the method(s) used to value the Fund's assets.

Instructions.

1. Describe the valuation procedure(s) that the Fund uses in determining the net asset value and public offering price of its shares.

2. Explain how the excess of the offering price over the net amount invested is distributed among the Fund's principal underwriters or others and the basis for determining the total offering price.

3. Explain the reasons for any difference in the price at which securities are offered generally to the public, and the prices at which securities are offered for any class of transactions or to any class of individuals.

2-7B Federal Securities Act of 1933 PART B

4. Unless provided as a continuation of the balance sheet in response to Item 27, include a specimen price-make-up sheet showing how the Fund calculates the total offering price per unit. Base the calculation on the value of the Fund's portfolio securities and other assets and its outstanding securities as of the date of the balance sheet filed by the Fund.

(d) *Redemption in Kind*. If the Fund has received an order of exemption from section 18(f) or has filed a notice of election under rule 18f-1 that has not been withdrawn, describe the nature, extent, and effect of the exemptive relief or notice.

(e) *Arrangements Permitting Frequent Purchases and Redemptions of Fund Shares*. Describe any arrangements with any person to permit frequent purchases and redemptions of Fund shares, including the identity of the persons permitted to engage in frequent purchases and redemptions pursuant to such arrangements, and any compensation or other consideration received by the Fund, its investment adviser, or any other party pursuant to such arrangements.

Instructions.

1. The consideration required to be disclosed by Item 23(e) includes any agreement to maintain assets in the Fund or in other investment companies or accounts managed by the investment adviser or by any affiliated person of the investment adviser.

2. If the Fund has an arrangement to permit frequent purchases and redemptions by a group of individuals, such as the participants in a defined contribution plan that meets the requirements for qualification under Section 401(k) of the Internal Revenue Code (26 U.S.C. 401(k)), the Fund may identify the group rather than identifying each individual group member.

Item 24. Taxation of the Fund

(a) If applicable, state that the Fund is qualified or intends to qualify under Subchapter M of the Internal Revenue Code. Disclose the consequences to the Fund if it does not qualify under Subchapter M.

(b) Disclose any special or unusual tax aspects of the Fund, such as taxation resulting from foreign investment or from status as a personal holding company, or any tax loss carry-forward to which the Fund may be entitled.

Item 25. Underwriters

(a) *Distribution of Securities.* For each principal underwriter distributing securities of the Fund, state:

(1) The nature of the obligation to distribute the Fund's securities;

(2) Whether the offering is continuous; and

(3) The aggregate dollar amount of underwriting commissions and the amount retained by the principal underwriter for each of the Fund's last three fiscal years.

(b) *Compensation.* Provide the information required by the following table with respect to all commissions and other compensation received by each principal underwriter, who is an affiliated person of the Fund or an affiliated person of that affiliated person, directly or indirectly, from the Fund during the Fund's most recent fiscal year:

(1)	(2)	(3)	(4)	(5)
Name of Principal Underwriter	Net Underwriting Discounts and Com- missions	Compensation on Redemptions and Repurchases	Brokerage Commissions	Other Compensation

Instruction. Disclose in a footnote to the table the type of services rendered in consideration for the compensation listed under column (5).

(c) *Other Payments.* With respect to any payments made by the Fund to an underwriter or dealer in the Fund's shares during the Fund's last fiscal year, disclose the name and address of the underwriter or dealer, the amount paid and basis for determining that amount, the circumstances surrounding the payments, and the consideration received by the Fund. Do not include information about:

(1) Payments made through deduction from the offering price at the time of sale of securities issued by the Fund;

(2) Payments representing the purchase price of portfolio securities acquired by the Fund;

(3) Commissions on any purchase or sale of portfolio securities by the Fund; or

(4) Payments for investment advisory services under an investment advisory contract.

Instructions.

1. Do not include in response to this paragraph information provided in response to paragraph (b) or with respect to service fees under the Instruction to Item 12(b)(2). Do not include any payment for a service excluded by Instructions 1 and 2 to Item 19(d) or by Instruction 2 to Item 34.

2. If the payments were made under an arrangement or policy applicable to dealers generally, describe only the arrangement or policy.

Item 26. Calculation of Performance Data

(a) *Money Market Funds.* Yield quotation(s) for a Money Market Fund included in the prospectus should be calculated according to paragraphs (a)(1) - (4).

(1) *Yield Quotation.* Based on the 7 days ended on the date of the most recent balance sheet included in the registration statement, calculate the Fund's yield by determining the net change, exclusive of capital changes and income other than investment income, in the value of a hypothetical pre-existing account having a balance of one share at the beginning of the period, subtracting a hypothetical charge reflecting deductions from shareholder accounts, and dividing the difference by the value of the account at the beginning of the base period to obtain the base period return, and then multiplying the base period return by (365/7) with the resulting yield figure carried to at least the nearest hundredth of one percent.

(2) *Effective Yield Quotation.* Based on the 7 days ended on the date of the most recent balance sheet included in the registration statement, calculate the Fund's effective yield, carried to at least the nearest hundredth of one percent, by determining the net change, exclusive of capital changes and income other than investment income, in the value of a hypothetical pre-existing account having a balance of one share at the beginning of the period, subtracting a hypothetical charge reflecting deductions from shareholder accounts, and dividing the difference by the value of the account at the beginning of the base period to obtain the base period return, and then compounding the base period return by adding 1, raising the sum to a power equal to 365 divided by 7, and subtracting 1 from the result, according to the following formula:

$$\text{EFFECTIVE YIELD} = [(\text{BASE PERIOD RETURN} + 1)^{[365/7]}] - 1.$$

(3) *Tax Equivalent Current Yield Quotation.* Calculate the Fund's tax equivalent current yield by dividing that portion of the Fund's yield (as calculated under paragraph (a)(1)) that is tax-exempt by 1 minus a stated income tax rate

and adding the quotient to that portion, if any, of the Fund's yield that is not tax-exempt.

(4) *Tax Equivalent Effective Yield Quotation.* Calculate the Fund's tax equivalent effective yield by dividing that portion of the Fund's effective yield (as calculated under paragraph (a)(2)) that is tax-exempt by 1 minus a stated income tax rate and adding the quotient to that portion, if any, of the Fund's effective yield that is not tax-exempt.

Instructions.

1. When calculating yield or effective yield quotations, the calculation of net change in account value must include:

(a) The value of additional shares purchased with dividends from the original share and dividends declared on both the original shares and additional shares; and

(b) All fees, other than nonrecurring account or sales charges, that are imposed on all shareholder accounts in proportion to the length of the base period. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size.

2. Exclude realized gains and losses from the sale of securities and unrealized appreciation and depreciation from the calculation of yield and effective yield. Exclude income other than investment income.

3. Disclose the amount or specific rate of any nonrecurring account or sales charges not included in the calculation of the yield.

4. If the Fund holds itself out as distributing income that is exempt from federal, state, or local income taxation, in calculating yield and effective yield (but not tax equivalent yield or tax equivalent effective yield), reduce the yield quoted by the effect of any income taxes on the shareholder receiving dividends, using the maximum rate for individual income taxation. For example, if the Fund holds itself out as distributing income exempt from federal taxation and the income taxes of State A, but invests in some securities of State B, it must reduce its yield by the effect of state income taxes that must be paid by the residents of State A on that portion of the income attributable to the securities of State B.

(b) *Other Funds.* Performance information included in the prospectus should be calculated according to paragraphs (b)(1) - (6).

2-7B Federal Securities Act of 1933 PART B

(1) *Average Annual Total Return Quotation.* For the 1-, 5-, and 10-year periods ended on the date of the most recent balance sheet included in the registration statement (or for the periods the Fund has been in operation), calculate the Fund's average annual total return by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or for the periods of the Fund's operations) that would equate the initial amount invested to the ending redeemable value, according to the following formula:

$P(1+T)^n = ERV$ Where:

P = a hypothetical initial payment of \$1,000.

T = average annual total return.

n = number of years.

ERV = ending redeemable value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion).

Instructions.

1. Assume the maximum sales load (or other charges deducted from payments) is deducted from the initial \$1,000 payment.

2. Assume all distributions by the Fund are reinvested at the price stated in the prospectus (including any sales load imposed upon reinvestment of dividends) on the reinvestment dates during the period.

3. Include all recurring fees that are charged to all shareholder accounts. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size. Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

4. Determine the ending redeemable value by assuming a complete redemption at the end of the 1-, 5-, or 10-year periods and the deduction of all nonrecurring charges deducted at the end of each period. If shareholders are assessed a deferred sales load, assume the maximum deferred sales load is deducted at the times, in the amounts, and under the terms disclosed in the prospectus.

5. State the average annual total return quotation to the nearest hundredth of one percent.

6. Total return information in the prospectus need only be current to the end of the Fund's most recent fiscal year.

2-7B Federal Securities Act of 1933 PART B

(2) *Average Annual Total Return (After Taxes on Distributions) Quotation.* For the 1-, 5-, and 10-year periods ended on the date of the most recent balance sheet included in the registration statement (or for the periods the Fund has been in operation), calculate the Fund's average annual total return (after taxes on distributions) by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or for the periods of the Fund's operations) that would equate the initial amount invested to the ending value, according to the following formula:

$P(1+T)^n = ATV[D]$ Where:

P = a hypothetical initial payment of \$1,000.

T = average annual total return (after taxes on distributions).

n = number of years.

ATV = ending value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion), after taxes on fund distributions but not after taxes on redemption.

Instructions.

1. Assume the maximum sales load (or other charges deducted from payments) is deducted from the initial \$1,000 payment.

2. Assume all distributions by the Fund, less the taxes due on such distributions, are reinvested at the price stated in the prospectus (including any sales load imposed upon reinvestment of dividends) on the reinvestment dates during the period.

3. Calculate the taxes due on any distributions by the Fund by applying the tax rates specified in Instruction 4 to each component of the distributions on the reinvestment date (e.g., ordinary income, short-term capital gain, long-term capital gain). The taxable amount and tax character of each distribution should be as specified by the Fund on the dividend declaration date, but may be adjusted to reflect subsequent recharacterizations of distributions. Distributions should be adjusted to reflect the federal tax impact the distribution would have on an individual taxpayer on the reinvestment date. For example, assume no taxes are due on the portion of any distribution that would not result in federal income tax on an individual, e.g., tax- exempt interest or non-taxable returns of capital. The effect of applicable tax credits, such as the foreign tax credit, should be taken into account in accordance with federal tax law.

4. Calculate the taxes due using the highest individual marginal federal income tax rates in effect on the reinvestment date. The rates used should correspond to the tax character of each component of the distributions (e.g., ordinary income rate for ordinary income distributions, short-term capital gain rate for short-term capital gain distributions, long-term capital gain rate for long-term capital gain distributions). Note that the required tax rates may vary over the measurement period. Disregard any potential tax liabilities other than federal tax liabilities (e.g., state and local taxes); the effect of phaseouts of certain exemptions, deductions, and credits at various income levels; and the impact of the federal alternative minimum tax.

2-7B Federal Securities Act of 1933 PART B

5. Include all recurring fees that are charged to all shareholder accounts. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size. Assume that no additional taxes or tax credits result from any redemption of shares required to pay such fees. Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

6. Determine the ending value by assuming a complete redemption at the end of the 1-, 5-, or 10-year periods and the deduction of all nonrecurring charges deducted at the end of each period. If shareholders are assessed a deferred sales load, assume the maximum deferred sales load is deducted at the times, in the amounts, and under the terms disclosed in the prospectus. Assume that the redemption has no tax consequences.

7. State the average annual total return (after taxes on distributions) quotation to the nearest hundredth of one percent.

(3) *Average Annual Total Return (After Taxes on Distributions and Redemption) Quotation.* For the 1-, 5-, and 10-year periods ended on the date of the most recent balance sheet included in the registration statement (or for the periods the Fund has been in operation), calculate the Fund's average annual total return (after taxes on distributions and redemption) by finding the average annual compounded rates of return over the 1-, 5-, and 10-year periods (or for the periods of the Fund's operations) that would equate the initial amount invested to the ending value, according to the following formula:

$P(1+T)^n = ATV[DR]$ Where:

P = a hypothetical initial payment of \$1,000.

T = average annual total return (after taxes on distributions and redemption).

n = number of years.

ATV[DR] = ending value of a hypothetical \$1,000 payment made at the beginning of the 1-, 5-, or 10-year periods at the end of the 1-, 5-, or 10-year periods (or fractional portion), after taxes on fund distributions and redemption.

Instructions.

1. Assume the maximum sales load (or other charges deducted from payments) is deducted from the initial \$1,000 payment.

2. Assume all distributions by the Fund, less the taxes due on such distributions, are reinvested at the price stated in the prospectus (including any sales load imposed upon reinvestment of dividends) on the reinvestment dates during the period.

3. Calculate the taxes due on any distributions by the Fund by applying the tax rates specified in Instruction 4 to

2-7B Federal Securities Act of 1933 PART B

each component of the distributions on the reinvestment date (e.g., ordinary income, short-term capital gain, long-term capital gain). The taxable amount and tax character of each distribution should be as specified by the Fund on the dividend declaration date, but may be adjusted to reflect subsequent recharacterizations of distributions. Distributions should be adjusted to reflect the federal tax impact the distribution would have on an individual taxpayer on the reinvestment date. For example, assume no taxes are due on the portion of any distribution that would not result in federal income tax on an individual, e.g., tax-exempt interest or non-taxable returns of capital. The effect of applicable tax credits, such as the foreign tax credit, should be taken into account in accordance with federal tax law.

4. Calculate the taxes due using the highest individual marginal federal income tax rates in effect on the reinvestment date. The rates used should correspond to the tax character of each component of the distributions (e.g., ordinary income rate for ordinary income distributions, short-term capital gain rate for short-term capital gain distributions, long-term capital gain rate for long-term capital gain distributions). Note that the required tax rates may vary over the measurement period. Disregard any potential tax liabilities other than federal tax liabilities (e.g., state and local taxes); the effect of phaseouts of certain exemptions, deductions, and credits at various income levels; and the impact of the federal alternative minimum tax.

5. Include all recurring fees that are charged to all shareholder accounts. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size. Assume that no additional taxes or tax credits result from any redemption of shares required to pay such fees. Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

6. Determine the ending value by assuming a complete redemption at the end of the 1-, 5-, or 10-year periods and the deduction of all nonrecurring charges deducted at the end of each period. If shareholders are assessed a deferred sales load, assume the maximum deferred sales load is deducted at the times, in the amounts, and under the terms disclosed in the prospectus.

7. Determine the ending value by subtracting capital gains taxes resulting from the redemption and adding the tax benefit from capital losses resulting from the redemption.

(a) Calculate the capital gain or loss upon redemption by subtracting the tax basis from the redemption proceeds (after deducting any nonrecurring charges as specified by Instruction 6).

(b) The Fund should separately track the basis of shares acquired through the \$1,000 initial investment and each subsequent purchase through reinvested distributions. In determining the basis for a reinvested distribution, include the distribution net of taxes assumed paid from the distribution, but not net of any sales loads imposed upon reinvestment. Tax basis should be adjusted for any distributions representing returns of capital and any other tax basis adjustments that would apply to an individual taxpayer, as permitted by applicable federal tax law.

2-7B Federal Securities Act of 1933 PART B

(c) The amount and character (e.g., short-term or long-term) of capital gain or loss upon redemption should be separately determined for shares acquired through the \$1,000 initial investment and each subsequent purchase through reinvested distributions. The Fund should not assume that shares acquired through reinvestment of distributions have the same holding period as the initial \$1,000 investment. The tax character should be determined by the length of the measurement period in the case of the initial \$1,000 investment and the length of the period between reinvestment and the end of the measurement period in the case of reinvested distributions.

(d) Calculate the capital gains taxes (or the benefit resulting from tax losses) using the highest federal individual capital gains tax rate for gains of the appropriate character in effect on the redemption date and in accordance with federal tax law applicable on the redemption date. For example, applicable federal tax law should be used to determine whether and how gains and losses from the sale of shares with different holding periods should be netted, as well as the tax character (e.g., short-term or long-term) of any resulting gains or losses. Assume that a shareholder has sufficient capital gains of the same character from other investments to offset any capital losses from the redemption so that the taxpayer may deduct the capital losses in full.

8. State the average annual total return (after taxes on distributions and redemption) quotation to the nearest hundredth of one percent.

(4) *Yield Quotation.* Based on a 30-day (or one month) period ended on the date of the most recent balance sheet included in the registration statement, calculate the Fund's yield by dividing the net investment income per share earned during the period by the maximum offering price per share on the last day of the period, according to the following formula:

$YIELD = 2[(a-b/cd + 1)[6]-1]$ Where:

- a = dividends and interest earned during the period.
- b = expenses accrued for the period (net of reimbursements).
- c = the average daily number of shares outstanding during the period that were entitled to receive dividends.
- d = the maximum offering price per share on the last day of the period.

Instructions.

1. To calculate interest earned on debt obligations for purposes of "a" above:

(a) Calculate the yield to maturity of each obligation held by the Fund based on the market value of the obligation (including actual accrued interest) at the close of business on the last business day of each month or, with respect to obligations purchased during the month, the purchase price (plus actual accrued interest). The maturity of an obligation with a call provision(s) is the next call date on which the obligation reasonably may be expected to be called, or if none, the maturity date.

2-7B Federal Securities Act of 1933 PART B

(b) Divide the yield to maturity by 360 and multiply the quotient by the market value of the obligation (including actual accrued interest) to determine the interest income on the obligation for each day of the subsequent month that the obligation is in the portfolio. Assume that each month has 30 days.

(c) Total the interest earned on all debt obligations and all dividends accrued on all equity securities during the 30-day (or one month) period. Although the period for calculating interest earned is based on calendar months, a 30-day yield may be calculated by aggregating the daily interest on the portfolio from portions of 2 months. In addition, a Fund may recalculate daily interest income on the portfolio more than once a month.

(d) For a tax-exempt obligation issued without original issue discount and having a current market discount, use the coupon rate of interest in lieu of the yield to maturity. For a tax-exempt obligation with original issue discount in which the discount is based on the current market value and exceeds the then-remaining portion of original issue discount (market discount), base the yield to maturity on the imputed rate of the original issue discount calculation. For a tax-exempt obligation with original issue discount, where the discount based on the current market value is less than the then-remaining portion of original issue discount (market premium), base the yield to maturity on the market value.

2. For discount and premium on mortgage or other receivables-backed obligations that are expected to be subject to monthly payments of principal and interest ("paydowns"):

(a) Account for gain or loss attributable to actual monthly paydowns as an increase or decrease to interest income during the period; and

(b) The Fund may elect:

(i) To amortize the discount and premium on the remaining securities, based on the cost of the securities, to the weighted average maturity date, if the information is available, or to the remaining term of the securities, if the weighted average maturity date is not available; or

(ii) Not to amortize the discount or premium on the remaining securities.

3. Solely for the purpose of calculating yield, recognize dividend income by accruing $1/360$ of the stated dividend rate of the security each day that the security is in the portfolio.

2-7B Federal Securities Act of 1933 PART B

4. Do not use equalization accounting in calculating yield.
 5. Include expenses accrued under a plan adopted under rule 12b-1 in the expenses accrued for the period. Reimbursement accrued under the plan may reduce the accrued expenses, but only to the extent the reimbursement does not exceed expenses accrued for the period.
 6. Include in the expenses accrued for the period all recurring fees that are charged to all shareholder accounts in proportion to the length of the base period. For any account fees that vary with the size of the account, assume an account size equal to the Fund's mean (or median) account size.
 7. If a broker-dealer or an affiliate of the broker-dealer (as defined in rule 1-02(b) of Regulation S-X [17 CFR 210.1-02(b)]) has, in connection with directing the Fund's brokerage transactions to the broker-dealer, provided, agreed to provide, paid for, or agreed to pay for, in whole or in part, services provided to the Fund (other than brokerage and research services as those terms are used in section 28(e) of the Securities Exchange Act [15 U.S.C. 78bb(e)]), add to expenses accrued for the period an estimate of additional amounts that would have been accrued for the period if the Fund had paid for the services directly in an arm's length transaction.
 8. Undeclared earned income, calculated in accordance with generally accepted accounting principles, may be subtracted from the maximum offering price. Undeclared earned income is the net investment income that, at the end of the base period, has not been declared as a dividend, but is reasonably expected to be and is declared as a dividend shortly thereafter.
 9. Disclose the amount or specific rate of any nonrecurring account or sales charges.
 10. If, in connection with the sale of the Fund's shares, a deferred sales load payable in installments is imposed, the "maximum public offering price" includes the aggregate amount of the installments ("installment load amount").
- (5) *Tax Equivalent Yield Quotation.* Based on a 30-day (or one month) period ended on the date of the most recent balance sheet included in the registration statement, calculate the Fund's tax equivalent yield by dividing that portion of the Fund's yield (as calculated under paragraph (b)(2)) that is tax-exempt by 1 minus a stated income tax rate and adding the quotient to that portion, if any, of the Fund's yield that is not tax-exempt.
- (6) *Non-Standardized Performance Quotation.* A Fund may calculate performance using any other historical measure of performance (not subject to any prescribed method of computation) if the measurement reflects all elements

of return.

Item 27. Financial Statements

(a) *Registration Statement.* Include, in a separate section following the responses to the preceding Items, the financial statements and schedules required by Regulation S-X. The specimen price-make-up sheet required by Instruction 4 to Item 23(c) may be provided as a continuation of the balance sheet specified by Regulation S-X.

Instructions.

1. The statements of any subsidiary that is not a majority-owned subsidiary required by Regulation S-X may be omitted from Part B and included in Part C.

2. In addition to the requirements of rule 3-18 of Regulation S-X [17 CFR 210.3-18], any Fund registered under the Investment Company Act that has not previously had an effective registration statement under the Securities Act must include in its initial registration statement under the Securities Act any additional financial statements and condensed financial information (which need not be audited) necessary to make the financial statements and condensed financial information included in the registration statement current as of a date within 90 days prior to the date of filing.

(b) *Annual Report.* Every annual report to shareholders required by rule 30e-1 must contain the following:

(1) *Financial Statements.* The audited financial statements required, and for the periods specified, by Regulation S-X.

Instructions.

1. *Schedule VI - Summary schedule of investments in securities of unaffiliated issuers* [17 CFR 210.12-12C] may be included in the financial statements in lieu of *Schedule I - Investments in securities of unaffiliated issuers* [17 CFR 210.12-12] if: (a) the Fund states in the report that the Fund's complete schedule of investments in securities of unaffiliated issuers is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Fund's website, if applicable; and (iii) on the Commission's website at <http://www.sec.gov>; and (b) whenever the Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for the Fund's schedule of investments in securities of unaffiliated issuers, the Fund (or financial intermediary) sends a copy of *Schedule I - Investments in securities of unaffiliated issuers* within 3 business days of receipt by first-class mail or other means designed to ensure equally prompt delivery.

2-7B Federal Securities Act of 1933 PART B

2. In the case of a Money Market Fund, *Schedule I - Investments in securities of unaffiliated issuers* [17 CFR 210.12-12C] may be omitted from its financial statements, provided that: (a) the Fund states in the report that the Fund's complete schedule of investments in securities of unaffiliated issuers is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Fund's website, if applicable; and (iii) on the Commission's website at <http://www.sec.gov>; and (b) whenever the Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for the Fund's schedule of investments in securities of unaffiliated issuers, the Fund (or financial intermediary) sends a copy of *Schedule I--Investments in securities of unaffiliated issuers* within 3 business days of receipt by first-class mail or other means designed to ensure equally prompt delivery.

(2) *Condensed Financial Information.* The condensed financial information required by Item 13(a) with at least the most recent fiscal year audited.

(3) *Remuneration Paid to Directors, Officers, and Others.* Unless shown elsewhere in the report as part of the financial statements required by paragraph (b)(1), the aggregate remuneration paid by the Fund during the period covered by the report to:

(i) All directors and all members of any advisory board for regular compensation;

(ii) Each director and each member of an advisory board for special compensation;

(iii) All officers; and

(iv) Each person of whom any officer or director of the Fund is an affiliated person.

(4) *Changes in and Disagreements with Accountants.* The information concerning changes in and disagreements with accountants and on accounting and financial disclosure required by Item 304 of Regulation S-K [17 CFR 229.304].

(5) *Management Information.* The management information required by Item 17(a)(1).

(6) *Availability of Additional Information about Fund Directors.* A statement that the SAI includes additional information about Fund directors and is available, without charge, upon request, and a toll-free (or collect) telephone number for shareholders to call to request the SAI.

(7) *Management's Discussion of Fund Performance.* Disclose the following information unless the Fund is a Money Market Fund:

(i) Discuss the factors that materially affected the Fund's performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the Fund's investment adviser.

(ii)

(A) Provide a line graph comparing the initial and subsequent account values at the end of each of the most recently completed 10 fiscal years of the Fund (or for the life of the Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. Assume a \$10,000 initial investment at the beginning of the first fiscal year in an appropriate broad-based securities market index for the same period.

(B) In a table placed within or next to the graph, provide the Fund's average annual total returns for the 1-, 5-, and 10-year periods as of the end of the last day of the most recent fiscal year (or for the life of the Fund, if shorter), but only for periods subsequent to the effective date of the Fund's registration statement. Average annual total returns should be computed in accordance with Item 26(b)(1). Include a statement accompanying the graph and table to the effect that past performance does not predict future performance and that the graph and table do not reflect the deduction of taxes that a shareholder would pay on fund distributions or the redemption of fund shares.

Instructions.

1. *Line Graph Computation.*

(a) Assume that the initial investment was made at the offering price last calculated on the business day before the first day of the first fiscal year.

(b) Base subsequent account values on the net asset value of the Fund last calculated on the last business day of the first and each subsequent fiscal year.

(c) Calculate the final account value by assuming the account was closed and redemption was at the price last calculated on the last business day of the most recent fiscal year.

2-7B Federal Securities Act of 1933 PART B

(d) Base the line graph on the Fund's required minimum initial investment if that amount exceeds \$10,000.

2. *Sales Load.* Reflect any sales load (or any other fees charged at the time of purchasing shares or opening an account) by beginning the line graph at the amount that actually would be invested (i.e., assume that the maximum sales load, and other charges deducted from payments, is deducted from the initial \$10,000 investment). For a Fund whose shares are subject to a contingent deferred sales load, assume the deduction of the maximum deferred sales load (or other charges) that would apply for a complete redemption that received the price last calculated on the last business day of the most recent fiscal year. For any other deferred sales load, assume that the deduction is in the amount(s) and at the time(s) that the sales load actually would have been deducted.

3. *Dividends and Distributions.* Assume reinvestment of all of the Fund's dividends and distributions on the reinvestment dates during the period, and reflect any sales load imposed upon reinvestment of dividends or distributions or both.

4. *Account Fees.* Reflect recurring fees that are charged to all accounts.

(a) For any account fees that vary with the size of the account, assume a \$10,000 account size.

(b) Reflect, as appropriate, any recurring fees charged to shareholder accounts that are paid other than by redemption of the Fund's shares.

(c) Reflect an annual account fee that applies to more than one Fund by allocating the fee in the following manner: divide the total amount of account fees collected during the year by the Funds' total average net assets, multiply the resulting percentage by the average account value for each Fund and reduce the value of each hypothetical account at the end of each fiscal year during which the fee was charged.

5. *Appropriate Index.* For purposes of this Item, an "appropriate broad-based securities market index" is one that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used. Adjust the index to reflect the reinvestment of dividends on securities in the index, but do not reflect the expenses of the Fund.

6. *Additional Indexes.* A Fund is encouraged to compare its performance not only to the required broad-based index, but also to other more narrowly based indexes that reflect the market sectors in which the Fund invests. A Fund

2-7B Federal Securities Act of 1933 PART B

also may compare its performance to an additional broad-based index, or to a non-securities index (e.g., the Consumer Price Index), so long as the comparison is not misleading.

7. *Change in Index.* If the Fund uses an index that is different from the one used for the immediately preceding fiscal year, explain the reason(s) for the change and compare the Fund's annual change in the value of an investment in the hypothetical account with the new and former indexes.

8. *Other Periods.* The line graph may cover earlier fiscal years and may compare the ending values of interim periods (e.g., monthly or quarterly ending values), so long as those periods are after the effective date of the Fund's registration statement.

9. *Scale.* The axis of the graph measuring dollar amounts may use either a linear or a logarithmic scale.

10. *New Funds.* A New Fund (as defined in Instruction 6 to Item 3) is not required to include the information specified by this Item in its prospectus (or annual report), unless Form N-1A (or the annual report) contains audited financial statements covering a period of at least 6 months.

11. *Change in Investment Adviser.* If the Fund has not had the same investment adviser for the previous 10 fiscal years, the Fund may begin the line graph on the date that the current adviser began to provide advisory services to the Fund so long as:

(a) Neither the current adviser nor any affiliate is or has been in "control" of the previous adviser under section 2(a)(9) [15 U.S.C. 80a-2(a)(9)];

(b) The current adviser employs no officer(s) of the previous adviser or employees of the previous adviser who were responsible for providing investment advisory or portfolio management services to the Fund; and

(c) The graph is accompanied by a statement explaining that previous periods during which the Fund was advised by another investment adviser are not shown.

(iii) Discuss the effect of any policy or practice of maintaining a specified level of distributions to shareholders on the Fund's investment strategies and per share net asset value during the last fiscal year. Also discuss the extent to which the Fund's distribution policy resulted in distributions of capital.

(iv) Provide a table showing the number of days the Market Price of the Fund shares was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value (*i.e.*, premium or discount) for the most recently completed five fiscal years (or the life of the Fund, if shorter). The Fund may omit this table from the annual report if the Fund provides an Internet address at the Fund's Web site, which is publicly accessible, free of charge, that investors can use to obtain the premium/discount information required in Item 11(g)(2).

Instructions.

1. Provide the information in tabular form.
2. Express the information as a percentage of the net asset value of the Exchange-Traded Fund, using separate columns for the number of days the Market Price was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value. Round all percentages to the nearest hundredth of one percent.
3. Adjacent to the table, provide a brief explanation that: shareholders may pay more than net asset value when they buy Fund shares and receive less than net asset value when they sell those shares, because shares are bought and sold at current market prices.
4. Include a statement that the data presented represents past performance and cannot be used to predict future results.

(c) *Semi-Annual Report.* Every semi-annual report to shareholders required by rule 30e-1 must contain the following (which need not be audited):

(1) *Financial Statements.* The financial statements required by Regulation S-X for the period commencing either with:

- (i) The beginning of the Fund's fiscal year (or date of organization, if newly organized); or
- (ii) A date not later than the date after the close of the period included in the last report under rule 30e-1 and the most recent preceding fiscal year.

Instruction. Instructions 1 and 2 to Item 27(b)(1) also apply to this Item 27(c)(1).

(2) *Condensed Financial Information.* The condensed financial information required by Item 13(a), for the period of the report as specified by paragraph (c)(1), and the most recent preceding fiscal year.

(3) *Remuneration Paid to Directors, Officers, and Others.* Unless shown elsewhere in the report as part of the financial statements required by paragraph (c)(1), the aggregate remuneration paid by the Fund during the period covered by the report to the persons specified under paragraph (b)(3).

(4) *Changes in and Disagreements with Accountants.* The information concerning changes in and disagreements with accountants and on accounting and financial disclosure required by Item 304 of Regulation S-K [17 CFR 229.304].

(d) *Annual and Semi-Annual Reports.* Every annual and semi-annual report to shareholders required by rule 30e-1 must contain the following:

(1) *Expense Example.* The following information regarding expenses for the period:

Example

As a shareholder of the Fund, you incur two types of costs: (1) transaction costs, including sales charges (loads) on purchase payments, reinvested dividends, or other distributions; redemption fees; and exchange fees; and (2) ongoing costs, including management fees; distribution [and/or service] (12b-1) fees; and other Fund expenses. This Example is intended to help you understand your ongoing costs (in dollars) of investing in the Fund and to compare these costs with the ongoing costs of investing in other mutual funds.

The Example is based on an investment of \$1,000 invested at the beginning of the period and held for the entire period [insert dates].

Actual Expenses

The first line of the table below provides information about actual account values and actual expenses. You may use the information in this line, together with the amount you invested, to estimate the expenses that you paid over the period. Simply divide your account value by \$1,000 (for example, an \$8,600 account value divided by \$1,000 = 8.6), then multiply the result by the number in the first line under the heading entitled "Expenses Paid During Period" to estimate the expenses you paid on your account during this period. [If the Fund charges any account fees or other recurring fees that are not included in the expenses shown in the table, for example, because they are not charged to all investors, disclose the amounts of these fees, describe the accounts that are charged these fees, and explain how an investor would use this information to estimate the total ongoing expenses paid over the period and the impact of these fees on ending account value.]

Hypothetical Example for Comparison Purposes

The second line of the table below provides information about hypothetical account values and hypothetical

expenses based on the Fund's actual expense ratio and an assumed rate of return of 5% per year before expenses, which is not the Fund's actual return. The hypothetical account values and expenses may not be used to estimate the actual ending account balance or expenses you paid for the period. You may use this information to compare the ongoing costs of investing in the Fund and other funds. To do so, compare this 5% hypothetical example with the 5% hypothetical examples that appear in the shareholder reports of the other funds. [If the Fund charges any account fees or other recurring fees that are not included in the expenses shown in the table, for example, because they are not charged to all investors, disclose the amounts of these fees, describe the accounts that are charged these fees, and explain how an investor would use this information in making the foregoing comparison.]

Please note that the expenses shown in the table are meant to highlight your ongoing costs only and do not reflect any transactional costs, such as sales charges (loads), redemption fees, or exchange fees. Therefore, the second line of the table is useful in comparing ongoing costs only, and will not help you determine the relative total costs of owning different funds. In addition, if these transactional costs were included, your costs would have been higher.

[Click here to view image.](#)

Instructions.

1. *General.*

(a) Round all figures in the table to the nearest cent.

(b) Include the narrative explanations in the order indicated. A Fund may modify the narrative explanations if the explanation contains comparable information to that shown, and is required to make any modifications necessary to reflect accurately the Fund's circumstances. A Fund may eliminate any parts of the narrative explanations that are inapplicable. For example, a Fund that does not charge loads need not include the statement that the Example does not reflect loads or that costs would be higher if loads were included.

(c) The Fund's expense ratio shown in the footnote to the table should be calculated in the manner required by Instruction 4(b) to Item 13(a) using the expenses for the Fund's most recent fiscal half-year (the Fund's second fiscal half-year in the case of an annual report). Express the expense ratio on an annualized basis.

(d)

(i) If the Fund is a Feeder Fund, reflect the aggregate expenses of the Feeder Fund and the Master Fund. In a footnote to the Example, state that the Example reflects the expenses of both the Feeder and Master Funds.

(ii) If the report covers more than one Class of a Multiple Class Fund or more than one Feeder Fund that invests in the same Master Fund, provide a separate Example for each Class or Feeder Fund.

2-7B Federal Securities Act of 1933 PART B

(e) If the Fund is an Exchange-Traded Fund:

(i) Modify the narrative explanation to state that investors may pay brokerage commissions on their purchases and sales of Exchange-Traded Fund shares, which are not reflected in the example; and

(ii) If the Fund issues or redeems shares in creation units of not less than 25,000 shares each, exclude any fees charged for the purchase and redemption of the Fund's creation units.

2. *Computation.*

(a)

(i) In determining the Fund's "actual expenses" for purposes of this example, include all expenses that are deducted from the Fund's assets or charged to all shareholder accounts, including "Management Fees," "Distribution [and/or Service] (12b-1) Fees," and "Other Expenses" as those terms are defined in Instruction 3 to Item 3 of this form as modified by Instructions 2(a)(ii) and (c)(i) to this Item. Reflect recurring and non-recurring fees charged to all investors other than any exchange fees, sales charges (loads), or fees charged upon redemption of the Fund's shares. The amount of expenses deducted from the Fund's assets are the amounts shown as expenses in the Fund's statement of operations (including increases resulting from complying with paragraph 2(g) of rule 6-07 of Regulation S-X [17 CFR 210.6-07]).

(ii) For purposes of this Item 27(d)(1), "Other Expenses" include extraordinary expenses as determined under generally accepted accounting principles (see Accounting Principles Board Opinion No. 30). If extraordinary expenses were incurred that materially affected the Fund's "Other Expenses," the Fund may disclose in a footnote to the Example what "actual expenses" would have been had the extraordinary expenses not been included.

(b) Assume reinvestment of all dividends and distributions.

(c)

(i) Base the percentages of "actual expenses" on amounts incurred during the Fund's most recent fiscal half-year (the Fund's second fiscal half-year in the case of an annual report). "Actual expenses" should reflect actual expenses after expense reimbursement or fee waiver arrangements that reduced expenses during the most recent fiscal half-year.

(ii) If there have been any increases or decreases in Fund expenses that occurred during the Fund's most recent

fiscal half-year (or that have occurred or are expected to occur during the current fiscal year) that would have materially affected the information in the Example had those changes been in place throughout the most recent fiscal half-year, restate in a footnote to the Example the expense information using the current fees as if they had been in effect throughout the entire most recent fiscal half-year. A change in Fund expenses does not include a decrease in expenses as a percentage of assets due to economies of scale or breakpoints in a fee arrangement resulting from an increase in the Fund's assets.

(d) Reflect any shareholder account fees collected by more than one Fund by allocating the total amount of the fees collected during the Fund's most recent fiscal half-year (the Fund's second fiscal half-year in the case of an annual report) for all such Funds to each Fund in proportion to the relative average net assets of the Fund. A Fund that charges account fees based on a minimum account requirement exceeding \$1,000 may adjust its account fees based on the amount of the fee in relation to the Fund's minimum account requirement.

(2) *Graphical Representation of Holdings.* One or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (e.g., type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (e.g., net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Fund, given its investment objectives. Credit quality should be the ratings grade assigned by a nationally recognized statistical rating organization ("NRSRO"), as that term is used in paragraphs (c)(2)(vi)(E), (F), and (H) of Rule 15c3-1 under the Exchange Act [17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H)]. The fund should use ratings of only one NRSRO.

(3) *Statement Regarding Availability of Quarterly Portfolio Schedule.* A statement that: (i) the Fund files its complete schedule of portfolio holdings with the Commission for the first and third quarters of each fiscal year on Form N-Q; (ii) the Fund's Forms N-Q are available on the Commission's website at <http://www.sec.gov>; (iii) the Fund's Forms N-Q may be reviewed and copied at the Commission's Public Reference Room in Washington, DC, and that information on the operation of the Public Reference Room may be obtained by calling 1-800-SEC-0330; and (iv) if the Fund makes the information on Form N-Q available to shareholders on its website or upon request, a description of how the information may be obtained from the Fund.

(4) *Statement Regarding Availability of Proxy Voting Policies and Procedures.* A statement that a description of the policies and procedures that the Fund uses to determine how to vote proxies relating to portfolio securities is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Fund's website, if applicable; and (iii) on the Commission's website at <http://www.sec.gov>.

Instruction. When a Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for a description of the policies and procedures that the Fund uses to determine how to vote proxies, the Fund (or financial intermediary) must send the information disclosed in response to Item 17(f) of this Form, within three business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery.

(5) *Statement Regarding Availability of Proxy Voting Record.* A statement that information regarding how the Fund voted proxies relating to portfolio securities during the most recent 12-month period ended June 30 is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; or on or through the Fund's website at a specified Internet address; or both; and (ii) on the Commission's website at <http://www.sec.gov>.

Instructions.

1. If a Fund discloses that the Fund's proxy voting record is available by calling a toll-free (or collect) telephone number, and the Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for this information, the Fund (or financial intermediary) must send the information disclosed in the Fund's most recently filed report on Form N-PX, within three business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery.

2. If a Fund discloses that the Fund's proxy voting record is available on or through its website, the Fund must make available free of charge the information disclosed in the Fund's most recently filed report on Form N-PX on or through its website as soon as reasonably practicable after filing the report with the Commission. The information disclosed in the Fund's most recently filed report on Form N-PX must remain available on or through the Fund's website for as long as the Fund remains subject to the requirements of Rule 30b1-4 (17 CFR 270.30b1-4) and discloses that the Fund's proxy voting record is available on or through its website.

(6) *Statement Regarding Basis for Approval of Investment Advisory Contract.* If the board of directors approved any investment advisory contract during the Fund's most recent fiscal half-year, discuss in reasonable detail the material factors and the conclusions with respect thereto that formed the basis for the board's approval. Include the following in the discussion:

(i) Factors relating to both the board's selection of the investment adviser and approval of the advisory fee and any other amounts to be paid by the Fund under the contract. This would include, but not be limited to, a discussion of the nature, extent, and quality of the services to be provided by the investment adviser; the investment performance of the Fund and the investment adviser; the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the Fund; the extent to which economies of scale would be realized as the Fund grows; and whether fee levels reflect these economies of scale for the benefit of Fund investors. Also indicate in the discussion whether the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (*e.g.*, pension funds and other institutional investors). If the board relied upon such comparisons, describe the comparisons that were relied on and how they assisted the board in concluding that the contract should be approved; and

(ii) If applicable, any benefits derived or to be derived by the investment adviser from the relationship with the Fund such as soft dollar arrangements by which brokers provide research to the Fund or its investment adviser in return for allocating Fund brokerage.

Instructions.

1. Board approvals covered by this Item include both approvals of new investment advisory contracts and approvals of contract renewals. Investment advisory contracts covered by this Item include subadvisory contracts.
2. Conclusory statements or a list of factors will not be considered sufficient disclosure. Relate the factors to the specific circumstances of the Fund and the investment advisory contract and state how the board evaluated each factor. For example, it is not sufficient to state that the board considered the amount of the investment advisory fee without stating what the board concluded about the amount of the fee and how that affected its decision to approve the contract.
3. If any factor enumerated in paragraph (d)(6)(i) of this Item is not relevant to the board's evaluation of an investment advisory contract, note this and explain the reasons why that factor is not relevant.



111 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 7B Investment Company Act Forms

2-7B Federal Securities Act of 1933 PART C

PART C OTHER INFORMATION

Item 28. Exhibits

Subject to General Instruction D regarding incorporation by reference and rule 483 under the Securities Act [17 CFR 230.483], file the exhibits listed below as part of the registration statement. Letter or number the exhibits in the sequence indicated and file copies rather than originals, unless otherwise required by rule 483. Reflect any exhibit incorporated by reference in the list below and identify the previously filed document containing the incorporated material.

(a) *Articles of Incorporation.* The Fund's current articles of incorporation, charter, declaration of trust or corresponding instruments and any related amendment.

(b) *By-laws.* The Fund's current by-laws or corresponding instruments and any related amendment.

(c) *Instruments Defining Rights of Security Holders.* Instruments defining the rights of holders of the securities being registered, including the relevant portion of the Fund's articles of incorporation or by-laws.

(d) *Investment Advisory Contracts.* Investment advisory contracts relating to the management of the Fund's assets.

(e) *Underwriting Contracts.* Underwriting or distribution contracts between the Fund and a principal underwriter, and

agreements between principal underwriters and dealers.

(f) *Bonus or Profit Sharing Contracts.* Bonus, profit sharing, pension, or similar contracts or arrangements in whole or in part for the benefit of the Fund's directors or officers in their official capacity. Describe in detail any plan not included in a formal document.

(g) *Custodian Agreements.* Custodian agreements and depository contracts under section 17(f) [15 U.S.C. 80a-17(f)] concerning the Fund's securities and similar investments, including the schedule of remuneration.

(h) *Other Material Contracts.* Other material contracts not made in the ordinary course of business to be performed in whole or in part on or after the filing date of the registration statement.

(i) *Legal Opinion.* An opinion and consent of counsel regarding the legality of the securities being registered, stating whether the securities will, when sold, be legally issued, fully paid, and nonassessable.

(j) *Other Opinions.* Any other opinions, appraisals, or rulings, and related consents relied on in preparing the registration statement and required by section 7 of the Securities Act [15 U.S.C. 77g].

(k) *Omitted Financial Statements.* Financial statements omitted from Item 27.

(l) *Initial Capital Agreements.* Any agreements or understandings made in consideration for providing the initial capital between or among the Fund, the underwriter, adviser, promoter or initial shareholders and written assurances from promoters or initial shareholders that purchases were made for investment purposes and not with the intention of redeeming or reselling.

(m) *Rule 12b-1 Plan.* Any plan entered into by the Fund under rule 12b-1 and any agreements with any person relating to the plan's implementation.

(n) *Rule 18f-3 Plan.* Any plan entered into by the Fund under rule 18f-3, any agreement with any person relating to the plan's implementation, and any amendment to the plan or an agreement.

(o) *Reserved.*

2-7B Federal Securities Act of 1933 PART C

(p) *Codes of Ethics.* Any codes of ethics adopted under rule 17j-1 of the Investment Company Act [17 CFR 270.17j-1] and currently applicable to the Fund (*i.e.*, the codes of the Fund and its investment advisers and principal underwriters). If there are no codes of ethics applicable to the Fund, state the reason (*e.g.*, that the Fund is a Money Market Fund).

Instruction. A Fund that is a feeder fund also must file a copy of all codes of ethics applicable to the master fund.

Item 29. Persons Controlled by or Under Common Control with the Fund

Provide a list or diagram of all persons directly or indirectly controlled by or under common control with the Fund. For any person controlled by another person, disclose the percentage of voting securities owned by the immediately controlling person or other basis of that person's control. For each company, also provide the state or other sovereign power under the laws of which the company is organized.

Instructions.

1. Include the Fund in the list or diagram and show the relationship of each company to the Fund and to the other companies named, using cross-references if a company is controlled through direct ownership of its securities by two or more persons.

2. Indicate with appropriate symbols subsidiaries that file separate financial statements, subsidiaries included in consolidated financial statements, or unconsolidated subsidiaries included in group financial statements. Indicate for other subsidiaries why financial statements are not filed.

Item 30. Indemnification

State the general effect of any contract, arrangements or statute under which any director, officer, underwriter or affiliated person of the Fund is insured or indemnified against any liability incurred in their official capacity, other than insurance provided by any director, officer, affiliated person, or underwriter for their own protection.

Item 31. Business and Other Connections of the Investment Adviser

Describe any other business, profession, vocation or employment of a substantial nature that each investment adviser, and each director, officer or partner of the adviser, is or has been engaged within the last two fiscal years for his or her own account or in the capacity of director, officer, employee, partner, or trustee.

Instructions.

2-7B Federal Securities Act of 1933 PART C

1. Disclose the name and principal business address of any company for which a person listed above serves in the capacity of director, officer, employee, partner, or trustee, and the nature of the relationship.

2. The names of investment advisory clients need not be given in answering this Item.

Item 32. Principal Underwriters

(a) State the name of each investment company (other than the Fund) for which each principal underwriter currently distributing the Fund's securities also acts as a principal underwriter, depositor, or investment adviser.

(b) Provide the information required by the following table for each director, officer, or partner of each principal underwriter named in the response to Item 25:

(1)	(2)	(3)
Name and Principal Business Address	Positions and Offices with Underwriter	Positions and Offices with Fund

(c) Provide the information required by the following table for all commissions and other compensation received, directly or indirectly, from the Fund during the last fiscal year by each principal underwriter who is *not* an affiliated person of the Fund or any affiliated person of an affiliated person:

(1)	(2)	(3)	(4)	(5)
Name of Principal Underwriter	Net Underwriting Discounts and Commissions	Compensation on Redemption and Repurchases	Brokerage Commissions	Other Compensation

Instructions.

1. Disclose the type of services rendered in consideration for the compensation listed under column (5).

2. Instruction 1 to Item 25(c) also applies to this Item.

Item 33. Location of Accounts and Records

State the name and address of each person maintaining physical possession of each account, book, or other document required to be maintained by section 31(a) [15 U.S.C. 80a-30(a)] and the rules under that section.

Item 34. Management Services

Provide a summary of the substantive provisions of any management-related service contract not discussed in Part A or B, disclosing the parties to the contract and the total amount paid and by whom for the Fund's last three fiscal years.

Instructions.

1. The instructions to Item 19 also apply to this Item.
2. Exclude information about any service provided for payments totaling less than \$5,000 during each of the last three fiscal years.

Item 35. Undertakings

In initial registration statements filed under the Securities Act, provide an undertaking to file an amendment to the registration statement with certified financial statements showing the initial capital received before accepting subscriptions from more than 25 persons if the Fund intends to raise its initial capital under section 14(a)(3) [15 U.S.C. 80a-14(a)(3)].



112 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 7B Investment Company Act Forms

2-7B Federal Securities Act of 1933 Scope

SIGNATURES

Pursuant to the requirements of (the Securities Act and) the Investment Company Act, the Fund (certifies that it meets all of the requirement for effectiveness of this registration statement under rule 485(b) under the Securities Act and) has duly caused this registration statement to be signed on its behalf by the undersigned, duly authorized, in the City of _____, and State of _____ on the day of _____, _____ (Year)

Fund

By _____

(Signature and Title)

Pursuant to the requirements of the Securities Act, this registration statement has been signed below by the following persons in the capacities and on the date(s) indicated.

(Signature) (Title) (Date)



113 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 8.syn

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.syn Synopsis to Chapter 8: The Trust Indenture Act of 1939

Scope

§ 8.01 Introduction

§ 8.02 History and Purpose of the Trust Indenture Act

§ 8.03 Unique Regulatory Approach of the Trust Indenture Act

§ 8.04 Coverage of the Act

§ 8.05 Basic Indenture Requirement and Exemptions for Small Issues

[1] Securities Issued without an Indenture--Section 304(a)(8) and Rule 4a-1

[2] Securities Issued under Regulation A--Rule 4a-2

[3] Securities Issued under an Indenture Not Exceeding \$10 Million--Section 304(a)(9) and Rule 4a-3

[4] Integration of Issues Exempt under Sections 304(a)(8) and 304(a)(9)

§ 8.06 Exempt Securities

[1] Pre-1939 Indentures--Section 304(c)

[2] Securities Exempt under Section 3 of the Securities Act--Section 304(a)(4)

[3] Securities Issued in Operations of Secondary Markets for Real Estate Mortgages--Section 304(a)(5)

[4] Foreign Government Securities--Section 304(a)(6)

[5] Guarantees of Exempted Securities--Section 304(a)(7)

[6] Issues of Limited Dollar Amounts--Sections 304(a)(8) and (9)

[7] Bankruptcy Related Notes

[8] Commission's Authority to Exempt other Securities--Section 304(d)

[9] Small Business Investment Companies--Section 304(e)

§ 8.07 Exempt Transactions--Non-Issuer Offerings and Private Placements

§ 8.08 Drafting the Indenture

§ 8.09 Filing with the Commission--Coordination with the Securities Act of 1933

[1] Statement of Trustee's Eligibility and Qualification--Form T-1

[2] The Indenture, Table of Contents and Cross-Reference Sheet

[3] Securities Act Prospectus Disclosure of Security Terms and Indenture Provisions

[4] Refusal Orders

§ 8.10 Supplemental Indentures and Special Problems of Shelf Registrations

§ 8.11 Indenture Qualification in Recapitalizations and Reorganizations

[1] Form T-3--Application for Qualification of Indenture

§ 8.12 Who Is Eligible for Appointment As Trustee?--Section 310

§ 8.13 Conflicts of Interests--Section 310(a)(5) and Section 310(b)

[1] Dual Trusteeships

[a] Exceptions and Exemptions from Dual Trusteeship Prohibition.

[2] Prohibited Affiliations Between Trustee and Obligor or Underwriters

[3] Ownership of Trustee's Voting Securities by Obligor, Underwriter, or their Affiliates

[4] Direct or Indirect Ownership by Trustee of Securities of Obligor and Underwriters

[5] Trustee's Ownership of Obligor's or Underwriters' Securities in Fiduciary Capacities

[6] Trustee as Creditor of Obligor

§ 8.14 Duties of Obligors to Trustee

- [1] Furnishing Bondholders Lists
- [2] Furnishing Copies of Exchange Act Reports and Annual Certificates of Compliance
- [3] Furnishing Evidence of Recording and Compliance with Conditions Precedent
- [4] Form of Opinions on Compliance with Conditions or Covenants
- [5] Furnishing Certificates of Fair Value
- [6] Permissive Provisions on Evidence of Compliance with Covenants

§ 8.15 Duties of Trustee Prior to Default

- [1] Reports by Trustee to Security Holders--Section 313
- [2] Limitations on Trustee's Pre-Default Duties
- [3] Notice to Security Holders of Known Defaults
- [4] Resignation of Trustee in Anticipation of Default

§ 8.16 Duties of Paying Agent

§ 8.17 Powers and Duties of Trustee after Default

- [1] Post-Default Duties of Care and Skill
- [2] Powers of Trustee to Act on Behalf of Security Holders
- [3] Post-Default Obligations of Trustee-Creditor
- [4] Indenture Trustee's Role in Bankruptcy Proceedings

§ 8.18 Bondholders' Role in Enforcing Indenture Provisions

- [1] Communications among Bondholders
- [2] No-Action Clauses
- [3] Right to Sue for Principal and Interest
- [4] Postponement of Interest and Waiver of Past Defaults by Vote of Bondholders
- [5] Directions to Trustee by Bondholders
- [6] Removal of Trustee

§ 8.19 Liability of Indenture Trustee to Bondholders

§ 8.20 Civil Liability under Section 323(a); Commission Enforcement; Criminal Reference

[1] Civil Liability under Section 323(a)

[2] Commission Enforcement

[3] Criminal Reference

§ 8.21 State Trust Indenture Requirements

Howard M. Friedman n*

FOOTNOTES:

(n1)Footnote *.

This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.



114 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

Summary of This Chapter

The Trust Indenture Act was designed to protect investors who purchase publicly distributed debt securities. The terms used to describe the debt instruments involved include "bond," "note," "debenture," "commercial paper," "equipment trust certificate," and "collateral trust bond." The Trust Indenture Act, the terms of which are closely integrated with the Securities Act, focuses on the terms of the indenture to achieve investor protection by imposing minimum obligations on trustees and ensuring that trustees have the powers and resources to meet their obligations. *See § 8.01 infra.*

The Trust Indenture Act identifies the abuses that led to its adoption in 1939. The final version of the Act was designed to remedy these perceived abuses and to reflect certain concerns of brokers and businesses. *See § 8.02 infra.*

As amended in 1990, the Trust Indenture Act provides that specified substantive provisions concerning the trustee's powers, duties, and qualifications as well as the issuer's duties are a part of and govern every qualified indenture, whether qualified before or after 1990. The "business provisions" of the indenture are left unregulated. Breaches of the indenture's provisions are enforceable only by the trustee or the bondholders through court proceedings. The statutorily required provisions of the indenture are governed by federal law while the "business provisions" of the instrument are governed by state law. *See § 8.03 infra.*

The Trust Indenture Act applies only to debt securities and interests in debt securities. The Commission has excluded interests not represented by a separate physical certificate and interests in which there is no fixed obligation to pay a sum of money from the coverage of the Act. Only primary distributions require indenture qualification; sales by persons acting as conduits for the issuer, however, are not exempt from the Act's provisions. The brokers' transaction exemption under the Securities Act is incorporated into the Trust Indenture Act. *See § 8.04 infra.*

The Trust Indenture Act generally requires that all securities covered by the Act be issued under an indenture that meets

the requirements of the Act. Exemptions are available under the Act that permit an issuer to issue not more than \$5 million of debt securities during a twelve month period without an indenture, or, if the indenture limits the amount of securities that may be outstanding under it at any time to \$10 million the indentures' substantive terms need not fully comply with the provisions of the Act. In certain cases, the Commission has required the integration of separate transactions or issues under the exemptive provisions. *See § 8.05 infra.*

The Trust Indenture Act provides for the exemption of certain securities. Issuers may apply to the Commission for an order to exempt securities issued under open-end provisions of pre-1939 indentures. The Trust Indenture Act was closely integrated with the Securities Act and, with two exceptions (the exemptions for recapitalizations involving exchanges with existing security holders and judicially and administratively approved reorganizations) the exemptions under Securities Act Section 3 were incorporated into the Trust Indenture Act. Several provisions cover exemptions from the Trust Indenture Act for securities issued in connection with the creation and maintenance of a secondary market in real estate mortgages. Other exemptions from the Trust Indenture Act involve certain foreign government securities, guarantees of exempted securities, issues of limited dollar amounts and bankruptcy related commercial notes. The Commission may grant other exemptions by order or rule, and has done so for certain cross-border offerings of Canadian securities and for certain exchange offers and business combination transactions by foreign private issuers. *See § 8.06 infra.*

The Trust Indenture Act also provides for the exemption of debt securities sold in transactions that are also exempt under Securities Act Section 4. Thus, the exemptions for certain private placements, offers and sales to "accredited investors" of up to \$5 million, and sales in large dollar amounts of promissory notes secured by certain first lien real estate mortgages are incorporated by the Trust Indenture Act. *See § 8.07 infra.*

The Trust Indenture Act specifies the mandatory provisions that are part of every qualified indenture as well as permissible provisions, many of which are included by operation of law unless indenture language to the contrary appears. Other provisions, some of which are standardized and others negotiable, may also be included. Generally, four alternative formats for qualified indentures are available: an indenture which relies upon the automatic incorporation provisions of the Trust Indenture Act; the conventional unified document; the two-part indenture recommended by the American Bar Foundation; and the Revised Model Simplified Indenture. *See § 8.08 infra.*

Filing with the Commission under the Securities Act and the Trust Indenture Act is closely coordinated. Under the Trust Indenture Act, the indenture is deemed qualified when the Securities Act registration statement becomes effective. The issuer of debt securities must file with the Commission: the Securities Act registration statement; Form T-1, the statement of eligibility and qualification of the trustee; and a copy of the indenture with a table of contents. The Securities Act prospectus must contain a description of the debt securities being registered and of the indenture. *See § 8.09 infra.*

Supplemental indentures that make changes in the rights of indenture security holders or effect other indenture amendments may be entered into provided they comply with the provisions of the Trust Indenture Act. Shelf registrations of debt securities under Rule 415 present special problems regarding the form of a supplemental indenture when they are needed. SEC rules adopted in July 2005 will simplify the process by permitting large companies to add debt securities to shelf registrations by post-effective amendment. *See § 8.10 infra.*

Securities that are exempt from registration under the Securities Act but not under the Trust Indenture Act (certain recapitalizations and reorganizations) require indenture qualification. In such cases, the requirement of indenture qualification generally depends on whether a "sale" has occurred. If no Securities Act registration statement is to be filed, the issuer's application for qualification of the indenture on Form T-3, the trustee's statement of eligibility and qualification on Form T-1, and all other items required for qualification when a Securities Act registration is required must be filed with the Commission. *See § 8.11 infra.*

2-8 Federal Securities Act of 1933

The Trust Indenture Act requires that under every qualified indenture there always be at least one institutional trustee with a combined capital and surplus of at least \$150,000. A permissive provision may provide that the trustee's capital and surplus be determined by reference to the trustee's most recently published report of condition. Foreign business entities may act as the institutional trustee only if permitted by Commission order or rule. The Act permits the use of one or more co-trustees, who may be individuals, but the trustees' rights, powers, duties and obligations must be imposed on and carried out by the required institutional trustee, either alone, or jointly with the co-trustees. *See § 8.12 infra.*

The obligor and its affiliates may not serve as indenture trustee. Specific post-default conflicts of interest require the resignation or removal of the trustee unless the Commission, in the case of certain defaults not involving non-payment permits a delay in the obligation to resign. The prohibited conflicts include: dual trusteeships (with some exceptions); prohibited affiliations between the trustee and the obligor or underwriters; beneficial ownership of the trustee's voting securities by the obligor, underwriter, or their affiliates; direct or indirect ownership by the trustee of securities of the obligor and underwriters; and the trustee's being a creditor of the obligor, the trustee's ownership of the obligor's or underwriters' securities in fiduciary capacities; and the trustee's being a creditor of the obligor. *See § 8.13 infra.*

Under every qualified indenture, the obligor must furnish to the indenture trustee: bondholder lists; copies of Exchange Act reports; annual certification of compliance with conditions and covenants; evidence of recording the indenture and compliance with any conditions precedent; and certificates of fair value. Permissive provisions obligating the issuer to furnish the trustee other evidence of compliance with indenture conditions and covenants may also be included in the indenture. *See § 8.14 infra.*

The Trust Indenture Act imposes certain duties on the indenture trustee prior to any default by the obligor. The trustee must provide annual reports and periodic reports on certain developments to indenture security holders and to give notice to the security holders of all defaults known to the trustee within ninety days of their occurrence. Unless provided to the contrary in the indenture, the trustee's liability is limited to the performance of the duties specified in the indenture. The trustee, though, must examine certificates and opinions to determine if they comply with the indenture's requirements. A trustee's resignation is effective only upon appointment and acceptance by a successor trustee. *See § 8.15 infra.*

Among the servicing functions that must be provided for debt securities, only the duties of the paying agent are regulated by the Trust Indenture Act. The Act requires that each paying agent hold all funds received by it for the payment of principal or interest in trust for the indenture security holders or the indenture trustee and give the trustee notice of any default by an obligor in the payment of principal or interest. *See § 8.16 infra.*

The Trust Indenture Act imposes an enhanced duty of care and skill on trustees after default and to give trustee adequate powers to carry out their duties. The Act grants the trustee the authority, before and after default, to file proofs of claim and other papers in judicial proceedings and to recover judgment in its own name; indentures generally give the trustee other post-default remedial powers not specified in the Act. The Act permits the trustee prior to default to be a direct creditor of the obligor on the indenture securities, but requires the apportionment of amounts collected by the trustee during a specified time. The trustee is also empowered to represent the interest of indenture security holders in bankruptcy proceedings. *See § 8.17 infra.*

The Trust Indenture Act provides for direct action to be taken by the indenture security holders to enforce their rights, such as requirements that facilitate communications between bondholders and guarantee the bondholder's right to sue for principal and interest, and permissive provisions that authorize bondholders to postpone interest payments and waive past defaults, direct the trustee in conducting remedial proceedings, and remove the trustee. The Act permits indentures to include no-action clauses (except to enforce payment of principal or interest) to prevent small numbers of bondholders from acting contrary to the best interests of bondholders in general. *See § 8.18 infra.*

2-8 Federal Securities Act of 1933

The indenture trustee who fails to carry out its obligations under a qualified indenture may be liable to injured bondholders under state law breach of duty claims or a federal private right of action explicitly recognized by the 1990 amendments to the Trust Indenture Act. *See § 8.19 infra.*

The Trust Indenture Act creates a private right of action for damages in favor of a person who relies on a materially false or misleading statement in a Trust Indenture Act document. The 1990 amendments to the Trust Indenture Act created some uncertainty as to whether the Commission's enforcement power extends beyond ensuring initial indenture qualification and enforcing prohibitions against false or misleading statements in filings made with the Commission. Willful violations of the Trust Indenture Act, presumably including failure to comply with mandatory obligations imposed by law under the 1990 amendments may result in criminal prosecution. *See § 8.20 infra.*

The Trust Indenture Act does not preempt state jurisdiction provided the state law does not conflict with federal law. Several states have adopted trust indenture requirements for securities offered or sold in state. *See § 8.21 infra.*



115 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.01

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.01 Introduction

The Trust Indenture Act was designed to protect investors who purchase publicly distributed debt securities. The terms used to describe the debt instruments involved include "bond," "note," "debenture," "commercial paper," "equipment trust certificate," and "collateral trust bond." The Trust Indenture Act, the terms of which are closely integrated with the Securities Act, achieves investor protection by imposing minimum obligations on trustees and ensuring that trustees had the powers and resources to meet their obligations.

Debt financing by corporations takes numerous forms. Sometimes funds are borrowed directly from one or a group of banks, or directly from other institutional lenders. At other times funds are borrowed through the sale of debt securities to public investors. The Trust Indenture Act of 1939 n1 (hereafter referred to as the "Act" or the "TIA") governs some aspects of debt financing from public investors.

The terms employed to describe the different debt instruments depend generally upon whether the instruments are long or short term, whether they are issued under an indenture, and whether they are secured by collateral or are unsecured. While the term "bond" is sometimes used to refer to all long term debt evidenced by securities, "bonds" are, more accurately long term debt instruments secured by a mortgage on property of the corporate issuer. "Bonds" are to be contrasted with "debentures" which are long term uncollateralized debt securities. Debenture holders are general unsecured creditors of the issuer. n2

There is some disagreement over the use of the term "note." Sometimes the term is employed to describe any comparatively short term corporate debt instrument. n3 At other times, "note" is used to describe a debt instrument of any duration that is issued pursuant to a loan agreement directly between the borrower and the lender, as opposed to an instrument issued under an indenture with a third party as trustee. n4

Within these broad outlines, there are also rather specific subcategories of debt instruments. "Commercial paper," for example, refers to high quality short-term unsecured promissory notes traded in the organized money markets.

Maturities vary from one day to nine months, but are most commonly between 30 and 90 days, at which time the paper is usually rolled over. n5 Commercial paper is generally exempt from both Securities Act registration and Trust Indenture Act qualification. n6

Debt instruments secured by more exotic forms of collateral often are referred to by special titles. For example, "equipment trust certificates" are rather complex debt instruments used to finance the purchase of railroad cars, airplanes, or similar equipment, secured by the equipment whose title has been transferred to a trustee and then leased back or sold under a conditional sale agreement to the railroad, airline, or other borrower. n7 "Collateral trust bonds" are debt securities collateralized by the pledge of other securities, often those of a subsidiary. n8

In the volatile markets of the 1980s, a number of innovative types of debt securities were created to provide greater flexibility in terms and the ability to come to market rapidly. These included medium term notes which were offered on a continuous basis or in multiple tranches, debt securities with variable interest rates, and debt securities denominated in or indexed to foreign currencies. n9 In addition, the securities markets became increasingly internationalized. n10

The Trust Indenture Act was designed to protect investors who purchase publicly distributed debt securities. The provisions of the Trust Indenture Act are closely integrated with those of the Securities Act of 1933. In registered offerings, compliance with the requirements of the Trust Indenture Act is a condition to the Commission's ordering effective a Securities Act registration statement relating to debt securities. n11

The Trust Indenture Act focuses on the terms of the indenture as the method of achieving investor protection. An indenture is a contract between the issuer of debt securities and a trustee, generally a bank or trust company. n12 Section 303(7) of the Trust Indenture Act defines "indenture" broadly to mean "any mortgage, deed of trust, trust or other indenture or similar instrument or agreement" under which securities are issued, whether or not any property is mortgaged under it. n13

Historically, the corporate indenture originated as a mortgage of property securing the corporate debtor's obligation on its bonds. n14 The indenture trustee was the mortgagee, holding the mortgage for the benefit of numerous bondholders. The indenture developed into a complex document that largely centralized the enforcement of bondholders' rights in the trustee, even where unsecured debentures were being issued. n15 Courts, however, were in disagreement as to whether the indenture trustee stood in a true fiduciary relationship with bondholders, or was something less than a fiduciary. n16

The Trust Indenture Act of 1939 was an attempt by Congress to impose minimum obligations on trustees, and to assure that trustees had the powers and resources to meet those obligations. In doing so, Congress created an immensely complex statute. This complexity was for many years a deterrent to the updating of the Act by later Congresses. n17 Changes in the securities markets and in trust institutions since 1939 however finally led to significant statutory revisions. n18 In late 1987, at the urging of the SEC, a number of amendments were introduced in Congress as the Trust Indenture Reform Act of 1987. n19 The proposals in slightly modified form were enacted as Title IV of the Securities Acts Amendments of 1990. n20

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C.A. §§ 77aaa-77bbb (2009).

(n2)Footnote 2. See Thomas Arthur & Steven B. Kite, 13-3rd C.P.S. (BNA), *Corporate Bond Financing* A-1 to A-2 (1999).

(n3)Footnote 3. See W. Klein and J. Coffee, *Business Organization and Finance* 251 (10th ed., 2007).

(n4)Footnote 4. See Arthur & Kite, n.2 *supra* , at A-2 (1999).

The American Bar Foundation's *Commentaries on Indentures* 8 (1971) states:

There is no basic or historically established distinction between 'debentures' and 'notes.' There has emerged, however, a clear and useful distinction in modern usage. According to this usage, in the area of long-term debt securities, a security is properly termed a 'note' when it is not issued pursuant to an indenture and there is no indenture trustee. However, it may be, and usually is, issued to one or a few purchasers pursuant to a purchase or loan agreement. ...

See generally, J. McCann (ed.), *Term Loan Handbook* (1983).

(n5)Footnote 5. See Comment, "The Commercial Paper Market and the Securities Acts," 39 *U. Chi. L. Rev.* 362, 363-64 (1972); Lowenstein, "The Commercial Paper Market and the Federal Securities Laws," 4 *Corp. L. Rev.* 128 (1981).

(n6)Footnote 6. See § 3.04 *supra*, for discussion of the exemption from Securities Act registration for short term paper.

See also § 8.06[2] *infra*, for discussion of the exemption from Trust Indenture Act qualification for short term paper.

(n7)Footnote 7. See L. Loss & J. Seligman, *Fundamentals of Securities Regulation* 296-97 (5th ed. 2004).

(n8)Footnote 8. See Arthur & Kite, n.2 *supra* , at A-61 (1999).

(n9)Footnote 9. See Slonaker & Wiltshire, *Innovative Debt Securities*, 20 *Rev. of Securities & Commodities Regulation* 89 (1987).

(n10)Footnote 10. See generally, Symposium, *Globalization of Securities Markets'90*, 14 *Hastings Intl. & Compar. L. Rev.* 253-473 (1991). This was recognized by Congress in its enactment of the 1990 Amendments to the Trust Indenture Act. Sec. L. Rep. No 101-155 (1989) 101st Cong., 1st Sess., p.30.

(n11)Footnote 11. See § 8.09 *infra*, for discussion of coordination of filings under the Securities Act and the Trust Indenture Act.

(n12)Footnote 12. See generally, J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 19-44 (2d ed. 1975).

(n13)Footnote 13. Where guarantees of securities are to be issued, the guaranty agreement between the trustee and the guarantor is generally considered to be an "indenture." See *The First Federal Savings Bank* (No Action Letter, Jan. 16, 1986); *First Southern Federal Savings & Loan* (No Action Letter, March 28, 1983); *First Federal Savings and Loan Association*, C.C.H. Fed. Sec. L. Rep. P 77,355 (Div. Corp. Fin. 1983); *Hawaiian Electric Company, Inc.* (No Action Letter, Oct. 11, 1971).

(n14)Footnote 14. See Draper, "A Historical Introduction to the Corporate Mortgage," 2 *Rocky Mtn. L. Rev.* 71 (1930).

(n15)Footnote 15. American Bar Foundation, *Commentaries on Indentures* 4-8 (1971).

(n16)Footnote 16. See Posner, *The Trustee and the Trust Indenture*, 46 *Yale L. J.* 737 (1937).

(n17)Footnote 17. See Friedman, *Updating the Trust Indenture Act*, 7 *U. Mich. J. L. Reform* 329 (1974).

(n18)Footnote 18. A number of revisions were proposed in the American Law Institute's Federal Securities Code, Part XIII (1980). The Code has not been enacted. The principal change which would be effected by it would be that much of what the present Trust Indenture Act requires to be set forth *in extenso* in an indenture would be deemed incorporated without the necessity of setting it forth in each indenture.

(n19)Footnote 19. See Trust Indenture Reform Act of 1987, C.C.H. Fed. Sec. L. Rep. P 84,205.

(n20)Footnote 20. P.L. 101-330, 104 Stat. 2713, 2721 (1990). See *generally* Campbell, Implications of the Trust Indenture Act of 1990 Breathing New Life Into the Trust Indenture Act of 1939, 11 Ann. Rev. of Banking Law 181 (1992).



116 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.02

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.02 History and Purpose of the Trust Indenture Act

The Trust Indenture Act identifies the abuses that led to its adoption in 1939. The final version of the Act was designed to remedy these perceived abuses and to reflect certain concerns of brokers and businesses.

In 1934, the Senate version of the Securities Exchange Act would have imposed registration and disclosure obligations on bondholder protective committees formed in connection with corporate reorganizations or liquidations. n1 The Conference Committee rejected this proposal and instead adopted Section 211 of the 1934 Act n2 directing the Commission to undertake a study of protective and reorganization committees. n3 The report by the Commission was issued in eight parts over the next several years. n4 It led ultimately to the enactment of the Chandler Act in 1938 dealing with corporate reorganizations under the Bankruptcy Act, n5 and to the enactment of the Trust Indenture Act in 1939. n6

Abuses of the pre-1939 period were identified by Congress in the statutory findings set out in the Trust Indenture Act. n7 Widely dispersed bondholders were unable to effectively enforce their rights without the existence of an indenture trustee with adequate powers and responsibilities. n8 When a trustee was provided for, the indenture often imposed few obligations on the trustee and often contained broad exculpatory clauses protecting the trustee. n9 Trustees often had conflicts of interest that interfered with the performance of their duties to bondholders or had inadequate resources to carry out their duties. n10 Corporate obligors in many cases were not required to furnish to either the trustee or bondholders current financial information or information about the obligor's compliance with indenture covenants. n11 Indeed, even names and addresses of bondholders were generally unavailable. n12 Provisions in indentures were sometimes misleading, and, in any event, full and fair disclosure to investors of the effect of indenture provisions was lacking. n13 Finally, little opportunity existed for potential investors to change the situation since the timing and complexity of the drafting of the indenture precluded any meaningful participation by them in the negotiation of the indenture's terms. n14

The Trust Indenture Act was designed to remedy these perceived abuses. n15 The drafting of the Act, however, was

affected by the lobbying efforts of banks and businesses:

Banking institutions which frequently acted as trustees registered vigorous opposition to further regulation of business under what they called the "dominion theory." They viewed the [Securities and Exchange] Commission as a new agency seeking to expand its regulatory role and increasingly to encroach upon private business, and the registration procedures as so time consuming and costly that necessary financing would cease to be available. n16

The approach of the Trust Indenture Act ultimately reflected these concerns of banks and businesses. Indeed, early versions of the bill, which would have given the Commission discretionary authority to promulgate rules regarding many of the terms of the indenture, were ultimately rejected in favor of precise enumeration of the required terms by Congress. n17

FOOTNOTES:

(n1)Footnote 1. 78 Cong. Rec. 8699-8700 (May 12, 1934).

(n2)Footnote 2. Pub. L. 73-291, 48 Stat. 881, 909 (1934).

(n3)Footnote 3. Conference Report, 78 Cong. Rec. 10248-10264 at 10264.

(n4)Footnote 4. SEC, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees* (1936-1940).

(n5)Footnote 5. Chandler Act, Pub. L. 75-696, 52 Stat. 840, 883 (1938).

(n6)Footnote 6. 2 Loss, *Securities Regulation* 719-20 (1961).

(n7)Footnote 7. TIA Section 302, 15 U.S.C. § 77bbb (1976).

(n8)Footnote 8. TIA Section 302(a)(1).

(n9)Footnote 9. TIA Section 302(a)(2).

(n10)Footnote 10. TIA Section 302(a)(3).

(n11)Footnote 11. TIA Section 302(a)(4).

(n12)Footnote 12. *Id.*

(n13)Footnote 13. TIA Section 302(a)(5).

(n14)Footnote 14. TIA Section 302(a)(6).

(n15)Footnote 15. TIA Section 302(b). More recent scholarship has suggested other approaches to deal with the collective action problems experienced by public bondholders. See Yakov Amihud, Kenneth Garbade & Marcel Kahan, A New Governance Structure for Corporate Bonds, 51 *Stanford L. Rev.* 447 (1999).

(n16)Footnote 16. *Morris v. Cantor*, 390 F. Supp. 817, 821, C.C.H. Fed. Sec. L. Rep. P 94,996, p. 97,449-50 (S.D.N.Y. 1975) .

(n17)Footnote 17. See Banks, "Discussion of the Barclay Bill," A-2 Corp. Reorg. & Amer. Bkrptcy Rev. 53, 59-63

2-8 Federal Securities Act of 1933 § 8.02

(1938); Trust Indenture Act of 1939, S. Rep. No. 248, 76th Cong., 1st Sess. 2 (1939); Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 28, 30 (1939).



117 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.03

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.03 Unique Regulatory Approach of the Trust Indenture Act

As amended in 1990, the Trust Indenture Act provides that specified substantive provisions concerning the trustee's powers, duties, and qualifications as well as the issuer's duties are a part of and govern every qualified indenture, whether qualified before or after 1990. The "business provisions" of the indenture are left unregulated. Breaches of the indenture's provisions are enforceable by the trustee or the bondholders through court proceedings. The statutorily required provisions of the indenture are governed by federal law while the "business provisions" of the instrument are governed by state law.

A trust indenture statute which, like the Securities Act, would have given the Commission ongoing enforcement powers would have been unacceptable to business interests in 1939. Further, investors would not have been adequately protected by a disclosure statute modeled after the Securities Act of 1933. n1 The adhesion nature of lending arrangements between corporations and bondholders required that the terms of the indenture itself be regulated.

As originally enacted, the Trust Indenture Act required in part that every indenture qualified under the Act contain specified substantive provisions relating to the trustee's powers, duties, and qualifications, and other provisions relating to the issuer's duties. n2 As amended in 1990, Section 318(c) automatically makes these provisions a part of every qualified indenture, whether or not the provisions are physically contained in the indenture. Prior to 1990, the Act also contained a number of permissive provisions that could be placed in the indenture. The 1990 amendments automatically make many of these part of every qualified indenture unless the indenture specifically excludes them. The Act also prohibits certain exculpatory clauses from being inserted in the indenture and precludes certain interferences with bondholders' rights to enforce their claims to principal and interest payments. Section 318(a) of the Act provides that the Trust Indenture Act's provisions control any indenture terms that are inconsistent with those provisions.

The Act, however, leaves the "business provisions" of the indenture unregulated. Section 318(b) of the Trust Indenture Act permits a qualified indenture to contain any provisions not in contravention of the Trust Indenture Act, in addition to the provisions specifically authorized by the Act. The Trust Indenture Act imposes no controls on such things as

interest rates, financial covenants, maturity dates, or the definition of when a default occurs. The issuer is free to draft these provisions in light of prevailing market conditions and accepted customs of the securities industry, n3 but many business provisions typically follow a boilerplate form developed over time. n4

The automatic incorporation of substantive terms into the indenture that is provided for by the 1990 amendments to the Act accomplished two kinds of efficiencies. First, it eliminated the need for the Commission staff to examine indentures to assure that the mandatory provisions were in fact included. n5 Indeed staff limitations in recent years had jeopardized investor protection by permitting a large proportion of indentures to become qualified without undergoing staff review. n6 Second, the automatic incorporation of required indenture provisions permits issuers to save substantial legal and printing costs by omitting their verbatim inclusion in the indenture. n7 Over the years, much energy had been devoted to devising ways to shorten the required verbiage. n8 Indentures now need make no mention at all of mandatory provisions, although (while not required) issuers may still wish to include a short statement to the effect that the indenture is governed by the provisions of the Trust Indenture Act.

The decision by Congress in 1939 to structure the Act to prescribe the substantive terms of each indenture accomplished the goal of eliminating ongoing Commission enforcement of indenture provisions. Once the indenture was initially qualified, the Commission was largely out of the picture. n9 Later breaches of duties were enforceable only by the trustee or by bondholders through court proceedings. Indeed, Section 309(e) of the Act provides that "[n]othing in this title shall be construed as empowering the Commission to conduct an investigation or other proceeding for the purpose of determining whether the provisions of an indenture which has been qualified under this title are being complied with, or to enforce such provisions."

The 1990 amendments to the Act not only provide for automatic incorporation into the indenture of the Act's provisions, they also state that the provisions of the Act, which impose a duty upon any person, "govern every qualified indenture." n10 The Senate Report described the effect of this language as follows:

This Title would convert the mandatory contractual terms in the Act to direct statutory commands and impose those terms on any indenture qualified under the Act. In other words, the Act's mandatory terms would govern the rights and duties under a qualified indenture both as provisions of positive law and as provisions of the indenture contract. n11

In mandating compliance with the standards of the Act by obligors, trustees and paying agents, separately from any contractual obligation that arises because of the constructive inclusion of mandatory terms in the indenture, the 1990 amendments appear to have substantially expanded the federal government's enforcement role. Since failure to comply with these standards would be a direct violation of the TIA, it would appear that such non-compliance could be prosecuted under TIA Section 325. n12 It is unclear, however, how this is affected by the provisions of Section 309(e) which were retained after 1990 and which preclude the Commission from conducting any investigation to determine whether the provisions of a qualified indenture have been complied with, or from enforcing the provisions of a qualified indenture.

Section 318(c) not only applies the TIA requirements, regardless of the contents of the indenture, to indentures that were qualified after the enactment of the 1990 amendments, but also applies the requirements retroactively to previously qualified indentures. n13 However, optional provisions that require an explicit opt-out for newly qualified indentures will not be deemed to be added to previously qualified indentures that did not contain them.

The original statutory structure led to significant confusion over the relationship between state and federal law when private parties attempted to enforce indenture provisions. The indenture contract and mortgage are basically documents governed by state contract and property law. Clearly, the business provisions of the indenture are governed by state law. The more complex question, and one focused on by the courts only many years after the Act's passage, was whether interpretation of the statutorily mandated provisions was to be governed by federal law.

In *Morris v. Cantor*,ⁿ¹⁴ Judge Ward strongly affirmed the federal law nature of the required indenture provisions:

[T]he remedy Congress chose was simply to state precisely which terms were required, permitted and prohibited in the contract. It viewed the problem as nationwide in scope and sought a nationwide solution. ... Accordingly, this legislation must be viewed as an indirect method of imposing nationally uniform and clearly defined obligations upon those associated with the issuance of corporate debt. The Court holds that the statute thereby 'created liability' as surely as though it had directly required the same actions and standards of behavior of trustees and obligors. ...ⁿ¹⁵

This interpretation leads to a federalization of the statutorily required portions of the indenture contract, while the other "business" portions of the same document are governed by state law.

Language added in 1990 to Section 322(b) of the Act was intended by Congress to confirm that prescribed indenture provisions are governed by federal law.ⁿ¹⁶

In 1996, some in Congress, under the rubric of deregulation, proposed repeal of the TIA, or at least study of the need for its repeal. Opposition by corporate trustees prevented these initiatives from being enacted into law.ⁿ¹⁷

FOOTNOTES:

(n1)Footnote 1. The Trust Indenture Act was originally drafted by William O. Douglas and Abe Fortas. See W. Douglas, *Go East, Young Man* 260 (1974). Douglas had long opposed the approach of the Securities Act as being inadequate to protect investors. See 1 Loss, *Securities Regulation* 124 (1961).

(n2)Footnote 2. See §§ 8.12, 8.13, 8.15, 8.17, and 8.19 *infra*, for discussion of the trustee's powers, duties, and qualifications.

See also § 8.14 *infra*, for discussion of the issuer's duties.

(n3)Footnote 3. See Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. Corp. L. 211 (1991).

(n4)Footnote 4. See American Bar Foundation (ABF), *Commentaries On Indentures* 3 (1971). The ABF Corporate Debt Financing Project has drafted model provisions not only for clauses that were required by the Trust Indenture Act, but also for "provisions [that] are practically 'non-negotiable,' not in the sense that they cannot be negotiated, but in the sense that they seldom are in fact negotiated and as a practical matter in most cases ought not to be." *Id.* Model provisions for use in drafting negotiated covenants were updated in 2006 with publication of Committee on Trust Indentures and Indenture Trustees, ABA Section of Business Law, *Model Negotiated Covenants and Related Definitions*, 61. Bus. Law. 1439 (2006). These are designed to integrate with the Revised Model Simplified Indenture, discussed *infra* in this section at fn. 8.

(n5)Footnote 5. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess. pp. 30-31.

(n6)Footnote 6. By 1988, staff limitations at the Commission had resulted in 54.5% of all indentures being qualified without staff review. *Id.*

(n7)Footnote 7. *Id.*

(n8)Footnote 8. See, e.g., Revised Model Simplified Indenture, 55 Bus. Law. 1115 (2000).

(n9)Footnote 9. See *Morris v. Cantor*, 390 F. Supp. 817, C.C.H. Fed. Sec. L. Rep. P 94,996 (S.D.N.Y. 1975) .

(n10)Footnote 10. TIA Section 318(c).

(n11)Footnote 11. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess. p. 31.

(n12)Footnote 12. TIA Section 325 is discussed at § 8.20[3], *supra*.

(n13)Footnote 13. This does not appear to create any federal constitutional problems. See Fouhey, Godfrey & Trefny, *Reform of Trust Indenture Act Eases Conflicting-Interest Rules*, Natl. L. Jour., Feb. 4, 1991, p. 26, citing *The Gold Clause Cases*, 294 U.S. 240 (1934) .

(n14)Footnote 14. 390 F. Supp. 817, C.C.H. Fed. Sec. L. Rep. P 94,996 (S.D.N.Y. 1975) .

(n15)Footnote 15. 390 F. Supp. at 822, C.C.H. Fed. Sec. L. Rep. at p. 97,450 .

(n16)Footnote 16. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., p. 51. But see *Harriet & Henderson Yarns, Inc. v. Castle*, 75 F. Supp. 2d 818, 832-33 (W.D. Tenn. 1999) , which incorrectly suggests that whether or not the Trust Indenture Act was incorporated into a post-1990 indenture depends upon whether the terms of the indenture provided for such incorporation.

(n17)Footnote 17. See Harold L. Kaplan & Marla Chernof Cohen, *The Role of Indenture Trustees in Modern Finance*, in ABA Section of Business Law Committee on Trust Indentures and Indenture Trustees, *Repeal of the Trust Indenture Act? Issues for Reform* 1, 3-4 (Boston, Apr. 4, 1997), and James Gadsden & Amy L. Krassner, *Legislative, Regulatory and Case Law Developments*, *id.* at 65, 67-68.



118 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.04

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.04 Coverage of the Act

The Trust Indenture Act applies only to debt securities and interest in debt securities. The Commission has excluded interests not represented by a separate physical certificate and interests in which there is no fixed obligation to pay a sum of money from the coverage of the Act. Only primary distributions require indenture qualification; sales by persons acting as conduits for the issuer, however, are not exempt from the Act's provisions. The brokers' transaction exemption under the Securities Act is incorporated into the Trust Indenture Act.

The Trust Indenture Act applies only to debt securities and interests in debt securities. It does not apply to stock. n1 More specifically, Section 304(a)(1) of the Act limits its application to:

- (1) any "note, bond, debenture, or evidence of indebtedness, whether or not secured";
- (2) any "certificate of interest or participation in" such debt securities; n2 or
- (3) any "temporary certificate for, or guarantee n3 of" such debt securities or certificates of interest. n4

Certain debt securities exempted from Securities Act coverage under Section 3 of the Securities Act are also exempt from the Trust Indenture Act under Section 304(a)(4). For example, short term commercial paper is exempt under Securities Act Section 3(a)(3) n5 and Trust Indenture Act Section 304(a)(4). n6

The SEC has permitted the sale of "Tuition Certificates" under a private *IRC* § 529 pre-paid tuition plan without compliance with the TIA. It apparently accepted the argument that the certificates are not "securities" because they are not purchased for investment, but instead in order to receive future educational benefits for use and consumption. n7

In its interpretation of Section 304(a)(1), the Commission has tended to exclude from Trust Indenture Act coverage interests not represented by a separate physical certificate. In several no-action letters, for example, interests in

liquidating trusts, or contingent payment rights granted in connection with a business acquisition, were found to be exempt from qualification under the Trust Indenture Act where the interests were not evidenced by a certificate and were not transferable except by will, intestate succession, or operation of law. n8 In other cases, even where certificates were issued by liquidating trusts, since they were issued to shareholders they were found not to be *debt* securities requiring qualification under the Trust Indenture Act, even though registration under the Securities Act of 1933 might have been required. n9

The Commission's emphasis on the existence of physical certificates seems to be an attempt to distinguish "securities" from commercial or open account indebtedness. So, an arrangement equivalent to deferred cash payments in a stock repurchase plan n10 or an arrangement for paying off commercial or open account creditors in future installments n11 is not covered by the Trust Indenture Act.

While the Commission usually has not focused on the tests applied by the courts under the Securities Act of 1933 and the Securities Exchange Act of 1934 to deal with the analogous issue of when a promissory note is or is not a security, n12 it does seem to have taken the position that when deferred payment arrangements relate to obligations originally evidenced by a security, qualification is necessary even where physical certificates are not issued to represent the deferred payment rights. n13

In situations such as those involving interests in litigation proceeds n14 and interests in profit sharing plans, n15 the Commission has focused on the absence of a fixed obligation to pay an amount of money to holders of the interests as the basis for concluding that the interests are not debt securities covered by the Trust Indenture Act.

The Commission's focus on whether an instrument involves a fixed obligation to pay a sum of money involves the problem of distinguishing debt securities from equity investments. n16 Although similar problems have arisen most often under the Internal Revenue Code, n17 tax law does not seem to present the most relevant precedents. The close relationship that has existed historically and in underlying purpose between the Trust Indenture Act and the federal bankruptcy laws should make precedents relating to bankruptcy liquidations and reorganizations the most relevant for Trust Indenture Act purposes. Distinctions between debt claims and equity interests must typically be made in bankruptcy proceedings. n18 Bankruptcy courts generally focus on the state law's characterization of an instrument as debt or equity. n19

Section 304(a)(2) of the Trust Indenture Act further excludes from the Act's coverage "any certificate of interest or participation in two or more securities having substantially different rights and privileges, n20 or a temporary certificate for any such certificate." Thus, the Act would apply to certificates of participation into which a large mortgage and note had been divided, n21 but would not cover interests in a mutual fund whose portfolio consisted of various debt securities, since the portfolio securities in which the mutual fund stockholders have an interest have substantially different rights. n22 The provisions of the Act would also not apply where a certificate involved interests in more than one security of a single issuer. n23

The Trust Indenture Act's requirements that debt securities be issued only under a qualified indenture apply only to public distributions of debt by or on behalf of the *issuer*. Even though registration under the Securities Act is required for secondary distributions, *i.e.*, for sales by or on behalf of control persons (affiliates), only primary distributions require indenture qualification. The force of the Act is directed only at the creation of the indenture by the issuer. This result is accomplished rather cryptically by Section 304(b), which exempts from the indenture qualification requirements any transaction that would be exempt from the Securities Act "but for the last sentence of paragraph (11) of section 2 of such Act" which is the provision that brings within the Securities Act's registration requirements most public distributions by or on behalf of affiliates. n24

Section 304(b), however, does not exempt from the provisions of the Trust Indenture Act sales by persons acting as conduits for the issuer. Thus, an institutional investor who acquired debt securities not qualified under the Trust

Indenture Act in an exempt private offering would violate not only the Securities Act but also Section 306 of the Trust Indenture Act if the investor resold the debt securities without registration and indenture qualification, unless the investor complied with Securities Act Rule 144 or found some other exemption. n25 At one time, it was common to include in the loan agreement for notes sold to institutional investors a "debenturizing" provision so that institutional holders could exchange their notes for debentures issued under a qualified indenture if the institution desired to resell in a nonexempt transaction. This provision is not frequently included in loan agreements today. n26

Section 304(b) of the Trust Indenture Act also incorporates the brokers' transactions exemption of Securities Act Section 4(4). n27 Thus, a broker who sells a debt security, not issued under a qualified indenture, is not in violation of the Trust Indenture Act if the purchaser was not solicited to buy the security, the broker performed only the normal broker's functions, and no more than the usual and customary broker's commission was paid. If, however, the broker is aware that he is acting as a conduit for the issuer in distributing unqualified debt securities, the broker would be acting as an underwriter and not merely as a broker and the brokers' transactions exemption would be unavailable. n28

Like the registration provisions of the Securities Act of 1933, the Trust Indenture Act's provisions are directed at protecting U.S. residents and citizens. Regulation S provides a safe harbor under the Securities Act of 1933 for offers and sales made outside the United States in compliance with the terms of the regulation. The Commission has indicated that it also will not take any enforcement action under the Trust Indenture Act if offers and sales are made off shore in compliance with the safe harbor provisions of Rule 903 or 904 of Regulation S. n29

FOOTNOTES:

(n1)Footnote 1. *See, e.g.,* Westgate-California (No-Action letter, Dec. 27, 1976) (reorganization certificates representing interest in common stock to be issued in future are not covered by Trust Indenture Act).

(n2)Footnote 2. Preferred securities issued by a trust representing an interest in a single obligor's debt securities are covered by the TIA. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 101.04, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n3)Footnote 3. *See* Standard Oil Co. (Indiana), C.C.H. Fed. Sec. L. Rep. P 76,822 (Div. Corp. Fin. 1980).

See § 8.06[5] *infra* for discussion of TIA Section 304(a)(7) regarding the exemption for guarantees of exempted securities.

(n4)Footnote 4. The SEC apparently does not consider exchange-traded options on corporate debt securities to be covered by the TIA. *See, Order Granting Approval of Proposed Rule Change to List and Trade Options on Corporate Deb Securities*, SEC Release No. 34-55976 (June 28, 2007).

(n5)Footnote 5. *See* Sec. Act Rel. 4412, 1 C.C.H. Fed. Sec. L. Rep. P 2045 (1961).

See also Lowenstein, *The Commercial Paper Market and the Federal Securities Laws*, 4 Corp. L. Rev. 128 (1981); Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. Chi. L. Rev. 362 (1972).

For discussion of Securities Act Section 3(a)(3), see § 3.04 *supra*.

(n6)Footnote 6. *Cf.* Heights Finance (No Action Letter, Jan. 24, 1983) (short term notes that do not meet the requirements for a Section 3(a)(3) exemption under the Securities Act are not exempt from the Trust Indenture Act under TIA section 304(a)(4)).

For further discussion of TIA Section 304(a)(4), see § 8.06[2] *infra*.

For a definition of commercial paper, see § 8.01 *supra*.

(n7)Footnote 7. Tuition Plan Consortium, LLC (No-Action Letter, Feb 4, 2003), 2003 SEC No-Act. LEXIS 117.

(n8)Footnote 8. *See, e.g.*, Lawyer's Title of Dallas, Inc. (No Action Letter, April 2, 1991); American Beverage Corp. (No Action Letters, Dec. 20, 1982 and Dec. 27, 1982); Star Supermarkets Inc. (No Action Letter, Dec. 22, 1982); National Liberty Corp. (No Action Letters, Feb. 27, 1981 and May 15, 1981); Far East Power Corp. (No Action Letter, Nov. 3, 1980); Canadian Int'l Power Co. Ltd. (No Action Letter, May 29, 1979); Dico Corp. (No Action Letters, Sept. 1, 1978 and Sept. 13, 1978); Allied Properties (No Action Letter, April 2, 1977); Citadel Industries, Inc. C.C.H. Fed. Sec. L. Rep. P 80,764 (Div. Corp. Fin. 1976); Sunset International Petroleum Corp. (No Action Letter, March 2, 1972). *See also* Official Unsecured Creditors' Committee of American Freight Systems, Inc. and USA Western, Inc. (No Action Letter, July 15, 1991) (Distribution interests issued by surviving corporation in bankruptcy reorganization, using liquidating trust on standby basis, treated in same manner as interests in liquidating trust); Lorimar, Inc. (No Action Letter, Nov. 4, 1985) (deferred payment rights of shareholders of acquired company in merger, not evidenced by certificates, are not debt securities), GID/TL, Inc., C.C.H. Fed. Sec. L. Rep. (SEC, 1989) (similar deferred payment rights do not require qualification under TIA; Genentech Clinical Partners (No Action Letter, April 28, 1989) (Contingent payment rights given as part of consideration for purchase of assets, not evidenced by certificates, are not securities subject to TIA); First Boston, Inc. (No Action Letter, December 2, 1988) (deferred payment rights, not evidenced by certificates, granted to shareholders in merger are not subject to TIA requirements).

(n9)Footnote 9. Management Assistance, Inc. (No Action Letter, Jan. 17, 1986); Southern Syndicate Inc. (No Action Letter, Sept. 12, 1975); Niagara Frontier Transit System Inc. (No Action Letter, Jan. 10, 1975), USM Corp. (No Action Letter, May 28, 1973). In some cases, Securities Act registration of certificates issued by liquidating trusts has been found to be unnecessary because no "sale" is involved. *See, e.g.*, Dunes Hotels and Casinos, Inc. (No Action Letter, July 15, 1983); Heizer Corp. (No Action Letter, April 25, 1984) (noting that certificates will be non-transferrable, trust will have limited purpose and will expire in reasonable time, and trust will issue annual financial reports and other information to beneficiaries).

(n10)Footnote 10. Rospatch Corp., C.C.H. Fed. Sec. L. Rep. P 77,071 (Div. Corp. Fin. 1981); *cf.* Continental Investment Corp. (No Action Letter, August 28, 1981).

(n11)Footnote 11. Federated Department Stores, Inc. (No Action Letter, January 31, 1992); Great American Mgt. & Investment Co. (No Action Letter, October 23, 1978); Ames Department Stores Inc. (No Action Letter, September 25, 1978); Chicken Unlimited Enterprises Inc. (No Action Letter, September 11, 1978); Valley International (No Action Letter, May 4, 1977).

(n12)Footnote 12. *See Reeves v. Ernst & Young*, 894 U.S. 56 (1990). For a no-action letter in which the SEC may have relied on the *Reeves* test, see Tuition Plan Consortium, LLC (No-Action Letter, Feb 4, 2003), 2003 SEC No-Act. LEXIS 117.

(n13)Footnote 13. The State Street Mortgage Co. (No Action Letter, April 11, 1991) (qualification required for deferred payment rights granted to holders of demand notes previously issued in reliance on private offering and Regulation D exemptions), rejecting the staff's earlier contrary position in Food Fair Inc. (No Action Letter, January 19, 1981) (qualification not required where provisions included payment to debenture holders as well as to creditors who were not security holders). Also see Greenwood Associates (No Action Letter, September 12, 1990) (qualification required for deferred payment rights issued in exchange for industrial development bonds); American First Corp. (No Action Letter, September 14, 1989) (apparently also rejecting Food Fair Inc.).

(n14)Footnote 14. Continental Mortgage Investors (No Action Letter, Dec. 13, 1982); Penn Central Transp. Co. (No Action Letter, March 3, 1978); Central Railroad Co. of N.J. (No Action Letter, October 11, 1979); American

Campgrounds, Inc. (No Action Letter, April 17, 1975); Shastina Properties, Inc. (No Action Letter, October 23, 1974). Cf. Metropolitan Holding Co., Inc. (No Action Letter, April 29, 1985) (escrowed certificates representing contingent rights to receive debentures and cash in reorganization, depending on outcome of tax dispute, are not debt securities).

(n15)Footnote 15. Pilot Freight Carriers, Inc. (No Action Letter, Aug. 26, 1985); Travelers Corp., C.C.H. Fed. Sec. L. Rep. P 76,358 (Div. Corp. Fin., 1980); Aetna Casualty & Surety Co. (No Action Letter, May 7, 1973).

(n16)Footnote 16. See, NCNB Corp. (No Action Letter, July 21, 1986) (involving warrants with redemption feature giving them some similarity to convertible debentures).

(n17)Footnote 17. See, e.g., *I.R.C. § 385* (1976).

(n18)Footnote 18. See Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101(4), 101(11), 101(15).

(n19)Footnote 19. See *Price v. Gurney*, 324 U.S. 100 (1945) ; *In re Lela & Co., Inc.*, 551 F.2d 399, 406 (D.C. Cir. 1977) ; but see *In re Eastern Erectors, Inc.*, 346 F. Supp. 293 (E.D. Pa. 1973) , *aff'd without op.*, 485 F.2d 679 (3d Cir. 1973) .

(n20)Footnote 20. See Harbor Financial, Inc. (No Action Letter, Oct. 31, 1988).

(n21)Footnote 21. See H. R. Rep. No. 1016, 76th Cong. 1st Sess. 39, 41 (1939).

(n22)Footnote 22. Cf. *id.*, at 41, referring to the exemption of "fixed trust certificates evidencing an interest in a group of assorted bonds." See, Marion Bass Securities, Inc. (No Action Letter, July 9, 1984).

(n23)Footnote 23. See Penn Central Transportation Co. (No Action Letter, March 3, 1978) (beneficial interests in a package of securities of same issuer).

(n24)Footnote 24. For discussion of Securities Act Section 2(11), see § 4.01[2] *supra*.

(n25)Footnote 25. See *Resale by Institutional Investors of Debt Securities Acquired in Private Placements*, 34 Bus. Law. 1927 (1979).

(n26)Footnote 26. J. McCann, *Term Loan Handbook* 152 (1983).

(n27)Footnote 27. Securities Act Section 4(4) is discussed in § 4.06 *infra*.

(n28)Footnote 28. See Securities Act Rule 144(g), discussed in §6.02[4][d]; §6.05[6], [9], [10] *supra*.

(n29)Footnote 29. Offshore Offers and Sales, Securities Act Rel. No. 33-6863 (April 24, 1990), C.C.H. Fed. Sec. L. Rep. P 84,524, at pg. 80,682. Also see Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 201.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.



119 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.05

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.05 Basic Indenture Requirement and Exemptions for Small Issues

The Trust Indenture Act generally requires that all securities covered by the Act be issued under an indenture that meets the requirements of the Act. n1 Exemptions are available under the Act that permit an issuer to issue not more than \$5 million of debt securities during a twelve month period without an indenture, or, if the indenture limits the amount of securities that maybe outstanding under it at any time to \$10 million, the indenture's substantive terms need not fully comply with the provision of the Act. In addition, up to \$5 million of debt securities may be offered under Regulation A without Trust Indenture Act compliance. In certain cases, the Commission has required the integration of separate transactions or issues under the exemptive provisions.

The Trust Indenture Act generally requires that all securities covered by the Act be issued under a qualified indenture which is governed by the requirements of Sections 310-318 of the Act. n2 However, exemptions from this requirement are available for issuances of small dollar amounts of debt securities. In 1992, the Commission used its rule making authority under Sections 304(a)(8) and (9) and 304(d) of the Act to implement exemptions from the Trust Indenture Act that parallel its various small business regulatory initiatives under the Securities Act of 1933. n3 These exemptions expand substantially on the pre-1992 exemptions available for small issuances.

[1] Securities Issued without an Indenture--Section 304(a)(8) and Rule 4a-1

Rule 4a-1 promulgated under Section 304(a)(8) of the Trust Indenture Act permits an issuer to issue not more than \$5 million of debt securities during a twelve month period without using an indenture. n4 Thus, an offering made pursuant to Rule 504 of 505 of the Securities Act of 1933 will be free of Trust Indenture Act restrictions. n5 The Commission will permit more than \$5 million of non-indenture debt securities to be registered at one time under the Securities Act, so long as the plan of distribution detailed in the prospectus limits the amount issued and sold in any one year to \$5 million or less. n6 When a debt security is issued along with an equity security in a unit, the exemption is available so long as the aggregate amount of the debt portion is under \$5 million. n7

[2] Securities Issued under Regulation A--Rule 4a-2

Pursuant to its Section 304(d) authority to promulgate exemptive rules, the Commission has adopted Rule 4a-2 which exempts from the requirements of the Trust Indenture Act any security that has been issued or will be issued in accordance with the provisions of Regulation A under the Securities Act of 1933. n8 Regulation A permits offerings of up to \$5 million. n9

[3] Securities Issued under an Indenture Not Exceeding \$10 Million--Section 304(a)(9) and Rule 4a-3

If the Rule 4a-1 or 4a-2 exemptions are not available to the issuer, its debt securities must be issued under an indenture. However, under Section 304(a)(9) and Rule 4a-3, the indenture's substantive terms need not comply with the provisions of the Trust Indenture Act if the indenture limits the amount of securities that may be outstanding under it at any time to \$10 million. The Section 304(a)(9) exemption may not be applied to more than \$10 million of securities of the same issuer in any thirty-six-month period. However the 36-month period is a "rolling period", beginning with the initial offering under the indenture. n10

The Section 304(a)(9)/ Rule 4a-3 exemption allows only one \$10 million indenture to be used during a 36-month period, even if the securities issued under a prior indenture have been redeemed and the indenture terminated. n11

Despite the language of Section 304(a)(9), which requires the indenture itself to limit the dollar amount of securities outstanding under it to be exempt, in at least one case, the Commission, because of the judicial supervision involved, has permitted the offering of debt securities in a bankruptcy reorganization to begin without indenture qualification even though the dollar limit might ultimately be exceeded. The Commission required, however, that the indenture be qualified before actual issuance of the securities if the dollar amount was in fact exceeded when the precise amount of debt securities to be issued in the reorganization was determined. n12

The indenture that is required when the \$10 million limit is not exceeded need not fully comply with the requirements of the Trust Indenture Act. No action letters have defined minimal standards for these unqualified indentures. These indentures should contain "the usual covenants, events of default, and the procedures by which the collective rights of the security holders may be enforced." n13 Thus, while Section 304(a)(9) does not explicitly require that an indenture provide for a trustee, the Commission takes the position that "as a practical matter, such collective rights are best enforced by a trustee who is accorded specific powers for this purpose." n14 The trustee, however, need not meet the eligibility requirements of Section 310, which would be applicable in the case of a qualified indenture. n15

[4] Integration of Issues Exempt under Sections 304(a)(8) and 304(a)(9)

The dollar limits in the exemptive provisions of both Section 304(a)(8) and Section 304(a)(9) pose problems relating to the integration of separate transactions: which securities sold in the relevant time periods must be aggregated in computing the \$5 million limit on non-indenture securities and the \$10 million limit on indenture securities exempt from Trust Indenture Act requirements? While the last sentence of Section 304(a) provides that, in computing the relevant dollar amounts under Sections 304(a)(8) and (9), securities exempt under any other provisions of the Trust Indenture Act may be disregarded, n16 it does appear that non-indenture securities issued in reliance on Section 304(a)(8) or otherwise, count against the overall limit in Section 304(a)(9) and Rule 4a-3 restricting the total dollar amount within any consecutive 36 month period to which Section 304(a)(9) may be applied. n17

In adopting Rule 4a-2 providing a Trust Indenture Act exemption for securities offered under Regulation A, the Commission indicated that it intended the rule to parallel those under the Securities Act of 1933. n18 Under the Securities Act, a Regulation A offering is not integrated with *prior* Rule 504 or 505 offerings. n19 Thus, an offering under Rule 504 or 505 which is exempt from the Trust Indenture Act under Rule 4a-1 could be combined with a subsequent Regulation A offering which relied on Rule 4a-2 for a Trust Indenture Act exemption. However, where a Rule 504 or 505 offering *follows* a Regulation A offering, under the Securities Act of 1933 the dollar limits permitted

under Rule 504 or 505 are decreased by the amount of any Regulation A offering during the prior twelve months. n20 Thus, Rule 504 and 505 are effectively unavailable for a year following a Regulation A offering.

Under the Securities Act of 1933, a Regulation A offering is not integrated with a subsequent registered offering. n21 Pursuant to the non-integration provisions of Trust Indenture Act Section 304(a), an offering under Regulation A relying on Rule 4a-2 could be combined with a subsequent registered offering that relies upon either Rule 4a-1 or Rule 4a-3 for a Trust Indenture Act exemption.

Despite the non-integration provision in Section 304(a), the Commission has required integration of debt securities issued to a corporation's controlling shareholder with the concurrent issuance of identical debt securities of a limited dollar amount to its other shareholders. This application of traditional Securities Act integration standards n22 prevented the combined use of Section 304(a)(8) with the private offering exemption of Section 304(b)(1) to avoid indenture qualification when the two transactions were, in fact, closely related aspects of a single recapitalization. n23

However, the Commission has not required integration of convertible debentures issued in a tender offer to a few United States security holders with those issued simultaneously to overseas security holders of the target company. n24

FOOTNOTES:

(n1)Footnote 1. *But see* SBC Communications, Inc., Pacific Telesis Group (No Action Letter, January 27, 1998) (guarantees of obligations of wholly owned subsidiary providing additional protection without security holders paying consideration or giving up any rights does not involve a sale. Therefore, they may be issued without an indenture, apparently even though subsequent transferees who pay value for the securities will lack the protections afforded by the TIA as to obligations of the parent issuer.)

(n2)Footnote 2. *See* TIA Sections 305(b), 307(c).

(n3)Footnote 3. *See Small Business Initiatives, Sec. Act Rel. No. 33-6949, 57 F.R. 36442 (Aug. 13, 1992)* . For a discussion of the small business initiatives see § 7.04[3] *supra*.

(n4)Footnote 4. *See* American First Corp. (No Action Letter, September 14, 1989) (deferred payment obligations totaling less than \$2 million to non-trade creditors in bankruptcy reorganization exempt from TIA qualification requirements under prior version of Rule 4a-1). Sullivan County Harness Racing Assn., Inc., 16 B.N.A. Sec. Reg. & L. Rep. 690 (Div. Corp. Fin. 1984) (a corporation's offering of bonds would be exempt from the Trust Indenture Act's registration requirements since the aggregate principal amount is less than \$2 million then required by Rule 4a-1).

(n5)Footnote 5. *See Small Business Initiatives, Sec. Act Rel. No. 33-6924, 57 F.R. 9768, 9776 (March 20, 1992)* . Rules 504 and 505 are discussed at § 4.04 *supra*.

(n6)Footnote 6. *See* Local Loan Co. (No Action Letter, Aug. 13, 1978) (under lower dollar limits of pre-1980 version of Section 304(a)(8)).

(n7)Footnote 7. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 204.01, 217.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n8)Footnote 8. *See Small Business Initiatives, Sec. Act Rel. No. 33-6949, 57 F.R. 36442 (Aug. 13, 1992)* .

(n9)Footnote 9. *See* Chapter 5, *supra*. For a discussion of the extent to which Rule 4a-2 may be cumulated with the exemption in Rule 4a-1, see § 8.05[4] *infra*.

(n10)Footnote 10. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 205.01, 218.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n11)Footnote 11. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 205.02, 218.02, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n12)Footnote 12. First Home Investment Corp. of Kansas, C.C.H. Fed. Sec. L. Rep. P 80,490 (Div. Corp. Fin. 1976).

(n13)Footnote 13. Allied-Carson Corp., C.C.H. Fed. Sec. L. Rep. P 80,434 (Div. Corp. Fin. 1976); Mr. Steak Inc. (No Action Letter, Dec. 13, First Home Investment Corp. of Kansas, C.C.H. Fed. Sec. L. Rep. P 80,490 (Div. Corp. Fin. 1976); *Cf.* Standard Duplicating Machinery Corp., C.C.H. Fed. Sec. L. Rep. P 81,325 (Div. Corp. Fin. 1977).

(n14)Footnote 14. Allied-Carson Corp., C.C.H. Fed. Sec. L. Rep. P 80,434 (Div. Corp. Fin. 1976) Mr. Steak Inc. (No Action Letter, Dec. 13, 1976); First Home Investment Corp. of Kansas, C.C.H. Fed. Sec. L. Rep. P 80,490 (Div. Corp. Fin. 1976); Standard Duplicating Machinery Corp., C.C.H. Fed. Sec. L. Rep. P 81,325 (Div. Corp. Fin. 1977).

(n15)Footnote 15. Allied-Carson Corp., C.C.H. Fed. Sec. L. Rep. P 80,434 (Div. Corp. Fin. 1976); Mr. Steak, Inc. (No Action Letter, Dec 13, 1976); First Home Investment Corp. of Kansas, C.C.H. Fed. Sec. L. Rep. P 80,490 (Div. Corp. Fin. 1976).

TIA Section 310 is discussed in § 8.12 and § 8.13 *infra* .

(n16)Footnote 16. *See* Victoria Station, Inc. (No Action Letter, April 20, 1987); UST Corp. (No Action Letter, May 9, 1977); *Cf.* Model Finance Co. (No Action Letter, Dec. 27, 1973).

(n17)Footnote 17. Mathews v. Fisher, C.C.H. Fed. Sec. L. Rep. P 97,336 (S.D. Ohio 1978) at p. 97,230.

(n18)Footnote 18. *Small Business Initiatives, Sec. Act Rel. No. 33-6924, 57 F.R. 9768, 9776 (March 20, 1992)* .

(n19)Footnote 19. Securities Act Rule 251(c)(1).

(n20)Footnote 20. Securities Act Rule 504(b)(2), 505(b)(2)(i).

(n21)Footnote 21. Securities Act Rule 251(c)(2)(i). For a limited exception to this, see Securities Act Rule 254(d).

(n22)Footnote 22. *See* Sec. Act Rel. No. 33-4552, 1 C.C.H. Fed. Sec. L. Rep. P 2770, 2781-82 (1961), discussed in § 4.03[1] *supra*.

(n23)Footnote 23. Reliable Stores Corp. (No Action Letter, Aug. 31, 1979).

Section 304(b)(1) is discussed in § 8.07 *infra*.

(n24)Footnote 24. Procordia Aktiebolag, C.C.H. Fed. Sec. L. Rep. P 79,433 (SEC 1990).



120 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.06

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.06 Exempt Securities

The Trust Indenture Act provides for the exemption of certain securities. Issuers may apply to the Commission for an order to exempt securities issued under open-end provisions of pre-1939 indentures. The Trust Indenture Act was closely integrated with the Securities Act and, with two exceptions (the exemptions for recapitalizations involving exchanges with existing security holders and judicially and administratively approved reorganizations), the exemptions under Securities Act Section 3 were incorporated into the Trust Indenture Act. Several provisions cover exemptions from the Trust Indenture Act for securities issued in connection with the creation and maintenance of a secondary market in real estate mortgages. Other exemptions from the Trust Indenture Act involve certain foreign government securities, guarantees of exempted securities, issues of limited dollar amounts, and bankruptcy related commercial notes. The Commission may grant other exemptions by order or rule, and has done so for certain cross-border offerings of Canadian securities.

[1] Pre-1939 Indentures--Section 304(c)

A special problem is posed by sales of securities issued under open-end indentures executed prior to the effective date of the Trust Indenture Act. n1 Open-end indentures provide for later issuance of additional series of bonds. Use of supplemental indentures authorizing new issuances under these open-end provisions, rather than the execution of new indentures, might be necessary to make collateral available to secure. n2 To allow future series of debt securities to be issued under the terms of the original indenture, however, would permit the issuer, long after 1939, to avoid giving new bondholders the protections of the Act. On the other hand, the original indenture might require an unobtainable consent of the bondholders for some of the changes necessary to bring the indenture into compliance with the Trust Indenture Act. Congress reconciled these competing demands through Section 304(c).

Section 304(c) permits the issuer to apply to the Commission for an order to exempt from one or more provisions of the Trust Indenture Act securities issued under open-end provisions of pre-1939 indentures. Under Section 304(c)(1), the Commission is to issue the order if it finds that any pre-1939 indenture or any provision of law would require consent of

indenture security holders before a supplemental indenture or other form of amendment could be used to conform the indenture to the requirements of the Act. n3 Under Section 304(c)(2), the Commission is to issue an order for exemption even when consent of bondholders is not required, if compliance with the provisions of the Act would impose an undue burden on the issuer. n4

Applications for an order under Section 304(c) are to be made on Form T-4. Rules 4c-1 through 4c-5 of the Act detail the formal and procedural requirements for these applications. T-4 is still *required* to be filed with the SEC in paper form rather than being filed electronically through the EDGAR system. n5 Three copies of Form T-4 are to be filed. n6 The Form calls for an indication of each provision of the Act from which an exemption is sought and other information necessary to permit the Commission to determine whether an exemption should be granted. n7 An applicant under Section 304(c)(1) may waive its right to a hearing and request the Commission to decide the matter on the basis of the application and other information in the Commission's files. n8

Initially, the duration of the Section 304(c) application for exemption provision was self-limiting, since it could be invoked only so long as some debt securities issued under the original indenture prior to 1940 were still outstanding. In 1960, the section was amended so that issuers who still had not brought their pre-1939 indentures into compliance with the Trust Indenture Act could continue to apply for an exemption for securities which continue to be issued under supplemental indentures. n9 So long as indenture securities sold prior to 1940 were outstanding on January 2, 1959, the issuer can continue indefinitely to apply for exemptions even though at the time of application the obligation under the pre-1940 securities have been satisfied and these securities are no longer outstanding. n10

Section 304(c) has not been widely used because of the Commission's holding in *Hugo Stinnes Corp.* n11 that an indenture may be amended without the consent of security holders to increase the duties of the trustee when the indenture is silent as to the procedure for these amendments. As a practical matter, few non-conforming pre-1939 open-end indentures remain under which new debt may be issued. n12

[2] Securities Exempt under Section 3 of the Securities Act--Section 304(a)(4)

While the Trust Indenture Act was closely integrated with the provisions of the Securities Act of 1933, two exemptive provisions of the Securities Act were not carried over into the Trust Indenture Act. n13

The first was the Securities Act exemption for recapitalizations involving exchanges solely with existing security holders under Securities Act Section 3(a)(9). n14 Congress reasoned that, while existing security holders may not need additional disclosures under the Securities Act, they do need the substantive protections of the Trust Indenture Act. n15

Second, the Securities Act exemption for judicially and administratively approved reorganizations under Section 3(a)(10) n16 was excluded because courts and agencies were thought to rarely examine trust indentures as part of their review of the fairness of a plan of reorganization. n17

The remaining exemptions from Section 3(a) of the Securities Act were incorporated into the Trust Indenture Act through Trust Indenture Act Section 304(a)(4). The 1990 amendments to Section 304(a)(4) n18 simplified coordination of exemptions under the Securities Act and the Trust Indenture Act. Prior to those amendments, Section 304(a)(4) had, with one exception, n19 incorporated only the 1939 version of exemptions under the Securities Act. n20 By the language adopted in 1990, Congress assured that Trust Indenture Act exemptions track the present versions of, and any future amendments to, Securities Act Sections 3(a)(2)-(8) and 3(a)(11).

The Section 3(a)(2) exemption incorporated into Section 304(a)(4)(A) of the Trust Indenture Act, exempts securities issued or guaranteed by the United States, n21 its territories, the District of Columbia, or by congressionally authorized federal instrumentalities, n22 and those issued or guaranteed by any state or its political subdivisions, or government instrumentalities, n23 and securities issued or guaranteed by state and national banks. n24 Thus, participation

certificates in a pool of municipal and government agency bonds, where the certificates are sold and unconditionally guaranteed by a bank, are exempt under Section 304(a)(4)(A).ⁿ²⁵ Section 3(a)(2) of the Securities Act also exempts certain interests in bank common trust funds, various interests or participations in tax sheltered employee benefit plans, and certain industrial development bonds.ⁿ²⁶ Industrial development bonds outside the scope of Section 3(a)(2) must be qualified under the Trust Indenture Act.ⁿ²⁷

The Securities Act Section 3(a)(3), incorporated through Trust Indenture Act Section 304(a)(4), exempts short term notes arising out of current transactions.ⁿ²⁸

Securities Act Section 3(a)(4) exempts securities of non-profit organizations.ⁿ²⁹ Through the exemption, bonds issued by churches, universities, non-profit hospitals, and similar institutions are exempt from Trust Indenture Act coverage.ⁿ³⁰

Section 3(a)(5) of the Securities Act exempts securities of savings and loan associationsⁿ³¹ and of farmer's cooperative organizations.ⁿ³² The incorporation of the exemption into the Trust Indenture Act is important, for example, in relation to guarantees of industrial revenue bonds issued by savings and loan associations.ⁿ³³ The exemption does not extend to participation interests in a pooled fund of tax exempt bonds offered by a savings and loan association,ⁿ³⁴ or to interests in a pool of savings and loan association bonds.ⁿ³⁵

Section 3(a)(6) of the Securities Act exempts any interest in a railroad equipment trust.ⁿ³⁶

Section 3(a)(7) of the Securities Act originally provided an exemption for "[c]ertificates issued by a receiver or by a trustee in bankruptcy, with the approval of the court."ⁿ³⁷ With the passage of the Bankruptcy Reform Act of 1978, conforming amendments to Section 3(a)(7) were added to retain in the Securities Act the exemption for certificates issued with bankruptcy court approval by a receiver, trustee, or debtor in possession.ⁿ³⁸ In addition, the exemption of these securities from Trust Indenture Act coverage (as well as from various other securities law provisions) was effected through language in Section 364(f) of the Bankruptcy Reform Act.ⁿ³⁹ The legislative history makes clear the Congressional intent. Representative Edwards, the sponsor of the bill, described Section 364(f) as follows:

This provision continues the exemption found in section 3(a)(7) of the Securities Act of 1933 for certificates of indebtedness issued by a trustee in bankruptcy. The exemption applies to any debt security issued under section 364 of Title 11. The section does not intend to change present law which exempts such securities from the Trust Indenture Act. ...ⁿ⁴⁰

Section 3(a)(8) of the Securities Act, as incorporated into the Trust Indenture Act, exempts insurance policies and annuity contracts.ⁿ⁴¹ Under this exemption, it would appear that guarantees issued by insurance companies to guarantee payment of corporate bonds are exempt from Trust Indenture Act coverage.ⁿ⁴²

The Securities Act Section 3(a)(11) intrastate offering exemption is also incorporated by Trust Indenture Act Section 304(a)(4).ⁿ⁴³ However, an intrastate offering of debt securities may require both Securities Act registration and Trust Indenture Act qualification when an out-of-state offering of *stock* is part of the same plan of financing and is thus integrated with the debt offering for determining whether the debt is "part of an issue" of securities that meets the Section 3(a)(11) requirements.ⁿ⁴⁴

[3] Securities Issued in Operations of Secondary Markets for Real Estate Mortgages--Section 304(a)(5)

An array of provisions exempts from the Trust Indenture Act securities issued in connection with the creation and maintenance of a secondary market in real estate mortgages, including securities issued by Government National Mortgage Association (GNMA) and the Federal National Mortgage Association (FNMA).

Section 304(a)(5) of the Trust Indenture Act initially exempts "any security issued under a mortgage indenture as to which a contract of insurance under the National Housing Act is in effect." n45 It was contemplated that this exemption would cover insured mortgage-backed securities issued as financing instruments by the then governmentally-owned Federal National Mortgage Association (FNMA), which had been chartered under provisions enacted in 1938. n46 However, the Commission has also interpreted the section to exempt certificates representing interests in pools of government insured mortgages, where the certificates are distributed by (1) investment banking firms, or (2) the trustee itself, which holds the mortgages. n47

In 1954, Congress began the process that would lead to the division of the original FNMA into two entities. The split was finally implemented in 1968 when FNMA became a privately-owned (but government sponsored) corporation and, at the same time, a new government corporation, Government National Mortgage Association (GNMA), was created. n48 FNMA may issue stock, debt, and mortgage-backed securities. n49 GNMA may issue government guaranteed mortgage-backed securities (pass-throughs) as well as bond type securities. n50 General provisions enacted in 1968 n51 treat the securities issued by both associations as "exempt securities within the meaning of laws administered by the Securities and Exchange Commission." n52

Prior to the passage of the 1968 provisions, two other Trust Indenture Act exemptions, which still remain, were enacted. One exemption dating from 1964 n53 exempts from all federal securities laws FNMA securities evidencing participations in mortgages held by various federal government agencies. n54 The other exemption, dating from 1966, and found in Section 304(a)(10) of the Trust Indenture Act, exempts from the coverage of the Trust Indenture Act securities issued under a mortgage or trust deed on group medical practice facilities, insured under Title XI of the National Housing Act.

Besides the sale of mortgage-backed securities, the secondary mortgage market involves the sale of mortgages themselves, and fractional interests in mortgages. In 1960, the Commission took a no-action position concerning Trust Indenture Act coverage of sales by financial institutions to private investors of Federal Housing Administration insured mortgages and fractional interests in them. n55 While these sales are not literally within the exemption of Section 304(a)(5), the Commission relied on Congressional policy underlying that section in finding that these sales could be made without Trust Indenture Act qualification. n56

In 1975, Congress added Section 4(5) to the Securities Act of 1933, which in turn is incorporated into the Trust Indenture Act by Section 304(b). Section 4(5) exempts the offer and sale of promissory notes directly secured by a first lien on improved residential or commercial real estate, and participation interests in and forward commitments on such notes. n57 To be exempt, these securities must be sold in amounts of \$250,000 or more. Where the purchaser is not a bank, savings and loan, or insurance company, the exemption may be applied only to mortgages originated by banks or savings and loans. Where the purchaser is a bank or savings and loan, mortgages originated by other HUD-approved mortgagees are also within the exemption.

[4] Foreign Government Securities--Section 304(a)(6)

Even though foreign government securities must be registered under the Securities Act of 1933, Section 304(a)(6) exempts from the Trust Indenture Act:

any note, bond, debenture, or evidence of indebtedness issued or guaranteed by a foreign government or by a subdivision, department, municipality, agency, or instrumentality thereof.

The Senate and House reports on the Trust Indenture Act explain the distinction between the two Acts merely by stating that "[s]ubstantially different considerations apply to such issues." n58

The Trust Indenture Act exemption, by including agencies and instrumentalities of foreign governments, is broader than

the language of Section 7 of the Securities Act, which permits the use of Schedule B for registration of offerings by "foreign governments, or political subdivisions thereof." n59 The Commission has generally treated securities of international agencies as being exempt under Section 304(a)(6), and has taken a no-action position when Schedule B under the Securities Act is used, without passing on whether the multilateral organizations are within the language of Securities Act Section 7. n60

[5] Guarantees of Exempted Securities--Section 304(a)(7)

Guarantees of debt securities are included within the coverage of the Trust Indenture Act, n61 but guarantees of securities exempted by Section 304(a) are themselves exempt under Section 304(a)(7). n62

In recent years, credit default swaps have often been used in place of guarantees to protect lenders against significant payment defaults. n63 However, the TIA does not apply to most credit default swaps. Section 2A of the Securities Act excludes individually negotiated swap agreements from the definition of "security," and TIA Section 303 incorporates that definition into the Trust Indenture Act. Many standardized credit default swaps have been exempted from the TIA through a temporary SEC rule, TIA Rule 4d-11T. This exemption was adopted as part of a package of rules that encourage the trading of standardized credit default swaps through central counterparties. n64 The TIA rule exempts from qualification and indenture requirements any CDS sold in reliance on Securities Act 239T, i.e. a standardized CDS sold through a clearing agency to an "eligible contract participant" (as defined in §1(a)(12) of the Commodity Exchange Act). n65

[6] Issues of Limited Dollar Amounts--Sections 304(a)(8) and (9)

Sections 304(a)(8) and 304(a)(9) provide exemptions for issues of debt securities under \$5 million and \$10 million, respectively. n66

[7] Bankruptcy Related Notes

While the drafters of the Trust Indenture Act contemplated that debt securities issued in judicially approved reorganizations would be covered by the Act, n67 Congress, in the Bankruptcy Reform Act of 1978, exempted one type of bankruptcy-related security from the Trust Indenture Act. Section 1145(d) of the Bankruptcy Reform Act provides that:

The Trust Indenture Act of 1939 does not apply to a note issued under the plan that matures not later than one year after the effective date of the plan. n68

The statement of Representative Edwards, the sponsor of the bill, explaining this provision indicates some confusion by the drafters of the Bankruptcy Reform Act about the coverage of the Trust Indenture Act. He stated:

Some commercial notes receive such an exemption under 304(a)(4) of the Trust Indenture Act of 1939 ... and others may receive protection by incorporation by reference into the Trust Indenture Act of securities exempt under Section 3(a)(3), (7), (9), or (10) of the Securities Act of 1933.

In light of the amendments made to the Securities Act of 1933 [by the Bankruptcy Reform Act] ... a specific exemption from the Trust Indenture Act is required in order to create certainty regarding plans of reorganization. Section 1145(d) is not intended to imply that commercial notes issued under a plan that matures more than 1 year after the effective date of the plan are automatically covered by the Trust Indenture Act of 1939 since such notes may fall within another exemption thereto. n69

Of course, Representative Edwards was incorrect in stating that the Trust Indenture Act incorporates the Sections 3(a)(9) and 3(a)(10) exemptions of the Securities Act. n70

[8] Commission's Authority to Exempt other Securities--Section 304(d)

Section 304(d) authorizes the Commission to exempt from one or more of the provisions of the Trust Indenture Act, either conditionally or unconditionally, any persons, registration statements, indentures, securities or transactions. Upon application by an interested person, exemptions may be made in individual cases through a Commission order. Upon the Commission's own motion, more general exemptions may be granted through rules. Section 304(d) places few limits upon the Commission's exemptive authority. It requires only that any exemption granted be "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by this title." It also permits the Commission "in its sole discretion, [to] decline to entertain any application for an order of exemption."

These provisions were enacted as part of the 1990 amendments to the Trust Indenture Act, replacing a narrower exemptive authority that had been available only for foreign private issuers. The broader authority was seen as necessary to permit the Commission to take account of changes in types of debt securities, in methods of public financing, and in relations between obligors and their financial intermediaries. ⁿ⁷¹ As an example, in proposing the legislation the Commission had pointed to the problems of applying the verification requirements of TIA Section 314(d) for release or substitution of collateral to collateralized mortgage obligations (CMOs) secured by pools of fungible, high quality securities. ⁿ⁷²

In May 1991, the Commission adopted Rules 4d-7 and 4d-8, specifying the procedures for applying for an exemptive order under Section 304(d). ⁿ⁷³ Basically, an application must contain a statement of the relevant facts, including a justification for the exemptions requested and a discussion of any benefit expected for security holders, trustees and/or obligors. Applications for exemptive relief under TIA § 304(d) are one of the few types of documents that are still *required* to be filed with the SEC in paper form rather than being filed electronically through the EDGAR system. ⁿ⁷⁴

In addition, the Commission has used its rulemaking Section 304(d) authority to facilitate cross-border offerings by foreign issuers. ⁿ⁷⁵ Effective July 1, 1991, the Commission adopted Rule 4d-9 as part of its multijurisdictional disclosure system for cross-border offerings by certain Canadian issuers. ⁿ⁷⁶ The Canada Business Corporations Act, which governs indentures of federally chartered corporations; the Bank Act, which governs indentures for debt securities issued by Canadian banks; the British Columbia Company Act of 1979, which covers indentures of companies incorporated under British Columbia Law; and the Business Corporations Act, 1982 (Ontario), which governs all trust indentures used in connection with debt offerings made by prospectus in Ontario regardless of the law under which the corporation was organized, all provide protections similar to those found in the Trust Indenture Act. ⁿ⁷⁷ Rule 4d-9 exempts from many of the Trust Indenture Act's requirements indentures of issuers subject to these Canadian statutes if the indenture securities are registered under the Securities Act of 1933 on Form SB-2 F-7, F-8, F-9, F-10 or F-80. However, Section 310(a)(1), (2) and (5) of the Trust Indenture Act which set out the eligibility requirements for institutional trustees continue to apply to such indentures. ⁿ⁷⁸ So does Section 316(b) which prohibits the impairment, without the security holder's consent, of the holder's right to receive payment of principal and interest when due and to institute suit to enforce such payment. ⁿ⁷⁹ Canadian law does not provide protections comparable to those found in Section 316(b) to indenture security holders. ⁿ⁸⁰ The Commission has also used its rulemaking Section 304(d) authority to encourage issuers to include U.S. security holders of foreign companies in exchange offers and business combinations on an equal basis with foreigners. In the past, some countries had allowed the exclusion of U.S. security holders because of the difficulties of complying with U.S. regulatory requirements, even though their law otherwise required equal treatment of all security holders. Where U.S. persons held small amounts of securities so that their participation was not necessary for the success of the transaction, their exclusion was common. This prevented U.S. investors from receiving a premium for their securities. In 1999, the SEC adopted Securities Act Rule 802 to exempt from 1933 Act registration requirements securities exchanged for the securities of a foreign private issuer in an exchange offer or business combination, if U.S. holders own no more than 10% of the securities that are the subject of the exchange offer or business combination, and if certain other requirements are met. In order to avoid undermining the usefulness of the Rule 802 exemption, the SEC at the same time adopted Trust Indenture Act Rule 4d-10 which exempts from the requirements of the TIA any debt security issued in compliance with Rule 802, even if the security is not

issued under an indenture of any kind.

[9] Small Business Investment Companies--Section 304(e)

In 1958, Congress gave the Commission authority to issue exemptive rules for Small Business Investment Companies' securities under both the Securities Act and the Trust Indenture Act by adding Section 3(c) to the Securities Act and Section 304(e) to the Trust Indenture Act. n81 While the Commission has implemented its Securities Act authority through the promulgation of Regulation E for offerings not exceeding \$5,000,000, n82 it has enacted no rules to implement its authority under Section 304(e).

FOOTNOTES:

(n1)Footnote 1. Former TIA Section 304(a)(3), which was repealed by the Securities Act Amendments of 1990, 104 Stat. 2713, 2722, made February 3, 1940 the effective date of the Act by exempting sales of securities made before that date from compliance with the Trust Indenture Act. *See Dick & Reuteman Co. v. Doherty Realty Co.*, 16 Wis.2d 342, 354, 114 N.W.2d 475, 481-82 (1962) .

(n2)Footnote 2. *See* Thomas Arthur & Steven B. Kite, 13-3rd C.P.S. (BNA), *Corporate Bond Financing* A-11 (1999).

(n3)Footnote 3. TIA Section 304(c)(1).

(n4)Footnote 4. TIA Section 304(c)(2).

(n5)Footnote 5. Regulation S-T, Rule 101(c)(5).

(n6)Footnote 6. Trust Indenture Act Rule 4c-3.

(n7)Footnote 7. Form T-4 is reproduced at 4 C.C.H. Fed. Sec. L. Rep. P 43,161 to 43,165.

(n8)Footnote 8. Trust Indenture Act Rule 4c-4 and Item 6, Form T-4.

(n9)Footnote 9. 74 Stat. 902 (Act of September 13, 1960).

(n10)Footnote 10. Section 304(c) continues to refer to § 304(a)(3) even though § 304(a)(3) was repealed by the 1990 amendments to the TIA.

(n11)Footnote 11. 7 S.E.C. 622, 628-29 (1940) .

(n12)Footnote 12. For discussion of the practice under TIA Section 304(c), see IV Loss & Seligman, *Securities Regulation* 1651-54 (3d ed., 1990).

For a recent use of the TIA Section 304(c) exemption, see Trust Indenture Act Rel. 828 (June 1, 1983), 27 SEC Docket 1874 (1983); Public Service Electric and Gas Co., Trust Indenture Act Re. No. 2257 (Feb. 13, 1991) and No. 2258 (March 12, 1991).

(n13)Footnote 13. The small issue exemption of Securities Act Section 3(b), discussed in § 5.01 *supra*, also is not incorporated into the Trust Indenture Act. The essence of Section 3(b), however, is carried over into the Trust Indenture Act through the exemptions for limited dollar amounts found in Trust Indenture Act Sections 304(a)(8), (9), discussed in § 8.05 *supra*. Thus, the specific Securities Act exemptive rules promulgated pursuant to Section 3(b), *e.g.*, Rules 504

and 505, are not incorporated into the Trust Indenture Act.

(n14)Footnote 14. Securities Act Section 3(a)(9) is discussed in § 3.10 *supra*.

(n15)Footnote 15. H. Rep. No. 1016 (1939), 76th Cong., 1st Sess. p. 41.

(n16)Footnote 16. Securities Act Section 3(a)(10) is discussed in § 3.11 *supra*.

(n17)Footnote 17. H. Rep. No. 1016, N. 15 *supra*, pp. 41-42. *But see, N.Y. Real Property Law §§ 124-130k; City Bank Farmers Trust Co. v. Stafford Bros., Inc., 40 N.Y.S.2d 205 (Sup. Ct. 1943) .*

(n18)Footnote 18. Securities Act Amendments of 1990, 104 Stat. 2713, 2722 (1990).

(n19)Footnote 19. The exception was found in TIA § 304(a)(4)(B) which brought into the Trust Indenture Act's exemptions the 1970 amendments to Securities Act § 3(a)(2) relating to industrial development bonds. Although now redundant, TIA § 304(a)(4)(B) was retained in the 1990 revisions to the Trust Indenture Act.

(n20)Footnote 20. In 1939, Congress was concerned with the possibility that "future amendments of the Securities Act will exempt from the operation of that act securities which ... are not entitled in principle to an exemption from [the Trust Indenture Act]." H. Rep. No. 1016 (1939), 76th Cong., 1st Sess. p. 42.

(n21)Footnote 21. *See, e.g.,* State of Israel, A.I.D. Housing Guaranty Program (No Action Letter, March 27, 1991); Military Sea lift Command (No Action Letter, Sept. 26, 1984); Newman & Associates, Inc. (No Action Letter, Nov. 9, 1987).

(n22)Footnote 22. Federal Home Loan Mortgage Corporation, 2002 SEC No-Act. LEXIS 637 (July 12, 2002); Fannie Mae, 2002 SEC No-Act. LEXIS 661 (July 12, 2002); Pension Benefit Guaranty Corp., C.C.H. Fed. Sec. L. Rep. P 76,670 (Div. Corp. Fin., 1993). *Cf.* Exemption from the registration requirements of the Securities Act of 1933 pursuant to Public Law No. 101-73 (FIRREA), Securities Act Rel. No. 6844 (Sept. 8, 1989), 1989 SEC LEXIS 1757 .

(n23)Footnote 23. *See, e.g.,* Virginia Higher Education Tuition Trust Fund (No Action Letter, November 6, 1999); New Hampshire Higher Education Savings Plan Trust (No Action Letter, June 30, 1998); Missouri Family Trust Fund (No Action Letter, September 22, 1992); Florida Prepaid College Program (No Action Letter, September 12, 1990); State of Ohio Tuition Trust Authority (No Action Letter, August 6, 1990); Lancaster Area Sewer Authority (No Action Letter, March 30, 1990); Central Missouri Water and Sewer Authority (No Action Letter, August 15, 1988). *But see,* Maryland Industrial Development Financing Authority, C.C.H. Fed. Sec. L. Rep. P 79,312 (SEC, 1989) (bonds that are not general obligations of government instrumentality require qualification.) However, in South Carolina Tuition Prepayment Program (No Action Letter, Sept. 29, 1998), the SEC staff found contracts issued under a Qualified State Tuition Program as defined by *IRC* § 529 to be exempt even though the state (rather than a state instrumentality) claimed to be the issuer and the full faith and credit of the state did not back the contract. Offerings under Section 529 qualified state tuition programs that are administered by state instrumentalities have generally been found to be exempt from both 1933 Act registration and from the qualification requirements of the TIA. *See e.g.* Ohio Tuition Trust Authority, Ohio Variable College Savings Trust Fund, 2000 SEC No-Act. LEXIS 897 (Oct. 2, 2000), Alaska Higher Education Savings Trust, 2001 SEC No-Act. LEXIS 294 (March 8, 2001).

(n24)Footnote 24. The Commission views this exemption as also applying to securities issued by a branch or agency of a foreign bank in the United States when the branch or agency is subject to regulation substantially equivalent to that of domestically chartered banks. Securities Act Release 6661 (1986), C.C.H. Fed. Sec. L. Rep. P 2024A.

(n25)Footnote 25. Banco Central Corp. (No Action Letter, June 10, 1983), *summarized in* 41 B.N.A. Wash. Fin. Rep. 22 (1983); McDonald & Co. Securities, Inc., C.C.H. Fed. Sec. L. Rep. P 77,564 (Div. Inv. Mgt. 1983). Certificates backed by stand by letters of credit issued by banks are treated as securities which are guaranteed by banks so long as

the backing extends to the participation certificates themselves and is not limited to the underlying securities. City National Bank (No Action Letter, March 9, 1984) summarized in 16 B.N.A. Sec. Reg. L. Rep. 565 (1984); State of Georgia Installment Purchase Contracts (No Action Letter, April 10, 1985). *See also* Citizens Fidelity Corp. (No Action Letter, Sept. 5, 1985) (promissory notes secured by bank letter of credit are 'guaranteed' by a bank).

(n26)Footnote 26. Securities Act Section 3(a)(2) is discussed in § 3.03 *supra*.

Even before the 1990 amendments to TIA § 304(a)(4), the Commission appeared to treat the industrial revenue bond exemptions in both Securities Act Section 3(a)(2) and Trust Indenture Act Section 304(a)(4)(B), the scope of which are defined by reference to *Section 103 of the Internal Revenue Code*, as incorporating the post-1970 amendments to *IRC § 103*. *See, e.g.*, Tooele County, Utah (No Action Letter, August 30, 1989); City of Fayetteville, Arkansas (No Action Letter, March 27, 1979). In New Jersey Economic Development Authority (No Action Letter, April 5, 1984) the Commission staff took the position that industrial development bonds that qualify as tax exempt when issued will retain their Securities Act exemption even if specified subsequent tax legislation retroactively destroys their tax exempt status.

(n27)Footnote 27. *See* Securities Act Rule 131, discussed in § 3.03 *supra*.

(n28)Footnote 28. *See Vernon Johnson Family Ltd. Partnership v. Bank One Texas*, 80 F. Supp. 2d 1127, 1131 (W.D. Wash. 2000). Securities Act Section 3(a)(3) is discussed in § 3.04 *supra*.

The exemption under Section 304(a)(4) of the Trust Indenture Act for short term commercial paper is discussed in § 8.04 *supra*.

(n29)Footnote 29. Securities Act Section 3(a)(4) is discussed in § 3.05 *supra*.

(n30)Footnote 30. *See, e.g.*, National Council for Community Development, Inc. (No Action Letter, April 5, 1989); American State Bank of Yankton, South Dakota (No Action Letter, Oct. 30, 1985); Baptist Church Loan Corp. (No Action Letter, Oct. 28, 1983); Kaiser Foundation Hospitals, C.C.H. Fed. Sec. L. Rep. P 76,409 (Div. Corp. Fin. 1980); Adelphi University, C.C.H. Fed. Sec. L. Rep. P 80,885 (Div. Corp. Fin. 1976). *But cf. SEC v. AMI Securities, Inc., Litigation Release No. 13258, 1992 SEC LEXIS 1364 (June 2, 1992)*, and *Litigation Rel. No. 13851, 1993 SEC LEXIS 3043 (Oct. 29, 1993)*.

(n31)Footnote 31. *See Mathews v. Fisher*, C.C.H. Fed. Sec. L. Rep. P 97,336 (S.D. Ohio 1978) at pp. 97,229-30.

(n32)Footnote 32. *See* National Grape Cooperative Association, Inc. (No Action Letter, November 13, 1992). Securities Act Section 3(a)(5) is discussed in § 3.06 *supra*.

(n33)Footnote 33. Michigan Strategic Fund, C.C.H. Fed. Sec. L. Rep. § 78,507 (Div. Corp. Fin., 1987). First Southern Federal Savings & Loan (No Action Letter, March 28, 1983); First Financial Savings and Loan Association, C.C.H. Fed. Sec. L. Rep. P 77,355 (Div. Corp. Fin. 1983).

(n34)Footnote 34. Central West End Savings and Loan Association (No Action Letter, July 19, 1984).

(n35)Footnote 35. Ohio Financial Service Corp. (No Action Letter, Jan. 19, 1984).

(n36)Footnote 36. Securities Act § 3(a)(6) is discussed in § 3.07 *supra*. Section 3(a)(6) originally exempted all securities of railroads and motor carriers whose issuance was subject to ICC regulation. 52 Stat. 1236, 1240 (Act of June 29, 1938); *see Friedman v. Chesapeake and Ohio Railway Co.*, 261 F. Supp. 728, 731, C.C.H. Fed. Sec. L. Rep. P 91,898 (S.D.N.Y. 1966). Section 3(a)(6) was amended in 1976 to eliminate the exemption for railroad securities other than interests in railroad equipment trusts, Pub. L. 94-210, 90 Stat. 31; and in 1982 to eliminate the exemption for securities of motor carriers, Pub. L. 97-261, 96 Stat. 1102. Even before the 1990 amendments to TIA § 304(a)(4), the Commission, relying upon the 1976 legislative history, S. Conf. Rep. 95-595, 95th Cong., 2nd Sess. 168 (1976), took

the position that the narrowing amendments relating to railroad securities enacted in 1976 were effectively incorporated into the Trust Indenture Act. *Burlington Northern, Inc.*, C.C.H. Fed. Sec. L. Rep. P 82,149 (Div. Corp. Fin. 1979).

(n37)Footnote 37. 48 Stat. 76 (1933).

(n38)Footnote 38. 92 Stat. 2674 (1978).

Securities Act Section 3(a)(7) is discussed in § 3.08 *supra*.

(n39)Footnote 39. 11 U.S.C. § 364(f) (1978). See *Matter of Standard Oil & Exploration of Delaware, Inc.*, 136 B.R. 141 (Bkrptcy. W.D. Mich. 1992) .

(n40)Footnote 40. 124 Cong. Rec. 32396 (Sept. 28, 1978).

For the treatment of debt securities issued under the plan of reorganization, see § 8.06[7] and § 8.11 *infra* .

(n41)Footnote 41. Securities Act Section 3(a)(8) is discussed in § 3.09 *supra*.

(n42)Footnote 42. See *Sentry Financial Services Corp.*, C.C.H. Fed. Sec. L. Rep. P 81,001 (Div. Corp. Fin. 1977) (relating to Securities Act exemption).

(n43)Footnote 43. Reliance on the intrastate exemption for the offer and sale of mortgage pass-through certificates may be combined with reliance on the Securities Act Section 3(a)(5) exemption for a savings and loan guarantee of payment of the underlying mortgage loans. *First Federal Savings Bank* (No Action Letter, Nov. 15, 1984). Securities Act Section 3(a)(11) is discussed in § 3.12 *supra*.

(n44)Footnote 44. *Property Investments, Inc.*, C.C.H. Fed. Sec. L. Rep. P 79,201 (Div. Corp. Fin. 1972).

(n45)Footnote 45. The section also exempts such securities from the Securities Act "to the same extent as though such security were specifically enumerated in section 3(a)(2) of such Act."

(n46)Footnote 46. Title III of the National Housing Act Amendments, 48 Stat. 1246 (1938). See, e.g., *City of Overland Park, Kansas* (No Action Letter, Oct. 16, 1978).

(n47)Footnote 47. See *Stephens, Inc.*, C.C.H. Fed. Sec. L. Rep. P 78,406 (Div. Corp. Fin., 1987); *USGA, Inc.*, 15 B.N.A. Sec. Reg. & L. Rep. 2085 (Div. Corp. Fin. 1983); *First Boston Corp.* (No Action Letter, Oct. 13, 1982); *Salomon Brothers*, C.C.H. Fed. Sec. L. Rep. P 77,078 (Div. Corp. Fin. 1981); *Washington Federal Savings & Loan Assoc. of Univ. Heights* (No Action Letter, Jan. 23, 1975).

(n48)Footnote 48. See *FNMA Charter Act*, 68 Stat. 612 (1954); *Housing and Urban Development Act*, Pub. L. 90-448, 82 Stat. 476 (Act of August 1, 1968).

(n49)Footnote 49. 12 U.S.C. §§ 1718-1719 (1974).

(n50)Footnote 50. 12 U.S.C. §§ 1721(b), 1721(g); 24 C.F.R. Part 390 (1982).

(n51)Footnote 51. 12 U.S.C. §§ 1719(d), (e) and 1723(c).

(n52)Footnote 52. Similar exemptive language was not included in legislation relating to the government-owned Federal Home Loan Mortgage Corporation (FHLMC), 12 U.S.C. §§ 1451-1459. However, FHLMC securities are presumably exempt from the Trust Indenture Act under Section 304(a)(5), or by exemptions in Section 4(5) or Section 3(a)(2) of the Securities Act discussed in § 4.07 and § 3.03 *supra* , respectively, which are incorporated into the Trust Indenture Act, or by general language in 12 U.S.C. § 1459 that the powers of, and the provisions relating to FHLMC are

exercisable and effective "without regard to any other law."

(n53)Footnote 53. 12 U.S.C. § 1717(c)(1).

(n54)Footnote 54. The federal agencies covered by this provision are the Farmers Home Administration, the Department of Education with respect to certain construction loans and student loan programs, the Department of Housing and Urban Development, the Veteran's Administration, the Export-Import Bank, and the Small Business Administration. 12 U.S.C. § 1717(c)(2).

(n55)Footnote 55. Letter Ruling of SEC to Federal Housing Administration, C.C.H. Fed. Sec. L. Rep. P 76,746 (1960).

(n56)Footnote 56. *Id. See also* City of Des Plaines, Illinois (No Action Letter, Jan. 30, 1987) (involving FHA co-insured mortgage notes).

(n57)Footnote 57. Securities Act Section 4(5) is discussed in § 4.07 *supra*.

(n58)Footnote 58. S. Rep. No. 248, 76th Cong., 1st Sess. 16 (1939); H. R. Rep. No. 1016, 76th Cong., 1st Sess. 42 (1939).

(n59)Footnote 59. *See* Finnish Export Credit Ltd. (No Action Letter, December 15, 1988); Kreditanstalt für Wiederaufbau, C.C.H. Fed. Sec. L. Rep. P 78,469 (Div. Corp. Fin., 1987); Israel Bank of Agriculture Ltd., C.C.H. Fed. Sec. L. Rep. P 81,592 (Div. Corp. Fin. 1978); Sveriges Investorings Bank AB (No Action Letter, April 3, 1975).

(n60)Footnote 60. Nordiska Investorings Banken (No Action Letter, Feb. 1, 1982); European Atomic Energy Community, C.C.H. Fed. Sec. L. Rep. P 81,341 (Div. Corp. Fin. 1977); European Economic Community, C.C.H. Fed. Sec. L. Rep. P 80,990 (Div. Corp. Fin. 1976); Central American Bank for Economic Integration (No Action Letter, April 13, 1973).

See also Trust Indenture Act Rel. 37, 4 C.C.H. Fed. Sec. L. Rep. P 42164, (1947), concurring in the position that securities of the International Bank for Reconstruction and Development (IBRD) are exempt from the Trust Indenture Act. An exemption under the Securities Act for IBRD securities is provided in 22 USC § 286k-1.

(n61)Footnote 61. *See* Trust Indenture Act Section 304(a)(1); Standard Oil Co. (Indiana), C.C.H. Fed. Sec. L. Rep. P 76,822 (Div. Corp. Fin. 1980); *In the Matter of Hugo Stinnes Corp.*, 7 SEC 622, 635 (1940) .

(n62)Footnote 62. *See* Trans World Corp. (No Action Letter, Dec. 22, 1982). Colorado-Ute Electric Association, Inc. (No Action Letter, Sept. 7, 1984); Equitable Real Estate Investment Management--Merrill Lynch Realty Fund I (March 17, 1987). Also see, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 202.01, 203.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n63)Footnote 63. *See* Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 Am. Bankr. L.J. 405 (2007).

(n64)Footnote 64. *Temporary Exemptions for Eligible Credit Default Swaps*, SEC Release No. 33-8999 (Jan. 14, 2009).

(n65)Footnote 65. Initially the rules were set to expire on Sept. 25, 2009, but will presumably be extended or adopted in permanent form thereafter.

(n66)Footnote 66. TIA Sections 304(a)(8) and 304(a)(9) are discussed in § 8.05 *supra*.

(n67)Footnote 67. *See* § 8.06[2] *supra*.

(n68)Footnote 68. *11 U.S.C. § 1145(d) (1978)*.

(n69)Footnote 69. 124 Cong. Rec. 32408 (Sept. 28, 1978). For examples of longer term notes issued in bankruptcy reorganizations which are exempt from TIA qualification under Section 304(b) because they are issued in private offerings, see Smith International, Inc. (No Action Letter, Oct. 23, 1987). Victoria Station, Inc. (No Action Letter, April 20, 1987).

(n70)Footnote 70. For the treatment of trustee's certificates issued during a reorganization, see § 8.06[2] *supra*.

(n71)Footnote 71. See S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., p. 46.

(n72)Footnote 72. Memorandum of the Securities and Exchange Commission In Support of the Trust Indenture Reform Act of 1987, C.C.H. Fed. Sec. L. Rep. P 84,205. For examples of the SEC's use of its § 304(d) authority, see World Omni Financial Corp., SEC Release No. 39-2374 (Sept. 1, 1999), *1999 SEC LEXIS 1783* ; World Omni Financial Corp., SEC Release No. 39-2370 (Nov. 25, 1998), *1998 SEC LEXIS 2582* ; Coltec Industries, Inc., SEC Release No. 39-2367 (Aug. 17, 1998), *1998 SEC LEXIS 1753* ; Metallurg, Inc., SEC Release No. 39-2352 (April 2, 1997), *1997 SEC LEXIS 727* ; Daimler-Benz Aktiengesellschaft, SEC Release No. 39-2353 (April 25, 1997), *1997 SEC LEXIS 909* ; World Omni Financial Corp., SEC Release No. 39-2358 (Nov. 13, 1997), *1997 SEC LEXIS 2343* .

(n73)Footnote 73. Rules and Forms to Implement the Trust Indenture Reform Act of 1990, Securities Act Rel. No. 6892 (May 8, 1991), C.C.H. Fed. Sec. L. Rep. P 84,732.

(n74)Footnote 74. Regulation S-T, Rule 101(c)(5).

(n75)Footnote 75. Before the final enactment of the 1990 amendments to the Trust Indenture Act, the Commission proposed Rules 4d-1 through 4d-6 and related forms to permit Canadian institutions to apply for exemptions in order to act as sole trustees under qualified indentures. Multijurisdictional Disclosure and Modification to the Current Registration and Reporting System for Canadian Issuers, Securities Act Rel. No. 6879 (Oct. 16, 1990), C.C.H. Fed. Sec. L. Rep. P 84,701. The 1990 amendments to § 310(a)(1) eliminated the need for reliance upon TIA § 304(d), and instead authorized the Commission to adopt rules or issue orders permitting various foreign institutions to act as trustees. Pursuant to this new authority the Commission has adopted Rule 10a-5. The 1990 amendments to TIA § 310(a)(1) and Rule 10a-5 are discussed at § 8.12 *infra*.

(n76)Footnote 76. Multijurisdictional Disclosure and Modifications of the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 6902 (June 21, 1991), C.C.H. Fed. Sec. L. Rep. P 84,812; Multijurisdictional Disclosure: Eligibility of British Columbia Trustees and Exemption for British Columbia Trust Indentures from Specific Provisions of the Trust Indenture Act, SEC Rel. No. 33-7002 (June 10, 1993), C.C.H. Fed. Sec. L. Rep. P 85,203.

(n77)Footnote 77. See Multijurisdictional Disclosure: Eligibility of Canadian Trustees and Exemptions for Canadian Trust Indentures from Specified Provisions of the Trust Indenture Act, Securities Act Release No. 6889 (March 22, 1991), C.C.H. Fed. Sec. L. Rep. P 84,717; Multijurisdictional Disclosure and Modifications of the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 6902 (June 21, 1991), C.C.H. Fed. Sec. L. Rep. Par. 84,812.

(n78)Footnote 78. See Rule 10a-5 under the Trust Indenture Act, discussed at § 8.12 *infra*.

(n79)Footnote 79. TIA § 316(b) is discussed at § 8.18[3].

(n80)Footnote 80. See Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings, SEC Release No. 33-7759 (Oct. 22, 1999), C.C.H. Fed. Sec. L. Rep. Par. 86,214.

Multijurisdictional Disclosure: Eligibility of Canadian Trustees and Exemptions for Canadian Trust Indentures from Specified Provisions of the Trust Indenture Act, Securities Act Rel. No. 6889 (March 22, 1991), C.C.H. Fed. Sec. L. Rep. P 84,717.

(n81)Footnote 81. Small Business Investment Act of 1958, 72 Stat. 689, 694 (Act of 1958).

(n82)Footnote 82. Regulation E is discussed in § 5.04 *supra*.



121 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.07

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.07 Exempt Transactions--Non-Issuer Offerings and Private Placements

The Trust Indenture Act also provides for the exemption of debt securities sold in transactions that are also exempt under Securities Act Section 4. Thus, the exemptions for certain private placements, offers and sales to "accredited investors" of up to \$5 million, and sales in large dollar amounts of promissory notes secured by certain first lien real estate mortgages are incorporated by the Trust Indenture Act.

Section 304(b) of the Trust Indenture Act provides that any debt securities sold in transactions exempt under Section 4 of the Securities Act are also exempt from the requirement that they be issued under a qualified indenture. n1 This incorporation of Securities Act Sections 4(1), n2 4(3) n3 and 4(4), n4 along with the Trust Indenture Act Section 304(b) exemption for sales on behalf of affiliates, effectively exempts all offerings except those by the issuer or distributions by those acting as conduits for the issuer. n5

Section 304(b) also incorporates the private offering exemptions of Securities Act Sections 4(2), n6 4(5) n7 and 4(6). n8 Thus, the typical private placement of debt securities with institutional investors in reliance on Securities Act Section 4(2), or its counterpart, Rule 506, n9 is exempt from the Trust Indenture Act qualification requirement.

Similarly, offers or sales to "accredited investors" of up to \$5 million in reliance on Securities Act Section 4(6) is also exempt from Trust Indenture Act qualification. The parallel Securities Act Rule 505 exemption, n10 however, does not exempt an issuer from the Trust Indenture Act since that rule was promulgated not as a definition of terms in Section 4(6), n11 but pursuant to Section 3(b) of the Securities Act. Exemptions under Section 3(b) are not carried over into the Trust Indenture Act. Debt securities issued under the Securities Act Rule 505 exemption, with its \$5 million ceiling, can usually find an exemption from Trust Indenture Act qualification under Section 304(a)(9) and Rule 4a-2, n12 in which case only an indenture of a more limited type would be required. n13

The exemption in Securities Act Section 4(5) for sales in large dollar amounts of promissory notes secured by certain first lien real estate mortgages is also incorporated by Trust Indenture Act Section 304(b). n14

FOOTNOTES:

(n1)Footnote 1. It is clear from the 1954 amendments to TIA Section 304(b) that Section 304(b) was intended to incorporate the exemptions of Securities Act Section 4 as amended. The Act of August 10, 1954 deleted the phrase "as heretofore amended" that originally had modified the reference to Section 4. *See* Pub. L. 83-577, 68 Stat. 683, 687 (Act of Aug. 10, 1954).

(n2)Footnote 2. Securities Act Section 4(1) is discussed in § 4.02 *supra*.

(n3)Footnote 3. Securities Act Section 4(3) is discussed in § 4.05 *supra*.

(n4)Footnote 4. Securities Act Section 4(4) is discussed in § 4.06 *supra*.

(n5)Footnote 5. *See* § 8.04 *supra* for discussion of sales by the issuer and distribution by those acting as conduits for the issuer.

(n6)Footnote 6. Securities Act Section 4(2) is discussed in § 4.03 *supra*.

(n7)Footnote 7. Securities Act Section 4(5) is discussed in § 4.07 *supra*.

(n8)Footnote 8. Securities Act Section 4(6) is discussed in § 4.08 *supra*.

(n9)Footnote 9. Securities Act Rule 506 is discussed in § 4.04 *supra*.

(n10)Footnote 10. Securities Act Rule 505 is discussed in § 4.04 *supra*.

(n11)Footnote 11. *See* Securities Act Rule 505(a).

Similarly, Securities Act Rule 504, discussed in § 4.04[4] *supra*, was adopted pursuant to Section 3(b). *See* Securities Act Rule 504(a).

Securities Act Rule 215 separately deals with the definition of "accredited investor" for purposes of Section 4(6).

(n12)Footnote 12. *Cf.* Pyrenco, Inc., C.C.H. Fed. Sec. L. Rep. P 76,439 (Div. Corp. Fin. 1980) (under predecessor to Rule 505 and prior version of TIA Sections 304(a)(8) and 304(a)(9)).

(n13)Footnote 13. Section 304(a)(9) and Rule 4a-2 are discussed in § 8.05 *supra*.

(n14)Footnote 14. The incorporation of the Securities Act Section 4(5) exemption is discussed in § 8.06[3] *supra*.



122 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.08

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.08 Drafting the Indenture

The Trust Indenture Act specifies the mandatory provisions that are part of every qualified indenture as well as permissible provisions, many of which are included by operation of law unless indenture language to the contrary appears. Other provisions, some of which are standardized and others negotiable, may also be included. Generally, four alternative formats for qualified indentures are available: an indenture which relies upon the automatic incorporation provisions of the Trust Indenture Act; the conventional unified document; the two-part indenture commended by the American Bar Foundation; and the Revised Model Simplified Indenture.

The lawyer's most common encounter with the Trust Indenture Act will be in the drafting of an indenture that is governed by the requirements of the Act. Sections 310 to 318 of the Trust Indenture Act:

- (1) set out mandatory provisions that are included automatically by operation of law in every qualified indenture;
- (2) set out other permissible provisions, many of which are automatically included in the indenture by operation of law unless specifically excluded by language in the indenture, and others that may be (and often are) included in the qualified indenture; and
- (3) prohibit the inclusion of certain types of exculpatory clauses.

Of course, the drafting of an indentureⁿ¹ involves a good deal more than merely compliance with the provisions of the Trust Indenture Act. An indenture will contain many other provisions, some of which have in practice become somewhat standardized, and others of which must be carefully negotiated. In recent years, notions of the extent to which indenture terms are negotiable has changed. Except for the provisions required by the Trust Indenture Act, standard boilerplate seems to have become less sacrosanct.ⁿ²

In general, four alternative formats for qualified indentures are available. The simplest is one which does not recite the mandatory provisions or most of the optional provisions of the Trust Indenture Act, and instead relies upon their being automatically included in the indenture pursuant to Section 318(c). In using this option, the lawyer might wish to include a statement in the indenture to make it clear that reliance is being placed upon automatic incorporation. Such a statement might read: "This indenture is governed by the provisions of the Trust Indenture Act of 1939, as amended."

Prior to 1990, the most widely used format was the conventional unified document, in which both the negotiated and the boilerplate clauses are set out in a single integrated document. The provisions mandated by the Trust Indenture Act are included verbatim within the indenture.

The third format is the two-part indenture recommended by the American Bar Foundation's Corporate Debt Financing Project, in which the indenture consists of two related documents. The first is an Incorporating Indenture containing the negotiated terms and incorporating by reference the second document, the *Model Indenture*, which is appended. The Model Indenture contains the provisions mandated by the Trust Indenture Act set out verbatim, plus additional standard provisions that are considered by the drafters of the model provisions to be best left in well-considered boilerplate form.
n3

The two part format has never received acceptance in the tradition-bound world of corporate finance. The American Bar Foundation admitted this when in 1981 it published its Mortgage Bond Indenture Form in the traditional integrated manner, stating that the incorporating technique "has rarely been used in practice by law firms because of its complexities." n4 The ABF did however retain in the Mortgage Bond Indenture Form the notion of negotiable and non-negotiable provisions, printing each of the two in a distinctive type style.

The fourth available format is the Revised Model Simplified Indenture. n5 It embodies two major innovations. First, it is drafted in the "plain English" style that is becoming increasingly popular in legal documents n6 and increasingly a focus of SEC rulemaking under other statutes. n7 Second, it incorporates by reference, and sometimes relies on TIA Section 318(c)'s automatic incorporation into the indenture of, n8 the mandatory and permissive clauses set out in the Trust Indenture Act, rather than setting them out in full as part of the indenture document. For example, instead of setting out in full the lengthy mandatory provisions relating to preferential collections of claims against the company by the trustee, the Revised Model Simplified Indenture merely provides in Section 7.11:

Upon and so long as the Indenture is qualified under the TIA, the Trustee is subject to TIA Section 311(a), excluding any creditor relationship listed in TIA Section 311(b).

The definitional provisions in Section 1.01 of the Revised Model Simplified Indenture assure that incorporation by reference locks in the Trust Indenture Act as it is in force on the date the indenture is executed. Section 309(c) of the Trust Indenture Act provides that, with one exception, changes by the Commission in its rules or orders shall not affect the qualification, form, or interpretation of previously qualified indentures. The exception to this is the Commission's rulemaking authority under Section 314(a) to require obligors to file reports with the indenture trustee and the Commission, and to furnish information to any security holders.

FOOTNOTES:

(n1)Footnote 1. Several resources are available to the practitioner who is drafting an indenture. Perhaps the most comprehensive is the American Bar Foundation's *Commentaries on Indentures* published in 1971 as part of the ABF's Corporate Debt Financing Project. It contains the text of ABF's Model Debenture Indenture provisions for fairly standardized portions of the indenture and samples of numerous types of generally negotiated indenture provisions, all accompanied by extensive explanatory comments. Other reference sources that may be helpful in the drafting task are the separately published American Bar Foundation's Mortgage Bond Indenture Form (1981); Suggested Provisions for

Corporate Mortgages and Indentures published in 4 C.C.H. Fed. Sec. L. Rep. P 43,500 ff; and Securities Act Release 6090 (July 11, 1979) Techniques in Drafting Trust Indentures, 5 C.C.H. Fed. Sec. L. Rep. P 42,164A. An excellent guide, extending beyond merely the drafting problems, is Thomas Arthur & Steven B. Kite, *Bond Financing*, which is a portfolio in the Bureau of National Affairs' Corporate Practice Series. A similarly broad work focusing on issues from the trustee's perspective is R. Landau & J. Kruegar, *Corporate Trust Administration and Management* (5th ed., 1998). Finally, the most recent addition to aid in drafting an indenture is the American Bar Association's Revised Model Simplified Indenture, 55 *Bus. Law.* 1115 (2000).

(n2)Footnote 2. In 1971, the American Bar Foundation's *Commentaries on Indentures* stated that certain clauses not required by the Trust Indenture Act are nevertheless "practically 'non-negotiable,' not in the sense that they cannot be negotiated, but in the sense that they seldom are in fact negotiated and as a practical matter in most cases ought not to be." *Id.*, p. 3. A dozen years later, the drafters of the Model Simplified Indenture stated that except for the required Trust Indenture Act provisions, "nearly all portions of an indenture are subject to negotiation in varying degrees." *Model Simplified Indenture*, 38 *Bus. Law.* 741, 742 (1983).

(n3)Footnote 3. American Bar Foundation, *Commentaries on Indentures* 3 (1971). The Corporate Debt Financing Project has published two model indentures designed for use within incorporating indentures: Model Debenture Indenture Provisions (1965) and Model Debenture Indenture Provisions, All Registered Issues (1967). Each also contains a Sample Incorporating Indenture.

(n4)Footnote 4. ABF, Mortgage Bond Indenture Form IX (1981).

(n5)Footnote 5. The Model Simplified Indenture and notes on it were first published in 38 *Bus. Law.* 741 (1983). It was updated in 1999, particularly to take account of prevailing changes in subordination and trustee provisions. The Model originally derived from a form of indenture first used by Navco Corp. and given explicit encouragement and approval by the Commission in Trust Indenture Act Rel. 605 (1981), 4 C.C.H. Fed. Sec. L. Rep. P 42,164B.

See McDaniel, *A Simplified Indenture*, 13 *Rev. of Sec. Reg.* 871 (1980).

A number of issuers had used indentures similar to the Model Simplified Indenture even before its initial publication. See *Model Simplified Indenture*, 38 *Bus. Law.* 741 n.3 (1983) *infra*.

(n6)Footnote 6. See Wydick, *Plain English for Lawyers*, 66 *Cal. L. Rev.* 727 (1978); "Plain English in the Law," 62 *Mich. Bar Jour.* 941 (1983). As part of this movement toward readability, anti-dilution provisions for convertible debt are stated as algebraic equations rather than as lengthy textual provisions. See *Sections 10.07 to 10.10* of the Revised Model Simplified Indenture, 55 *Bus. Law.* 1115, 1151-54 (2000).

(n7)Footnote 7. See, e.g., Plain English Disclosures, SEC Release No. 33-7497 (Jan. 28, 1998), C.C.H. Federal Securities Law Reporter Par. 86,003.

(n8)Footnote 8. Revised Model Simplified Indenture, Note 2 to Section 7.01/7.02, 55 *Bus. Law.* 1115, 1196 (2000). TIA Section 318 is discussed further in § 8.03 *supra*.



123 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.09

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.09 Filing with the Commission--Coordination with the Securities Act of 1933

Filing with the Commission under the Securities Act and the Trust Indenture Act is closely coordinated. Under the Trust Indenture Act, the indenture is deemed qualified when the Securities Act registration statement becomes effective. The issuer of debt securities must file with the Commission: the Securities Act registration statement; Form T-1, the statement of eligibility and qualification of the trustee; and a copy of the indenture with a table of contents. The Securities Act prospectus must contain a description of the debt securities being registered and of the indenture.

Since in almost all cases securities offerings that require indenture qualification also require Securities Act registration, the requirements for filing with the Commission under both Acts are closely coordinated. n1

Under Section 309(a)(1) of the Trust Indenture Act, the indenture will be deemed to have been qualified when the Securities Act registration statement becomes effective. Along with the Securities Act registration statement, the issuer of debt securities must file with the Commission:

- (1) a statement of eligibility and qualification of the indenture trustee, usually on Form T-1;
- (2) a copy of the indenture including a table of contents; and
- (3) a cross-reference sheet showing the location in the indenture of the mandatory and permissive Trust Indenture Act provisions. n2

In addition, the prospectus filed under the Securities Act must contain a description of the debt securities being registered and of the indenture. n3 With the full phasing in of the EDGAR system in 1996, these filings must all be made electronically. n4

[1] Statement of Trustee's Eligibility and Qualification--Form T-1

Section 305(a)(1) of the Trust Indenture Act requires that with the Securities Act registration statement there be filed such information as the Commission may prescribe in order to enable it to determine whether the trustee is eligible to serve. If the trustee does not meet the criteria of Section 310(a), the Commission, under Section 305(b), is to issue a refusal order prior to the effective date of the registration statement to prevent the registration statement from becoming effective. n5

The statement of eligibility and qualification will be filed by the trustee on Form T-1, the form to be used by corporations designated to act as trustees. n6 Section 310(a)(1) requires that if, as is typically the case, there is only one indenture trustee, it must be a corporation. An individual may only serve as a co-trustee along with the institutional trustee. In the unusual situation where an individual co-trustee is used, Form T-2 must also be filed as his statement of eligibility and qualification. n7 The March 1996 Report of the SEC's Task Force on Disclosure Simplification recommended that the SEC eliminate Forms T-1 and T-2. It recommended that these be replaced merely by a representation in the registration statement that the trustee is eligible to serve, or, in a shelf registration, that the trustee will be eligible upon selection, along with a statement by the trustee confirming its eligibility which would be filed as an exhibit. n8 However, the SEC did not act upon that recommendation.

Form T-1 is to be filed through EDGAR as a separate part of the registration statement. n9 It may not be incorporated by reference from a previous filing. n10 If a single trustee will serve under two indentures being qualified with the same registration statement, only one Form T-1 needs to be filed. However reference should be made on the cover page of the T-1 to the fact that there are two indentures. n11 The Form T-1 must be signed by the trustee, through its duly authorized agent or officer. n12 Form T-1 is filed in an item and response format. n13 The items elicit information relevant to whether the trustee complies with the requirements of Section 310. n14 Among the required exhibits is a copy of the trustee's latest report of financial condition published as required by law or by the supervising authority. Where publication is not required, the SEC will accept the unpublished report filed with the supervising authority. n15 Forms T-1 and T-2 were revised in May 1991 to conform to the 1990 amendments to the Act. n16

If the Form T-1 contains any material misstatement or omission, Section 323(a) of the Trust Indenture Act creates a private right of action for damages caused by reliance on the misstatement or omission in favor of any person who, not knowing of the inaccuracy, purchases or sells a security issued under the indenture to which the Form T-1 relates. The defendant who is responsible for the inaccurate statement is allowed the defense that he acted in good faith and had no knowledge of the inaccuracy. n17

Section 305(b)(2) was added to the Trust Indenture Act in 1990 to facilitate the qualification of debt securities registered for delayed offering under Securities Act Rule 415. n18 This section permits indentures for shelf registered debt to be qualified at the time the 1933 Act registration statement becomes effective, even though no trustee is named until the securities are actually later offered to the public. This procedure may be particularly useful when debt securities that must be registered may in fact never be issued, such as payment in kind securities (PIKs) where dividends or interest may be paid at the issuer's election in debt securities, or equity securities convertible into debt.

Under TIA Section 305(b)(2), the Commission is to adopt rules requiring an application to be filed to determine the eligibility of the indenture trustee shortly after the actual sale of any of the shelf-registered securities. Given the minimal requirements for eligibility, Congress anticipated that few instances of ineligibility would arise. The application will be effective ten days after filing, unless effectiveness is accelerated by the Commission. Congress anticipated that effectiveness would be accelerated in almost all cases. In the event that the designated trustee is not eligible, the Commission is to issue a refusal order. If a refusal order is issued, the obligor on the securities must appoint an eligible trustee within five calendar days. n19

In May 1991, the Commission adopted Rules 5b-1 to 5b-3 in order to carry out Congress' mandate. n20 Under these rules, the trustee is required to file Form T-1 and, where necessary, Form T-2, no later than the second business day

following the initial date of public offering or sales after effectiveness of the registration statement. At the same time, the Commission amended Item 512 of Regulation S-K to require that when a registration statement for a shelf offering is filed without qualifying a trustee, an undertaking must be included providing that the registrant will file to qualify the trustee at the time required by, and otherwise in accordance with, the Commission rules. n21 Where Form T-1 is filed on a delayed basis in a shelf offering, it must be separately filed through EDGAR as form type "305B2", and not filed as a post-effective amendment to the registration statement or on a Form 8-K incorporated by reference into the registration statement. n22

If the issuer fails to file an application as required to determine the eligibility of a trustee after shelf-registered securities are sold, the Commission may issue a stop order suspending the effectiveness of the registration statement or of the application for qualification of the indenture. n23

[2] The Indenture, Table of Contents and Cross-Reference Sheet

Item 601(b)(4) of Regulation S-K requires that there be filed as an exhibit to Securities Act registration statements all instruments, including indentures, defining the rights of the holders of the debt securities being registered. n24 In addition, subparagraph (b)(4)(iv) of Item 601 provides:

If any of the securities being registered are, or will be issued under an indenture to be qualified under the Trust Indenture Act, the copy of such indenture which is filed as an exhibit shall include or be accompanied by (A) a reasonably itemized and informative table of contents; and (B) a cross-reference sheet showing the location in the indenture of the provisions inserted pursuant to Sections 310 through 318(a) inclusive of the Trust Indenture Act of 1939.

The American Bar Foundation's model indentures and the Revised Model Simplified Indenture contain both tables of contents and cross-reference sheets that comply with these requirements.

This requirement for a table of contents and a cross reference sheet appears superfluous after the 1990 amendments to the Act, and apparently the Commission staff will not object to the omission of a cross reference sheet. n25 The requirement was originally designed to simplify the Commission staff's review of the indenture and Form T-1 that occurred simultaneously with review of the Securities Act registration statement. n26 The automatic incorporation of the mandatory provisions effected by the 1990 amendments to the Act eliminated the need for staff review of indentures, n27 and permitted the prompter processing of indentures that is of special concern in registered offerings made during brief favorable interest "windows."

[3] Securities Act Prospectus Disclosure of Security Terms and Indenture Provisions

Securities Act registration statements must contain a description of the securities being registered. n28 The information required to be set out in the prospectus is detailed in Item 202 of Regulation S-K. n29

The drafters of the Trust Indenture Act were troubled by the then-common practice of describing debt securities being offered by merely including in the prospectus a literal transcription of complex indenture provisions. n30 Therefore, Section 305(a)(2) required the issuer to include in the registration statement an analysis of a number of important indenture provisions. Specifically, the analysis was required to deal with:

- (1) the indenture's definitions of default and its provisions relating to when notice of these defaults could be withheld from security holders;
- (2) the provisions relating to authentication and delivery of the indenture securities and the application of the proceeds of the offering;

- (3) provisions on release and substitution of collateral;
- (4) provisions relating to satisfaction and discharge of the indenture; and
- (5) provisions relating to the issuer's furnishing of evidence of compliance with conditions and covenants.

As originally enacted, Sections 305(a)(2) and 305(c) required this analysis to be set forth in full in the prospectus, and also permitted the Commission, in individual cases, to require inclusion in the prospectus of a supplementary analysis prepared by the Commission. n31 To give the Commission flexibility to simplify Securities Act prospectuses, n32 Congress, in 1954, amended Section 305(c) to permit the Commission to determine by rule the extent to which prospectuses must contain the issuer's analysis of indenture provisions. n33 Item 202 of Regulation S-K, in fact, excludes some of the information that is otherwise specified in Section 305(a)(2). Instruction 3 to Item 202 states:

Section 305(a)(2) of the Trust Indenture Act ... shall not be deemed to require the inclusion in a registration statement or in a prospectus of any information not required by this Item. n34

The Commission's authority under Section 305(c) to prepare its own supplementary analysis and require its inclusion in the prospectus, has never been used. n35 When the Trust Indenture Act was enacted, Congress apparently assumed that the Commission-prepared analysis would become an important disclosure tool. In reliance on the safeguard provided by the Commission's power to prepare a supplementary analysis, n36 Congress in Section 305(d) exempted from the civil and criminal provisions of both the Securities Act and the Trust Indenture Act n37 any misstatements or omissions in the issuer's required analysis of the indenture. Misstatements and omissions in the analysis, however, are not exempt from Exchange Act *Rule 10b-5*, n38 and it seems clear that the courts would not imply such an exemption. n39

Adequate disclosure of the terms of the securities being offered is also furthered by rules requiring the title of securities used in the registration statement and in the Form T-1 to be fully descriptive of the securities' terms. n40

[4] Refusal Orders

If the requirements of the Trust Indenture Act have not initially been met, the Commission's formal administrative remedy is the issuance of an order refusing to permit effectiveness of the Securities Act registration statement offering the debt securities. Section 305(b) of the Trust Indenture Act sets out three grounds for refusal orders:

- (1) the security has not been issued under an indenture;
- (2) the indenture does not conform to the requirements of the Trust Indenture Act; or
- (3) the designated trustee is not eligible or has a prohibited conflict of interest.

The procedures for notice and hearing before the issuance of a refusal order are specified by reference to Section 8(b) of the Securities Act. n41

The unrealistic procedural restrictions surrounding Section 8(b) proceedings, however, have eliminated the use of the refusal order as an enforcement device. n42 Section 8(b) requires notice to the issuer not later than ten days after filing of the registration statement, and an opportunity for a hearing within ten days after the notice. Under the Securities Act, Section 8(d) stop order proceedings have replaced the use of refusal orders. n43 This option does not appear to exist under the Trust Indenture Act. n44 In fact, as in the vast majority of Securities Act situations, any Trust Indenture Act deficiencies before the effective date of the registration statement are handled by letters of comment from the staff of

the Commission's Division of Corporation Finance. n45

After the indenture qualification has become effective, under Section 309(b) no stop order shall be issued under Securities Act Section 8(d), except on the grounds specified in Section 8(b) of the Securities Act, *i.e.*, material misstatements or omissions, or failure to cooperate in a Section 8(e) examination. Post-effective non-compliance with Trust Indenture Act mandated terms is left to private enforcement by security holders. n46

FOOTNOTES:

(n1)Footnote 1. Qualification of indentures in situations in which a Securities Act registration statement is not required is discussed in § 8.11 *infra*. An obligor may qualify an indenture to issue debt securities that are subject to the TIA even though another obligor has issued securities under the indenture that are exempt from the TIA. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 101.01 (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n2)Footnote 2. Rule 0-12 under the TIA provides for the filing of electronic format documents for issuers permitted to participate in the EDGAR pilot system.

(n3)Footnote 3. *See* Ch. 7 *supra*.

(n4)Footnote 4. Regulation S-T, Rule 14, Rule 101(a)(1)(ii). *See* § 7.02[4], *supra*. As to hardship exemptions from the electronic filing rules, see Regulation S-T, Rules 201-202.

(n5)Footnote 5. TIA Section 307(c) applies the same refusal order provisions to applications for indenture qualification where a Securities Act exemption from registration is available, but an exemption from the Trust Indenture Act is not available. In such cases, the provisions of TIA Section 305(b) apply to the application "as though such application were a registration statement. ..." TIA Section 307(c).

(n6)Footnote 6. Form T-1 calls for disclosures relating to the following:

Item 1. General Information.

Item 2. Affiliations with the Obligor.

Item 3. Voting Securities of the Trustee.

Item 4. Trusteeships Under Other Indentures.

Item 5. Interlocking Directorates and Similar Relationships With the Obligor or Underwriters.

Item 6. Voting Securities of the Trustee Owned by the Obligor or Its Officials.

Item 7. Voting Securities of the Trustee Owned by Underwriters or Their Officials.

Item 8. Securities of the Obligor Owned or Held by the Trustee.

Item 9. Securities of Underwriters Owned or Held by the Trustee.

Item 10. Ownership or Holdings by the Trustee of Voting Securities of Certain Affiliates or Security Holders of the Obligor.

Item 11. Ownership or Holdings by the Trustee of Any Securities of a Person Owning 50 Percent or

More of the Voting Securities of the Obligor.

Item 12. Indebtedness of the Obligor to the Trustee.

Item 13. Defaults by the Obligor.

Item 14. Affiliations with the Underwriters.

Item 15. Foreign Trustee.

Item 16. List of Exhibits.

If the obligor is not in default, the applicant need only provide the information required by Items 1, 2, 15, and 16, where applicable.

(n7)Footnote 7. Form T-2 calls for disclosure relating to the following:

Item 1. Affiliations With Obligor and Underwriters.

Item 2. Trusteeships Under Other Indentures.

Item 3. Certain Relationships Between the Trustee and the Obligor or an Underwriter.

Item 4. Securities of the Obligor Owned or Held by the Trustee.

Item 5. Securities of Underwriters Owned or Held by the Trustee.

Item 6. Holdings by the Trustee of Voting Securities of Certain Affiliates or Principal Holders of Voting Securities of the Obligor.

Item 7. Holdings by the Trustee of Any Securities of a Person Owning 50 Percent or More of the Voting Securities of the Obligor.

Item 8. Indebtedness of the Obligor to the Trustee.

Item 9. Defaults by the Obligor.

Item 10. Affiliations with the Underwriters.

Item 11. List of Exhibits.

If the obligor is not in default, the applicant need only provide the information required by Items 1 and 11.

(n8)Footnote 8. Report on Disclosure Simplification, Sec. IV.G.2. (March 1996), C.C.H. Fed. Sec. L. Rep. P 85,738.

(n9)Footnote 9. TIA Rule 5a-3(d); Regulation S-T, Rule 101(a)(1)(ii). Hardship exemptions from electronic filing are available under Regulation S-T, Rules 201 and 202. See, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 219.03, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiinterp.htm>.

(n10)Footnote 10. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 108.02, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiinterp.htm>.

(n11)Footnote 11. *Id.*, Sec. 219.01.

(n12)Footnote 12. Form T-1 (Signature), 4 C.C.H. Fed. Sec. L.Rep. P 43,105. For signature requirements on electronic filings, see Regulation S-T, Rule 302.

(n13)Footnote 13. Trust Indenture Act Rule 7a-16. Other requirements for the physical format of the Form T-1 are found in Trust Indenture Act Rules 7a-16 to 7a-20. General requirements as to contents, incorporation by reference, exhibits and amendments are found in Trust Indenture Act Rules 7a-21 to 7a-36.

(n14)Footnote 14. TIA Section 310 is discussed in § 8.12 and § 8.13 *infra* .

(n15)Footnote 15. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 219.02, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n16)Footnote 16. Rules and Forms to Implement the Trust Indenture Reform Act of 1990, Securities Act Rel. No. 6892 (May 8, 1991), C.C.H. Fed. Sec. L. Rep.P 84,732.

(n17)Footnote 17. Private actions under Section 323(a) are discussed in § 8.20[1] *infra*.

(n18)Footnote 18. For discussion of supplemental indentures and special problems of shelf registrations, see § 8.10 *infra*. For further discussion of Rule 415, see § 7A.05 *supra*.

(n19)Footnote 19. See S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., pp. 31-32,47-48; Memorandum of the Securities and Exchange Commission In Support of the Trust Indenture Reform Act of 1987, C.C.H. Fed. Sec. L. Rep. P 84,205.

(n20)Footnote 20. Rules and Forms to Implement the Trust Indenture Reform Act of 1990, Securities Act Rel. No. 6892 (May 8, 1991), C.C.H. Fed. Sec. L. Rep.P 84,732.

(n21)Footnote 21. Regulation S-K, Item 512(j). Also see, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 103.01, 109.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n22)Footnote 22. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 206.01, 220.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n23)Footnote 23. TIA Section 309(b).

(n24)Footnote 24. Item 601(b)(4) of Regulation S-K is discussed in § 7.02 *supra*.

(n25)Footnote 25. Fouhey, Godfrey & Trefny, *Reform of Trust Indenture Act Eases Conflicting-Interest Rules*, Natl. L. Jour., Feb. 4, 1991, pp. 26, 27.

(n26)Footnote 26. See also Techniques in Drafting Trust Indentures, Sec. Act. Rel. 6090, 4 C.C.H. Fed. Sec. L. Rep. P 42,164A (1979).

(n27)Footnote 27. See § 8.03 *supra*.

(n28)Footnote 28. Cf. *In re Discon Corp.*, 346 F. Supp. 839, 843-44 (S.D. Fla.1971) (discussing inaccurate prospectus description of indenture terms).

(n29)Footnote 29. Item 202 of Regulation S-K is discussed in § 7.02 *supra*.

(n30)Footnote 30. Trust Indenture Act of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 44 (1939). Cf. *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1383-84, C.C.H. Fed. Sec.L. Rep. P 95,234, at pp. 98,233-34 (2d Cir. 1975) ,

cert. denied 423 U.S. 947 (1975) .

(n31)Footnote 31. Trust Indenture Act of 1939, 53 Stat. 1149, 1155 (1939).

(n32)Footnote 32. See S. Rep. No. 1036, 83rd Cong., 2d Sess. 19 (1954).

(n33)Footnote 33. Pub. L. 577, Section 303, 68 Stat. 683, 687 (1954).

(n34)Footnote 34. This Instruction was presumably promulgated pursuant to the rulemaking authority granted to the Commission in TIA Section 319(a). Good faith reliance on it should shield any registrant from liability under either the Trust Indenture Act or the Securities Act. See TIA Section 319(c); Securities Act Section 19(a).

(n35)Footnote 35. See 2 ALI Federal Securities Code 488, Comment (3), (1980).

(n36)Footnote 36. See H. Rep. No. 1016, 76th Cong., 1st Sess. 44 (1939).

(n37)Footnote 37. TIA Section 305(d) exempts the indenture analysis from Sections 11 (discussed in § 9.02 *infra*), 12 (discussed in §§ 9.03, 9.04 *infra*), 17 (discussed in § 10.11 *infra*), and 24 of the Securities Act and from Sections 323 and 325 of the Trust Indenture Act, discussed *infra*.

(n38)Footnote 38. Exchange Act Rule 10b-5 is discussed in §10.12 *infra*.

(n39)Footnote 39. See *Herman & McLean v. Huddleston*, 103 S. Ct. 683, C.C.H. Fed. Sec. L. Rep. P 99,058 (1983) , and TIA Section 323(b).

(n40)Footnote 40. See Instruction 1.B., Item 202, Regulation S-K, and TIA Rule 7a-27.

(n41)Footnote 41. Securities Act Section 8(b) is discussed in § 10.10[2] *infra*.

(n42)Footnote 42. See H. Friedman, *Securities and Commodities Enforcement* 33 (1981).

(n43)Footnote 43. See 1 Loss, *Securities Regulation* 302-03 (1961).

(n44)Footnote 44. TIA Section 309(b) appears to assume that Securities Act Section 8(d) stop orders are available only after the effective date of the registration statement or application for indenture qualification. It was not until 1945 in *Red Bank Oil Co.*, 20 SEC 863, C.C.H. Fed. Sec. L. Rep. P 75,582 (1945) , that the Commission definitively articulated the position that stop orders may also be used in the pre-effective period. However, well prior to 1939 the Commission practice was to use stop orders in the pre-effective period, see *Red Bank Oil Co.*, *supra*, at 20 SEC 866 n.6, C.C.H. Fed. L. Rep. P 75,582 at pg. 77,001 n.6 . Indeed, in *Jones v. SEC* 298 U.S. 1 (1936) , the U.S. Supreme Court acquiesced in such use of Section 8(d), although it reversed the Commission's challenged decision on other grounds.

(n45)Footnote 45. TIA Section 324 prohibits "any person in offering, selling, or issuing any security to represent or imply ... that any action or failure to act by the Commission in the administration of ... [the Trust Indenture Act] means that the Commission has in anyway passed upon the merits of, or given approval to, any trustee, indenture or security, or any transaction ... therein ... or ... with regard to any statement or report filed with or examined by the Commission ... has the effect of a finding by the Commission that ...[it] is true and accurate on its face or that it is not false or misleading."

(n46)Footnote 46. The Commission's other enforcement powers under the Trust Indenture Act are discussed in § 8.20[2] *infra*.



124 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.10

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.10 Supplemental Indentures and Special Problems of Shelf Registrations

Supplemental indentures that make changes in the rights of indenture security holders or effect other indenture amendments may be entered into provided they comply with the provisions of the Trust Indenture Act. Shelf registrations of debt securities under Rule 415 present special problems regarding the form of a supplemental indenture when they are needed.

Supplemental indentures may be entered into to make changes in the rights of the indenture security holders, or, in the case of open-end indentures, to create a new series of securities. n1 The Commission requires that all qualified indentures contain a provision that any supplemental indenture will comply with the provisions of the Trust Indenture Act. This is the Commission's only alternative to assure that future indenture amendments will comply with the Act since, under Section 309(e), the Commission is denied continuing jurisdiction over indentures once they are qualified. n2

As discussed in §8.11, modifications of rights that result in the offering of a new security require a new qualification of the indenture. However modifications that are not significant enough to amount to the creation of a new security may be made by merely filing the supplemental indenture with the SEC. Where the indenture securities are still being offered under a Form S-3 registration statement, the supplemental indenture is filed as an exhibit on Form 8-K. Otherwise it is filed as an automatically-effective, exhibits-only, post effective amendment as provided in Securities Act Rule 462(d). If the offering of the debt securities has terminated, the supplemental indenture is to be filed as Exhibit 4 to the company's next Exchange Act report. n3

Some rights of the indenture security holders may, subject to the limitations of Section 316, n4 be modified under the typical indenture by a vote of security holders without the filing of a supplemental indenture. n5 Solicitation of consents from indenture security holders will be subject to the Commission's proxy rules only if the indenture securities are convertible securities listed on an exchange or registered under Section 12(g) of the Exchange Act. n6 Exchange listed non-convertible debt securities are exempted from the proxy rules by Securities Exchange Act Rule 3a12-11. Some

indentures authorize the issuer to fix a record date for purposes of determining bondholders whose consents will be solicited. This may be necessary in order to allow securities depositories to effectively receive instructions from ever-changing beneficial owners. n7

Typically, the indenture provides that supplemental indentures effecting certain changes that do not adversely affect the rights of the security holders n8 may be entered into without consent of the indenture security holders. In other situations, supplemental indentures require the consent of specified percentages of security holders. n9 Section 316(b) precludes the use of a supplemental indenture to extend the maturity date or to postpone any interest payment for more than three years over the objection of any indenture security holder.

The adoption of Securities Act Rule 415, liberalizing the use of "shelf registration," has created particular problems relating to supplemental and additional indentures. n10 Rule 415 offerings may merely be delayed offerings of securities whose terms are completely spelled out in the initial registration statement and accompanying indenture. Often, however, shelf registrations of debt securities are designed to take advantage of interest "windows" so that a supplemental indenture will be needed to define the precise terms of the series to be issued. In such a case, where the securities being offered have generally been fully described in the registration statement, a sticker, rather than a post-effective amendment, may be used on the prospectus to reflect the interest rate, price, maturity date, redemption and similar provisions of the series being offered. n11 Under Rule 415, shelf offerings of debt securities by the issuer will virtually always be registered on Securities Act Form S-3. n12 Therefore, the supplemental indenture may be filed with the Commission on a Form 8-K, n13 rather than as an exhibit in a post-effective amendment, since the Form S-3 incorporates by reference future Exchange Act filings n14 made during the offering. n15

When the issuer is not certain of the form that the debt securities will take at the time of initial registration, it may file and qualify several forms of indentures that either are open-ended or specify the amounts of securities to be issued under them. For example, the issuer could file straight coupon, deep discount, and zero coupon forms of indentures, and later by prospectus sticker indicate which is being used. n16 The issuer, however, may not merely qualify a model form of indenture that does not relate to specific securities until the indenture is amended at some future time to include their characteristics. n17 Finally, an issuer may not omit the indenture in the original registration statement in contemplation of later filing it as part of a post-effective amendment. n18

The largest publicly-held companies have an additional option. In July 2005, the SEC adopted extensive revisions in its regulation of securities offerings. n19 A part of the changes permit "well-known seasoned issuers" n20 to raise capital through an "automatic shelf-registration process." Using this process, eligible companies can wait and add additional classes of securities or guarantees of securities to their shelf registration statement by post-effective amendment after the registration statement is effective. n21 The post-effective amendment will become effective as soon as it is filed. n22 Where debt securities are added by post-effective amendment, the filing then must also include the indenture and any other forms, information and signatures necessary to qualify the indenture under the TIA. n23

FOOTNOTES:

(n1)Footnote 1. As to open end indentures, see Thomas Arthur & Steven B. Kite, 13-3rd C.P.S. (BNA), *Corporate Bond Financing* A-11 to A-12 (1999); American Bar Foundation, *Commentaries on Indentures* 150-53 (1971).

(n2)Footnote 2. SEC, Manual-Trust Indenture Act of 1939 at p. 157 (June 1958).

Usually such clauses will refer to the Trust Indenture Act as in effect at the date of the supplemental indenture. See Revised Model Simplified Indenture Section 9.03, *55 Bus. Law. 1115, 1147 (2000)*. ABF, Model Debenture Indenture--All Registered Issues, Section 905 (1967).

(n3)Footnote 3. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 102.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>. Also see *id.* Section 111.01, pointing out that post-effective amendments to an Application for Qualification of an Indenture (Form T-3) are neither required nor permitted.

(n4)Footnote 4. *See § 8.18 infra.*

(n5)Footnote 5. *See* American Bar Foundation, *Commentaries on Indentures* 239-41, 302, 470-73 (1971); *Browning Debenture Holders' Committee v. DASA Corp.* 357 F. Supp. 1010, C.C.H. Fed. Sec. L. Rep. P 93,473 (S.D.N.Y. 1972) .

(n6)Footnote 6. *See Browning Debenture Holders' Committee v. DASA Corp.* 357 F. Supp.1010, C.C.H. Fed. Sec. L. Rep. P 93,473 (S.D.N.Y. 1972) .

Section 12(g) of the Exchange Act and Rule 12g-1 require registration of equity securities traded over-the-counter if the issuer has total assets exceeding \$10 million and the class of the equity securities is held of record by 500 or more persons. Convertible debt is defined as an equity security. Exchange Act Section 3(a)(11).

(n7)Footnote 7. *See* Revised Model Simplified Indenture, Note 3. to Section 9.04, 55 *Bus. Law.* 1115, 1205 (2000).

(n8)Footnote 8. *See* American Bar Foundation, *Commentaries on Indentures* 303-05 (1971); Revised Model Simplified Indenture, Section 9.01, 55 *Bus. Law.* 1115, 1146 (2000).

(n9)Footnote 9. *See* American Bar Foundation, *Commentaries On Indentures* 305-09 (1971); Revised Model Simplified Indenture, Section 9.02, 55 *Bus. Law.* 1115, 1146 (2000).

(n10)Footnote 10. *See § 8.09[1] supra* for discussion of delayed appointment of trustee in a shelf offering. Securities Act Rule 415 is discussed in § 7A.03[3] *supra*.

(n11)Footnote 11. *See* Item 512(a), Regulation S-K; Ferrara & Sweeny, "Shelf Registration Under SEC Temporary Rule 415," 5 *Corp. L. Rev.* 308, 311 (1982). *Cf.* *Storage Equities, Inc.*, C.C.H. Fed. Sec. L. Rep. P 77,536 (Div. Corp. Fin. 1983).

(n12)Footnote 12. Securities Act Form S-3 is discussed in § 7.04 *supra*.

(n13)Footnote 13. Exchange Act Form 8-K is used for current reports filed with the Commission.

(n14)Footnote 14. *See* Item 12(b), Form S-3, discussed in § 7.04 *supra*.

(n15)Footnote 15. *Trust Indenture Act of 1939*, C.C.H. Fed. Sec. L. Rep. P 77,345 (Div. Corp. Fin. 1982).

(n16)Footnote 16. *Id.*

(n17)Footnote 17. *Id.*

(n18)Footnote 18. *Id.*

(n19)Footnote 19. *Securities Offering Reform*, SEC Rel. No. 33-8591 (July 19, 2005).

(n20)Footnote 20. This new category of registrant, in general, is a company that qualifies to use Form S-3 or F-3 which has outstanding equity float of \$700 million or more or which has issued at least \$1 billion in non-convertible debt and preferred stock during the last 3 years. Certain other things, such as failure to file SEC reports or recent

bankruptcy, can also disqualify a company from meeting the requirements for being a well-known seasoned issuer. There are various other disqualifications as well. The details are set out in Securities Act Rule 415.

(n21)Footnote 21. Rule 413(b)

(n22)Footnote 22. Rule 462(e).

(n23)Footnote 23. *Id.* Fns. 520 and 527. Also see, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 201.02, 201.04, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.



125 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.11

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.11 Indenture Qualification in Recapitalizations and Reorganizations

Securities that are exempt from registration under the Securities Act but not under the Trust Indenture Act (certain recapitalizations and reorganizations) require indenture qualification. In such cases, the requirement of indenture qualification generally depends on whether a "sale" has occurred. n1 If no Securities Act registration statement is to be filed, the issuer's application for qualification of the indenture on Form T-3, the trustee's statement of eligibility and qualification on Form T-1, and all other items required for qualification when a Securities Act registration is required, must be filed with the Commission.

Sections 306 and 307 of the Trust Indenture Act require, and provide the procedures for, qualification of indentures covering securities exempt from registration under the Securities Act, but not from the Trust Indenture Act. These exemptions include the Securities Act Section 3(a)(9) exemption for exchanges of securities with existing security holders exclusively where no payment is made for soliciting the exchange n2 and the Section 3(a)(10) exemption for judicially or administratively approved reorganizations. n3

Section 306 of the Trust Indenture Act prohibits the use of interstate facilities or the mails to sell or to deliver after sale any security issued under an unqualified indenture, where that security is not registered under the Securities Act and is not exempt from the Trust Indenture Act. n4 Recapitalizations that do not amount to "sales" of debt securities do not fall under the prohibitions of Section 306. Section 303(2) of the Trust Indenture Act defines "sale" and its derivative terms by reference to Section 2(3) of the Securities Act, n5 except that a sale of a certificate of interest or participation is a sale of the underlying security only if convertible into such security.

A frequent question is whether particular changes in the terms of debt securities through amendments to the indenture involve the exchange, and thus the "sale," of new securities. n6 If so, a new indenture qualification would be required. It has usually been held that the sale of a new security has occurred when the modification extends the maturity date of the debt securities. n7 Other changes in an indenture (not, of course, involving the mandatory Trust Indenture Act provisions) n8 have usually been viewed as not creating a new security. n9 Typical of these are amendments relating to

the acquisition of the issuer by another corporation (e.g., the assumption of the debt by the acquiring company),ⁿ¹⁰ or changes in covenants that trade off concessions to the issuer for an increased interest rateⁿ¹¹ or for an earlier maturity date.ⁿ¹² Reincorporations or reorganizations that shift debt to a successor business entity, or add a guarantee by the successor, are generally permitted without requalification so long as the original indenture permits the trustee to enter into supplemental indentures without the vote or consent of security holders.ⁿ¹³ Similarly, increasing the interest rate on outstanding convertible securities to discourage conversion does not create a new security; however additional changes may raise questions.ⁿ¹⁴

The Commission has not articulated a consistent rationale for these determinations. One court has suggested that the touchstone is whether the modifications benefit the security holders.ⁿ¹⁵ Requests for no-action letters that have been granted generally focus on the rationale that changes made in accordance with amendment procedures found in the original indenture are merely contractual modifications anticipated in the original security, and are therefore not the issuance of a new security.ⁿ¹⁶ No-action requests also argue that modifications that do not materially or fundamentally change the security do not result in a new security.ⁿ¹⁷ Finally, when the amendment is one that the indenture permits without consent of the security holders, it is argued that no sale has occurred because no investment decision is being sought or made.ⁿ¹⁸ Thus, no sale occurs when there is a substitution of a new obligor under indenture provisions that permit such a change without approval or consent of holders of the indenture securities. However, if approval by debt holders must be solicited, the sale of a new security has taken place.ⁿ¹⁹ Even where the sale of a new security is not involved, however, if the modified securities are voluntarily registered under the Securities Act, the Commission requires a new Form T-1 to be filed to requalify the trustee.ⁿ²⁰

Various reorganizations and recapitalizations involving exchanges of securities require Trust Indenture Act qualification, even though a Securities Act exemption is available. Perhaps the most common situation is the issuance of certain debt securities in a reorganization under Chapter 11 of the Bankruptcy Reform Act.ⁿ²¹ While trustees' certificates issued during the course of a reorganization, and commercial notes issued under a plan of reorganization that mature within one year, are exempt from Trust Indenture Act coverage, longer term debt securities issued under a plan of reorganization require Trust Indenture Act qualification, even though they are exempt from Securities Act registration by reason of Section 1145(a) of the Bankruptcy Reform Act.ⁿ²²

In a bankruptcy reorganization, the SEC views the solicitation of plan approval from creditors and other claimants as the event that constitutes an offering of debt securities under the plan. Therefore an application for qualification on Form T-3 must be filed before creditors are solicited to approve the plan. The issuer cannot wait until after court approval of the plan.ⁿ²³

Securities issued in other non-bankruptcy reorganizations and recapitalizations also generally require Trust Indenture Act qualification, even though exempt from Securities Act registration under Sections 3(a)(9) or 3(a)(10).

When debt securities are exempt from Securities Act registration but nevertheless require indenture qualification, Sections 306 and 307 of the Trust Indenture Act set up separate qualification procedures and disclosure requirements, generally modeled after Securities Act registration of non-exempt securities.ⁿ²⁴ Section 306 basically tracks the format of Section 5 of the Securities Act.ⁿ²⁵ Under Section 306(c), no offers may be made through interstate facilities or the mails unless the security is to be issued under an indenture and an application for qualification has been filed.ⁿ²⁶ Section 306(b) prohibits written offers (*i.e.*, use of a "prospectus" as defined in Section 303(3) of the Trust Indenture Act) through interstate facilities or the mail unless the offers include, to the extent required by Commission rule, the information prescribed in Section 305(c) analyzing the indenture terms.ⁿ²⁷ Section 306(a) prohibits the use of interstate facilities or the mails for sales of securities or deliveries after sale unless the securities are to be issued under an indenture and an application for qualification of the indenture is effective.

A drafting error, however, does complicate the provisions of Section 306. Section 306 was amended in 1954,ⁿ²⁸ and the legislative history makes it absolutely clear that Congress' intent was to conform the Trust Indenture Act to the

Securities Act amendments that were enacted at the same time. n29 In particular, the amendments to Section 306 were intended to permit certain offers to be made during the waiting period between filing of the application for indenture qualification and its effective date, in the same way that certain waiting period offers under the Securities Act were legalized. n30 If the amendment had been properly drafted, Section 306(b) would have permitted oral offers and written offers containing specified disclosures in the waiting period between filing and effectiveness. As drafted, however, Section 306(b) only refers to offers made in the post-effective period. It appears, however, that the Commission treats Section 306(b) as if it were drafted in accordance with the intent expressed by Congress. n31

The disclosures to be made along with any written offer are, under Section 306(b), to be prescribed by Commission rule. The Commission has not promulgated any rules, but apparently advises registrants to provide the analysis of indenture provisions specified in Section 305(c) when it is deemed necessary. n32

[1] Form T-3--Application for Qualification of Indenture

When no Securities Act registration statement is to be filed, Section 307(a) specifies the procedures for obtaining qualification of the indenture under the Trust Indenture Act. An application for qualification of the indenture must be filed by the issuer on Form T-3. The trustee's statement of eligibility and qualification, generally filed on Form T-1, n33 must also be separately filed, n34 as well as all other items required under Section 305(a) for qualification when a Securities Act registration statement is required. n35 These filings are to be made electronically through the EDGAR system. n36 A filing fee of \$100 for the Form T-3 must be sent to the US Treasury's designated lockbox depository. n37

The form requires disclosure of information regarding:

- (1) the issuer's form of organization and the state under whose laws it is organized;
- (2) a list or diagram of the issuer's "affiliates"; n38
- (3) a list of directors, executive officers, and principal (10% or more) shareholders;
- (4) names and addresses of past and prospective underwriters;
- (5) a table showing the issuer's capital structure and amounts of each class of securities authorized and outstanding;
- (6) an analysis of certain indenture provisions, as required by Section 305(a)(2); n39
- (7) the name and address of other obligors on the indenture securities; and
- (8) various exhibits, including the indenture and a cross reference sheet from it to the Trust Indenture Act's provisions, any prospectus sent to security holders, the issuer's charter and bylaws, and the relevant court or administrative order where an exemption from Securities Act registration has been claimed under Securities Act Section 3(a)(10). Offering materials that are required to be filed as an exhibit may be filed in definitive form when acceleration of the Form T-3 is requested. n40

Form T-3 is to be signed on behalf of the issuer by a duly authorized person. n41

If Form T-3 is to be used to qualify guaranteed debt, the primary obligor and each guarantor must file separate Form T-3's. Each Form T-3 will reflect information relating to the entity filing it. n42

Under Section 306, no sales of indenture securities may be made until after the indenture qualification is effective. The

timing and procedures of Securities Act Section 8 regarding effectiveness of registration statements are incorporated into the Trust Indenture Act by Section 307(c) and thereby made applicable to Form T-3 applications for qualification. Thus an indenture qualification becomes effective twenty days after the last amendment to it is filed, unless the Commission accelerates the effective date. Rule 7a-9 under the Trust Indenture Act provides for use of an automatic delaying amendment in any Form T-3, to prevent effectiveness until the Commission staff has completed its review.

In two early Releases, n44 the Commission applied the prohibitions of Section 306 strictly to when-issued trading of securities. It took the position that no when-issued trading of debt securities to be issued in judicially approved reorganizations exempt from registration under Securities Act Section 3(a)(10) could occur until after the relevant indenture qualification was effective. n45 The Division of Corporation Finance appears to have retreated from this position in a 1986 no-action letter. n46 Examining proposed when-issued trading of securities to be issued in a recapitalization without registration in reliance on Securities Act Section 3(a)(9), the Division permitted when-issued trading by investors (other than the issuer) and by broker-dealers who are not underwriters to begin as soon as Form T-3 is filed with the Commission. The Division added, however, that if in the future the Commission were to implement TIA Section 305(c) by rules requiring an analysis of indenture provisions to be included in any prospectus, then dealers as well as issuers and underwriters would be required to await qualification of the indenture before selling and, pursuant to Section 306(b), they would be required to deliver that analysis.

Section 307(c) incorporates both the Section 8(b) refusal order and the Section 8(d) stop order provisions of the Securities Act, as well as the Section 8(e) procedures for an examination to determine whether a stop order should be issued. Section 309(b) provides that a stop order may be issued after the effective date of the application for qualification only on the grounds specified in Securities Act Section 8, *i.e.*, if the offering circular being used is materially false or misleading. Only a *pre-effective* refusal order or stop order may be used to deal with a non-complying indenture or an ineligible trustee.

When a stop order or refusal order is in effect, or when a pre-effective public examination or proceeding has been instituted, Section 306(c) prohibits the use of interstate facilities or the mail to offer indenture securities, n47 except in unsolicited brokers' transactions permitted under the exemption incorporated by Section 304(b). n48

FOOTNOTES:

(n1)Footnote 1. See SBC Communications, Inc., Pacific Telesis Group (No Action Letter, January 27, 1998) (guarantees of obligations of wholly owned subsidiary created by resolution of parent's board of directors without vote by security holders, providing additional protection without security holders paying consideration or giving up any rights, does not involve a sale.)

(n2)Footnote 2. Securities Act Section 3(a)(9) is discussed in § 3.10 *supra*. An exchange offer involving no more than \$5 million in debt securities, however, will be exempt from TIA Section 306 if it meets the requirements of TIA Section 304(a)(8) and Rule 4a-1, discussed *infra*. § 8.05[1]. See Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 207.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n3)Footnote 3. Securities Act Section 3(a)(10) is discussed in § 3.11 *supra*. For a discussion of the Securities Act exemptions that are incorporated into the Trust Indenture Act, see § 8.06 and § 8.07 *supra*.

(n4)Footnote 4. TIA Section 306(a) applies to sales where Securities Act registration was required, but did not occur, as well as to transactions that were exempt under the Securities Act but not under the Trust Indenture Act. See *In re North American Acceptance Corporation Securities Cases*, 513 F. Supp. 608, 615, 620, 645, C.C.H. Fed. Sec. L. Rep. P 97,961 at pp.90,920, 90,924, 90,946 (N.D. Ga. 1981) (neither attorney nor trustee violated Trust Indenture Act

Section 306(a) because they were not sellers or aiders and abettors in the sales of unregistered debt securities). Cf. *Cronin v. Midwestern Oklahoma Development Authority*, 619 F.2d 856, 862-63, C.C.H. Fed. Sec. L. Rep. P 97,347 at pp. 97, 316-17 (10th Cir. 1980). Also see Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 104.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>, (Section 306(a) does not override the exemptions in TIA Sec. 304).

(n5)Footnote 5. See NCNB Corp. (No Action Letter, July 21, 1986). Securities Act Section 2(3) is discussed in § 2.02 *supra*.

(n6)Footnote 6. See McGuigan & Aiken, "Amendment of Securities," 9 Rev. of Sec. Reg. 935 (1976); Bryant B. Edwards & Jon J. Bancone, *Modifying Debt Securities: The Search for the Elusive "New Security" Doctrine*, 47 Bus. Lawyer 571 (1992).

(n7)Footnote 7. *SEC v. Associated Gas & Electric Co.*, 24 F. Supp. 899 (S.D.N.Y. 1938) ; *In the Matter of Hugo Stinnes Corp.*, 7 SEC 622, 635-36 (1940) ; *Allied Carson Corp.*, C.C.H. Fed. Sec. L. Rep. P 80,434 (Div. Corp. Fin., 1976); *Magic Marker Corp.* (No Action Letter, June 30, 1971). But cf. *National Mortgage Fund* (No Action Letter, May 12, 1975) (waiver by note holders of early maturity option permitted without new indenture qualification); and *IDS Realty Trust*, C.C.H. Fed. Sec. L. Rep. P 80,555 (Div. Corp. Fin. 1976) (modification affecting amounts available for early payment of debentures permitted without new indenture qualifications).

(n8)Footnote 8. The SEC requires all qualified indentures to provide that all amendments shall be by way of a supplemental indenture that complies with the Trust Indenture Act. See Revised Model Simplified Indenture, Note 1. to Section 9.03, 55 Bus. Law. 1115, 1205 (2000). SEC, Manual--Trust Indenture Act of 1939 at p. 157 (June, 1958).

(n9)Footnote 9. But see *ICI Americas Inc.* (No Action Letter, June 21, 1979), which suggests that the substitution of obligors after only a partial acquisition of the initial obligor's assets might involve the issuance of a new security.

(n10)Footnote 10. E.g., *Union Carbide Corp.* (No Action Letter, April 12, 1991); *McKesson Corp.* (No Action Letter, Sept. 12, 1985); *Pan American World Airways, Inc.* (No Action Letter, May 28, 1984); *Continental Telephone Co. of Upstate New York, Inc.*, 15 B.N.A. Sec. Reg. & L. Rep. 1311 (Div. Corp. Fin. 1983); *Wickes Companies (The)*, C.C.H. Fed. Sec. L. Rep. P 76,455 (Div. Corp. Fin. 1980); *Envirodyne, Inc.*, C.C.H. Fed. Sec. L. Rep. P 80,712 (Div. Corp. Fin. 1976).

(n11)Footnote 11. E.g., *Electronic Memories And Magnetics Corp.* (No Action Letter, Nov. 15, 1984); *NCNB Corp.* (No Action Letter, March 11, 1982); *Mississippi River Corp.*, C.C.H. Fed. Sec. L. Rep. P 78,504 (Div. Corp. Fin. 1971).

(n12)Footnote 12. *Wilson Foods Corp.* (No Action Letter, Aug. 6, 1984).

(n13)Footnote 13. E.g., *Weatherford International, Ltd* (No Action Letter, Jan. 14, 2009), 2009 SEC No-Act. LEXIS 20; *Mercer International, Inc.*, (No Action Letter, Dec. 12, 2005), 2005 SEC No-Act. LEXIS 832; *Shire Pharmaceuticals Group Plc and Shire Plc*, (No Action Letter, Nov. 17, 2005), 2005 SEC No-Act. LEXIS 790.

(n14)Footnote 14. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 101.02, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n15)Footnote 15. *Browning Debenture Holders' Committee v. DASA Corp.*, C.C.H. Fed. Sec. L. Rep. P 95,071 (S.D.N.Y. 1975), *aff'd* 560 F.2d 1078, C.C.H. Fed. Sec. L. Rep. P 96,131 (2d Cir. 1977) .

(n16)Footnote 16. E.g., *Northwestern Mutual Life Mortgage Realty Investors* (No Action Letter, Dec. 22, 1982); *Leasco Corp.* (No Action Letter, Oct. 22, 1982); *Macmillan Inc.* (No Action Letter, Feb. 22, 1982); *IDS Realty Trust*, C.C.H. Fed. Sec. L. Rep. P 80,555 at p.86,430 (Div. Corp. Fin. 1976).

(n17)Footnote 17. *E.g.*, Continental Telephone Co. of Upstate New York, Inc., 15 B.N.A. Sec. Reg. & L. Rep. 1311 (Div. Corp. Fin. 1983); Southern Railway Co. (No Action Letter, Sept.14, 1981).

(n18)Footnote 18. *E.g.*, Weatherford International Inc., Weatherford International Ltd., 2002 SEC No-Act. LEXIS 612 (June 25, 2002); Reliant Energy, Incorporated, 2001 SEC No-Act. LEXIS 848 (Dec. 21, 2001); The Bank of Tokyo-Mitsubishi, Ltd., 2001 SEC No-Act. LEXIS 539 (March 28, 2001); Nortek, Inc. (No Action Letter, April 20, 1984); Purex Corp. (No Action Letter, Sept. 6, 1982); The Limited Stores, Inc. (No Action Letter, May 12, 1982); Motorola, Inc. No Action Letter, (March 5, 1982); Envirodyne, Inc. C.C.H. Fed. Sec. L. Rep. P 80,712 (Div. Corp. Fin. 1976); Wickes Companies (The), C.C.H. Sec. L. Rep. P 76,455 (Div. Corp. Fin. 1980).

(n19)Footnote 19. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 101.03, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n20)Footnote 20. Envirodyne, Inc., C.C.H. Fed. Sec. L. Rep. P 80,712 (Div. Corp. Fin. 1976).

(n21)Footnote 21. *See* § 8.06[6] and [7] *supra*.

(n22)Footnote 22. The State Street Mortgage Co. (No Action Letter, April 11, 1991). *Cf.* Trust Indenture Act Rel. 30, 4 C.C.H. Fed. Sec. L. Rep. P 42,218-28 (1944) (trading on when-issued basis of securities to be issued in bankruptcy reorganization); Trust Indenture Act Rel. 31, 4 C.C.H. Fed. Sec. L. Rep. P 42,230 (1941) (application of Trust Indenture Act to when-issued trading in debt securities to be issued under an already-confirmed plan of reorganization).

(n23)Footnote 23. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 101.05, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n24)Footnote 24. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 44-45 (1939). *Cf.* *Christie v. Fifth Madison Corp.*, 13 A.D. 2d 43, 46-47, 211 N.Y.S.2d 787, 791 (1961) (discussing Commission's requiring rescission offer when securities were illegally offered prior to indenture qualification).

For discussion of Securities Act registration, see Ch. 7 *supra*.

(n25)Footnote 25. Securities Act Section 5 is discussed in § 7.04, § 7.05 and § 7.06 *supra*.

(n26)Footnote 26. However, in reorganization is exempt from Securities Act registration under Section 3(a)(10), but not in ones exempt under Section 3(a)(9), the Commission has permitted a deviation from this requirement. Where, because of various options available to security holders in the reorganization, the debt securities ultimately issued may be of a sufficiently small dollar amount to be exempt under TIA § 304(a)(8) or § 304(a)(9), the Commission has permitted a solicitation to occur without the filing of an application for qualification provided that, if the exemption is ultimately unavailable, an indenture will be qualified under the TIA before the issuance and delivery of the securities. First Home Investment Corp. of Kansas (No Action Letter, April 22, 1976); Mississippi Chemical Corp., C.C.H. Fed. Sec. L. Rep. P 78,898 (SEC 1988).

(n27)Footnote 27. As in the Securities Act, the Trust Indenture Act permits "tombstone ads" and additional sales literature ("free writing") once the statutorily required disclosures have been transmitted. TIA Section 303(3).

(n28)Footnote 28. Pub. L. 83-577, 68 Stat. 683, 686-88 (Act of 1954).

(n29)Footnote 29. *See* H. Rep. No. 1542, 83rd Cong., 2d Sess. (1954). The parallel Securities Act provisions are in Section 5(b).

(n30)Footnote 30. *Id.*

(n31)Footnote 31. Mississippi Chemical Corp., C.C.H. Fed. Sec. L. Rep. P 79,311 (SEC 1989).

(n32)Footnote 32. 4 C.C.H. Fed. Sec. L. Rep. P 42,240.02.

(n33)Footnote 33. *See § 8.09 supra*.

(n34)Footnote 34. TIA Rule 5a-3(d).

(n35)Footnote 35. *See § 8.09 supra*.

(n36)Footnote 36. Regulation S-T, Rule 14, Rule 101(a)(1)(ii). *See § 7.02[4] supra*.

(n37)Footnote 37. TIA Section 307(b); TIA Rule 7A-10; SEC Rules of Practice, Informal and Other Procedures § 202.3a.

(n38)Footnote 38. Trust Indenture Act Rule 0-2 defines "affiliate."

(n39)Footnote 39. Section 305(a)(2) is discussed in § 8.09[3] *supra*.

(n40)Footnote 40. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 201.05, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n41)Footnote 41. TIA Rule 7a-3(b). As to signatures in electronic filings made through the EDGAR system, see Regulation S-T, Rule 302.

(n42)Footnote 42. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 201.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n43)Footnote 43. A similar procedure is available for Securities Act registration statements under Securities Act Rule 473.

(n44)Footnote 44. Sec. Act Rel. No. 33-3011 (1944), 1 C.C.H. Fed. Sec. L. Rep. P 2190-91; Sec. Act Rel. 33-3038 (1945), 1 C.C.H. Fed. Sec. L. Rep. P 2195.

(n45)Footnote 45. For further discussion, see § 3.11[5] *supra*.

(n46)Footnote 46. Jerome L. Coben, Esq. (No Action Letter, March 12, 1986).

(n47)Footnote 47. This provision is patterned after Securities Act Section 5(c).

(n48)Footnote 48. TIA Section 304(b), discussed in § 8.04 *supra*, incorporates, *inter alia*, the broker's transactions exemption of Securities Act Section 4(4), discussed in § 4.06 *supra*.



126 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.12

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.12 Who Is Eligible for Appointment As Trustee?--Section 310

The Trust Indenture Act requires that under every qualified indenture there always be at least one institutional trustee with a combined capital and surplus of at least \$150,000. A permissive provision may provide that the trustee's capital and surplus be determined by reference to the trustee's most recently published report of condition. Foreign business entities may act as the institutional trustee only if permitted by Commission order or rule. The Act permits the use of one or more co-trustees, who may be individuals, but the trustees' rights, powers, duties and obligations must be imposed on and carried out by the required institutional trustee, either alone, or jointly with the co-trustees.

One of the concerns articulated by Congress in 1939 was that indenture trustees often did not have resources commensurate with their responsibilities. n1 To remedy this, Section 310(a) provides that under every indenture that is qualified, or to be qualified, there must always be at least one institutional trustee that shall have a combined capital and surplus of at least \$150,000. n2 The institutional trustee must be a corporation organized and doing business under the laws of the United States, of any state or territory, or of the District of Columbia. The institution must be authorized by those laws to exercise corporate trust powers, and must be subject to supervision or examination by those governmental authorities. n3 A subsidiary of a foreign company is not disqualified so long as it is organized and doing business under U.S. law or the law of any U.S. state. n4

As amended in 1990, Section 310(a)(1) authorizes the Commission to prescribe rules to allow a foreign corporation or business entity to act as the institutional indenture trustee if under the laws of its home country it is authorized to exercise corporate trust powers and if it is subject to examination or supervision by its home country that is substantially equivalent to that imposed on United States banks and trust companies. The Commission apparently interprets this to require that the trustee be chartered as a bank or trust company and will not permit a company organized under a state's general corporation law to act as the institutional trustee. n5 In formulating its rules, the Commission is directed to consider whether reciprocal rights to act as sole trustee are given to U.S. banks and trust companies in the foreign country involved. n6 An application under Section 310(a)(1) is to be filed on Form T-6. n7 A foreign trustee that does not meet the requirements of Section 310(a)(1) can seek an exemptive order under Section 304(d) permitting it to serve.

n8

Acting under the authority granted in Section 310(a)(1), the Commission has adopted Rule 10a-5. n9 The rule covers indenture securities registered under the Securities Act of 1933 on Form S-B, F-7, F-8, F-9, F-10 or F-80, developed under the Commission's multijurisdictional disclosure system for cross-border offerings by certain Canadian issuers. The rule permits trust companies which are incorporated and regulated under the laws of Canada or its political subdivisions to serve as sole trustee under a qualified indenture for securities of these issuers, without separately applying for an order under Section 310(a)(1). To be eligible, a trust company must be subject to supervision or examination pursuant to the Trust Companies Act (Canada), R.S.C. 1985, or the Canada Deposit Insurance Corporation Act, R.S.C. 1985. Rule 10a-5 also requires each Canadian trustee relying upon the rule to file on Form F-X an appointment of a person in the United States as agent for service of process. n10

When Form T-6 is used by a foreign entity solely to apply for permission to act as the institutional indenture trustee, the applicant must complete Item 1, General Information; Item 15, Substantial Equivalency of Trust Regulation in the Foreign Jurisdiction and Eligibility of United States Trustees to Act as Sole Trustees in the Foreign Jurisdiction; and Item 16. List of Exhibits. Where Form T-6 is also used to assure that the trustee meets the TIA's eligibility requirements, additional items similar to those called for in Form T-1 must be completed. n11

Whatever the efficacy in 1939 of the \$150,000 capital and surplus figure to assure that the trustee had adequate resources to carry out its duties, the figure is ridiculously low today. As a matter of practice, most indentures today impose a \$5 million minimum capital and surplus requirement on trustees. n12 Section 310(a)(2) permits the indenture to provide that the trustee's capital and surplus is to be determined by reference to the trustee's most recently published report of condition, so long as its reports are published at least annually pursuant to law or requirements of state or federal regulatory authorities. Indentures generally include this permissive provision. n13 If the securities are to be listed on the New York Stock Exchange, the trustee must also meet the requirements established by the NYSE Company Manual, one of which is that it must be "a bank or trust company, having substantial capital and surplus, and having the experience and facilities for the proper performance of corporate trust functions." n14

Sometimes indentures require that the trustee have its principal office in New York City or some other major financial center, n15 which typically will also be the city designated by the indenture as the place where an office will be maintained for holders to obtain payment of principal and interest, and for them to present the securities for transfer, exchange, or registration. n16 The Trust Indenture Act does not require a provision of this sort, but if debt securities are to be listed on the New York Stock Exchange, the Exchange must approve the bank or trust company chosen as registrar and/or transfer agent. n17 Usually the issuer will appoint the trustee as its agent for these purposes. n18

The Trust Indenture Act, through Section 310(a)(3), permits the use of one or more co-trustees, who may be individuals, in addition to the required institutional trustee. n19 However, where co-trustees are used, Section 310(a)(3) also requires that all rights, powers, duties and obligations of the trustees shall be imposed on and carried out by the institutional trustee, either alone, or jointly with the co-trustees, except to the extent that the institutional trustee is legally incompetent or unqualified to do so.

Finally, Section 310(a)(4) provides that when the indenture relates to certificates of interest or participation, the trustee shall have all rights, powers, and privileges of a holder of the underlying securities.

Form T-1, filed by the trustee with the Commission to indicate the trustee's eligibility, n20 elicits on the facing sheet, in Item 1, and through required exhibits, the information necessary to determine whether the eligibility requirements of Section 310(a) have been met. Since the indenture can be qualified only if the original trustee meets the eligibility requirements, n21 the ongoing eligibility requirements are relevant primarily to subsequent changes in the trustee's status and to the eligibility of successor trustees. n22 Since Section 310(a)(1) requires that there shall at all times be at least one trustee who meets the Trust Indenture Act's eligibility requirements, indentures generally require the trustee to

resign if it ceases to be eligible. n23 Further, indentures generally specify procedures for removing the trustee that has lost its eligibility and has not voluntarily resigned. n24 Typically, in these situations, the trustee may be removed by the board of directors of the issuer, by holders of a majority in principal amount of the indenture securities, or by a court upon petition by any indenture security holder (or sometimes upon petition by any person who has been an indenture security holder for at least six months). n25

Indentures also typically provide a procedure for the appointment of a successor trustee after the original trustee has resigned or been removed. The Revised Model Simplified Indenture provides for the issuer to promptly appoint a successor. If a successor does not take office within 30 days, the retiring trustee may appoint a successor. After 45 days, the issuer, the retiring trustee or debenture holders may petition a court for appointment of a successor. n26 A successor trustee needs to file a Form T-1 only if there is an offer or sale of the debt securities in connection with the succession. An offer or sale that requires 1933 Act registration, or otherwise requires indenture qualification, would also require qualification of the successor trustee. n27

FOOTNOTES:

(n1)Footnote 1. TIA Section 302(a)(3).

(n2)Footnote 2. TIA Section 310(a)(2).

(n3)Footnote 3. TIA Section 310(a)(1).

(n4)Footnote 4. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 105.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n5)Footnote 5. Vigil Asset Management Group, Inc. (No Action Letter, February 13, 1992).

(n6)Footnote 6. The Commission has promulgated rules 10a-1 to 10a-4 to implement these provisions. Rules and Forms to Implement the Trust Indenture Reform Act of 1990, Securities Act Rel. No. 6892 (May 8, 1991), C.C.H. Fed. Sec. L. Rep. P 84,732. Under Rule 10a-4, each trustee must file with the Commission on Form F-X an appointment of a person in the United States as agent for service of process.

(n7)Footnote 7. If a § 310(a)(1) order is sought at the same time that the issuer is filing a registration statement, Form T-6 may also be used to assure that the trustee meets the TIA's eligibility requirements. Where a prior order has been issued under § 310(a)(1) or § 304(d) permitting a foreign person to act as institutional trustee, the trustee is to file Form T-1 to establish its eligibility. Form T-6, General Instructions A.

When Form T-6 is used by a foreign entity solely to apply for permission to act as the institutional indenture trustee, the applicant must complete Item 1, General Information; Item 15, Substantial Equivalency of Trust Regulation in the Foreign Jurisdiction and Eligibility of United States Trustees to Act as Sole Trustees in the Foreign Jurisdiction; and Item 16. List of Exhibits. Where Form T-6 is also used to assure that the trustee meets the TIA's eligibility requirements, additional items similar to those called for in Form T-1 must be completed. *See § 8.09[1] supra*.

(n8)Footnote 8. *See* S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess. p. 48. TIA Section 304(d) is discussed at § 8.06[8] *supra*. For an example of such an exemptive order, see Deutsche Bank AG, New York Branch, SEC Release No. 39-2359 (Nov. 26, 1997), 1997 SEC LEXIS 2424 .

(n9)Footnote 9. Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Sec. Act Rel. No. 33-6902 (June 21, 1991), C.C.H. Fed. Sec. L. Rep. P 84,812; Multijurisdictional Disclosure; Eligibility of British Columbia Trustees and Exemption for British Columbia Trust Indentures from Specific

Provisions of the Trust Indenture Act, SEC Rel. No. 33-7002 (June 10, 1993), C.C.H. Fed. Sec. L. Rep. P 85,203.

(n10)Footnote 10. Rule 10a-5(d).

(n11)Footnote 11. *See* § 8.09[1] *supra*.

(n12)Footnote 12. J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 51 (2d ed., 1975). *See* ABF, Model Debenture Indenture--All Registered Issues Section 609 (1967).

The ALI Federal Securities Code Section 1306(a)(1)(1980) proposed a minimum combined capital and surplus of \$2 million.

(n13)Footnote 13. *See, e.g.*, ABF, Model Debenture Indenture--All Registered Issues Section 609 (1967); Revised Model Simplified Indenture Section 12.09, *55 Bus. Law. 1115, 1164 (2000)*.

(n14)Footnote 14. NYSE Listed Company Manual, Sec. 603.01 (June 1983).

(n15)Footnote 15. J. Kennedy & R. Landau, *Corporate Trust Administration and Management*, 51 (2d ed., 1975).

(n16)Footnote 16. *See* American Bar Foundation, *Commentaries On Indentures* 149-50, 270, 314-16 (1971).

(n17)Footnote 17. NYSE Listed Company Manual, Sec. 601.01(2009).

(n18)Footnote 18. American Bar Foundation, *Commentaries On Indentures* 315 (1971).

(n19)Footnote 19. *See also* NYSE Company Listed Manual, Sec. 603.01 (June 1983) permitting non-institutional co-trustees. This may be done where the primary trustee is not qualified to do business in certain states. *See* J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 57-59 (2d ed., 1975).

(n20)Footnote 20. *See* § 8.09[1] *supra*.

(n21)Footnote 21. TIA Sections 305(b)(1)(B), 307(c).

(n22)Footnote 22. J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 51-52 (2d ed., 1975). For a case holding that a bank did not become a successor trustee merely by acquiring the corporate trust division of the original trustee, see *In re Sunshine Jr. Stores, Inc.*, 456 F.3d 1291, 1309-10 (11th Cir., 2006) .

(n23)Footnote 23. *See* American Bar Foundation, *Commentaries on Indentures* 270 (1971); ABF, Model Debenture Indenture--All Registered Issues Section 609 (1967). The Revised Model Simplified Indenture does not explicitly require resignation, though it is presumably implicit in Section 7.10, *55 Bus. Law. 1115, 1143 (2000)*.

(n24)Footnote 24. Removal of the trustee is discussed further in § 8.13 and § 8.18[6] *infra* .

(n25)Footnote 25. *See* American Bar Foundation, *Commentaries On Indentures* 272-74 (1971); ABF, Model Debenture Indenture--All Registered Issues Section 610(c), (d), (1967); Revised Model Simplified Indenture, Section 7.08, *55 Bus. Law. 1115, 1142 (2000)*. SEC, Manual--Trust Indenture Act of 1939 at pp. 1-2 (June 1958).

(n26)Footnote 26. Revised Model Simplified Indenture, Section 7.08, *55 Bus. Law. 1115, 1142-43 (2000)*. *Also see* ABF, Model Debenture Indenture--All Registered Issues Section 610(e) (1967) (appointment of successor by issuer or debenture holders). A trustee's resignation becomes effective only when its successor has accepted appointment. *See* last paragraph in TIA § 310(b), discussed in § 8.15[4] *infra*.

(n27)Footnote 27. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 108.01,

2-8 Federal Securities Act of 1933 § 8.12

(March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.



127 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.13

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.13 Conflicts of Interests--Section 310(a)(5) and Section 310(b)

The obligor and its affiliates may not serve as indenture trustee. Specific post-default conflicts of interest require the resignation or removal of the trustee unless the Commission, in the case of certain defaults not involving non-payment, permits a delay in the obligation to resign. The prohibited conflicts include: dual trusteeships (with some exceptions); prohibited affiliations between the trustee and the obligor or underwriters; beneficial ownership of the trustee's voting securities by the obligor, underwriter, or their affiliates; direct or indirect ownership by the trustee of securities of the obligor and underwriters; the trustee's ownership of the obligor's or underwriters' securities in fiduciary capacities; and the trustee's being a creditor of the obligor.

Section 310(a)(5) disqualifies the obligor on the indenture securities, or any person directly or indirectly controlling, controlled by, or under common control with such obligor, from serving as indenture trustee. n1 Under the 1990 amendments to the Trust Indenture Act, only these conflicts of interest disqualify a trustee from serving initially. Upon default, however, a broader group of relationships will be deemed to be conflicts of interest and will require the trustee's resignation so that the trustee can "take vigorous action for the enforcement of rights under the indenture." n2

As originally enacted in 1939, the Trust Indenture Act enumerated a broader list of conflicts that precluded initial eligibility to serve as trustee. By 1990, however, it appeared to Congress and the Commission that before default, the trustee's duties are essentially ministerial in nature involving little exercise of discretion on behalf of security holders. Thus, many relationships that were previously treated as impermissible pre-default conflicts of interest are, under the 1990 amendments, now permitted to exist before default. n3 In taking this position, Congress responded to the Commission's concern that the broad pre-default conflict standards in the original Act unduly restricted other business activities of trustees. In particular, participation by affiliates of United States banks in overseas offerings was hampered. The original Act prohibited a bank from acting as trustee if its affiliate had served as an underwriter of any securities issued by the obligor during the previous three years. n4

Section 310(b) now enumerates specific relationships which become conflicts of interest and require a trustee to resign

when the indenture securities are in default. n5 For this purpose, Section 310(b) provides that the definition of default found in the indenture, exclusive of any period of grace or requirement of notice, controls. Notice and grace periods are ignored in order to prevent evasion of the disqualification provisions through definitions in the indenture. n6 These prohibited post-default relationships are largely the conflicts which the 1939 Act specified as being prohibited either before or after default, with the significant addition of most creditor relationships between the trustee and the obligor as well.

Even with this addition, however, the enumerated conflicts fail to include a number of situations that the traditional state law of fiduciary duties might well find to be conflicts of interest. n7 This was apparent to the Commission at the time the original Trust Indenture Act was being considered by Congress, but the Commission reluctantly endorsed the approach embodied in the Trust Indenture Act, which it described as setting out "rules of thumb" for the trustee as to conflicts of interest. n8

Section 310(b) creates as a required part of the indenture provisions an elaborate mechanism for resignation or removal of the trustee that has or acquires one of the enumerated conflicts. n9 If a default has occurred, the trustee must, within 90 days after it ascertains that it has a prohibited conflict of interest, either eliminate the conflict or resign. The resignation is effective upon appointment of a successor and the successor's acceptance of appointment. The obligor must take prompt steps to have a successor appointed.

If the trustee fails to resign, it must notify the indenture security holders of this within ten days after the expiration of the 90-day resignation period. Finally, any person who has owned the indenture securities for at least six months may petition a court for removal of a trustee that has not eliminated a prohibited conflict of interest, and for appointment of its successor, if the trustee has not submitted its required resignation after the security holder has requested it in writing. n10 If, however, the default which has triggered the trustee's duty to resign may be cured or waived and does not involve failure to pay principal, interest, or any sinking or purchase fund installment, the trustee may petition the Commission to delay its obligation to resign. The trustee's application must describe the procedures available under the indenture for eliminating the default, and the trustee must sustain the burden of proving both that the default may be cured or waived during a reasonable period and that a stay will not be inconsistent with the interests of indenture security holders. The filing of the application automatically stays the trustee's duty to resign until the Commission orders otherwise. n11 Rules 10b-4 to 10b-6 set out the application procedures, including provisions for publication of notice so that interested persons may submit information bearing on the desirability of holding a hearing on the application. n12

When securities are privately placed, but issued under an indenture in anticipation of a later resale to the public that will require indenture qualification, the indenture provisions reflecting the requirements of Section 310(b), as well as those mandated by several other Trust Indenture Act sections, traditionally have been conditioned by a "trigger clause." Under this clause, these indenture provisions do not become operative unless and until the indenture is qualified under the Trust Indenture Act. n13 However, once operative, the mandatory provisions must apply to all outstanding securities issued prior to qualification, as well as to any issued later. n14 Since the 1990 amendments to the Act, this same result can be obtained more simply by eliminating physical inclusion of the mandatory terms in the original indenture and relying upon their becoming included by operation of law when the indenture is later qualified. Presumably, upon qualification, the terms included by operation of law would apply to outstanding securities issued under the indenture prior to qualification. n15

[1] Dual Trusteeships

Under Section 310(b)(1), one prohibited conflict after default, with some exceptions, results from the trustee's serving as a trustee under any other indenture relating to other securities of the same issuer. n16 The trustee would find itself representing two groups of claimants competing for the same assets. n17

More precisely, the Section 310(b)(1) prohibition applies to other indenture trusteeships for any "obligor" on the indenture securities. Section 303(12) defines "obligor" as every person who is liable on the security, and if the security is a certificate of interest or participation, as also including every person liable on the underlying securities. n18 Thus, when a parent corporation guarantees the securities of a subsidiary, both corporations are obligors on the securities. n19 In 1987, Section 303(12) was amended to specifically include guarantors as obligors. n20

However, absent a guarantee, Section 310(b)(1) does not generally prohibit the trustee from serving under separate indentures of affiliates. Thus, parent and subsidiary or brother-sister corporations may employ the same trustee for indentures covering their debt securities, since they are different obligors. n21

The multiple trusteeship prohibition is not limited to situations where both indentures are qualified. A conflict would apparently be present when a trustee under a qualified indenture relating to a utility company's bonds, for example, is also trustee under an exempt indenture for industrial revenue bonds issued for the benefit of and guaranteed by the same utility. The utility is a primary obligor as to one issue of bonds and an obligor through its guarantee on the other. n22

The 1990 amendments to Section 310(b) apply the prohibition on multiple trusteeships not only to trusteeships under other indentures, but also to trusteeships for more than one outstanding series of securities issued under a single indenture. A separate series is present when a group of securities issuable under an indenture has the right to vote to take action or direct the indenture trustee to take action, separate from another such group of securities. However, even such a separate vote will not create a separate series if under the indenture all groups of securities rank equally and are wholly unsecured. n23 This definition will not cover typical mortgage bond indentures of public utilities which authorize the issuance of bonds in series, but which do not give separate voting rights to each series. n24 The legislative history indicates that this extension of Section 310(b)(1) to separate series of securities issued under a single indenture merely codified an existing interpretive position of the Commission. n25

In recent years, there have been extensive mergers among U.S. banks. This may make it more difficult than in the past to find separate trustees for multiple indentures. n26

[a] Exceptions and Exemptions from Dual Trusteeship Prohibition. There are several exceptions to the dual trusteeship prohibitions in Section 310(b)(1). Where one indenture relates to collateral trust certificates and the other relates to the securities that are the only collateral under the collateral trust indenture, no conflict is present. n27 Similarly, when the obligor is a real estate company with no substantial unmortgaged assets and two indentures are secured by wholly separate and distinct parcels of real estate, a dual trusteeship is permitted since there would not be later competition for any of the same assets. n28

Subject to express provisions to the contrary in the indenture, Section 310(b)(1)(i) generally permits dual trusteeships for indentures or series that are wholly unsecured and rank equally. The statutory language provides that for a dual trusteeship to be permitted, the indenture must specifically describe the other indentures or series, or else the other indenture must be one which is subsequently qualified under the Trust Indenture Act. However, the SEC staff takes the position that "the technical omission of references to earlier indentures does not prevent reliance on this self-executing exclusion from the conflict of interest provision...." n29 Despite the general exemption, dual trusteeships will not be permitted where the Commission has declared by order that the indentures (or the separate series), even though wholly unsecured and of equal rank, contain provisions which are so likely to involve material conflicts of interest that the dual trusteeships should be prohibited. Normally, the Commission will not enter a disqualifying order declaring that material conflicts of interest are likely to exist unless the securities issued under the different indentures have different priorities or materially different default provisions. n30

The Commission staff has taken the position that a qualified indenture covering debentures remains "wholly unsecured" for purposes of Section 310(b)(1)(i) even though "in-substance defeasance" arrangements have been made to extinguish the debt. n31 Furthermore, the trustee of a defeasance trust which meets the requirements of SFAS No. 76 n32 is not

precluded from also acting as an indenture trustee under another wholly unsecured indenture as a result of acting as defeasance trustee for the same issuer. n33

Even if Section 310(b)(1)(i) is unavailable, subject to express provisions to the contrary in the indenture Section 310(b)(1)(ii) permits a dual trusteeship if the issuer, upon application to the Commission and after opportunity for hearing, sustains the burden of proving that there is not likely to be a conflict of interest. n34 Rule 10b-2 under the Trust Indenture Act streamlines the approval of this application where the prior indenture under which the trustee serves relates to securities that are being refunded by the proceeds of the new indenture securities being issued. In this situation, the dual trusteeship will only be temporary. Under Rule 10b-2, a filed application will be deemed to have been granted unless the Commission orders a hearing within seven days.

After notice and opportunity for hearing, in several other situations the Commission routinely grants applications under Section 310(b)(1)(ii) to permit dual trusteeships. Typically at issue are two unsecured indentures, one previously qualified under the Trust Indenture Act and the other exempt from qualification. The exempt indenture often relates to industrial development bonds n35 or to privately placed debt securities. n36 Section 310(b)(1)(ii) is also available to permit dual trusteeships involving secured debt where conflicts of interest are unlikely to develop. A common situation involves issues of equipment trust certificates or of other debt where the multiple indentures rank *pari passu* and are each secured by separate collateral. n37

In another case, after the issuer filed in bankruptcy under Chapter 11 a trustee under one indenture proposed to become a successor trustee under a second indenture of the issuer. The original trustee, a creditor of the issuer, was forced to resign because the bankruptcy filing constituted a default. n38 Both indentures now in default had almost identical remedy provisions. Since both indentures were unsecured and ranked equally, dual trusteeships would have been permitted under Section 310(b)(1)(i) if the later indenture had specifically described the earlier one. However, it did not. In this situation, the Commission found that a material conflict was unlikely to develop and granted an order under Section 310(b)(1)(ii) permitting the trustee to serve under both indentures. n39

Applications for exemptive relief under TIA Section 310 are one of the few types of documents that are still *required* to be filed with the SEC in paper form rather than being filed electronically through the EDGAR system. n40 No specific form has been promulgated by the Commission for applications under Section 310(b)(1)(ii). The form which most applications take sets out the relevant facts and requests that the Commission issue the appropriate order. Usually the applicant waives its right to a hearing and its right to specify procedures pursuant to Rule 8(b) of the Commission's Rules of Practice. The application is generally accompanied by a draft for the Commission of a public notice of the filing and of the opportunity to request a hearing, and is sometimes accompanied by a draft of an order for granting the application. n41 The SEC staff has advised that three copies of the application should be filed, with at least the original signed. n42

[2] Prohibited Affiliations Between Trustee and Obligor or Underwriters

Conflicts of interest may arise after default from affiliations between the trustee and the issuer of the indenture securities or its underwriters. These affiliations are defined as prohibited conflicts of interest by Sections 310(b)(2), (3), and (4).

Section 310(b)(2) prohibits the trustee or any of its directors or executive officers from being an underwriter for the obligor. This prohibition is not limited to an underwriter for the indenture securities, but also extends to any person who within the prior one-year period was an underwriter of any security of the obligor still outstanding when the determination of underwriter status is made. n43 The potential conflict here stems from the generally close ties between underwriters and management of the issuer, including the underwriter's access to inside information n44 that might be used in trading in the issuer's stock. n45

The term "underwriter" is defined more narrowly in one respect under the Trust Indenture Act than in the Securities Act. Unlike Securities Act Section 2(a)(11), n46 Trust Indenture Act Section 303(4) does not include persons involved in a distribution on behalf of affiliates of the issuer in the definition of "underwriter." n47 Section 310(a)(5), however, as a condition of eligibility separately prohibits the trustee from being an affiliate of the issuer. n48

In *Shop Rite Foods, Inc.*, n49 the Commission staff indicated that a bank's sale to correspondent banks of participations in its loans to the issuer, where the correspondents agree to purchase them for investment, does not constitute the seller bank as an underwriter n50 within Section 303(4) or Section 310(b)(2), since the sales do not constitute a distribution. n51

Section 310(b)(3) defines as a prohibited conflict situations in which the trustee directly or indirectly controls, is controlled by, or is under common control with an underwriter n52 for the obligor. n53 Thus, Section 310(b)(3) prohibits affiliates of the trustee from placing themselves in positions that would constitute a conflict under Section 310(b)(2) if held by the trustee itself. n54 Trust Indenture Act Rule10b-3 sets out procedures whereby a proposed trustee may obtain an advance ruling from the Commission as to whether it is an affiliate of any person who will be named in a registration statement or a Form T-3 n55 as an underwriter for the obligor. n56

Of particular concern under Section 310(b)(3) is the potential conflict created by the presence of foreign investment banking subsidiaries of bank holding companies. If, within one year prior to default, the foreign subsidiary has underwritten securities of the obligor, a commercial bank subsidiary of the same holding company would be required to resign as indenture trustee since a person under common control with the trustee would be an underwriter for the obligor. n57 Where a U.S. parent has guaranteed securities of a foreign subsidiary, a foreign investment banking firm distributing the subsidiary's securities will also be underwriting securities, i.e., the guaranties, of the parent. Thus, after default a bank affiliated with the foreign investment banking firm would be required to resign as indenture trustee for the parent. n58

Conflict of interest problems may also arise because affiliates and bona fide subsidiaries of insured state banks that are not members of the Federal Reserve System are permitted to underwrite corporate securities. n59 Moreover, affiliates and subsidiaries of national banks and state member banks are permitted to engage in limited amounts of underwriting activities. n60 Thus, the potential for affiliation between a trustee and underwriters for an obligor are increased.

Section 310(b)(4) defines, as a prohibited conflict of interest, various interlocks between the trustee and the obligor or its underwriters. n61 With certain exceptions, the trustee and any of its directors or executive officers are precluded from being a director, officer, partner, employee, appointee, or representative of an obligor, or of an underwriter for an obligor who is currently engaged in the business of underwriting. n62

Many of the interpretive problems under Section 310(b)(4) relate to who is a "director" or "executive officer" of the trustee. "Director" is defined in Section 303(5) as a director or any individual performing similar functions for a business, whether or not it is incorporated. The Commission, in a no action letter, after initially taking the contrary position, indicated its view that an emeritus, honorary, or advisory director who is appointed rather than elected, who does not have the right to vote, and who serves merely as an advisor without customary directorial responsibilities would not be a "director" as defined in Section 303(5). n63

"Executive officer" is defined in Section 303(6) to mean "the president, every vice president, every trust officer, the cashier, the secretary, and the treasurer of a corporation, and any individual customarily performing similar functions with respect to any organization whether incorporated or unincorporated, but shall not include the chairman of the board of directors." n64 The Commission, however, has taken the position that the chairman of the board will be considered an "executive officer" where he performs the duties and functions of an executive officer in addition to those of chairman of the board. n65

The Trust Indenture Act does permit a limited number of interlocking directors between the trustee and the obligor. n66 This provision in Section 310(b)(4) stems from Congress' conclusion that some representation of the trustee on the obligor's board is a means by which bondholders can have their interests protected. The concern was that interlocks not be so extensive that representatives of the obligor deter the trustee in its performance of its duties on behalf of security holders. n67

Congress, therefore, permitted interlocks of one director or executive officer each way, with one additional common director if the trustee's board has over nine members. n68 More precisely, Section 310(b)(4)(A) permits one person to be a director, or an executive officer, or both, of the trustee, and a director, or executive officer, or both, of the obligor, so long as the person is not at the same time an executive officer of both. n69 Section 310(b)(4)(B) permits an additional individual to be a director, or executive officer, or both, of the trustee and a director of the obligor, so long as the number of directors of the trustee in office is more than nine.

Section 310(b)(4) prohibits the trustee's directors or executive officers from being an "employee, appointee or representative" of the obligor or its underwriters. While this has been read by the Commission as not prohibiting a person from being an independent contractor, difficult problems have arisen as to directors of the trustee who are lawyers for the obligor or its underwriter. After a period of some confusion on the issue, the Commission finally took the position that a lawyer will not be considered an "employee, appointee or representative" of the obligor or its underwriter unless the lawyer is employed as house counsel, or there are other extenuating circumstances. n70

In one case, the Commission took the position that the prohibition in Section 310(b)(4) on the trustee or its directors or executive officers being a "partner" of the obligor included a prohibition on becoming a "limited partner." n71 With the spread of publicly held limited partnerships, n72 this position may create numerous problems where a limited partnership is an obligor and principals of the trustee, or the trustee in a fiduciary capacity, hold small amounts of the obligor's limited partnership interests. It would seem, despite the Commission's earlier position, that these interests should not disqualify the trustee where holdings of the same amount of stock, if the obligor were a corporation, would not create a prohibited conflict of interest.

Finally, despite the general prohibition on the trustee being an "appointee" or "representative" of the obligor, or its underwriters, Section 310(b)(4)(C) permits the trustee to be designated by any obligor or underwriter to act as transfer agent, registrar, custodian, paying agent, fiscal agent, escrow agent, depositary, or to act in a similar capacity, or to act as trustee so long as the dual trusteeship prohibitions of Section 310(b)(1) are not violated.

[3] Ownership of Trustee's Voting Securities by Obligor, Underwriter, or their Affiliates

Separate from the pre-default prohibition of Section 310(a)(5) on control of the trustee by the obligor and the Section 310(b)(3) prohibition n73 on control of the trustee after default by an underwriter, for the obligor, Section 310(b)(5) defines as a post-default conflict of interest the beneficial ownership of specific percentages of the trustee's voting securities by the obligor, its underwriters, or certain principals of either.

The beneficial ownership of 10% or more of the trustee's voting securities by the obligor or any one of its directors, partners, or executive officers is a conflict, as is the beneficial ownership of 20% or more, collectively, by any two or more such persons. The same 10% prohibition applies under Section 310(b)(5) to an underwriter n74 for the obligor and to directors, partners, and executive officers of the underwriter, except that collective as well as individual ownership of only 10%, rather than 20%, will also trigger a conflict.

"Voting securities," defined in Section 303(16), are any securities presently entitling one to vote in the direction or management of a company's affairs, or any voting trust certificate or similar security whereby trustees or agents of the security holder are presently entitled to so vote. Computation of the percentage of voting securities owned is aided by directives in Section 303(16) and Rule 10b-1. The percentage of voting securities is calculated in relation to the

aggregate votes of all outstanding voting securities. n75 Outstanding securities are those issued and not held by or for the account of the issuer. Securities placed in escrow by the issuer are not counted as outstanding unless a person other than the issuer is entitled to vote them. n76

"Beneficial ownership" of securities has been defined by the Commission so that a person is generally treated as beneficially owning securities held in the name of his or her spouse and their minor children, since usually a person receives benefits substantially equivalent to ownership from those securities. n77 Also, a person is treated as beneficially owning securities held in the name of any other person where by reason of contract, understanding, relationship, agreement, or other arrangement he receives benefits substantially equivalent to ownership of the securities. n78 A rebuttable presumption of a person's beneficial ownership exists as to securities held in the name of relatives or spouse's relatives who share the person's home. n79 Finally, regardless of other indicia, a person is the beneficial owner of any securities as to which he can vest or revest title in himself either at once or at some future time. n80

[4] Direct or Indirect Ownership by Trustee of Securities of Obligor and Underwriters

Sections 310(b)(6), (7), and (8) of the Trust Indenture Act define, as post-default conflicts of interest, certain beneficial ownership of securities by the trustee and certain holdings by it of securities as collateral for an obligation which is in default. These holdings do not disqualify a trustee from serving prior to default. n81 These post-default prohibitions apply variously to securities of the obligor, its affiliates, and its underwriters. Some of these prohibitions apply to ownership of any class, including debt securities and non-voting stock, while others apply only to ownership of voting securities. However, none of the prohibitions apply to holding or ownership of any note or other evidence of indebtedness issued in connection with a bank loan, or any certificate of interest or participation in such instruments. The prohibitions apply only to securities generally known as corporate securities. n82

Prohibited ownership of the obligor's securities by the trustee is covered by Section 310(b)(6). A conflict exists if the trustee owns beneficially n83 or holds as collateral for an obligation that is in default either 5% or more of the obligor's voting securities, or 10% or more of any other class of the obligor's securities (other than securities issued under the subject indenture and under any other indenture as to which it serves as trustee). n84 A conflict also exists if the trustee similarly owns or holds 10% or more of any class of security of an underwriter n85 for the obligor.

Sections 310(b)(7) and (8) deal with securities of particular affiliates of the obligor. Section 310(b)(7) relates to securities of a person who, to the knowledge of the trustee, either owns 10% or more of the obligor's voting securities, or directly or indirectly controls or is under common control with the obligor. n86 The trustee has a conflict of interest if it beneficially owns or holds as collateral for an obligation that is in default 5% or more of the voting securities of such an affiliate.

Section 310(b)(8) relates to securities of any person who, to the knowledge of the trustee, owns 50% or more of the obligor's voting securities. The trustee has a conflict of interest if it beneficially owns, or holds as collateral for an obligation in default, 10% or more of any class of such parent's securities.

In applying the provisions of Sections 310(b)(6), (7), and (8), as to voting securities, the definitions and computational rules discussed with regard to the ownership of the trustee's voting securities by the obligor apply. n87 In determining whether the prohibited percentage ownership of other classes of securities, as well as of voting stock, exists, Trust Indenture Act Rule 10b-1 gives additional assistance. Percentages are to be computed in relation to:

- (1) the number of shares outstanding for classes of stock;
- (2) the principal amount outstanding for classes of debt securities; and

(3) the number of units outstanding for classes of other securities. n88

Securities are of the same class if they confer substantially the same rights and privileges. Where secured evidences of indebtedness are issued under a single indenture, differences in interest rates and maturity dates of various series are not sufficient to create different classes. Similarly, different classes are not created by interest or maturity variations in unsecured debt, whether or not issued under a single indenture. n89

In determining the principal amount of securities outstanding, computations are to exclude:

- (1) securities of an issuer held in a sinking fund relating to the same class;
- (2) securities held in a sinking fund relating to another class if that other class is not in default as to principal, interest or otherwise;
- (3) securities pledged by the issuer as security for an obligation of the issuer not in default as to principal, interest, or otherwise; and
- (4) securities held in escrow if placed in escrow by the issuer and, as to voting securities, if no person other than the issuer is entitled to vote them. n90

In determining whether the trustee holds collateral for an obligation that is in default, "default" includes only a default in principal that has continued for thirty days or more and has not been cured. n91 The trustee is not to be deemed the owner or holder of any security held:

- (1) as collateral that is not in default as so defined;
- (2) as collateral under the indenture to be qualified, irrespective of any default; n92 or
- (3) as agent for collection, custodian, escrow agent, depository, or in any similar representative capacity. n93

[5] Trustee's Ownership of Obligors' or Underwriters' Securities in Fiduciary Capacities

Section 310(b)(9) of the Trust Indenture Act defines when a post-default conflict of interest arises from the trustee's ownership of securities in the capacity of executor, administrator, testamentary or inter vivos trustee, guardian, committee or conservator, or in other similar capacities. However, securities held as agent for collection, custodian, escrow agent, depository, or in a similar representative capacity are not counted for purposes of Section 310(b)(9). n94 A trustee for the obligor's profit sharing plan (assuming it does not have the power to vote shares held by the plan) is subject to the disqualification provisions of Section 310(b)(9) instead of the stricter requirements of Section 310(b)(6). n95

If, on the date of default (as defined in the indenture but exclusive of any grace period or notice requirement) or on any anniversary of such default, the trustee owns in the aggregate in any of these fiduciary capacities 25% or more of the voting securities or of any class of securities which is covered by Sections 310(b)(6), (7), or (8), then a conflict exists. Thus, the trustee may not hold in a fiduciary capacity 25% or more of any of the following:

- (1) the voting securities of an obligor;
- (2) any other class of an obligor's securities (except securities issued under the current indenture and under other indentures for which it is trustee);

- (3) any class of securities of the underwriter for an obligor;
- (4) the voting securities of any person who, to the knowledge of the trustee, owns 10% or more of an obligor's voting securities, or controls or is under common control with an obligor; or
- (5) any class of securities of any person who, to the knowledge of the trustee, owns 50% or more of the obligor's voting securities.

However, a two year grace period applies to securities acquired by the trustee as executor, administrator, or testamentary trustee of an estate, so long as the estate does not itself own an amount in excess of the prohibited 25%.

n96

Section 310(b)(9) requires that promptly after any default and annually thereafter so long as the securities remain in default, the trustee shall make a check of its holdings as of such dates in the various fiduciary capacities covered by the section's prohibitions. While Section 310(b)(9) does not explicitly require any pre-default check of holdings, the requirement in Section 313(a)(2) to report annually the creation of or any material change to a relationship that would create a post-default conflict effectively requires annual pre-default checks on holdings. n97

The 25% trigger under Section 310(b)(9) is unlikely to be exceeded except in the case of banks or trust companies that act as trustees under corporate pension or profit sharing plans that invest heavily in employer securities. In these cases, a crucial issue will be whether the bank is acting under the plan as a true trustee, or whether, instead, it is acting merely as a custodian or in some similar representative capacity so that its stock holdings are not counted against the 25% figure. In response to a no-action letter request posing this issue, the Commission staff refused to take a position on the matter because it was raised in connection with an already-qualified indenture, over which the Commission had no enforcement authority. n98

If the obligor is in default on the payment of principal for interest, a more constraining conflict of interest requirement is triggered by Section 310(b)(9). When a default in principal or interest has continued for thirty days, the trustee shall make a prompt check of its security holdings in its Section 310(b)(9) fiduciary capacities as of the end of the thirty day period. Thereafter, all of its holdings in its fiduciary capacities, whether in sole or joint control, are subject to the lower percentage triggers of Sections 310(b)(6), (7), and (8). This is consistent with Section 316(b)'s special protection of indenture security holders when there has been a payment default. n99

The various definitional and computational rules relating to Sections 310(b)(6), (7), and (8) also apply to Section 310(b)(9). n100

[6] Trustee as Creditor of Obligor

Section 310(b)(10), added in 1990, provides (with limited exceptions) that a conflict of interest exists if, after default, the trustee is or becomes a creditor of the obligor. In enacting this section, Congress stated:

No conflict could be clearer than that between the interests of a trustee with significant loans to a corporate borrower ... and that corporation's bondholders. On default, a trustee/creditor may become a competitor for funds of the corporation and, thus, in a relation adverse to the rights of the bondholders. Because most institutional trustees are commercial banks, a creditor relationship with the obligor is an ordinary occurrence. n101

Indeed Congress recognized that even prior to 1990 when such creditor relationships were permitted, the common practice was for trustee/creditors to resign when a default occurred in recognition of their inability to both fairly

represent indenture security holders and assert their own claims. n102

Prior to 1990, few provisions of the Trust Indenture Act had created so much controversy as those which permitted the indenture trustee to also be a direct creditor of the obligor on the indenture securities. n103 In fact, despite the implicit acceptance of the dual creditor-trustee status, n104 cases indicated that a cause of action existed under state law for breach of fiduciary duty against a trustee-creditor which had collected funds on its own behalf, n105 and similarly, under the Trust Indenture Act itself when the dual status originated through the willful misconduct of the trustee. n106

The conflicts of interest that resulted from dual creditor-trustee status were justified on two pragmatic grounds. First, it was claimed that banning of the dual role would either lead all banks to opt for the more lucrative creditor relationship so that responsible trustees would be unavailable, or else would lead to exorbitant trustee's fees. n107 Second, it was urged that the trustee bank might be the only lender willing to make a "rescue loan" as insolvency approached. n108 The force of these objections to prohibiting the trustee-creditor conflict was largely eliminated when the 1990 amendments to the Trust Indenture Act limited the creditor-trustee's obligation to resign to post-default creditor relationships.

Section 310(b)(10) excludes from the definition of prohibited relationships five of the relationships that are also excluded from the apportionment requirements of Section 311(b). These excluded relationships, described by Congress as "incidental creditor relations ... which ordinarily do not involve opportunity for material conflict with the interests of indenture security holders," n109 are:

- (1) a creditor relationship arising from the ownership or acquisition of securities issued under any indenture, or any security or securities having a maturity of one year or more at the time of acquisition by the indenture trustee;
- (2) a creditor relationship arising from disbursements made in the ordinary course of business in the capacity of trustee under an indenture, transfer agent, registrar, custodian, paying agent, fiscal agent or depositary, or other similar capacity;
- (3) a creditor relationship arising from an indebtedness created as a result of services rendered or premises rented, or from an indebtedness created as a result of goods or securities sold in a cash transaction as defined in the indenture;
- (4) a creditor relationship arising from the ownership of stock or other securities of an Edge Act corporation where that corporation is a creditor of the obligor on the indenture securities; and
- (5) a creditor relationship arising from the acquisition, ownership, acceptance, or negotiation of any drafts, bills of exchange, acceptances, or obligations which are self-liquidating paper as defined in the indenture. n110

FOOTNOTES:

(n1)Footnote 1. The legislative history of this provision indicates that it merely embodies the conflict prohibition that, prior to 1990, was found in TIA § 310(b)(2). S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., p. 48. In fact, the pre-1990 prohibition was narrower, applying only to the obligor and any of its directors or executive officers. In *Daimler-Benz Aktiengesellschaft*, SEC Rel. No. 39-2353 (Apr. 25, 1997), 1997 LEXIS 909, the SEC granted an exemption from the provisions of § 310(a)(5) where the trustee was the registered owner of the obligor's stock under its American Depositary Receipt program, but did not have discretion to vote or transfer those shares.

(n2)Footnote 2. S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., p. 33.

(n3)Footnote 3. For a criticism of this approach, see Efrat Lev, *The Indenture Trustee: Does It Really Protect Bondholders*, 8 *U. Miami Bus. L. Rev.* 47 (1999).

(n4)Footnote 4. S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., pp. 32-33, 48-49; Memorandum of the Securities and Exchange Commission in Support of the Trust Indenture Reform Act of 1987, C.C.H. Fed. Sec. L. Rep. P 84,205.

(n5)Footnote 5. In enacting the 1990 amendments to Section 310(b), the Senate Committee Report stated that the disqualification requirements of the original TIA were "an outgrowth of the 1936 Report and reflected Congress' concern about instances of abuses involving relationship between the obligor and the trustee. However, each of the instances of abuse cited in the 1936 Report arose in situations in which there had been a default on the bonds. In the cases described in the Report, the trustees took steps to protect their own financial interests, instead of protecting the interests of the bondholders. There is no indication in the legislative history of the TIA that Congress was concerned about abuses by trustees prior to a default." S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., p. 32.

(n6)Footnote 6. S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., pp. 33, 49.

(n7)Footnote 7. *Meckel v. Continental Resource Co.*, 758 F.2d 811, 816, C.C.H. Fed. Sec. L. Rep. P 91,980 at p. 90,885-86 (2d Cir. 1985) (An indenture trustee is not subject to the ordinary trustee's duty of undivided loyalty.). See Friedman, *Updating the Trust Indenture Act*, 7 *U. Mich. J. L. Reform* 329, 332-44 (1974); J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 52 (2d ed., 1975).

(n8)Footnote 8. See SEC Manual--Trust Indenture Act of 1939 at pp 10-11, discussing and quoting legislative history in this regard. Two lines of cases suggest routes of attack on alleged conflicts that are not enumerated in Section 310(b). One line suggests that the Trust Indenture Act itself creates liability when the circumstances under which the conflict of interest was created constituted willful misconduct. See *In re Equity Funding Corp. of America Securities Litigation*, 416 F. Supp. 161, 203 (C.D. Cal. 1976); *Morris v. Cantor*, 390 F. Supp. 817, C.C.H. Fed. Sec. L. Rep. P 94,996 (S.D.N.Y. 1975). See § 8.19 *infra*. The other line recognizes that state law may impose additional fiduciary obligations on indenture trustees. See, e.g., *Broad v. Rockwell International Corp.*, 614 F.2d 418, 431-32, C.C.H. Fed. Sec. L. Rep. P 97,326 at pp. 97,192-93, *aff'd en banc*, 642 F.2d 929, C.C.H. Fed. Sec. L. Rep. P 97,956 (5th Cir. 1980), *cert. denied*, 454 U.S. 965 (1981); Cf. *In re North American Acceptance Corp. Securities Cases*, 513 F. Supp. 608, 639, C.C.H. Fed. Sec. L. Rep. P 97,961 at p. 90,941 (N.D. Ga. 1981). The tension between these holdings and the typical indenture provision, permitted by Section 315(a), which limits the trustee's liability for pre-default conduct to breaches of those duties specifically set out in the indenture, is discussed in § 8.15[2] *infra*. The present discussion is limited to the conflict of interest provisions of Section 310(b) itself.

(n9)Footnote 9. TIA Section 310(b) applies to "any indenture trustee," not just to the institutional trustee. Thus, it would apply to any co-trustee.

(n10)Footnote 10. Removal of the trustee is discussed further in § 8.12 *supra* and § 8.18[6] *infra*.

(n11)Footnote 11. See first paragraph and penultimate paragraph in TIA § 310(b). Also see, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 208.03, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n12)Footnote 12. See Rules and Forms to Implement the Trust Indenture Reform Act of 1990, Securities Act Rel. No. 6892 (May 8, 1991), C.C.H. Fed. Sec. L. Rep. P 84,732.

(n13)Footnote 13. See American Bar Foundation, *Commentaries On Indentures* 263-64 (1971); ABF, *Model Debenture Indenture--All Registered Issues* Section 608 (1967).

(n14)Footnote 14. See SEC, Manual--Trust Indenture Act of 1939 at p. 157 (June 1958).

(n15)Footnote 15. TIA § 318, discussed at § 8.03 *supra*.

Trust Indenture Reform Act, Sec. 8, and Section-by-Section Analysis, C.C.H. Fed. Sec. L. Rep. P 84,205.

(n16)Footnote 16. A company having any debt securities listed on the New York or American Stock Exchange which are not qualified under the Trust Indenture Act is required by each Exchange to have different trustees under each of its indentures, whether or not all of the indentures relate to listed securities. NYSE Listed Company Manual, Sec. 603.01 (July 1998); AMEX Listing Standards, Policies and Requirements, Sec. 811(b) (May 1998).

(n17)Footnote 17. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 52-54 (2d ed., 1975).

(n18)Footnote 18. TIA Section 303(12) excludes from the definition of "obligor" certain merely formal issuers, *i.e.*, trustees who issue certificates of interest or participation, equipment trust certificates or like securities. This parallels the definition of "issuer" in Securities Act Section 2(4), discussed in § 4.02[1] *supra*. See, *e.g.*, CSX Corporation, Seal and Service, Inc. (No Action Letter, Aug. 10, 1987); National Cooperative Services Corp. (No Action Letter, May 3, 1985); Military Sealift Command (No Action Letter, Sept. 26, 1984); Colorado-Ute Electric Association, Inc. (No Action Letter, Sept. 7, 1984), all involving non-recourse issuers in leveraged lease transactions.

Similarly, the formal issuers of equipment trust certificates, *i.e.*, the owner-trustees, are not "indenture trustees" for purposes of the Trust Indenture Act. See World Airways Inc. (No Action Letter, Sept. 12, 1977); Pan American World Airways, Inc., C.C.H. Fed. Sec. L. Rep. P 78,551 (Div. Corp. Fin. 1971); Trans World Airlines, Inc. (No Action Letter, June 10, 1971). *Cf.* United States Trust Company of New York (No Action Letter, June 16, 1975) (no dual trusteeship conflict under TIA Section 310(b)(1) by reason of being an owner-trustee and an indenture trustee in connection with same corporation).

(n19)Footnote 19. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 53 (2d ed., 1975).

(n20)Footnote 20. Securities and Exchange Commission Authorization Act of 1987, Pub. L. 100-181, Sec. 502, 101 Stat. 1249, 1260.

(n21)Footnote 21. Trust Indenture Act Rel. 16, 4 C.C.H. Fed. Sec. L. Rep. 42,318-24 (1941). However, where the parent so dominates the subsidiary that piercing the corporate veil is appropriate, parent and subsidiary may be considered the same obligor. *Id.* Also see, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 106.01, 110.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

For a brief period after 1939, the Commission took a much broader view, construing "obligor" to include subsidiaries and affiliates and similarly taking the position that parents, subsidiaries, and affiliates of the trustee could not serve as trustee under indentures of the same obligor as the trustee. These positions were abandoned in the 1940's. See SEC Manual--Trust Indenture Act of 1939 at pp. 14a-16 (June 1958).

(n22)Footnote 22. *Cf.* Dorsey, Marquart, Windhurst, West & Hallady (No Action Letter, Jan. 16, 1974).

It has been suggested that great care be taken in examining the situation even when there is no formal guarantee, but the credit of an obligor under another indenture is in fact the primary security for payment of the obligations under the subject indenture trusted by the same person. An example is "if corporation A issued securities for the construction of certain facilities to be leased to corporation B, the rental payments being sufficient to service the securities and the lease, and the right to receive the rents being pledged under the indenture." J. Kennedy & R. Landau, *Corporate Trust*

Administration and Management 53-54 (2d ed., 1975).

See Maryland National Bank (No Action Letter, Dec. 26, 1973).

(n23)Footnote 23. See TIA paragraph following § 310(b)(10)).

(n24)Footnote 24. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., p. 49. See Tucson Trust Electric Company (No Action Letter, January 2, 1992).

(n25)Footnote 25. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., p. 49; Memorandum of the Securities and Exchange Commission in Support of the Trust Indenture Reform Act of 1987, C.C.H. Fed. Sec. L. Rep. P 84,205. For discussion of the Commission's previous policy, see SEC, Manual--Trust Indenture Act of 1939 at pp. 12-14 (June 1958). Texas Commerce Bank National Association, C.C.H. Fed. Sec. L. Rep. P 78,163 (Div. Corp. Fin. 1985). While the SEC's policy prior to the 1990 TIA amendments also permitted certain series of separately collateralized securities which ranked equally to be issued under a single indenture with the same trustee even when the series had separate voting rights, the Commission required that such indentures mandate the resignation of the trustee when material conflicts of interest between series arose. Texas Commerce National Association, *supra*. Since a default on one of the series might well have created a conflict of interest, the 1990 TIA amendments which limit prohibitions on dual trusteeships to post-default situations do not seem to substantially narrow the Commission's former position.

(n26)Footnote 26. Robert I. Landau & John E. Krueger, *Corporate Trust Administration and Management* 48 (5th ed., 1998).

(n27)Footnote 27. Trust Indenture Act Section 310(b)(1)(A) and (B).

(n28)Footnote 28. Trust Indenture Act Section 310(b)(1)(C).

(n29)Footnote 29. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 209.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n30)Footnote 30. American Bar Foundation, *Commentaries On Indentures* 266 (1971). Cf. Genesco (No Action Letter, Oct. 18, 1972) (conflict where obligations have different priorities).

(n31)Footnote 31. Sperry Corp. (No Action Letter, April 18, 1984).

(n32)Footnote 32. SFAS is codified at FASB, Accounting Standards Current Text Section D 14 'Debt: Extinguishments.' The Commission's discussion of SFAS No. 76 is found in its Codification of Financial Reporting Policies, Section 217, 'Accounting for Extinguishment of Debt,' C.C.H. Fed. Sec. L. Rep. P 73,061. In its discussion, the Commission states that while SFAS No. 76 does not specify the eligibility requirements for a defeasance trustee, the Commission believes that the FASB standard contemplates that the trustee should be independent of the issuer. The Commission further states: 'Trustees that meet the eligibility requirements for trustees under Sections 310(a)(1) and 310(a)(2) of the Trust Indenture Act of 1939 ..., for example, will be presumed by the Staff of the Commission to be appropriate [defeasance] trustees.'

(n33)Footnote 33. Sperry Corp. (No Action Letter, April 18, 1984).

(n34)Footnote 34. See, e.g., Altos Hornos De Mexico, SEC Release No. 39-2379 (Nov. 17, 1999); *In the Matter of Cambridge Building Corp.*, 14 S.E.C. 651 (1943) ; *In the Matter of Prudence-Bonds Corp.*, 15 S.E.C. 521, C.C.H. Fed. Sec. L. Rep. P 75,432 (1944) . Cf. Hawaiian Electric Co., Inc. (No Action Letter, Oct. 11, 1971) (permitting use of this procedure to eliminate a conflict that developed under a previously qualified indenture when trustee acquired dual trusteeship through obligor's guarantee of its subsidiary's securities under a later unqualified indenture).

(n35)Footnote 35. *See, e.g.,* Application of Standard Oil Company (Indiana), Aug. 25, 1983 (File No. 22-12701); Application of Hospital Corporation of America, Aug. 12, 1983 (File No. 22-12683). The exemption for industrial development bonds is discussed in § 8.06[2] *supra*.

(n36)Footnote 36. The exemption for private placements is discussed in § 8.07 *supra*.

(n37)Footnote 37. *See, e.g.,* Application of American Airlines Inc., Dec. 29, 1981 (File No. 22-11486). Equipment trust certificates are discussed in § 8.01 *supra* and § 8.13[1] *supra*.

(n38)Footnote 38. *See* § 8.13[6], *infra*.

(n39)Footnote 39. *Application and Opportunity for Hearing: Armstrong World Industries, Inc.*, SEC Release No. 39-2400, 2002 SEC LEXIS 1821 (July 16, 2002); *Armstrong World Industries, Inc.*, SEC Release No. 39-2401, 2002 SEC LEXIS 2172 (Aug. 20, 2002). For another similar case, see *Application and Opportunity for Hearing: USG Corporation*, SEC Release No. 39-2398, 2002 SEC LEXIS 729 (March 22, 2002); *USG Corporation*, SEC Release No. 39-2399, 2002 SEC LEXIS 1034 (March 22, 2002).

(n40)Footnote 40. Regulation S-T, Rule 101(c)(5).

(n41)Footnote 41. Since August 1982, the Commission has followed the practice of issuing a formal release under the Trust Indenture Act both when a Section 310(b)(1)(ii) application is filed and when it is granted. These brief releases set out little of the factual bases for the applications. The relevant facts can be determined only from the complete applications. From August 1982 until the end of 1983, well over fifty applications under Section 310(b)(1)(ii) were approved by the Commission. The relevant releases are listed in Volume 6 of the C.C.H. Federal Securities Law Reporter.

(n42)Footnote 42. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 208.02, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm> (application should follow TIA Rule 7a-3).

(n43)Footnote 43. TIA Section 310(b) (third from last paragraph).

See American Bar Foundation, *Commentaries On Indentures* 268 (1971), citing to SEC Trust Indenture Act Rel. 6; *In the Matter of Shell Union Oil Corp.*, 8 S.E.C. 520 (1941) as to underwriters of securities to be issued under the indenture being qualified. *See also* SEC Manual--Trust Indenture Act of 1939 at pp. 50-52 (June, 1958).

(n44)Footnote 44. *Cf. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, C.C.H. Fed. Sec. L. Rep. P 94,473 (2d Cir. 1974).

(n45)Footnote 45. *See* Friedman, "Updating the Trust Indenture Act," 7 *Univ. Mich. J. L. Reform* 329, 334 (1974).

(n46)Footnote 46. Securities Act Section 2(11) is discussed in § 4.02[2] *supra*.

(n47)Footnote 47. TIA Rules 3(4)-1, 3(4)-2, and 3(4)-3 further elaborate on the definition of "underwriter." They generally parallel Securities Act Rules 140, 141 and 142.

(n48)Footnote 48. The narrower definition in TIA Section 303(4) was directed primarily at limiting the Trust Indenture Act's qualification provisions to primary distributions. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 39 (1939).

See § 8.04 *supra*, for discussion of the Act's focus on primary distributions and sales by persons acting as conduits for the issuer.

(n49)Footnote 49. Shop Rite Foods, Inc. (No Action Letter, Aug. 21, 1975).

2-8 Federal Securities Act of 1933 § 8.13

(n50)Footnote 50. This is consistent with the holding in *Securities Industry Association v. Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986) , *cert. denied*, 107 S. Ct. 3228 (1987) .

(n51)Footnote 51. *Cf.* TIA Section 310(b) (fourth from last paragraph, clause (A)), which excludes from the definition of "security" any "evidence of indebtedness issued to evidence an obligation to repay moneys lent to a person by one or more banks, trust companies or banking firms. ..."

(n52)Footnote 52. TIA Section 310(b) (third from last paragraph) defines "underwriter" for purposes of Section 310(b) to include only a person "who, within one year prior to the time as of which the determination is made, was an underwriter of any security of such obligor outstanding at the time of determination." The current underwriters of the securities under the indenture being qualified are also included. *See* SEC Manual--Trust Indenture Act of 1939 at pp. 50-52 (June 1958); *In the Matter of Shell Union Oil Corp.*, 8 S.E.C. 520 (1941) ; American Bar Foundation, *Commentaries On Indentures* 268 (1971). Prior to the 1990 amendments, "underwriter" included all persons who had acted as an underwriter within *three* years before the time the determination was made. This change was intended to "recognize that relationships between obligors and investment brokers lack the permanency they had in the nineteen thirties." S. Rep. No. 101-155 (1989), 101st Cong., 1st Sess., p.33.

The Trust Indenture Act does not define persons who sell on behalf of affiliates to be underwriters of the obligor.

(n53)Footnote 53. TIA Rule 0-2 defines "control" as "the power to direct the management and policies of a person, directly or through one or more intermediaries, whether through the ownership of voting securities, by contract, or otherwise."

TIA Rule 7a-26 permits the applicant in a Form T-3 and the trustee in a Form T-1 to disclaim control if the question is open to reasonable doubt. However, the facts that are material to the question must be disclosed if control is disclaimed.

TIA Section 310(b) (third from last paragraph) requires the indenture to provide that the percentage ownership figures in Sections 310(b)(5)-(9), discussed in § 8.13[3] and § 8.13[4] *infra* , are not relevant to the issue of control under Section 310(b)(3).

(n54)Footnote 54. If debt securities, whether or not qualified under the Trust Indenture Act, are listed on the New York Stock Exchange, the NYSE prohibits affiliates from serving as trustee. NYSE Listed Company Manual, Sec. 603.01 (June 1983).

(n55)Footnote 55. Form T-3 is discussed in § 8.11[1] *supra*.

(n56)Footnote 56. *See J.P. Morgan & Co., Inc.*, 10 S.E.C. 119 (1941) .

The Commission also has permitted Rule 10b-3 to be used to determine whether any Section 310(b)(6) conflicts between the proposed trustee and underwriter exist. *Id.* at 150 .

(n57)Footnote 57. *See* J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 56 (2d ed., 1975).

(n58)Footnote 58. *Baxter Laboratories, Inc.*, C.C.H. Fed. Sec. L. Rep. P 78,575 (Div. Corp. Fin. 1971). *Cf.* ALI, *Federal Securities Code* at pp. 500-501 (Comment (2)) (1980).

(n59)Footnote 59. 12 CFR § 337.4 (1993). A temporary limitation on new activities of this sort, enacted as part of the Competitive Equality Banking Act of 1987, Pub. L. 100-86, 101 Stat. 552, § 103, has expired.

(n60)Footnote 60. *See Securities Industry Association v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988) , *cert. denied*, 486 U.S. 1059 (1988) . A temporary moratorium on authorizing such activities,

enacted as part of the Competitive Equality Banking Act of 1987, Pub. L. 100-86, 101 Stat. 552, § 201(b), has expired.

(n61)Footnote 61. For the limited definition of underwriter for these purposes, see § 8.13[2] *supra*.

(n62)Footnote 62. TIA Section 310(b)(4) excludes from its operation interlocks between the trustee and an underwriter where the underwriter is the trustee itself. However, since Section 310(b)(2) prohibits the trustee from being an underwriter for the obligor, this exclusion in Section 310(b)(4) appears to be irrelevant.

(n63)Footnote 63. Wells Fargo Bank (American Bankers Association), C.C.H. Fed. Sec. L.Rep. P 77,029 (Div. Corp. Fin. 1981), *reversing position in* Wells Fargo Bank, C.C.H. Fed. Sec. L. Rep. P 76,438 (Div. Corp. Fin. 1980).

(n64)Footnote 64. *Cf.* Securities Exchange Act Rule 3b-7 defining "executive officer" for purposes of the Exchange Act.

(n65)Footnote 65. Trust Indenture Act Rel. 225, C.C.H. Fed. Sec. L. Rep. P 77,285 (1965).

(n66)Footnote 66. Even limited interlocks between the underwriter and the trustee are prohibited. This reflects the policy of the National Banking Act, 12 USC § 78, which prohibits such interlocks. *See* SEC, Manual--Trust Indenture Act of 1939 at p. 37 (June 1958).

(n67)Footnote 67. Friedman, "Updating the Trust Indenture Act," 7 *U. Mich. J. L. Reform* 329, 335-36 (1974).

(n68)Footnote 68. *See* Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 47 (1939).

(n69)Footnote 69. If debt securities are listed on the New York Stock Exchange, whether or not they are qualified under the Trust Indenture Act, the NYSE prohibits the trustee from being an organization in which an officer of the issuing company is an executive officer. NYSE Listed Company Manual, Sec. 603.01 (June 1983).

(n70)Footnote 70. *See* Trust Indenture Act Rel. 35, C.C.H. Fed. Sec. L. Rep. (1947); SEC Manual--Trust Indenture Act of 1939 at pp. 39-43 (June 1958).

(n71)Footnote 71. *See* SEC Manual--Trust Indenture Act of 1939 at p. 43 (June 1958).

(n72)Footnote 72. *See* Million & Bolding, "Metamorphosis: Liquidation of the Corporation into a Publicly Traded Limited Partnership," 38 *Bus. Law.* 1487 (1983).

(n73)Footnote 73. *See* TIA Section 310(b)(4) (fifth from last paragraph).

(n74)Footnote 74. For the limited definition of "underwriter" for these purposes, §8.13[2] *supra*.

(n75)Footnote 75. TIA Section 303(16) and TIA Rule 10b-1(a), (c).

(n76)Footnote 76. TIA Rule 10b-1(d) relating to determining the amount of securities outstanding when they are pledged by the issuer or held in its sinking fund are discussed in § 8.13[4] *infra*.

(n77)Footnote 77. Trust Indenture Act Rel. 227, C.C.H. Fed. Sec. L. Rep. P 26,031-32 (1966).

(n78)Footnote 78. *Id.*

(n79)Footnote 79. *Id.*

(n80)Footnote 80. *Id.*

(n81)Footnote 81. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 208.01,

(March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n82)Footnote 82. TIA Section 310(b) (fourth from last paragraph, clause (A)).

(n83)Footnote 83. See *Merchants National Bank & Trust Co.*, C.C.H. Fed. Sec. L. Rep. P 79,442 (SEC, 1990) (raising question of definition of beneficial ownership under § 310(b)(6)).

(n84)Footnote 84. Typically, qualified indentures contain a provision explicitly permitting the trustee, paying agent, registrar, and other company agents to be the owners or pledgees of indenture securities. See ABF, *Model Debenture Indenture--All Registered Issues*, Section 605 (1967), discussed in American Bar Foundation, *Commentaries On Indentures* 259-60 (1971); Revised Model Simplified Indenture, Section 7.03, *55 Bus. Law. 1115, 1141* (2000).

(n85)Footnote 85. For the limited definition of "underwriter" for these purposes, see §8.13[2] *supra*.

(n86)Footnote 86. TIA Section 310(b) (fifth from last paragraph) provides that determination of control under Section 310(b)(7) are to be made without any presumptions arising from the percentages specified in Sections 310(b)(5)-(9).

(n87)Footnote 87. See § 8.13[3] *supra*.

(n88)Footnote 88. TIA Rule 10b-1(b), (c).

(n89)Footnote 89. TIA Rule 10b-1(e).

(n90)Footnote 90. TIA Rule 10b-1(d).

(n91)Footnote 91. TIA Section 310(b) (fourth from last paragraph, clauses (B), (C)).

(n92)Footnote 92. See, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 211.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n93)Footnote 93. TIA Section 310(b) (fourth from last paragraph, clause (C)).

(n94)Footnote 94. TIA Section 310(b) (fourth from last paragraph, clause (C)). The same rule applies to computations under Sections 310(b)(6), (7), and (8) as well as (9), as discussed in § 8.13[4] *supra*.

(n95)Footnote 95. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 210.01, 212.01 (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n96)Footnote 96. TIA Section 310(b)(9).

(n97)Footnote 97. Section 313(a) is discussed at § 8.15[1] *infra*.

(n98)Footnote 98. *Bankers Trust Company*, C.C.H. Fed. Sec. L. Rep. P 77,028 (Div. Corp. Fin. 1981).

(n99)Footnote 99. Section 316(b) is discussed in § 8.18[3] *infra*.

(n100)Footnote 100. See § 8.13[4] *supra*.

(n101)Footnote 101. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., pp. 33-34.

(n102)Footnote 102. *Id.* at p. 34 .

(n103)Footnote 103. See, e.g., Johnson, *The Forgotten Securities Statute: Problems in the Trust Indenture Act*, 13

U. Tol. L. R. 92, 101-08 (1981); ALI, Federal Securities Code 502-03 (1980); Smith, Case & Morison, *The Trust Indenture Act of 1939 Needs No Conflict of Interest Revision*, 35 *Bus. Law.* 161 (1979); Campbell & Zack, *Put a Bullet in the Poor Beast. His Leg is Broken and His Use is Past. Conflict of Interest in the Dual Role of Lender and Corporate Indenture Trustee: A Proposal to End It in the Public Interest*, 32 *Bus. Law.* 1705 (1977); Friedman, *Updating the Trust Indenture Act*, 7 *Univ. Mich. J. L. Reform* 329, 340-44, 354-56 (1974).

(n104)Footnote 104. *But see* *Mintener v. Michigan National Bank*, 117 *Mich. App.* 633,324 *N.W.2d* 110 (1982) .

(n105)Footnote 105. *Dabney v. Chase National Bank of the City of New York* 201 *F.2d* 635 (2d Cir.) , *cert. dismissed*, 346 *U.S.* 863 (1953) ; *Dunn v. Reading Trust Co.* 121 *F.2d* 854, 2 *S.E.C. Jud. Dec.* 378 (3rd Cir. 1941) .

(n106)Footnote 106. *In re Equity Funding Corp. of America Securities Litigation*, 416 *F. Supp.* 161, 203 (C.D. Cal. 1976) ; *Morris v. Cantor*, 390 *F. Supp.* 817, *C.C.H. Fed. Sec. L. Rep. P* 94,996 (S.D.N.Y. 1975) .

(n107)Footnote 107. *See* Smith, Case & Morison, "The Trust Indenture Act of 1939 Needs No Conflict of Interest Revision," 35 *Bus. Law.* 161, 165-66 (1979); J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 65 (2d ed., 1975).

(n108)Footnote 108. *See* Friedman, "Updating the Trust Indenture Act," 7 *Univ. Mich. J. L. Reform* 329, 341-42 (1974).

(n109)Footnote 109. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., p. 49.

(n110)Footnote 110. The scope of these incidental creditor relationships are discussed more fully at § 8.17[3] *infra*



128 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.14

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.14 Duties of Obligors to Trustee

Under every qualified indenture the obligor must furnish to the indenture trustee: bondholder lists; furnish copies of Exchange Act reports, annual certification of compliance with conditions and covenants; evidence of recording the indenture and compliance with any conditions precedent; and certificates of fair value. A parent that guarantees a subsidiary's debt securities is an "obligor" under the indenture, and so must also furnish these reports. n1 Permissive provisions obligating the issuer to furnish the trustee other evidence of compliance with indenture conditions and covenants may also be included in the indenture.

The Trust Indenture Act imposes upon each obligor certain duties to the indenture trustee.

[1] Furnishing Bondholders Lists

Section 312(a) of the Trust Indenture Act requires each obligor to furnish current bondholder lists to the trustee. At stated intervals of not more than six months, and at such other times as the trustee may request in writing, each obligor is required to furnish or cause to be furnished to the institutional trustee all information possessed by itself and its paying agents as to the names and addresses of the indenture security holders. Despite the six month requirement, qualified indentures often do not require the first list until more than six months after the date the indenture is qualified, but use a six month interval for subsequent lists. n2 Typically indentures peg the date for furnishing bondholder lists to the semiannual interest payment dates. n3

The indenture trustee must also preserve all the information furnished to it or received by it when it acts itself as paying agent n4 in as current a form as is reasonably practicable. n5

When the Trust Indenture Act was drafted, bonds were generally issued in bearer form, but Internal Revenue Code regulations required bondholders to file ownership certificates with the paying agent when presenting coupons for payment. n6 It was this information that Congress assumed would be turned over to the trustee. n7 Typically, indentures

for bonds in bearer form call for bondholder lists to be furnished to the trustee from 45 to 60 days after the interest payment dates. n8 The requirement for the filing of ownership certificates by holders of corporate bonds was eliminated in 1942 to reduce the massive paperwork burden that it had imposed. n9 This eliminated the only reliable source for the compiling of bondholder lists for bonds in bearer form. After 1942, information in the possession of the obligor and its paying agents as to the holders of bearer bonds was often incomplete. n10

The movement, in recent years, to fully registered bonds has again created an accurate source for bondholder lists. n11 Usually the trustee is also named registrar for the indenture securities, so that there is little if any additional information to be furnished to it under the Section 312(a) indenture provisions. n12 When the trustee is not the registrar, bondholder lists are available rapidly, and generally indentures require them to be furnished to the trustee either on or before the interest payment dates, n13 or not more than 15 days after such dates. n14

In private placements, where the securities are issued under an indenture in contemplation of later resale to the public, traditionally the requirements of Section 312(a) were made subject to a "trigger clause" that made them operative only if the indenture was later qualified under the Trust Indenture Act. n15 Since the 1990 amendments to the Act, this same result can be obtained more simply by eliminating physical inclusion of the mandatory terms in the original indenture and relying upon their becoming included by operation of law when the indenture is later qualified. n16

[2] Furnishing Copies of Exchange Act Reports and Annual Certificates of Compliance

Under Section 314(a)(1) of the Trust Indenture Act, each obligor must file with the trustee copies of all periodic reports required by Section 13 or Section 15(d) of the Securities Exchange Act. n17 Thus, every current report on Form 8-K, quarterly report on Form 10-Q, and annual report on Form 10-K is to be filed with the trustee. n18 Sometimes indentures call for the reports to be sent to the trustee within 15 days after they are required to be filed with the Commission. n19 Other indentures call for the reports to be sent to the trustee within 15 days after they are actually filed with the SEC. n20 The drafters of the Revised Model Simplified Indenture suggest that Section 314(a)(1) may permit electronic transmission of these reports to the trustee, if the trustee agrees to receive them in electronic form. n21

Courts have held that Section 314(a)(1) does not impose an independent obligation that 1934 periodic reports be filed on time. The section merely requires that the obligor file with the trustee those reports that it has in fact filed with the SEC. Thus failure to file a timely Form 10-K, 10-Q or 8-K is not a breach of the TIA or of an indenture covenant that generally requires compliance with the TIA. It is only a breach of a covenant if the indenture language sets a time frame for filing or transmission of periodic reports to the trustee. n22

Since the 1990 amendments to the Act, Section 314(a)(4) also requires each obligor to furnish the trustee at least annually a certificate regarding the obligor's compliance with all conditions and covenants under the indenture. A brief certificate from the obligor's principal executive officer, principal financial officer, or principal accounting officer as to his or her knowledge of the obligor's compliance satisfies the requirement. Compliance is to be determined without regard to any grace period or notice requirement provided under the indenture, the same manner in which default is determined for purposes of triggering the conflict of interest provisions under Section 310(b). n23 At least one court has held that the statutory requirement as to the officer who must furnish an annual certificate refers to job functions, not to formal titles. It is the individual who is in fact functioning as the principal executive, financial or accounting officer who must sign. n24

The obligor must also comply in the future with certain other information-furnishing requirements, if the Commission should decide to exercise its rulemaking authority under Section 314(a). n25 The Commission is given rulemaking power to:

- (1) require obligors that are not subject to the continuous reporting requirements of the Exchange Act to nevertheless file Exchange Act Section 13 reports, *i.e.*, Forms 8-K, 10-Q, and 10-K, with the

Commission and the trustee; n26

(2) require obligors to file with the trustee and the Commission reports on compliance with indenture conditions and covenants beyond the reports required by Section 314(a)(4), including annual accountants' reports on certain matters; n27 and

(3) require obligors to send to the indenture security holders summaries of Exchange Act reports and any other reports that Commission rules require the obligor to file with the trustee. n28

The Trust Indenture Act permits the Commission to promulgate these reporting rules and make them applicable to indentures that have been qualified in the past, as well as to newly qualified ones. n29 The Commission has not adopted any rules under these enabling provisions. n30 However, in a less direct manner, it has required the issuer to report any material defaults under the indenture to the trustee. Virtually all issuers of securities covered by the Trust Indenture Act are also subject to the continuous reporting requirements of Section 13 or 15(d) of the Securities Exchange Act. Both quarterly reports on Form 10-Q, and the financial statements in the Form 10-K annual reports must include information on defaults. As discussed above, copies of all Form 10-Q and 10-K reports must in turn be filed with the trustee.

Specifically, Item 3 of Form 10-Q requires reporting of any material default in payment of principal, interest, a sinking or purchase fund installment, or any other material default not cured within 30 days, if the indebtedness involved exceeds 5% of the total assets of the issuer and its consolidated subsidiaries. The Form 10-Q must identify the indebtedness, state the nature of the default, and indicate as to any default in the payment of principal, interest, or a sinking or purchase fund installment, the amount of the default and total arrearages to date. Disclosure is required only when occurrences have matured into events of default through the expiration of any grace period and compliance with any notice requirements. n31

In Form 10-K, the notes to the financial statements must reflect the information called for in Rule 4-08(c) of Regulation S-X. n32 This rule specifies disclosure of facts and amounts relating to any default in principal, interest, sinking fund or redemption provisions, or any breach of indenture covenants that existed as of the balance sheet date and were not subsequently cured. Also, information about any waiver of acceleration of the indebtedness must be furnished.

Private placements under indentures that may later be qualified traditionally used a trigger clause to delay the applicability of the Section 314(a) provisions. n33 Since the 1990 amendments to the Act, this same result can be obtained more simply by eliminating physical inclusion of the mandatory terms in the original indenture and relying upon their becoming included by operation of law when the indenture is later qualified. n34 When this is done, other covenants will often be negotiated to take immediate effect to assure the furnishing of information to the lenders about the issuer. n35

[3] Furnishing Evidence of Recording and Compliance with Conditions Precedent

Where the indenture is secured by a mortgage or pledge of property, Section 314(b) requires the obligor to furnish the trustee with evidence of proper recording of the indenture. Promptly after the execution and delivery of the indenture, an opinion of counsel (who may be counsel for the obligor) must be delivered to the trustee. The opinion must state either that the indenture has been properly recorded and filed so as to make its lien effective, giving the details of the filing, or else, the opinion must state that no recording is necessary to make the lien effective. A similar opinion of counsel must be furnished annually to evidence any re-recording and re-filing necessary to maintain the lien, or to indicate that this action is not necessary. n36 When the indenture securities are secured by a lien on personal property, presumably the opinions of counsel should focus on whether UCC-1 financing statements have been filed in order to perfect the lien, rather than on whether the indenture itself has been properly recorded. n37

Under Section 314(c), whenever the obligor requests the trustee to take any action under the indenture, such as

authenticating and delivering securities, n38 releasing or substituting (or both) mortgaged property, n39 or satisfying and discharging securities, n40 the obligor must furnish the trustee with evidence that all relevant conditions precedent have been met. n41 The evidence, detailed by Section 314(c), must consist of both a certificate by officers who are specified in the indenture, n42 and an opinion of counsel (who may be counsel for the obligor). In some situations, an accountant's certificate must also be furnished.

The language of Sections 314(c)(1) and (2), requiring officers' certificates and opinions of counsel, calls for each person to state that in his opinion there has been compliance with the relevant conditions precedent. However, as a practical matter, in giving such an opinion, officers must rely on counsel for legal matters, and counsel must rely on the officers for particular facts. Both must rely on accountants and engineers for other data. The Commission permits the indenture to include language stating that opinions may be based on representations of various experts, or on representations of officers as to facts in the possession of the company. This reliance will not be permitted, however, where the person relying knows, or in the exercise of reasonable care should have known, that the representations on which he relied were erroneous. n43

The requirements in Section 314(c)(3) for an accountant's certificate apply mainly in the context of mortgage bonds. They apply where conditions precedent are subject to verification by an accountant, such as requirements to maintain specified ratios or some amount of net quick assets, or negative pledge clauses. n44 Often, financial covenants in debentures are not drafted as conditions precedent to action by the trustee, and in such situations Section 314(c) is irrelevant. n45

Perhaps the most common situation in which an accountant's certificate may be required is a clause that conditions the issuance of additional series of bonds under an open-end indenture upon a certain ratio of earnings to interest charges having been achieved. n46 Issuance of additional bonds by companies subject to the Public Utility Holding Company Act must meet such a requirement. n47

The requirements of Section 314(c)(3) as to accountants' certificates call for the certificate to be furnished by an independent public accountant selected or approved by the trustee in the exercise of reasonable care when the trustee is called upon to authenticate and deliver substantial amounts of new indenture securities. This added requirement is triggered when the amount of securities authenticated and delivered since the beginning of the calendar year, together with the proposed additional issuance, equals or exceeds 10% of the amount outstanding. Excluded from the 10% computation are indenture securities as to which no accountant's certificate is required and those as to which an independent accountant's certificate has previously been furnished.

As to conditions precedent that involve information apparently thought to be available only to the issuer, Section 314(c) calls only for officers' certificates. This is the case where the condition precedent depends on facts as of a date or period not covered by required annual reports of the obligor. Thus, where an earnings test is applied as a condition precedent to the issuance of additional bonds, no accountant's certificate n48 is required where the relevant period over which earnings are to be measured is different from the period covered in the obligor's last annual report. n49 Further, officers' certificates alone are required as to the adequacy of depreciation, maintenance, or repairs when these are part of a condition precedent. Finally, where a condition precedent involves the amount and value of property additions, Section 314(c) calls only for an officers' certificate plus, where required by Section 314(d)(3), n50 an opinion of an engineer, appraiser, or other expert.

The evidentiary provisions required by Section 314(c) have sometimes been made subject to a trigger clause in private placements, so that they would become operative only if Trust Indenture Act qualification is effected. n51 Since the 1990 amendments to the Act, this same result can be obtained more simply by eliminating physical inclusion of the mandatory terms in the original indenture and relying upon their becoming included by operation of law when the indenture is later qualified. n52

[4] Form of Opinions on Compliance with Conditions or Covenants

Section 314(e) specifies the form that opinions relating to any indenture covenant or condition must take. The Act prescribes this format for Section 314(c) opinions on compliance with conditions precedent and also for any certificates regarding compliance with other covenants, n53 except for the annual certificates of compliance required by Section 314(a)(4). n54

Each certificate or opinion must include a statement that the person making it has read the relevant covenant or condition. It must contain a brief statement as to the nature and scope of the examination or investigation on which the person's statements or opinions are based. n55 It must recite that, in the opinion of the person making the certificate, he has made an examination or investigation that is adequate to permit him to express an informed opinion. Finally, the certificate must indicate whether or not, in the opinion of such person, there has been compliance with the relevant condition or covenant. n56 However, Section 314(e) does not require disclosure of the factual bases upon which the certificate or opinion is based. n57

The American Bar Foundation Model Debenture Indenture limits the requirements of Section 314(e) to each *individual* signing the certificate or opinion, on the ground that the Trust Indenture Act could not have intended "person" as used in Section 314(e) to include corporations or similar entities. n58

[5] Furnishing Certificates of Fair Value

For any indenture that is secured by the mortgage or pledge of property or securities, Section 314(d) imposes on the obligor a requirement to furnish certificates of fair value to the trustee. The certificates must be from an engineer, appraiser, or other expert. n59 They are to be furnished when the lien on any property or securities is to be released. Also, they are to be furnished when property or securities are to be added as the basis for authenticating and delivering additional securities, or as the basis for withdrawing cash or releasing other property that secures payment of the bonds. n60

Section 314(d)(1) mandates that for any property or securities to be released from the lien of the indenture, the certificate or opinion of the engineer, appraiser or other expert must state that in that person's opinion the proposed release will not impair the collateral in contravention of the indenture's provisions. n61

The Commission takes the position that certificates under any of the clauses of Section 314(d) must state the dollar amount of the value of the property in question, not merely that its value exceeds or is less than a particular amount. n62 If the dollar amount of property or securities to be released is substantial, the certificate must be from an independent engineer, appraiser, or expert who is selected or approved by the trustee in the exercise of reasonable care. Otherwise, unless the indenture expressly provides to the contrary, the expert need not be independent, and may be an officer or employee of the obligor. n63 The requirement of an independent expert is applicable if the fair value of the property or securities to be released, when added to the value of other releases since the beginning of the then current calendar year, equals 10% or more of the indenture securities outstanding. An independent expert, however, is not required if the value of the property or securities to be released is less than \$25,000 or less than 1% of the indenture securities outstanding. n64

The Commission raises no question when the indenture permits certain limited releases and substitutions without a certificate of fair value. In particular, provisions permitting the sale of obsolete or outworn tools and equipment, the surrender of leaseholds, franchises, and easements, the taking of property by eminent domain, the demolition or abandonment of property no longer useful to the business, or the sale of timber and crops, have been permitted, as has the substitution of other property thereafter, without certificates of fair value. n65 Similarly, certificate requirements may be ignored when deposited securities are to be surrendered in a reorganization, recapitalization, or merger, and the

new securities to be issued are to be substituted for them. n66

Where securities are collateralized by substantially all of the corporation's assets, a strict application of Section 314(d)(1) would prevent the sale of inventory and collection or other disposition of accounts or notes receivable by the obligor in the ordinary course of business without first furnishing a certificate of fair value before each sale or disposition. In *Mary Kay Cosmetics*, n67 the Commission permitted an indenture to be qualified which allowed such ordinary business activities so long as a semi-annual certificate was delivered to the trustee stating that all sales of inventory and all collections or other dispositions of accounts receivable and notes receivable during the immediately preceding six-month period were in the ordinary course of business. In addition, the indenture was to provide that the company could not dispose of over 10% of its assets (including inventory) other than in the ordinary course of business in any given year, and was to require delivery to the trustee annually of audited financial statements. n68 Subsequently, the Commission extended its no-action position to also permit other kinds of releases of collateral in the ordinary course of business (not exceeding 10% of the amount of indenture securities outstanding) without the furnishing of certificates of fair value each time. Again, this was subject to requirements to deliver annual audited financial statements and semi-annual certificates stating that the releases were in the ordinary course of business and that the proceeds were used in the ordinary course of business or to make cash payments permitted by the indenture. n69

The SEC appears willing to issue orders under TIA § 304(d) exempting indentures from the certificate of fair value delivery requirements that are broader than its no-action positions. It has exempted ordinary-course disposal of collateral, regardless of amount, from the requirements of § 314(d), so long as the issuer furnishes the trustee (1) annual audited financials and (2) semi-annual certificates stating that disposals of collateral were in the ordinary course of business and proceeds were used as permitted by the indenture. n70

In *International Harvester Co.*, n71 the issuer proposed to eliminate the Section 314(d) requirements insofar as they related to release of collateral under an "equal and ratable security" clause. Under this clause, debenture holders are given an equal and ratable lien with later creditors if the issuer later creates a lien on specifically identifiable assets. *International Harvester* created such a subsequent lien in a financing arrangement with institutional lenders. The collateral subject to the equal and ratable security clause was governed by "shared collateral agreements" between the issuer and a separate collateral trustee acting for the benefit of both the debenture holders and the institutional lenders. Only the institutional lenders had control over any release of the shared collateral from the lien. Under those circumstances the Commission staff concluded that the debenture indenture was not required to include the Section 314(d) provisions.

A later similar case involved a shared collateral agreement that was wholly external to the indenture. The issuer applied for a formal exemption arguing that Section 314(d) was not intended to apply to indentures that do not contain the provisions creating the security interest. In granting the exemption, the Commission emphasized both that the shared collateral agreement was external to the indenture and that decisions to maintain or release collateral were not made by the indenture trustee or the indenture security holders. n72

Section 314(d)(2) requires certificates of the fair value be furnished to the obligor on the indenture securities attesting to the value of securities whose deposit with the trustee is to be the basis for authentication and delivery of indenture securities, or the basis for the withdrawal of cash or release of collateral. n73 However, under this section, certificates are not required as to the deposit of securities issued under the subject indenture or as to securities secured by a lien prior to that of the indenture on property that also collateralizes the indenture securities. n74 The certificate of fair value must be provided by the same experts as under Section 314(d)(1), n75 who must be independent of the issuer whenever the value of the securities to be deposited plus all other securities deposited since the beginning of the calendar year equals 10% or more of the indenture securities outstanding. However, an independent expert is not required if the value of the securities to be deposited is less than \$25,000 or less than 1% of the indenture securities outstanding. In such cases, unless the indenture expressly provides to the contrary, the expert may be an officer or employee of the obligor. n76 When an independent expert is required because of the amount of securities to be deposited as a basis for

authentication and delivery of indenture securities, the certificate must also cover the value of all other securities deposited since the beginning of the calendar year as to which a certificate has not previously been furnished.

Section 314(d)(3) requires the indenture to contain provisions requiring the obligor to deliver to the trustee an engineer's, appraiser's, or other expert's certificate of the fair value to the obligor of any property that is to be subjected to the lien of the indenture as the basis for authenticating and delivering securities, withdrawing cash, or releasing collateral. n77 The requirements call for the certificate to be from an independent expert, selected or approved by the trustee in the exercise of reasonable care, if within six months prior to the acquisition of the property by the obligor, the property was used by someone else in a business similar to that in which the obligor will use it, and if the property is worth at least \$25,000 and at least 1% of the amount of the indenture securities outstanding. Where an independent expert is required and the addition of collateral relates to the authentication and delivery of indenture securities, the certificate must cover all the property added since the beginning of the then current calendar year as to which a certificate of an independent expert has not previously been furnished. Where an independent expert is not required, unless the indenture expressly provides to the contrary, the expert may be an officer or employee of the obligor. n78

The Commission takes the position that certificates are not required for property additions that are to be improved by new construction when cash is pledged for that purpose, even though technically the addition is the basis for withdrawing the cash. However, where property additions are the basis for the release of insurance proceeds that are not restricted to rebuilding or repair, a certificate is required. n79

Where after-acquired property is automatically or periodically subjected to the lien of the indenture, the Commission's view is that certificates of fair value should be provided at the time the property is used as the basis for authentication of bonds or for the release of property or cash, rather than at the time the lien first attaches. n80

There is some ambiguity as to whether certificates of fair value under Section 314(d) must comply with the format prescribed by Section 314(e), n81 since the statutory language is unclear whether certificates of fair value are certificates "with respect to compliance with a condition or covenant." The Commission has taken the position that an indenture may use the same ambiguous statutory language that Section 314(e) uses, but the indenture may not specifically exclude certificates of fair value from the Section 314(e) requirements. This conclusion is based on the Commission's view that certificates of fair value do evidence compliance with covenants or conditions when the certificates are used as an integral part of authentication and release provisions in the indenture. n82

The Commission's view is that certificates under all the clauses of Section 314(d) must be current, *i.e.*, as of a date within 90 days of the request that the trustee take action requiring the certificate. n83 This poses special difficulties under Section 314(d)(3) as to certain property addition clauses that are common in public utility indentures. These "accounting type" clauses permit the carry forward of the unused portions of past property additions. The credit carried forward is computed under a formula that involves all property additions since the date of the indenture, some of which may have since been altered or replaced. n84 The Commission has developed a number of methods for accommodating such clauses to the requirements for a current valuation under Section 314(d). They involve creating presumptions as to which property gives rise to the credits, or compromising on the current date requirement if the amount of the credit, the years from which it can be carried, or both, are limited, or if a maintenance fund with interim fund certificates plus periodic inspection of properties for the adequacy of maintenance is provided. n85

[6] Permissive Provisions on Evidence of Compliance with Covenants

Section 314(f) permits, but does not require, the indenture to include additional provisions obligating the issuer to furnish the trustee evidence of compliance with indenture conditions and covenants. Since 1990, Section 314(a)(4) has required an annual officer's certificate regarding compliance. n86

Prior to 1990, indentures typically included covenants requiring the obligor to furnish the trustee with an annual

statement of compliance indicating that the issuer had fulfilled all its obligations under the indenture. A common version called for a more elaborate certificate than the one described in 314(a)(4). It required a statement signed by two corporate officers indicating that a review of the company's activities and performance had been made under their supervision, and to the best of their knowledge, based on that review, the company had fulfilled all its obligations under the indenture. If defaults had occurred, then the certificate was to specify them and their nature and status. n87

Neither the provision for the officers' statements in the American Bar Foundation's *Commentaries On Indentures*, nor the one included in the Model Simplified Indenture, n88 required the compliance certificate to follow the format of Section 314(e). n89 This was intentional because of the ambiguity in the Section 314(e) requirement that the certificate state the nature and scope of the examination or investigation on which the opinion in the certificate is based. n90 The drafters of these model provisions apparently were convinced that this approach was permissible under the Trust Indenture Act, despite an earlier Commission position that Section 314(e) "would appear to be broad enough to cover certificates or opinions required by the terms of the indenture in addition to those required by Section 314(c) and (d) of the Act." n91 The 1990 amendments to the Act are consistent with the understanding of the drafters of the model provisions, excluding from the requirements of Section 314(e) the officer's certificate required by Section 314(a)(4). n92

An indenture may also call for the issuer to furnish the trustee a compliance certificate from the independent public accountants who have audited the issuer's annual financial statements. Typically, accountants are merely required to state that in the course of their examination of the company's books, they obtained no knowledge of any default or event that would become a default upon lapse of time, notice, or both, or of any failure to fulfill a covenant on the part of the issuer. The certificate may be required to extend to defaults and breaches under other indebtedness as well as under the indenture. n93

FOOTNOTES:

(n1)Footnote 1. See, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 214.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n2)Footnote 2. See American Bar Foundation, *Commentaries On Indentures* 280(1971), justifying this on ground that TIA Section 312(a) deals only with the interval between lists, and not with the date of the initial list.

(n3)Footnote 3. See ABF, Model Debenture Indenture--All Registered Issues, Section 701(1967); Revised Model Simplified Indenture, Section 2.05, 55 *Bus. Law.* 1115, 1128 (2000).

(n4)Footnote 4. TIA Section 312(a).

(n5)Footnote 5. See ABF, Model Debenture Indenture--All Registered Issues, Sections 701, 702(a) (1967); Revised Model Simplified Indenture, Section 2.05, 55 *Bus. Law.* 1115, 1128 (2000).

(n6)Footnote 6. Internal Revenue Code of 1936, § 147(b) and IRC Regulation Art.143-4, 392 C.C.H. Stand. Fed. Tax Serv. P 1074 (1939).

(n7)Footnote 7. See Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 50 (1939).

(n8)Footnote 8. See American Bar Foundation, *Commentaries On Indentures* 279-81 (1971); Suggested Provisions for Trust Indentures, 4 C.C.H. Fed. Sec. L. Rep. P 43,520.

(n9)Footnote 9. P.S. 34-75 (Dec. 28, 1942), 433 C.C.H. Stand. Fed. Tax Serv. P 6081(1943).

(n10)Footnote 10. American Bar Foundation, *Commentaries On Indentures* 280-81 (1971). Without ownership

certificates, the only source for bondholder lists is the envelopes in which coupons are received. J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 167-68 (2d ed., 1975).

(n11)Footnote 11. Long term debt securities (other than ones issued by natural persons) of the type offered to the public, if issued after December 31, 1982, must be issued in registered form in order to avoid substantial tax penalties. See 5 Cavitch, *Business Organizations with Tax Planning* (Matthew Bender) § 91.05[2].

(n12)Footnote 12. American Bar Foundation, *Commentaries On Indentures* 166,281 (1971).

(n13)Footnote 13. See Revised Model Simplified Indenture, Section 2.05 (requiring bondholder lists to be furnished at least 10 business days before each interest payment date and at other times as requested by the trustee), 55 *Bus. Law.* 1115, 1128 (2000).

(n14)Footnote 14. See ABF, Model Debenture Indenture--All Registered Issues, Section 701 (1967).

(n15)Footnote 15. See American Bar Foundation, *Commentaries On Indentures* 279 (1971).

(n16)Footnote 16. TIA Sec. 318, discussed at § 8.03 *supra*.

(n17)Footnote 17. Trust Indenture Act Rule 14a-1 applies the formal requirements of Trust Indenture Act Rules 7a-15 to 7a-37 to reports filed with the trustee under the Section 314(a)(1) requirements. The TIA refers to furnishing either the full reports, or such portions as the Commission may prescribe by rule. See TIA Section 314(a)(1). TIA Rule 19a-1, adopted in *Requirements For Arthur Andersen LLP Auditing Clients*, SEC Release No. 33-8070, 2002 SEC LEXIS 628 (March 18, 2002), gave clients of the troubled Arthur Andersen accounting firm who were required to file SEC reports with the indenture trustee the same temporary relief granted to them in filing 1934 Act reports with the SEC.

(n18)Footnote 18. See, *Finisar Corp. v. U.S. Bank Trust National Assoc.*, 2007 U.S. Dist. LEXIS 93637 (Dec. 7, 2007) (declaratory judgment action to determine the scope of this obligation presents a federal question, so action may be removed to federal court).

(n19)Footnote 19. See ABF, Model Debenture Indenture--All Registered Issues, Section 704 (1967); Revised Model Simplified Indenture, Section 4.02, 55 *Bus. Law.* 1115, 1134 (2000).

(n20)Footnote 20. See e.g. *Affiliated Computer Services, Inc. v. Wilmington Trust Co.*, 565 F.3d 924, 927 (5th Cir. 2009).

(n21)Footnote 21. Revised Model Simplified Indenture, Note 1 to Section 4.02, 55 *Bus. Law.* 1115, 1184 (2000).

(n22)Footnote 22. *Affiliated Computer Services Inc. v. Wilmington Trust Co.*, 565 F.3d 924 (5th Cir. 2009); *UnitedHealth Group, Inc. v. Wilmington Trust*, 548 F.3d 1124 (8th Cir., 2008); *American Stock Transfer & Trust Co. v. Par Pharmaceutical Companies*, 2009 U.S. Dist. LEXIS 52602 (SDNY, June 19, 2009); *Finisar Corp. v. U.S. Bank Trust National Assoc.*, 2008 U.S. Dist. LEXIS 65329 (ND CA, Aug. 25, 2008); *Cyberonics, Inc. v. Wells Fargo Bank National Association*, 2007 U.S. Dist. LEXIS 42779 (SD TX, June 13, 2007).

(n23)Footnote 23. See § 8.13 *supra*.

(n24)Footnote 24. *Semi-Tech Litig., LLC v. Bankers Trust Co.*, 353 F. Supp. 2d 460, 477 (S.D.N.Y. 2005), *affd.* 450 F.3d 121, 126-27 (2d Cir., 2006).

(n25)Footnote 25. *Id.* See also Avantor Financial Corp. (No Action Letter, March 29, 1990).

(n26)Footnote 26. TIA Section 314(a)(1).

(n27)Footnote 27. TIA Section 314(a)(2).

(n28)Footnote 28. TIA Section 314(a)(3).

In 1977, the SEC's Advisory Committee on Corporate Disclosure decried the Commission's lack of attention to the informational needs of bondholders. It recommended that, at a minimum, all reports by the issuer made available to stockholders should also be made available to debt holders who request them. Report of the Advisory Committee on Corporate Disclosure, Committee Print 95-29, 95th Cong., 1st Sess. 551-54 (1977).

See generally, McDaniel, "Disclosures For Corporate Debt Securities," 16 Rev. of Sec. Reg. 907 (1983).

Today most indentures do this by providing that bondholders will be mailed any quarterly and annual reports that the company furnishes to its stockholders. *See* Revised Model Simplified Indenture, Section 4.02 and Note 2 to Section 4.02, 55 *Bus. Law.* 1115, 1134, 1184 (2000).

(n29)Footnote 29. Trust Indenture Act Section 314(a) (last sentence).

(n30)Footnote 30. Peter H. Kesser, Esq. (No Action Letter, November 16, 1987). Also see, Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 107.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n31)Footnote 31. *Cf.* the requirements of TIA Section 315(b), discussed in § 8.15[3] *infra*.

(n32)Footnote 32. 17 C.F.R. § 210.4-08(c).

(n33)Footnote 33. *See* § 8.14[1] *supra*.

(n34)Footnote 34. TIA Section 318, discussed at § 8.03 *supra*.

(n35)Footnote 35. *See* American Bar Foundation, *Commentaries On Indentures* 289, 328-40 (1971).

(n36)Footnote 36. *See* ABF, Mortgage Bond Indenture Form, Section 14.05 (1981); Suggested Provisions for Trust Indentures, 4 C.C.H. Fed. Sec. L. Rep. P 43,517.

See also Kennedy & Landau, "Recent Developments In Debt Financing and Corporate Trust Administration," 22 *Bus. Law.* 353, 368-72 (1967).

(n37)Footnote 37. *See Harriet & Henderson Yarns, Inc. v. Castle*, 75 *F. Supp.* 2d 818, 822, 833 (W.D. Tenn. 1999).

(n38)Footnote 38. As to issuance of indenture securities, see J. Kennedy & R. Landau, *Corporate Trust Administration*, 89-99 (2d ed., 1975).

(n39)Footnote 39. As to release and substitution of property, *see id.* at 114-30.

(n40)Footnote 40. As to satisfaction and discharge, *see id.*, at 197-209.

(n41)Footnote 41. *See* ABF, Model Debenture Indenture--All Registered Issues, Section 102 (1967); Revised Model Simplified Indenture, Sections 12.03, 12.04, 55 *Bus. Law.* 1115, 1162-63 (2000).

(n42)Footnote 42. *See* ABF, Model Debenture Indenture--All Registered Issues, Section 101 (Officers' Certificate); Revised Model Simplified Indenture, Section 1.01 (Officers' Certificate), 55 *Bus. Law.* 1115, 1125 (2000).

(n43)Footnote 43. See SEC Manual--Trust Indenture Act of 1939 at pp. 101-04 (June 1958).

(n44)Footnote 44. Good faith reliance by accountants on opinions of counsel and engineers, and on facts represented by officers, may be permitted as a basis for their opinions. See SEC Manual--Trust Indenture Act of 1939 at pp. 103-104 (June 1958).

(n45)Footnote 45. See, e.g., the various covenants discussed in American Bar Foundation, *Commentaries On Indentures* 312-473 (1971).

(n46)Footnote 46. See ABF, Mortgage Bond Indenture Form 52-53 (1983).

(n47)Footnote 47. Public Utility Holding Company Act Rel. 13105, 4 C.C.H. Fed. Sec. L.Rep. P 36,675 at P 36,681 (1956).

(n48)Footnote 48. See ABF, Mortgage Bond Indenture Form, Section 5.02, at pp. 52-53(1983), which nevertheless provides for the officers' certificate in such cases to be signed by an accountant, though the accountant may be one of the officers.

(n49)Footnote 49. Whether an opinion of counsel is required in such cases is more ambiguous. The Commission has suggested that the clause calling only for officers' certificates in certain situations may qualify only the language calling for accountants' certificates, i.e., only clause (3) of Section 314(c). See SEC Manual--Trust Indenture Act of 1939 at p. 77 (June 1958). The ABF, Mortgage Bond Indenture Form, Sections 5.01-5.02 at 49-50, 52-53 would require an opinion of counsel.

(n50)Footnote 50. TIA Section 314(d)(3) is discussed in § 8.14[5] *infra*.

(n51)Footnote 51. See American Bar Foundation, *Commentaries On Indentures* 48-49 (1971).

(n52)Footnote 52. TIA Section 318, discussed at § 8.03 *supra*.

(n53)Footnote 53. See ABF, Model Debenture Indenture--All Registered Issues, Section 102 (1967); Revised Model Simplified Indenture, Section 12.04, 55 *Bus. Law.* 1115, 1163 (2000); SEC Manual--Trust Indenture Act of 1939 at p. 101 (June 1958).

(n54)Footnote 54. *But cf.* Revised Model Simplified Indenture, Note 2 to Section 4.03, 55 *Bus. Law.* 1115, 1185 (2000) (Revised Model Simplified Indenture imposes § 314(e) requirements on annual certificates of compliance).

(n55)Footnote 55. It is unclear as to how specific this description must be. See American Bar Foundation, *Commentaries On Indentures* 51 (1971). In *Cruden v. Bank of New York*, 957 F.2d 961, 970 (2d Cir. 1992), the court permitted a brief general description which merely stated: "we have reviewed the Agreement and Plan of Reorganization, the Indenture and Supplemental Indenture,... and such other documents, corporate records and certifications and such questions of law as we have considered necessary or appropriate."

(n56)Footnote 56. See *Cruden v. Bank of New York*, 957 F.2d 961, 970-72 (2d Cir. 1992).

(n57)Footnote 57. *Harris Trust and Savings Bank v. E-II Holdings, Inc.*, 926 F. 2d 636 (7th Cir. 1991).

(n58)Footnote 58. American Bar Foundation, *Commentaries On Indentures* 50-51 (1971, discussing ABF, Model Debenture Indenture--All Registered Issues, Section 102 (Second Paragraph) (1967).

(n59)Footnote 59. Appraisers and engineers may be permitted to rely on opinions of counsel and representations of officers as to facts not subject to verification by appraisers or engineers in making their certificates, unless the appraiser or engineer knows or reasonably should have known that the opinions or representations were erroneous. See SEC

Manual--Trust Indenture Act of 1939 at p. 103 (June 1958).

(n60)Footnote 60. See ABF, Mortgage Bond Indenture Form, Sections 5.02 and 6.02 (1981).

See, generally, Garrett & Thomas Arthur & Steven B. Kite, 13-3rd C.P.S. (BNA), *Corporate Bond Financing* A-12 to A-13 (1999).

(n61)Footnote 61. A certificate is not required for a release that takes place only upon redemption of all outstanding bonds under the indenture, since such a release cannot impair the bonds' security. *Page Mill Asset Management v. Credit Suisse First Boston Corp.*, 2000 U.S. Dist. LEXIS 3941 (S.D.N.Y. 2000) .

(n62)Footnote 62. *Id.* at p. 82.

(n63)Footnote 63. TIA Sections 314(d) (last two sentences) and 314(d)(1).

(n64)Footnote 64. TIA Section 314(d)(1).

(n65)Footnote 65. SEC Manual--Trust Indenture Act of 1939 at p. 87 (June 1958).

(n66)Footnote 66. *Id.* at p. 87.

(n67)Footnote 67. Mary Kay Cosmetics (Div. Corp. Fin., 1986), summarized in 18 BNA Sec. Reg. & L. Rep. 983 (1986). See also Federated Department Stores, Inc. (No Action Letter, January 31, 1992); Jack Eckerd Corp., (No Action Letter, Feb. 5, 1991); New World Entertainment Ltd. (No Action Letter, May 31, 1988); Monogram Models, Inc. (No Action Letter, Oct. 1, 1987).

(n68)Footnote 68. See also World Omni Financial Corp., SEC Release No. 39-2374 (Sept. 1, 1999), 1999 SEC LEXIS 1783 ; World Omni Financial Corp., SEC Release No. 39-2358 (Nov. 13, 1997), 1997 SEC LEXIS 2343 ; Metalburg, Inc., SEC Rel. No. 39-2352 (Apr. 2, 1997), 1997 SEC LEXIS 727 .

(n69)Footnote 69. Arch Wireless Holdings, Inc., 2002 SEC No-Act. LEXIS 648 (May 24, 2002).

(n70)Footnote 70. *Application and Opportunity for Hearing: Algoma Steel Inc.*, SEC Rel. No. 39-2403 (Nov. 20, 2002) and *Order Granting Application: Algoma Steel Inc.*, 2002 SEC LEXIS 3279 (Dec. 23, 2002) . See also *Order Granting Application for Exemption: Mrs. Fields Famous Brands LLC*, SEC Rel. No. 39-2434 (March 24, 2005), 2005 SEC LEXIS 700 ; *Order Granting Application for Exemption: NationsRent Companies, Inc.*, SEC Rel. No. 39-2425 (Sept. 7, 2004); *Application and Opportunity for Hearing: Covanta Energy Corp.*, 69 FR 12718 (March 17, 2004) ; *Order Granting Application for Exemption: Hard Rock Hotel, Inc.*, SEC Rel. No. 39-2414 (Jan. 5, 2004); *Order Granting Application for Exemption: Software Brokers of America, Inc.*, (Dec. 28, 2006), 2006 SEC LEXIS 3044 ; *Order Granting Application for Exemption: Grupo Iusacell Cellular, S.A. de C.V.*, SEC Rel. No. 39-2450 (Nov. 26, 2007), 2007 SEC LEXIS 2732 .

(n71)Footnote 71. C.C.H. Fed. Sec. L. Rep. P 77,413 (Div. Corp. Fin., 1983).

(n72)Footnote 72. *Application and Opportunity for Hearing; Allied Waste North America, Inc.*, SEC Release No. 39-2390, 2001 SEC LEXIS 1317 (July 2, 2001) ; *Allied Waste North America, Inc.*, SEC Release No. 39-2392, 2001 SEC LEXIS 1591 (Aug. 8, 2001) . Also see, *Pregis Corporation*, (No Action Letter, Dec. 7, 2007), 2007 SEC No-Act. LEXIS 665.

(n73)Footnote 73. For an example of the problem at which TIA Section 314(d)(2) was directed, See *Hazzard v. Chase National Bank*, 159 Misc. 57, 287 N.Y.S. 54 (Sup. Ct. 1936) , *aff'd*, 257 App. Div. 950, 14 N.Y.S.2d 147 (1939) , *aff'd*, 282 N.Y. 652, 26 N.E.2d 801 , *cert. denied*, 311 U.S. 708 (1940) .

(n74)Footnote 74. The Commission also permits, without explicit statutory support, the certificate requirement to be eliminated as to the deposit of a purchase money mortgage on property where the property has been released under a certificate of fair value to be sold, or as to the deposit of government securities where investment of funds in these is required and the obligor agrees to reimburse the trustee for any loss. SEC Manual--Trust Indenture Act of 1939 at p. 89 (June 1958).

(n75)Footnote 75. *See* §8.14[5] *supra*.

(n76)Footnote 76. *See* last two sentences in TIA Section 314(d).

(n77)Footnote 77. However, the Trust Indenture Act does not require that the certificates be used as the basis for authenticating the bonds or releasing the cash or collateral against property additions. SEC Manual--Trust Indenture Act of 1939 at p. 94 (June 1958).

(n78)Footnote 78. TIA Section 314(d) (last two sentences). For purposes of simplicity, the ABF, Mortgage Bond Indenture Form 60, 64 (1981) calls for an independent engineer even when the \$25,000/1% test is not met.

(n79)Footnote 79. SEC Manual--Trust Indenture Act of 1939 at p. 93 (June 1958).

(n80)Footnote 80. *Id.* at pp. 93-94.

(n81)Footnote 81. Section 314(e) is discussed in § 8.14[4] *supra*.

(n82)Footnote 82. SEC Manual--Trust Indenture Act of 1939 at pp. 101-02 (June 1958).

(n83)Footnote 83. *Id.* at pp. 88, 90, 94-95. However, where Section 314(d)(3) also requires inclusion of property additions since the beginning of the calendar year, those earlier additions may be valued in relation to the dates of the earlier authentication and delivery of securities for which the past additions were used. *Id.* at p. 98.

(n84)Footnote 84. *Id.* at pp. 95-96.

(n85)Footnote 85. *Id.* at pp. 96-98.

(n86)Footnote 86. *See* Revised Model Simplified Indenture, Section 4.03, 55 *Bus. Law.* 1115, 1134 (2000). TIA Section 314(a)(4) is also discussed in § 8.14[2] and [4] *supra*.

(n87)Footnote 87. *See* American Bar Foundation, *Commentaries On Indentures* 325-26 (1971); J. Kennedy & R. Landau, *Corporate Trust Administration* 140-41 (2d ed., 1975). *See also* Model Simplified Indenture, Section 4.03, 38 *Bus. Law.* 741,744 (1983).

(n88)Footnote 88. *Id.*

(n89)Footnote 89. TIA Section 314(e) is discussed in § 8.14[4] *supra*.

(n90)Footnote 90. American Bar Foundation, *Commentaries On Indentures* 325-26 (1971); Model Simplified Indenture, 38 *Bus. Law.* 741, 790 (1983).

(n91)Footnote 91. SEC Manual--Trust Indenture Act of 1939 at p. 101 (June 1958).

(n92)Footnote 92. *See* § 8.14[4] *supra*.

(n93)Footnote 93. *See* ABF, *Commentaries On Indentures* 334-36 (1971); Model Simplified Indenture, 38 *Bus. Law.* 741, 790 (1983). For the form of such opinions by accountants, see 1 C.C.H. AICPA, Professional Standards P 623.19-.21.



129 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.15

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.15 Duties of Trustee Prior to Default

The Trust Indenture Act imposes certain duties on the indenture trustee prior to any default by the obligor. The trustee must provide annual reports and periodic reports on certain developments to indenture security holders and to give notice to the security holders of all defaults known to the trustee within ninety days of their occurrence. Unless provided to the contrary in the indenture, the trustee's liability is limited to the performance of the duties specified in the indenture. A trustee's resignation is effective only upon appointment and acceptance by a successor trustee.

Despite the great concern expressed by Congress in 1939 over the passivity of indenture trustees in enforcing the rights of security holders, n1 the Trust Indenture Act imposes rather minimal duties on the indenture trustee prior to any default by the obligor. n2 Suggestions that the pre-default duties of trustees should be markedly increased have been met with strong protests that these changes would lead to prohibitively large increases in trustees' fees. n3

An indenture may permit the indenture trustee to temporarily invest idle cash in money market funds or other securities. n4 In light of the Gramm-Leach-Bliley Act which requires banks to sometimes register as broker-dealers, n5 questions arise as to whether this kind of investment activity can be carried out without broker-dealer registration. Exchange Act Section 3(a)(4)(B)(ii) excludes from the definition of "broker" any bank that merely effects transactions in a "trustee capacity", does not otherwise publicly solicit brokerage business and meets certain requirements as to its compensation. Prior to the adoption of Regulation R, Exchange Act Rule 3b-17 explicitly provided that an indenture trustee was acting in a "trustee capacity." The release adopting Regulation R repealed Rule 3b-17, relegating the definition of "trustee capacity" to the broader language of Section 3(a)(4)(D) of the Exchange Act. n6 That language, however, appears explicit enough to include indenture trustees. The Act's compensation requirements are aimed at assuring that banks operating as trustees are "chiefly compensated" by administration or annual fees, fees based on percentage of assets under management, and flat or capped per order fees reflecting only the cost of executing orders. Banks are not to be compensated primarily through traditional sales commissions without registering as broker-dealers. n7 However, where a bank as indenture trustee invests idle cash only in no-load money market mutual funds, Regulation R, Rule 741 under the Exchange Act permits it to ignore these compensation requirements. This permits bank indenture trustees to receive

payments from a no-load money market fund or its distributor for investing idle cash in that fund, even when that sales compensation exceeds the relationship compensation that the bank receives from the issuer of the indenture securities. Often trustees take this potential sales compensation into account in negotiating the trustee fees charged to issuers. n8

[1] Reports by Trustee to Security Holders--Section 313

Section 313 requires the trustee to:

- (1) transmit annual reports and periodic reports on certain developments to the indenture security holders; n9
- (2) file a copy of each report with every exchange on which the indenture securities are listed; and
- (3) file a copy of each report with the Commission. n10

Even with the full implementation of EDGAR, these reports are still to be filed in paper form. n11

The brief annual report required by Section 313(a) is required only if changes have occurred in any of eight different matters. First, the trustee must report with respect to any change in its continuing eligibility and qualification under Section 310. n12 Second, the trustee must report on the creation of, or any material change in, a relationship which, under Section 310(b), would constitute a conflict of interest after default by the obligor on the indenture securities.

Third, the trustee must report on the character and amount of any advances it has made that may result in a claim by it prior to the claims of the indenture security holders on property or funds held by the trustee, if the amount of such advances remaining unpaid equals more than 0.5% of the indenture securities outstanding. n13 The intent of Congress in enacting the 1990 amendments to the TIA was that reporting of advances should be required only when changes to the amount, interest rate, maturity or collateral have occurred. A drafting error in the amendments led to the language of Section 313(a)(3) appearing to require annual reporting of indebtedness whether or not such changes occurred. The Commission has stated that it intends to recommend a technical amendment to Congress correcting the legislation, and that until such time as the amendment can be made, trustees should prepare their reports to reflect Congressional intent, *i.e.*, they need only report changes during the year. n14

Fourth, the trustee must report the principal, interest rate, maturity date, and collateral for all other amounts owed to it on the date of the report by the obligor on the indenture securities. n15 However, the trustee need not report on indebtedness arising from the relationships described in Sections 311(b)(2), (3), (4), or (6). n16 Thus no report is required of indebtedness arising from:

- (1) certain authorized advances under the indenture or in bankruptcy;
- (2) disbursements in the ordinary course of business as indenture trustee, transfer agent, paying agent or in other similar capacities;
- (3) services rendered, premises rented, or goods or securities sold in a cash transaction; or
- (4) transactions in self-liquidating paper.

Fifth, the trustee must report on any changes in the property and funds physically in its possession.

Sixth, the trustee must report on any change to any release, or release and substitution, of property subject to the lien of the indenture, not previously reported. n17 The Commission has stated that the addition in 1990 of language requiring

reporting only of *changes to* releases and substitutions was a drafting error. The provision should require reporting of all previously unreported releases and substitutions. The Commission intends to recommend a technical amendment to Congress to correct this error. n18

Seventh, the trustee must report any additional issue of indenture securities not previously reported.

Finally, the trustee is to report any other action taken by it in performance of its duties under the indenture that it has not previously reported, which in its opinion is material, except any action concerning a default, the notice of which has been or is to be withheld under an indenture provision authorized by Section 315(b). n19

While the Trust Indenture Act does not specify the date for the trustee's annual report, under the pre-1990 version of the Act the Commission had suggested n20 that where the timing would not unduly advance nor delay the first report, a report dated as of shortly after May 15 would be most appropriate, since Section 310(b)(9) used to require the trustee to check its eligibility with regard to holdings in fiduciary capacities as of that date. Now Section 310(h)(4) requires a check only upon default and annually thereafter, n21 so that a preference for a May 15 reporting date is no longer necessary if another date would be more convenient. Usually, the indenture gives the trustee 60 days from the reporting date to prepare and transmit the report. n22

More frequent reports by the trustee are required when certain events occur. Section 313(b)(1) of the Trust Indenture Act requires the trustee to report to indenture security holders (and file copies with relevant exchanges and the Commission) within 90 days after any release, or release and substitution of property, unless the fair value of the property involved, as set forth in the required Section 314(d)(1) certificates, n23 is less than 10% of the amount of indenture securities then outstanding.

Section 313(b)(2) similarly requires more frequent reporting of large advances made to the obligor as to which the trustee may claim a lien prior to that of the indenture security holders on property or funds held by the trustee. Within 90 days after the unpaid advances that have not previously been reported aggregate over 10% of the indenture securities outstanding, the trustee must report their character and amount. The report must relate to advances since the date of the last annual report, or if no annual report has yet been transmitted, advances since the date of the indenture.

Section 313(c) prescribes the required manner of transmitting reports to the indenture security holders. n24 The reports must be mailed to all registered holders and to all holders of bearer form securities who have, within the past two years, filed their names and addresses with the trustee for that purpose. n25 The annual reports must also be mailed to everyone on the bondholders list furnished to the trustee pursuant to Section 312(a). n26 Because Section 313(c) specifically requires these reports to be transmitted by mail, the SEC's policies on electronic delivery of documents to investors do not apply. n27

If the indenture securities are listed on the New York Stock Exchange, the NYSE requires the issuer to instruct the trustee to give immediate notice to the exchange of:

- (1) any change or removal of deposited collateral;
- (2) acceleration of maturity by the trustee;
- (3) issuance or authentication of duplicate bonds;
- (4) cancellation, retirement, or other reduction in the amount of bonds outstanding; and
- (5) any call for redemptions including sinking fund requirements. n28

[2] Limitations on Trustee's Pre-Default Duties

Section 315(a) reflects a notion of the trustee's duties prior to default as being essentially administrative in nature. n29 Under Section 315(a)(1) unless express provisions to the contrary are included in the indenture, the indenture will automatically be deemed to provide that prior to default n30 the trustee shall not be liable except for the performance of those duties specifically set out in the indenture. n31 Often this is supplemented by another clause placed in the indenture stating that no provision of the indenture shall require the trustee to expend or risk its own funds or incur any liability in performing any of its duties under the indenture, if it reasonably believes that it will not be repaid or indemnified. n32

In *Meckel v. Continental Resources Co.*, n33 the Second Circuit stated: "Unlike the ordinary trustee, who has historic common-law duties imposed beyond those in the trust agreement, an indenture trustee is more like a stakeholder whose duties and obligations are exclusively defined by the terms of the indenture agreement." n34 Relying upon this principle, and pointing to the indenture clause permitted by Section 315(a)(1) which was included in the indenture at issue, the Second Circuit held that the indenture trustee had no obligation under the Trust Indenture Act to give the holders of convertible debentures notice of redemption beyond the notice by first class mail called for by the indenture. n35

Using a similar rationale, in *Elliott Associates v. J. Henry Schroder Bank & Trust Co.*, n36 the Second Circuit held that, absent self-dealing, the trustee was not obligated to weigh the financial interests of the debenture holders in waiving a 50 day notice period for redemption as permitted in the indenture.

The trustee is liable if it engages in willful misconduct, is negligent in carrying out its duties under the indenture, or negligently fails to perform those duties. n37 Section 315(d) prohibits the indenture from containing exculpatory n38 clauses relating to negligent or willful misconduct. n39 Under Section 315(a)(2), however, unless expressly provided to the contrary, the indenture is automatically deemed to provide that the trustee, in carrying out its pre-default duties, may conclusively rely on the truth of statements and the correctness of opinions in documents conforming to the requirements of the indenture, unless the trustee is acting in bad faith. n40 The trustee, though, must at least examine the certificates and opinions furnished to it pursuant to § 314 of the Trust Indenture Act to determine whether they conform to the indenture's requirements. n41

Semi-Tech Litigation, LLC v. Bankers Trust Company n42 held that TIA § 315(a) imposes a duty on the trustee to examine each certificate furnished to it to determine whether it conforms to the indenture, even if the trustee does not intend to rely on statements or opinions in the certificate. It also held that the requirement to examine certificates furnished "pursuant to section 314" includes not just the annual certificate of compliance required by § 314(a), but also additional certificates that the indenture may call for, since § 314(f) explicitly *permits* the indenture to provide for additional evidence of compliance with indenture conditions and covenants.

While the trustee is required to examine opinions of counsel actually furnished to it to determine that they conform to the indenture's requirements, the court in *Harriet & Henderson Yarns, Inc. v. Castle* held that the trustee breaches no duty when it ignores the obligor's total failure to furnish the statutorily required opinion of counsel stating that a lien on assets securing the indenture has been perfected. In the court's view, Section 314(b) "clearly does not impose a duty on indenture trustees to ensure that liens are perfected for the benefit of the debenture holders." n43

Unless expressly excluded by provisions in the indenture, the indenture will automatically be deemed to contain two other exceptions to the trustee's liability for negligence. First, under Section 315(d)(2), the trustee will be protected from liability for any good faith errors of judgment made by its own responsible officers, unless it is proven that the trustee was negligent in ascertaining the pertinent facts. n44 Second, Section 315(d)(3) protects the trustee in following the directions of holders of a majority of the indenture securities. n45

While Section 315(d) is framed in the negative and prohibits exculpatory clauses (except those discussed above), which excuse the trustee's willful misconduct or negligence, the Commission has traditionally insisted on an affirmative statement in the indenture. The indenture has been required to provide that no other provision of the indenture shall be construed to relieve the trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct. n46 The clause in this form qualifies any other indenture provision that might be exculpatory. n47 Requiring such an affirmative statement seems to be inconsistent with the 1990 amendments to the Act which were intended to assure full compliance without the necessity of physically including statutorily mandated language in the indenture. n48 Such an affirmative qualification is not automatically incorporated under the 1990 amendments and, if necessary, would thus require physical inclusion.

While the trustee may not be *relieved of liability* for its own negligence, it is less certain whether the TIA should be read to also exclude *indemnification* of the trustee for losses caused by its negligence. n49

[3] Notice to Security Holders of Known Defaults

Section 315(b) requires the trustee to give notice to the indenture security holders of all defaults known to the trustee, within 90 days of their occurrence. n50 Since the notice date runs from the date of the default, rather than the date of discovery by the trustee, the provision may occasionally create time pressures. Where the trustee does not learn of a default until after 90 days, n51 the Commission's view is that prompt notice to indenture security holders should then be given. n52 In *Semi-Tech Litigation, LLC v. Bankers Trust Company*, n53 the trustee did not know about a default because it failed to properly carry out its duty to examine certificates of compliance furnished to it. The Second Circuit held that the trustee's failure to examine the certificates did not excuse its failure to give notice to indenture security holders. However the breach of duty in this case was found to support only nominal damages since the note holders' losses would not have been prevented by the trustee's performing its duties properly.

Notice of default is to be transmitted by mail to indenture security holders identified in the manner prescribed in Section 313(c), *i.e.*, to all registered holders, to all persons whose names and addresses are on bondholders lists furnished to the trustee semi-annually as required by Section 312(a), and to all holders who have furnished their names and addresses to the trustee for the purpose of receiving reports during the preceding two years. n54

The Trust Indenture Act makes a sharp distinction between the trustee's duty of care before default and its duty after default. n55 The higher duty of care in post-default situations, however, is triggered under Section 315(c) only when there is a default as defined in the indenture. For the reasons to be described, this results in a situation in which the trustee has no affirmative duty to use reasonable care in discovering defaults by the obligor. n56

Indentures typically use the term "event of default" to describe the occasion for imposing the mandated higher standard of care on the trustee. n57 An event of default usually is defined as occurring when certain easily recognized things happen, *e.g.*, there has been a failure to pay principal at maturity, there has been a failure to pay interest that continues for 30 days after it is due, bankruptcy or similar proceedings have been instituted by the issuer, or a decree adjudging the company bankrupt or insolvent has been entered and has remained in effect for 60 consecutive days.

An event of default involving other indenture covenants, however, is usually defined as occurring only where a breach continues for 30 days after either the trustee gives notice to the issuer or at least 10% of the indenture security holders give notice to the issuer, or the trustee, or both. n58 Thus, merely the breach of a covenant without its discovery and some notice being given, would not raise the trustee's duty of care to that required after default.

The provision in Section 315(b) relating to the trustee's giving notice of default, however, is not drafted by reference to a default as defined in the indenture. Thus, the trustee must give notice within 90 days of any occurrence that will mature into an event of default after the passage of time permitted by a grace period in the indenture. n59 This is consistent with the provision of Section 310(b) which uses default exclusive of any grace period or notice requirement,

as the event which triggers the conflict of interest disqualifications of the trustee. n60

If a default is cured during a grace period before it matures into an event of default, or is waived, indentures typically excuse the trustee from reporting the situation to the indenture security holders. n61 The Commission appears to consider this to be consistent with the Act's requirements. n62

The indenture security holders could be seriously injured by premature disclosure of defaults that may be cured or as to which other arrangements may be made. n63 Therefore, unless expressly provided to the contrary in the indenture, Section 315(b) permits the trustee, in case of defaults other than in payment of principal, interest, sinking fund or purchase fund, to withhold the notice to security holders otherwise mandated by Section 315(b). For example, it is common for trustees to rely on this provision in cases where they receive from the issuer a certificate of compliance with indenture conditions and covenants that is not in proper form. n64 The trustee is protected in withholding this notice where the action has been approved by its board of directors, its executive committee, or by a trust committee comprised of directors or responsible officers or both, who in good faith determine that withholding of notice is in the interests of the indenture security holders. n65

[4] Resignation of Trustee in Anticipation of Default

The Trust Indenture Act does not appear to restrict the trustee's decision to resign, regardless of the reason. As amended in 1990, however, the Act does require that any resignation become effective only upon appointment of a successor and the successor's acceptance of the appointment. n66 While this reflects the terms that have traditionally appeared in most indentures, n67 the statutory amendment was designed to assure that a trusteeship would not be abandoned without a successor in anticipation of the obligor's default. n68 Resignation in anticipation of, or upon, default by a trustee who is also a direct lender to the obligor on the indenture securities was a common practice n69 even before post-default resignation of a trustee-creditor was mandated in 1990. n70 This course of action not only provides separate representation for bondholders when the trustee otherwise has conflicting interests, n71 but also, if early enough, may permit the trustee to avoid the otherwise applicable requirements of Section 311 to share with indenture security holders amounts collected by the trustee within three months before default, and after default. n72

If the indenture securities are listed on the New York Stock Exchange, the issuer must give the exchange at least 5 business days' notice of any change in trustee. n73 Indentures typically permit the trustee who has resigned to petition a court for appointment of a successor if one has not accepted appointment within 30 or 60 days. n74

FOOTNOTES:

(n1)Footnote 1. The findings by Congress embodied in TIA Section 302 state in part that "the general and reasonable assumption by ... investors [is] that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights," but that indenture provisions generally do not in fact meet this expectation. TIA Section 302(a)(2).

See also Dropkin, *Implied Civil Liability Under the Trust Indenture Act: Trends and Prospects*, 52 *Tulane L. Rev.* 299, 300-06 (1978).

(n2)Footnote 2. *See Harriet & Henderson Yarns, Inc. v. Castle*, 75 *F. Supp. 2d* 818, 833 (W.D. Tenn. 1999) (no duty to ensure that liens are perfected for the benefit of debenture holders.) *Also see* Robertson, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion In the Solvent Enterprise*, 11 *Harv. J. of Laws & Public Policy* 461 (1988).

(n3)Footnote 3. *See* 1 ALI, *Federal Securities Code* xl (1980).

(n4)Footnote 4. See *Definition of Terms in and Specific Exemptions for Banks Under Sections 3(a)(4) and 3(a)(5)*, SEC Release No. 34-44291 (May 11, 2001), II.B.1.a., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P86,505 [hereafter cited as *Definition of Terms for Bank Exemptions*]

(n5)Footnote 5. Gramm-Leach Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

(n6)Footnote 6. *Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks*, SEC Release No. 34-56501 (Sept. 24, 2007).

(n7)Footnote 7. *Definition of Terms for Bank Exemptions*, supra. note 3.1, at II.B.5.

(n8)Footnote 8. *Definition of Terms for Bank Exemptions*, supra. note 3.1, at II.B.5.g.

(n9)Footnote 9. TIA Section 313(a), (b), (c). Where there are co-trustees, each must submit reports, except a co-trustee need not report on releases of property and authentication and delivery of additional securities for which the institutional trustee alone is responsible. SEC Manual--Trust Indenture Act of 1939 at p. 64 (June 1958).

(n10)Footnote 10. TIA Section 313(d). The Model Simplified Indenture, Section 7.06, requires the issuer notify the trustee when the securities are listed on any exchange. 38 Bus. Law 741, 760, 797 (1983).

(n11)Footnote 11. Regulation S-T, Rule 101(c)(15).

(n12)Footnote 12. TIA Section 310 is discussed in § 8.12 and § 8.13 supra .

(n13)Footnote 13. Indentures generally permit the trustee to preserve collateral by advancing funds for such things as the payment of taxes, insurance, and rentals under leases. To preserve the trustee's full claim for these advances in case of default, the indenture should require notice to indenture security holders of these advances even if the amount remaining unpaid equals less than 0.5% of the indenture securities outstanding. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 219-20 (2d ed., 1975); TIA Section 311(b)(2), discussed in § 8.17[3] infra.

(n14)Footnote 14. Rules and Forms to Implement the Trust Indenture Reform Act of 1990, Securities Act Rel. No. 6892 (May 8, 1991), C.C.H. Fed. Sec. L. Rep. P 84,732.

(n15)Footnote 15. See *Cruden v. Bank of New York*, C.C.H. Fed. Sec. L. Rep. P 95,466 (S.D.N.Y. 1990). It is unclear whether the trustee must report compensating balances for loans which it holds, even though it may set these amounts off against sums due it. See Friedman, *Updating the Trust Indenture Act*, 7 U. Mich. J. of L. Reform 329, 344 (1974).

(n16)Footnote 16. See § 8.17[3] infra.

(n17)Footnote 17. Releases of cash funds is not required to be reported under this provision. SEC Manual--Trust Indenture Act of 1939 at p. 66 (June 1958).

(n18)Footnote 18. Rule and Forms to Implement the Trust Indenture Reform Act of 1990, Securities Act Rel. No. 6892 (May 8, 1991), C.C.H. Fed. Sec. L. Rep. P 84,732.

(n19)Footnote 19. Section 315(b) is discussed in § 8.15[3] infra.

(n20)Footnote 20. SEC Manual--Trust Indenture Act of 1939 at p. 64 (June 1958).

(n21)Footnote 21. See § 8.13[5] supra.

(n22)Footnote 22. See SEC Manual--Trust Indenture Act of 1939 at p. 64; ABF, Model Debenture Indenture--All

Registered Issues, Section 703 (1967), discussed in American Bar Foundation, *Commentaries On Indentures* 285-86 (1971); Revised Model Simplified Indenture, Section 7.06, 55 *Bus. Law.* 1115, 1141 (2000).

(n23)Footnote 23. See § 8.14[5] *supra*.

(n24)Footnote 24. For a case holding that an implied private right of action under federal law by debenture holders exists against a trustee who failed to transmit Section 313 reports, or made misleading statements in reports that were transmitted, see *Zeffiro v. First Pennsylvania Banking and Trust Co.*, 623 F.2d 290, C.C.H. Fed. Sec. L. Rep. P 97,514 (3rd Cir. 1980).

As to private enforcement by bondholders generally, see § 8.18 *infra*.

(n25)Footnote 25. Few holders of bearer securities ever file their names and addresses. Where the issuer or trustee wishes to communicate with these holders, the paying agent can ask banks presenting coupons for payment to complete and submit with the coupons a certificate of ownership that the paying agent provides. A bondholder list can be compiled from these. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 233-34 (2d ed., 1975).

(n26)Footnote 26. See § 8.14[1] *supra*.

(n27)Footnote 27. Neither of the SEC's basic releases on electronic delivery of information to investors apply to Trust Indenture Act documents. See *Use Of Electronic Media For Delivery Purposes*, SEC Rel. No. 33-7233 (Oct. 6, 1995), C.C.H. Fed. Sec. L. Rep. P 3200, and *Use Of Electronic Media By Broker-Dealers, Transfer Agents, And Investment Advisers For Delivery of Information*, SEC Rel. No. 33-7288 (May 9, 1996), C.C.H. Fed. Sec. L. Rep. P 3201.

(n28)Footnote 28. NYSE Listed Company Manual, Sec. 603.02 (June 1983).

(n29)Footnote 29. See American Bar Foundation, *Commentaries On Indentures* 250 (1971). See also S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., pp. 32, 44. The administrative nature of the indenture trustee's duties was found to justify as excusable neglect the indenture trustee's failure prior to default to file a timely proof of claim in the bankruptcy proceeding of a brokerage firm against which the trustee ultimately had a post-default claim. In re Drexel Burnham Lambert Group, Inc., No 90-B-10421, Chapter 11, 1992 Bankr. LEXIS 423 (S.D.N.Y. March 4, 1992).

(n30)Footnote 30. The limited duties of Section 315(a) may also be made applicable after a default has been cured. SEC Manual--Trust Indenture Act of 1939 at p. 117 (June 1958).

(n31)Footnote 31. See *Broad v. Rockwell International Corp.* 614 F.2d 418, 431-32, C.C.H. Fed. Sec. L. Rep. P 97,326 at pp. 97,192-93 (5th Cir. 1980); *Browning Debenture Holders' Committee v. DASA Corp.*, 560 F.2d 1078, 1083, C.C.H. Fed. Sec. L. Rep. P 96,131 at p. 92,083 (1977).

(n32)Footnote 32. See SEC Manual--Trust Indenture Act of 1939 at pp. 109-10 (June 1958); ABF, Model Debenture Indenture--All Registered Issues, Section 601(c)(4) (1967), discussed in American Bar Foundation, *Commentaries On Indentures* 251 (1971).

(n33)Footnote 33. 758 F.2d 811, C.C.H. Fed. Sec. L. Rep. P 91,980 (2d Cir. 1985).

(n34)Footnote 34. 758 F.2d at 816, C.C.H. Fed. Sec. L. Rep. at p. 90,886. See also *Lorenz v. CSX Corp.*, C.C.H. Fed. Sec. L. Rep. P 95, 298 736 F. Supp. 650 (W.D. Pa. 1990); *Baker v. Summit Bank*, 46 Fed. Appx. 689 (3d Cir., 2002).

(n35)Footnote 35. 758 F.2d at 815-16, C.C.H. Fed. Sec. L. Rep. at p. 90,885-86. Also see *Raymond James &*

Associates v. Bank of New York Trust Company, 2008 U.S. Dist. LEXIS 70607 (MD FL, Sept. 18, 2008) (no duty to give notice of prepayment beyond that specifically required by terms of the indenture).

(n36)Footnote 36. 838 F.2d 66, C.C.H. Fed. Sec. L. Rep. P 93,614 (2d Cir. 1988) .

(n37)Footnote 37. See *In re Equity Funding Corp. of America Securities Litigation*, 416 F. Supp. 161, 203 (C.D. Cal. 1976) ; *Morris v. Cantor*, 390 F. Supp. 817 , C.C.H. Fed. Sec. L. Rep. P 94,996 (S.D.N.Y. 1975).

(n38)Footnote 38. In *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, 1997 U.S. Dist. LEXIS 12858 at *28-*43 (S.D.N.Y. 1997) , the court refused to pass on whether TIA Section 315(d) precludes defendant from arguing that plaintiff bondholders impliedly consented to defendant's allegedly negligent conduct.

(n39)Footnote 39. The Trust Indenture Act does not prohibit exculpatory clauses for persons other than the trustee, such as stockholders, officers and directors of the obligor. SEC Manual--Trust Indenture Act of 1939 at p. 107 (June 1958). *But cf.* Securities Act Section 14 which voids any provision that binds any person acquiring a security to waive compliance with any provision of the Securities Act or rules thereunder.

(n40)Footnote 40. See *Cruden v. Bank of New York*, 957 F.2d 961, 969-72 (2d Cir. 1992) . The trustee's right to rely in good faith on counsel, corporate officers, and the trustee's own employees is usually expanded by a series of indenture provisions. See ABF, Model Debenture Indenture--All Registered Issues, Section 603 (1967), discussed in American Bar Foundation, *Commentaries On Indentures* 254-58 (1971); Revised Model Simplified Indenture, Section 7.02, 55 *Bus. Law.* 1115, 1140 (2000).

(n41)Footnote 41. TIA Section 315(a). For discussion of TIA § 314, see § 8.14 *supra*. For a claim alleging violation of the trustee's duty to examine an opinion of counsel to determine if it was in proper form, see *Cruden v. Bank of New York*, C.C.H. Fed. Sec. L. Rep. P 93,624 (S.D.N.Y. 1988). For a claim that the trustee failed to follow the required formalities in permitting the substitution of collateral, see *Argonaut Partnership L.P. v. Bankers Trust Company Ltd.*, 1997 U.S. Dist. LEXIS 1092 (S.D.N.Y. 1997) .

(n42)Footnote 42. 353 F. Supp. 2d 460 (S.D.N.Y. 2005) , *affd.* 450 F.3d 121, 126-27 (2d Cir., 2006) .

(n43)Footnote 43. *Harriet & Henderson Yarns, Inc. v. Castle*, 75 F. Supp. 2d 818, 833 (W.D. Tenn. 1999) .

(n44)Footnote 44. The Revised Model Simplified Indenture contains a provision generally permitting the trustee to create a wall between the corporate trust department and other departments of the bank and excusing the trustee from obtaining information about the issuer from other bank departments. The drafters acknowledge that the validity of this provision under the TIA is questionable. Revised Model Simplified Indenture, Section 7.02(e) and Note 9. to Section 7.02, 55 *Bus. Law.* 1115, 1140-41, 1198 (2000).

(n45)Footnote 45. Provisions giving indenture security holders the right to direct the trustee's action are discussed in § 8.18[5] *infra*.

(n46)Footnote 46. ABF, Model Debenture Indenture--All Registered Issues, Section 601(c) (1967); Revised Model Simplified Indenture, Section 7.01(c)-(d), 55 *Bus. Law.* 1115, 1140 (2000).

(n47)Footnote 47. See SEC Manual--Trust Indenture Act of 1939 at p. 127. See also TIA Section 318(a).

(n48)Footnote 48. See § 8.03, *supra*.

(n49)Footnote 49. Revised Model Simplified Indenture, Note 2 to Section 7.07, 55 *Bus. Law.* 1115, 1199 (2000).

(n50)Footnote 50. See ABF, Model Debenture Indenture--All Registered Issues, Section 602 (1967); Revised Model Simplified Indenture, Section 7.05, 55 *Bus. Law.* 1115, 1141 (2000).

(n51)Footnote 51. *Cf.* Revised Model Simplified Indenture, Section 4.04, 55 *Bus. Law.* 1115, 1134 (2000) (requiring issuer to give prompt written notice to trustee and paying agent of defaults, events of default and certain other matters).

(n52)Footnote 52. *See* SEC Manual--Trust Indenture Act of 1939 at pp. 119-20 (June 1958); Revised Model Simplified Indenture, Note 1 to Section 7.05, 55 *Bus. Law.* 1115, 1198 (2000).

(n53)Footnote 53. 450 *F.3d* 121 (2d Cir., 2006) .

(n54)Footnote 54. For further discussion of TIA Section 313(c), see § 8.15[1] *supra*.

(n55)Footnote 55. *See* TIA Sections 315(a), 315(d).

The trustee's post-default duties are discussed in § 8.17 *infra*.

(n56)Footnote 56. *See* Friedman, *Updating the Trust Indenture Act*, 7 *U. Mich. J. L. Reform* 329, 346-48 (1974). For suggestions regarding a much more active role for trustees in monitoring, renegotiating and enforcing covenants, see Yakov Amihud, Kenneth Garbade, & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 *Stan. L. Rev.* 447 (1999).

For litigation challenging the trustee's determination that a default existed, see *Fidelity Mortgage Investors v. First National City Bank*, 387 *F. Supp.* 544 (S.D.N.Y. 1974) .

(n57)Footnote 57. *See* ABF, Model Debenture Indenture--All Registered Issues, Sections 501, 601(b) (1967); Revised Model Simplified Indenture, Sections 6.01, 7.01(a), 55 *Bus. Law.* 1115, 1135, 1139 (2000).

(n58)Footnote 58. *Id.*

The Revised Model Simplified Indenture, Section 6.01, 55 *Bus. Law.* 1115, 1135-36 (2000) requires notice either by the trustee or by at least 25% of the indenture security holders and requires the breach to remain uncured for at least 60 days.

(n59)Footnote 59. *See* SEC Manual--Trust Indenture Act of 1939 at pp. 120-21 (June 1958).

The Commission considers the running of a period of time to be an essential element of a default, rather than a grace period, in some situations, *e.g.*, where an event of default includes a judgment against the obligor that has remained unsatisfied for 60 days, the 90 day notice period does not run from the date of the judgment. *Id.*

(n60)Footnote 60. *See* § 8.13 *supra*.

(n61)Footnote 61. *See* American Bar Foundation, *Commentaries On Indentures* 252-53 (1971); Revised Model Simplified Indenture, Section 7.05, 55 *Bus. Law.* 1115, 1141 (2000).

(n62)Footnote 62. *See* Letter from Division of Corporation Finance approving model indenture so providing in Section 602, reprinted in ABF, Model Debenture Indenture--All Registered Issues (1967).

(n63)Footnote 63. *See* J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 220-21 (2d ed. 1975).

(n64)Footnote 64. *See, Semi-Tech Litigation, LLC v. Bankers Trust Company*, 450 *F.3d* 121, 129 (2d Cir., 2006) .

(n65)Footnote 65. A definition of "responsible officer" of the trustee is usually included in the indenture. *See* ABF, Model Debenture Indenture--All Registered Issues, Section 101 (1967); Revised Model Simplified Indenture, Sections

1.01, 7.05 (using the term "Trust Officer"), *55 Bus. Law. 1115, 1125, 1141 (2000)*.

(n66)Footnote 66. *See* last paragraph in TIA § 310(b).

(n67)Footnote 67. *See* ABF, Model Debenture--All Registered Issues, § 610(a)-(b); Revised Model Simplified Indenture, Section 7.08, *55 Bus. Law. 1115, 1142 (2000)*.

(n68)Footnote 68. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., pp. 34, 50.

(n69)Footnote 69. *See, e.g., United States Trust Co. of New York v. First National City Bank*, 57 A.D. 2d 285, 287, 394 N.Y.S.2d 653, 655, C.C.H. Fed. Sec. L. Rep. Par. 96,065 at p.91,794 (1077), *aff'd*, 45 N.Y.2d 869, 410 N.Y.S. 2d 580, 382 N.E.2d 1355 (1978); Minsky, "Several Harvester Note Trustees Resign, Citing Conflict of Interest as Lenders," Wall St. Jour., Aug. 4, 1981, p.6; S. Rep. No. 101-155 (1989) 101st Cong. 1st Sess., pp. 34, 49.

(n70)Footnote 70. *See* § 8.13[6] *supra*.

(n71)Footnote 71. *See* Smith, Case & Morrison, "The Trust Indenture Act of 1939 Needs No Conflict of Interest Revision," *35 Bus. Law. 161, 168 (1979)*.

(n72)Footnote 72. *See* § 8.17[3] *infra*.

(n73)Footnote 73. NYSE Listed Company Manual, Sec. 603.04 (July 1998).

(n74)Footnote 74. *See* ABF, Model Debenture Indenture--All Registered Issues, Section 610(b) (1967) (30 days); Revised Model Simplified Indenture, Section 7.08, *55 Bus. Law. 1115, 1142 (2000)*.



130 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.16

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.16 Duties of Paying Agent

Various servicing functions must be provided for debt securities. The issuer will appoint a bond registrar, a paying agent, an exchange agent, and depending on the circumstances, a conversion agent, subscription agent, or both a conversion and subscription agent. Usually, the bank that is acting as indenture trustee will be appointed to handle these servicing functions, though additional banks may also be used. n1

The only one of these servicing functions regulated by the Trust Indenture Act is that of paying agent. Section 317(b) requires that each paying agent hold all funds received by it for the payment of principal or interest in trust for the indenture security holders or the indenture trustee. n2 In *In re Sunshine Jr. Stores Inc.*, n3 the court held that the fiduciary duty of a bank trust department holding prepayment funds deposited by the obligor on Notes that had been called includes payment of interest on those funds. Also, under Section 317(b), each paying agent must give the trustee notice of any default by an obligor in the payment of principal or interest.

A district court has concluded that once the obligor deposits funds in trust with the paying agent, the obligor loses control over the funds and has no ownership claim to them. Thus the obligor has no cause of action against the paying agent for diverting deposited funds to the indenture trustee to use to fund litigation expenses. n4

In *Continental Mortgage Investors v. First National City Bank*, n5 the indenture provided that no payment of principal or interest should be made on the indenture securities if senior indebtedness was in default. When it appeared that the senior indebtedness might shortly be in default, the obligor transmitted funds to cover the upcoming interest payment on the indenture securities to the bank that acted as trustee and paying agent. The funds were accompanied by a letter stating that they were to be used to pay interest unless the bank was instructed to the contrary by the obligor. The court held that these funds were not received by the bank in its capacity as trustee or paying agent, so that the relevant provisions of the indenture were not called into play; the funds were transferred under a separate agreement rather than under the indenture. n6

Since paying agents other than the trustee normally are not a party to the indenture, the requirements of Section 317(b) have traditionally been met by a clause imposing upon the obligor the task of assuring that each paying agent agrees in writing to comply with the obligations set out in Section 317(b).ⁿ⁷ The 1990 amendments which make the Act's requirements not only contractual in nature, but also impose them as provisions of positive law,ⁿ⁸ would appear to eliminate the need for such a clause since, presumably, the obligations of Section 317(b) would now be binding upon paying agents even when they are not formal parties to the indenture.

If the issuer will act as its own paying agent, the indenture has typically required it to set aside before the due date and to hold in trust for the indenture security holders, amounts sufficient to pay principal and interest, and require it to notify the trustee of its action in this regard or of its failure to so act. The language of Section 317(b) is ambiguous as to whether in the absence of a specific provision in the indenture this is mandatory when the issuer assumes the paying agent's role.ⁿ⁹

The New York Stock Exchange has broader rules for any debt securities listed on that exchange. Any indenture permitting the deposit of funds with the trustee, depository, or paying agent for payment, redemption, or release of collateral must contain provisions requiring the funds to be impressed with a trust for the benefit of the indenture security holders.ⁿ¹⁰

While Section 317(b) requires the paying agent to hold funds deposited for payment in trust, it does not require that those funds be segregated from other trust funds. Typically, indentures give permission to the trustee that holds funds as paying agent or in other capacities to mingle trust indenture funds with other funds.ⁿ¹¹ The New York Stock Exchange, on the other hand, requires segregation by the depository of funds relating to listed bonds where the depository is not a trust company or banking institution having substantial capital and surplus.ⁿ¹²

FOOTNOTES:

(n1)Footnote 1. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 154-86 (2d ed., 1975).

(n2)Footnote 2. TIA Section 317(b) does not compel the paying agent to disburse immediately the funds it receives for payment to the indenture security holders. *Mathews v. Fisher*, C.C.H. Fed. Sec. L. Rep. P 97,336 at p. 97,230 (S.D. Ohio 1978).

(n3)Footnote 3. 456 F.3d 1291, 1315 (11th Cir., 2006) .

(n4)Footnote 4. *Petrohawk Energy Corp. v. Law Debenture Trust Co.*, 2007 U.S. Dist. LEXIS 5803 (SDNY, Jan. 29, 2007) .

(n5)Footnote 5. 470 F. Supp. 59 (S.D.N.Y. 1979) , *aff'd*, 614 F.2d 1286 (2d Cir. 1979) .

(n6)Footnote 6. 470 F. Supp. at 62 .

(n7)Footnote 7. American Bar Foundation, *Commentaries On Indentures* 318-19 (1971).

(n8)Footnote 8. See § 8.03 *supra*.

(n9)Footnote 9. *Id.* at 317-18.

For clauses complying with Section 317(b), see, ABF, Model Debenture Indenture--All Registered Issues, Section 1003 (1967); Revised Model Simplified Indenture, Section 2.04, 55 *Bus. Law.* 1115, 1128 (2000).

(n10)Footnote 10. NYSE Listed Company Manual, Sec. 703.06(D) (July 1998). Prior to 1998, in order to protect

against insolvency of paying agents the NYSE also required that the deposit of funds would not operate to discharge the issuer from its obligation to pay principal, interest, or redemption price. This provision originated before the TIA. In 1998, the SEC agreed with NYSE that TIA protections and changed business practices justified removal of this requirement. Order Granting Approval of Proposed Rule Change, *SEC Release No. 34-40253 (July 23, 1998)*, 1998 *SEC LEXIS 1531* .

(n11)Footnote 11. See ABF, Model Debenture Indenture--All Registered Issues, Section 606 (1967), *discussed in*, American Bar Foundation, *Commentaries On Indentures* 260-61 (1971).

(n12)Footnote 12. NYSE Listed Company Manual, Sec. 602.01 (June 1983).



131 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.17

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.17 Powers and Duties of Trustee after Default

The Trust Indenture Act imposes an enhanced duty of care and skill on trustees after default and gives trustees adequate powers to carry out their duties. The Act grants the trustee the authority, before and after default, to file proofs of claim and other papers in judicial proceedings and to recover judgment in its own name; indentures generally give the trustee other post-default remedial powers not specified in the Act. The Act permits the trustee prior to default to be a direct creditor of the obligor on the indenture securities, but requires the apportionment of amounts collected by the trustee during a specified time.

The trustee is also empowered to represent the interests of indenture security holders in bankruptcy proceedings. Debtors in bankruptcy may have several different classes of debt securities outstanding and may have several different indenture trustees asserting claims in bankruptcy reorganization proceedings. Often the trustees will coordinate their efforts to preserve the debtor's collateral and collect amounts due to bondholders. In *United Airlines v. U.S. Bank N.A.*,ⁿ¹ the debtor in a reorganization proceeding claimed that it was a violation of the Sherman Antitrust Act for indenture trustees to cooperate in this way. The Seventh Circuit Court of Appeals in an opinion by Judge Easterbrook rejected the antitrust claim, describing coordination as "a normal function of indenture trustees."

One of the principal concerns of Congress in enacting the Trust Indenture Act was to assure that the indenture trustee would act responsibly and effectively after a default by the obligor.ⁿ² To accomplish this, the Trust Indenture Act imposes an enhanced duty of care and skill on trustees after default, and insures that trustees have adequate powers to carry out those duties.ⁿ³

[1] Post-Default Duties of Care and Skill

Section 315(c) provides that the trustee, in case of default (as defined in the indenture), must exercise the rights and powers vested in it by the indenture, and must use the same degree of care and skill in their exercise as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.ⁿ⁴

The Senate and House Reports describe the purpose of Section 315(c) to be to raise the standard of conduct for indenture trustees to that "observed by the more conscientious trust institutions ..." n5 The standard was intended to be the same as that imposed on trustees of personal trusts. n6 The House changed the language of Section 315(c) to its final form, referring to the degree of care and skill a prudent man would exercise "in the conduct of his own affairs." The Senate reference to the care that would be exercised by a prudent man "if he were a fiduciary" was rejected as confusing, in favor of the House version that was seen to reflect the "customary standard." n7

In *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, the court had occasion to examine the meaning of the TIA's "prudent man" standard. First, the court made clear, the standard requires that the trustee be judged by the facts as they existed at the time of the conduct, not by hindsight. Second, the trustee will not be held liable for a mere error in judgment so long as its decision was the result of careful and informed deliberation; but the trustee must have been well informed. The trustee may satisfy its obligation in this regard by relying on advice of counsel, but only if the trustee provided complete disclosure to counsel and only if the reliance was reasonable. Finally, if more than one course of action could be deemed prudent, the trustee will not be liable for choosing one rather than another of the acceptable alternatives. n8

The trustee's enhanced duties are triggered only by a default as defined in the indenture. n9 Thus, where the indenture defines an event of default as occurring only upon notice and the running of a grace period, the enhanced duty is not imposed before those conditions occur. n10 Also, as permitted by the Commission, indentures usually provide that the trustee remains under this enhanced duty only while the event of default continues. Once the event of default is cured or waived, the trustee may act as in the pre-default period. n11

Prior to enactment of the Trust Indenture Act, trustees saw themselves, after default, largely as an instrumentality of the security holders. n12 Upon default, trustees would confer with the obligor and work out tentative proposals. Then they would communicate with bondholders and assist them in forming a protective committee to represent their interests. n13 Section 315(c) was largely directed at preventing trustees from misusing indenture provisions that had originally been designed to protect the trustee during this consultative process. n14 The section prohibits immunity clauses that permit the trustee to demand that bondholders give it notice of default, n15 a demand for action, and indemnity before it exercises its powers under the indenture. n16

Even after default, the trustee, under Section 315(d)(3), is protected when it relies in good faith on the direction of not less than a majority of bondholders, as provided in Section 316(a), relating to the time, method, and place of conducting any proceeding for any remedy, or exercising any trust or power conferred on the trustee, under the indenture. n17 Also, under Section 315(d)(2), the trustee may be protected from liability for good faith errors in judgment of its own responsible officers, unless the trustee was negligent in ascertaining the pertinent facts. n18

However, a provision in an indenture which prohibits the indenture trustee from serving as an official voting member of any creditors' committee in any bankruptcy or insolvency proceeding is not permitted. Similarly an indenture provision prohibiting the indenture trustee from approving the appointment of additional creditors' committees for holders of the indenture securities, and from opposing the appointment of any individual security holder to any creditors' committee, is impermissible. The staff of the SEC has taken the position that such clauses would unduly circumscribe the post-default duties imposed on the indenture trustee by the TIA. n19

The indenture may give the trustee a prior lien on the mortgaged or pledged property, or the proceeds of suit, for its compensation and expenses in connection with enforcement. n20 Alternatively, indentures often excuse the trustee from expending its funds or incurring financial liability in performing its duties unless it has reasonable assurance of repayment. n21

At least one commentator has criticized the Trust Indenture Act's post-default standard as encouraging trustees to

initiate precipitate action after default to the possible detriment of all parties to protect themselves from charges of negligently failing to meet their enhanced post-default obligations. n22

Section 315(c) imposes enhanced post-default duties on the trustee in its exercise of the rights and powers vested in it by the indenture. The Commission has indicated that in its view, the language required by Section 315(c) may also be broad enough to cover implied rights and powers arising from the trustee's position. n23

[2] Powers of Trustee to Act on Behalf of Security Holders

For the trustee to effectively protect indenture security holders, it must have authority to pursue on their behalf claims against the obligor. n24 Section 317(a) assures that the trustee has sufficient enforcement powers. n25

Section 317(a)(2) authorizes the trustee, both before and after default, to file proofs of claim and other papers in connection with claims by the trustee or bondholders in any judicial proceeding relating to the obligor, its creditors, or its property. n26 This provision is necessary to assure that courts will not take the position that only the indenture security holders themselves have the right to file claims. n27

Section 317(a)(1) gives the trustee authority to recover judgment in its own name as trustee of an express trust against the obligor in case of default in payment of principal when due, or in case of a default in payment of interest, after any grace period provided by the indenture. n28 Again, this provision is necessary to assure that courts will not require suits for payment to be brought only by the indenture security holders directly. n29

Despite these provisions, courts have had some difficulty regarding the standing of the indenture trustee to represent indenture security holders in litigation affecting their interests where the defendant is not the obligor. In a case growing out of the Penn Central collapse, the Third Circuit found that the indenture trustee had standing to object to a settlement in derivative suits by shareholders of a corporation the stock of which was pledged as collateral under the indenture. n30

However, in a case involving settlement of securities claims, the Ninth Circuit refused to permit the indenture trustee to represent the interests of Equity Funding Corporation's debenture holders. n31 The indenture trustee wished to oppose the terms of the settlement of claims against persons other than Equity Funding who were involved in fraudulent activities relating to Equity Funding securities. Its objection related to a provision reducing the debenture holders' recovery by the amount of cash and stock they received in Equity Funding's bankruptcy reorganization. Since debenture holders were already represented by class representatives in the securities litigation, the court held that the indenture trustee could not be a representative in the class action. The provisions of Section 317(a) were found not to require a different result because no claims against the obligor on the indenture securities were involved in the class action. n32

In *National City Bank v. Coopers & Lybrand*, n33 the Minnesota Court of Appeals denied standing to the indenture trustee to pursue claims against the issuer's accountants after the completion of a bankruptcy reorganization. It held that the trustee's powers under the indenture were limited to claims on the notes or under the indenture and that, furthermore, under the terms of the reorganization plan, the relevant indentures were no longer in effect. A similar result was reached in *Central Bank of Denver, N.A. v. Deloitte & Touche*, n34 by the Colorado Court of Appeals. It held that the indenture, which was not covered by the TIA, did not grant the trustee authority to sue accountants to recover losses sustained by bondholders as a result of the accounting firm's negligence in auditing the issuer. As interpreted by the court, the authority given by the indenture to the trustee to enforce payment of the bonds was limited to action to accelerate the bonds and compel the issuer to make payment. It did not include an action against a third party to replenish the trust assets, particularly when any bondholders who did not rely on the financial statements should not share in a recovery against the accountants.

The drafters of the Revised Model Simplified Indenture state that their Indenture does not empower the trustee to pursue state or federal securities law claims or common law fraud claims for misrepresentations that induced bondholders to

purchase or hold the indenture securities. The trustee's role is to enforce rights arising under the indenture and the securities against the company for the equal benefit of all bondholders. Pursuing fraud claims may create conflicts for the trustee. Claims may be held by persons who are no longer holders of the indenture securities; different holders may have different rights to recover; recovery by holders of fraud claims may prejudice collections by current bond holders; and securities fraud claims may be subordinated in bankruptcy to claims for payment by current holders. n35

Normally, indentures will give the trustee a number of other post-default remedial powers that are not specified in the Trust Indenture Act. One of the most basic of these is the power to accelerate maturity upon an event of default. n36 When indenture securities are listed on the New York Stock Exchange, the NYSE must be given immediate notice of any acceleration of the maturity date that has been declared by the trustee. n37 Other remedial powers are often given to the trustee to enable the trustee to take possession of, or foreclose upon, collateral, n38 as well as to enable it to institute any other appropriate judicial proceedings. n39

[3] Post-Default Obligations of Trustee-Creditor

Subject to certain exceptions, Section 311 requires that if the indenture trustee is, or becomes, a creditor of the obligor within three months prior to, or after, a failure by the obligor to pay principal or interest as it becomes due, then unless and until the default is cured, the trustee must set aside in a special account for the benefit of both the trustee individually and the indenture security holders various amounts received by the trustee. The three month period runs from the date of non-payment of principal or interest, even if the indenture otherwise provides a grace period before non-payment becomes an event of default. n40 In case of a bankruptcy filing, the 3-month period is intended to reach preferential transfers from the start of the 3-month period and continuing until a court has allocated the funds set aside. n41 Also, where the trustee is a trustee under several qualified indentures under which there are payment defaults by the obligor, the three month period for holders of any of the indenture securities runs from the earliest default. n42

If the trustee is required to account to the indenture security holders, the funds and property held by the trustee in the special account must be apportioned so that the trustee and the security holders realize the same percentage of their respective claims. The apportionment formula combines payments from the special account with payments from unsecured claims filed in state or federal court in receivership, bankruptcy, or reorganization proceedings in computing the pro rata shares of the trustee and of the indenture security holders. The percentages realized are computed after deducting from the claims against the obligor any payments received from sources other than the special account and payments received in judicial proceedings. Distributions to security holders or the trustee-creditor with regard to the secured portion of their claims are excluded from the apportionment computations. n43

The amounts which the trustee must hold in the special account are:

- (1) all reductions in indebtedness effected after the beginning of the three month period that are valid against the obligor and its other creditors; n44 and
- (2) all property received after the start of the three month period as:
 - (a) security for the trustee's claim, n45
 - (b) in satisfaction or settlement of the claim, or otherwise as to the claim, n46 or
 - (c) any proceeds from the sale of such property. n47

The property received by the trustee, or its proceeds, however, are held subject to any rights of the obligor or its other creditors. n48 The trustee need not set aside reductions in the amount owed to it resulting from the exercise of any right of set-off that the trustee could have exercised n49 if bankruptcy had been filed on the date of default. n50

Section 311(a) excludes from the apportionment requirements receipts from several items as to which the element of competition with indenture security holders is not present. n51 Payments by persons other than the obligor who are liable on the trustee's claim, the proceeds from the sale of the claim to a third person, and distributions from bankruptcy, receivership, or reorganization proceedings n52 may be retained in full by the trustee. Similarly, amounts realized from the sale or release of property held as security for the claim, where the property was so held before the beginning of the three month period, may be retained by the trustee. Finally, bona fide rescue loans are encouraged n53 by permitting the trustee to realize for its own account the proceeds from the sale or release of collateral relating to a claim created after the beginning of the three month period, but only if the collateral was received simultaneously with the creation of the debt and the trustee proves that at the time of the loan it had no reasonable cause to believe that a failure to pay principal or interest would occur within three months.

Particularly in a corporate bankruptcy reorganization, the apportionment formula of Section 311(a) may be difficult to apply, since it requires a determination of the value of the securities or other property received by the trustee and the indenture security holders, respectively, in the reorganization. n54 Section 311(a), presumably in recognition of this, allows the court in which any receivership, bankruptcy, or reorganization is pending the option to depart from the strict application of the apportionment formula and instead to merely give the formula "due consideration in determining the fairness of the distributions to be made to the indenture trustee and the indenture security holders" n55

Section 311(a) requires the apportionment provisions to continue to apply to any trustee that has resigned or been removed during the three month period. However, if the trustee has resigned or been removed before the three month period, it is subject to the apportionment requirement only if it received payment on its claim after the beginning of the three month period *and* this was within three months after its resignation or removal.

The three month time periods in Section 311(a) were inserted in the 1990 amendments to the Act in order to conform the section to the provisions of the Bankruptcy Reform Act of 1978. n56 Section 311(a) provides that the prior Trust Indenture Act references to three-month periods will continue to apply to trustees in any bankruptcy proceedings filed under pre-1978 law.

Unless expressly provided to the contrary in the indenture, Section 311(b) excludes from the apportionment requirement six other creditor relationships that the trustee may have, but which are seen as not involving "an acute conflict of interest." n57

The first of the excluded creditor relationships is that arising from "the ownership or acquisition of securities issued under any indenture, or any security or securities having a maturity of one year or more at the time of acquisition by the indenture trustee." n58 The scope of this provision was the subject of extensive litigation in *United States Trust Company of New York v. First National City Bank*, n59 one of a number of cases growing out of the collapse of Equity Funding Corporation of America. The trustee under the indenture relating to Equity Funding's convertible subordinated debentures, as agent for itself and three other banks, entered into a revolving credit agreement with Equity Funding. Advances under the agreement were evidenced by a "grid note," that is, a note on which advances and repayments would be indicated by notations. The trustee claimed that the revolving credit agreement and the grid note were securities having a maturity of one year or more, and were therefore, under the terms of the indenture, excluded from the Trust Indenture Act's apportionment requirements.

The court rejected the trustee's claim, stating that the securities exclusion "was primarily intended to cover the case where the indenture trustee holds some securities out of a large public issue and where the indenture trustee's securities are treated the same as the vast majority of securities held by others and there is little or no opportunity or incentive for the indenture trustee to favor its individual interests over those of the debenture holders." n60

The second creditor relationship that is excluded from the apportionment requirements is one which arises by reason of

advances to preserve property subject to the lien of the indenture, or to discharge tax liens or other prior liens on the trust estate, if the advances are authorized by the indenture or by a bankruptcy or receivership court. This exclusion, however, is available only if notice of the advances and the circumstances surrounding them are given to the indenture security holders at the time and in the manner provided in the indenture. n61 The notice under this provision in Section 311(b)(2) covers advances of any amount, not merely advances sufficiently large to require reporting under Section 313. n62

The third excluded creditor relationship is that which arises from disbursements made in the ordinary course of business as indenture trustee, transfer agent, registrar, custodian, paying agent, fiscal agent or depositary, or in other similar capacity. n63

The fourth creditor relationship that is excluded from the operation of Section 311(a) is any indebtedness created as a result of services rendered or premises rented, or from goods or securities sold in a cash transaction. n64 The indenture must define "cash transaction" in the manner specified by Trust Indenture Act Rule 11b-4: "any transaction in which full payment is made within seven days after delivery of the goods or securities in currency, checks, or other orders drawn on banks and payable on demand."

A fifth exclusion is any creditor relationship arising from ownership of stock or other securities of an Edge Act n65 corporation, which are corporations engaged almost exclusively in financing foreign trade. n66

Finally, the Act excludes from the apportionment requirements creditor relationships arising from the acquisition, ownership, acceptance, or negotiation of any drafts, bills of exchange, acceptances, or obligations that are "self-liquidating paper." The indenture must define self-liquidating paper as it is defined in Rule 11b-6. Self-liquidating paper includes any obligation which is incurred for the purpose of financing trade, manufacture, or shipment of goods, and which is secured by a lien on the goods or the proceeds from their sale, if the security was received by the trustee at the same time that the creditor relationship was created.

Indentures used in private placements that may later be qualified under the Trust Indenture Act traditionally provided for the Section 311 apportionment provisions to become effective only upon any later qualification. n67 Since the 1990 amendments to the Act, this same result can be obtained more simply by eliminating physical inclusion of the mandatory terms in the original indenture and relying upon their becoming included by operation of law when the indenture is later qualified. n68

[4] Indenture Trustee's Role in Bankruptcy Proceedings

The role of the indenture trustee in representing interests of the indenture security holders is explicitly recognized in the Bankruptcy Reform Act of 1978. n69 An indenture trustee representing security holders may be a party that files an involuntary petition in bankruptcy against the obligor. n70 An indenture trustee, as well as a creditor, may file a proof of claim, n71 and may examine the debtor at a meeting of creditors. n72

In a reorganization under Chapter 11, the indenture trustee is one of the parties to receive a copy of the examiner's or bankruptcy trustee's statement of investigation of the debtor. n73 Similarly, the indenture trustee is one of the persons entitled to raise, appear, and be heard on any issue in the reorganization. n74 The indenture trustee is one of the parties entitled to file a plan of reorganization where a bankruptcy trustee has been appointed or where a debtor has failed to file a plan or obtain acceptance of a plan during specified time periods. n75

The indenture trustee is entitled to have allowed, as administrative expenses, its actual and necessary expenses plus reasonable compensation for its services based on the time, nature, extent, and value of the services and the cost of comparable services in other contexts. n76 Expenses and compensation for services, though, are allowable only when the indenture trustee made "a substantial contribution" in the Chapter 11 proceedings. n77

FOOTNOTES:

(n1)Footnote 1. 2005 U.S. App. LEXIS 8066 (7th Cir. May 6, 2005) .

(n2)Footnote 2. See Trust Indenture Act of 1939, S. Rep. No. 248, 76th Cong., 1st Sess.6-7 (1939). For a general discussion of issues relating to default with particular emphasis on municipal bonds, see J. Spiotto (ed), *The Problems of Indenture Trustees and Bondholders* 1988: *Defaulted Bonds and Bankruptcy* (P.L.I. Real Estate Law and Practice Course Handbook Series Number 304, 1988).

(n3)Footnote 3. Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 Ala. L. Rev. 1037 (2008).

(n4)Footnote 4. ABF, Model Debenture Indenture--All Registered Issues, Section 601(b)(1967); Revised Model Simplified Indenture, Section 7.01(a), 55 Bus. Law. 1115, 1139-40 (2000); *Cruden v. Bank of New York*, 1990 U.S. Dist. LEXIS 11564 (S.D.N.Y. 1990) , *aff'd in part*, 957 F.2d 961 (2d Cir. 1992) . Also see Vito J. Iacovazzi, *Indenture Trustees: No Longer a Bump on the Log*, 1997 ABI Jnl. LEXIS 171 (March 1997).

See generally, Johnson, "Default Administration of Corporate Trust Indentures: The General Nature of the Trustee's Responsibility and Events of Default," 15 St. Louis U.L.J. 203,210-21 (1970).

(n5)Footnote 5. Trust Indenture Act of 1939, S. Rep. No. 248, 76th Cong., 1st Sess. 7 (1939); Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 33 (1939).

(n6)Footnote 6. See SEC Manual--Trust Indenture Act of 1939 at p. 124 (June 1958); J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 215 (2d ed. 1975).

(n7)Footnote 7. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 33 (1939).

(n8)Footnote 8. LNC Investments, Inc. v. First Fidelity Bank, N.A., 1997 U.S. Dist. LEXIS 12858, at *47- *87 (S.D.N.Y. 1997) , *vacated and remanded on other grounds*, 173 F.3d 454 (2d Cir. 1999) . See also *Dresner Co. Profit Sharing Plan v. First Fidelity Bank, N.A.*, 1996 U.S. Dist. LEXIS 17913 (S.D.N.Y. 1996) . As to application of the prudent man standard where the trustee is dealing with unclear legal issues, see *LNC Investments, Inc. v. National Westminster Bank, N.J.*, 308 F.3d 169 (2d Cir. 2002) .

(n9)Footnote 9. See *Semi-Tech Litig., LLC v. Bankers Trust Co.*, 353 F. Supp. 2d 460, 480-82 (S.D.N.Y. 2005) , *aff'd*. 450 F.3d 121, 126-27 (2d Cir., 2006) . *Abeles v. Citytrust, C.C.H.* Fed. Sec. L. Rep. P 96,171 (S.D.N.Y. 1991) (dispute as to when default occurred).

(n10)Footnote 10. See SEC Manual--Trust Indenture Act of 1939 at p. 125 (June 1958); Johnson, "Default Administration of Corporate Trust Indentures: The General Nature of the Trustee's Responsibility and Events of Default," 15 St. Louis U. L. J. 203, 221-27 (1970).

See § 8.15[3] *supra*, for discussion of the trustee's obligation to give notice of known defaults to indenture security holders.

(n11)Footnote 11. SEC Manual--Trust Indenture Act of 1939 at p. 124 (June 1958). See ABF, Model Debenture Indenture--All Registered Issues, Section 601(b); Model Simplified Indenture, Section 7.01(a)-(b), 55 Bus. Law. 1115, 1139-40 (2000).

Where an event of default has resulted in acceleration of the principal, curing the original default still leaves a default

in payment unless the acceleration is rescinded. American Bar Foundation, *Commentaries On Indentures* 250 (1971).

(n12)Footnote 12. J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 214 (2d ed. 1975).

(n13)Footnote 13. *Id.*, at 214-15.

(n14)Footnote 14. *Id.*

(n15)Footnote 15. An event of default may still be defined so that notice is required to create the event of default. See § 8.15[3] *supra*.

Section 315(c) prohibits a notice requirement as a condition to the trustee's action after an event of default has occurred.

(n16)Footnote 16. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 55 (1939).

(n17)Footnote 17. See ABF, Model Debenture Indenture--All Registered Issues, Section 601(c)(1967); Revised Model Simplified Indenture, Section 7.01(c), 55 *Bus. Law.* 1115, 1140 (2000).

(n18)Footnote 18. *Id.*

(n19)Footnote 19. United States Trust Co. of New York, C.C.H. Fed. Sec. L. Rep. P 77,935 (Div. Corp. Fin. 1985).

(n20)Footnote 20. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 55 (1939).

See *In the Matter of Multiphonics, Inc.*, 436 F. Supp. 1072 (E.D. La. 1977) ; *In re New York, New Haven & Hartford Railroad Co.*, 46 F. Supp. 236, 2 SEC Jud. Dec. 608 (D. Conn. 1942) .

(n21)Footnote 21. See American Bar Foundation, *Commentaries On Indentures* 251 (1971); ABF, Model Debenture Indenture--All Registered Issues, Section 601(c)(4) (1967).

(n22)Footnote 22. J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 215 (2d ed., 1975).

(n23)Footnote 23. SEC Manual--Trust Indenture Act of 1939 at p. 126 (June 1958). See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 216-18 (2d ed., 1975).

Cf., TIA Section 315(a)(1), discussed in § 8.15[2] *supra*, permitting the limitation of the trustee's pre-default duties to those specifically set out in the indenture.

(n24)Footnote 24. See *Fleet National Bank v. Trans World Airlines, Inc.*, 767 F. Supp. 510 (S.D.N.Y. 1992) (indenture trustee for senior notes permitted to obtain preliminary injunction to prevent amendment of indenture covering junior debentures where amendment would have reduced assets available for senior note holders).

(n25)Footnote 25. In *Daimler-Benz Aktiengesellschaft*, SEC Rel. No. 39-2353 (Apr. 25, 1997), 1997 LEXIS 909, the SEC granted an exemption from the provisions of Section 317(a) where investors were sold depositary securities representing interests in underlying notes, and the enforcement powers required by Section 317(a) were to be exercised by the depositary on behalf of the trustee, rather than by the trustee.

(n26)Footnote 26. See ABF, Model Debenture Indenture--All Registered Issues, Section 504 (1967); Model Simplified Indenture, Section 6.09, 38 *Bus. Law.* 741, 758 (1983). See also 11 USC § 501(a) (expressly authorizing indenture trustee to file proofs of claims in bankruptcy).

(n27)Footnote 27. See American Bar Foundation, *Commentaries On Indentures* 227-29 (1971).

(n28)Footnote 28. See ABF, Model Debenture Indenture--All Registered Issues, Section 503 (1967); Revised Model Simplified Indenture, Section 6.03, 55 *Bus. Law.* 1115, 1137 (2000).

(n29)Footnote 29. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 222-23 (2d ed., 1975); American Bar Foundation, *Commentaries On Indentures* 225 (1975).

(n30)Footnote 30. *In re Pittsburgh and Lake Erie Railroad Co. Securities and Antitrust Litigation*, 543 F.2d 1058 (3rd Cir. 1976) .

(n31)Footnote 31. *In re Equity Funding Corp. of America Securities Litigation*, 603 F.2d 1353 (9th Cir. 1979) .

(n32)Footnote 32. *Id.* at 1360 n.9 .

(n33)Footnote 33. 409 N.W. 2d 862 (Minn. App. 1987) .

(n34)Footnote 34. 928 P.2d 754 (Ct. App. 1996) , cert. granted, 1996 Colo. LEXIS 673 (Colo. Sup. Ct. 11/29/96) .

(n35)Footnote 35. Revised Model Simplified Indenture, Note 2 to Section 6.03, 55 *Bus. Law.* 1115, 1190 (2000).

(n36)Footnote 36. J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 222 (2d ed., 1975), ABF, Model Debenture Indenture--All Registered Issues, Section 502 (1967); Revised Model Simplified Indenture, Section 6.02 (1983), 55 *Bus. Law.* 1115, 1136 (2000).

(n37)Footnote 37. NYSE Listed Company Manual, Sec. 603.02 (June 1983).

(n38)Footnote 38. A trustee under an indenture covering collateral trust notes need not have direct access to the physical assets collateralizing the securities which in turn collateralize the collateral trust notes. Indirect access through the power to require the indenture trustee on the collateral securities to proceed against those assets is sufficient. Colorado-Ute Electric Association, Inc. (No Action Letter, Sept. 7, 1984).

(n39)Footnote 39. See ABF Model Debenture Indenture--All Registered Issues, Section 503 (1967); Revised Model Simplified Indenture, Section 6.03, 55 *Bus. Law.* 1115, 1137 (2000). Johnson, "Default Administration of Corporate Trust Indentures: Default Remedial Provisions," 15 *St. Louis U. L. J.* 374, 386-97 (1971). Cf. J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 221-27 (2d ed. 1975).

(n40)Footnote 40. TIA Section 311(a) (last paragraph).

(n41)Footnote 41. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 213.01, (March 30, 2007), <www.sec.gov/divisions/corpfin/guidance/tiainterp.htm>.

(n42)Footnote 42. *Id.*

See Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 49 (1939). Often the same protection is extended to security holders under unqualified indentures having the same trustee and substantially similar sharing provisions. SEC Manual--Trust indenture Act of 1939 at pp. 56-57 (June 1958); ABF, Model Debenture Indenture--All Registered Issues, Section 613(c)(2) (1967).

(n43)Footnote 43. TIA Section 311(a) (penultimate paragraph).

(n44)Footnote 44. TIA Section 311(a)(1).

(n45)Footnote 45. See *United States Trust Company of New York v. First National City Bank*, 57 A.D.2d 285, 292-93, 394 N.Y.S.2d 653, 658-59 , C.C.H. Fed. Sec. L. Rep. P 96,605 at pp. 91,796-97 (1977), *aff'd*, 45 N.Y.2d 869,

410 N.Y.S.2d 580, 382 N.E.2d 1355 (1978) .

(n46)Footnote 46. TIA Section 311(a)(2).

(n47)Footnote 47. TIA Section 311(a)(2).

(n48)Footnote 48. TIA Section 311(a)(1) and (2).

(n49)Footnote 49. See *United States Trust Company of New York v. First National City Bank*, 57 A.D. 2d 258, 293-94, 394 N.Y.S.2d 653, 659, C.C.H. Fed. Sec. L. Rep. P 96,065 at p.91,797 (1977) , *aff'd*, 45 N.Y.2d 869, 410 N.Y.S.2d 580, 382 N.E.2d 1355 (1978) .

(n50)Footnote 50. TIA Section 311(a)(1).

(n51)Footnote 51. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 49 (1939).

(n52)Footnote 52. See *United States Trust Company of New York v. First National City Bank*, 57 A.D. 2d 285, 297, 394 N.Y.S. 2d 653, 661-62, C.C.H. Fed. Sec. L. Rep. P 96,065 at p.91,799 (1977), , *aff'd*, 45 N.Y.2d 869, 410 N.Y.S.2d 580, 382 N.E.2d 1355 (1978) .

(n53)Footnote 53. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 49 (1939).

(n54)Footnote 54. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 66-67 (2d ed., 1975).

(n55)Footnote 55. TIA Section 311(a) (penultimate paragraph).

(n56)Footnote 56. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess., pp. 35, 50.

(n57)Footnote 57. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess.49-50 (1939).

(n58)Footnote 58. TIA Section 311(b)(1).

(n59)Footnote 59. 57 A.D.2d 285, 394 N.Y.S.2d 653, C.C.H. Fed. Sec. L. Rep. P 96,065 (1977) , *aff'd*, 45 N.Y.2d 869, 410 N.Y.S.2d 580, 382 N.E.2d 1355 (1978) .

(n60)Footnote 60. 57 A.D.2d at 291, 394 N.Y.S.2d at 658, C.C.H. Fed. Sec. L. Rep. P 96,065 at p. 91,796 .

(n61)Footnote 61. TIA Section 311(b)(2).

(n62)Footnote 62. See § 8.15[1] *supra*, for discussion of Section 313.

(n63)Footnote 63. TIA Section 311(b)(3).

(n64)Footnote 64. TIA Section 311(b)(4).

(n65)Footnote 65. Section 25(a) of the Federal Reserve Act, as amended, 12 U.S.C. §§ 611-631.

(n66)Footnote 66. See Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 50 (1939).

(n67)Footnote 67. See Model Debenture Indenture--All Registered Issues, Section 613 (1967).

(n68)Footnote 68. TIA § 318, discussed at § 8.03 *supra*.

(n69)Footnote 69. For discussion of the pre-1978 precedents, see Johnson, "Default Administration of Corporate

Trust Indentures: Alternatives to Default Remedial Provisions and Judicial Arrangements and Reorganizations," 15 *St. Louis U. L. J.* 509, 523-38 (1971).

(n70)Footnote 70. 11 U.S.C. § 303(b).

(n71)Footnote 71. 11 U.S.C. § 501(a). See Bankruptcy Rules 3003(c), 3021.

(n72)Footnote 72. 11 U.S.C. § 343.

(n73)Footnote 73. 11 U.S.C. § 1106(a)(4).

(n74)Footnote 74. 11 U.S.C. § 1109(b). See Bankruptcy Rules 2002, 2015(c), 2019,6004(c), 6007(a), 9010(a), 9019.

(n75)Footnote 75. 11 U.S.C. § 1121(c). Cf. Bankruptcy Rule 3017(a).

(n76)Footnote 76. 11 U.S.C. § 503(b)(3)(D) and § 503(b)(5).

See *In the Matter of Multiphonics, Inc.*, 436 F. Supp. 1072 (E.D. La. 1977) (under prior law); *In re New York, New Haven & Hartford Railroad Co.* 46 F. Supp. 236, 2 S.E.C. Jud. Dec. 608 (D. Conn. 1942) (under prior law).

(n77)Footnote 77. 11 U.S.C. § 503(b)(3)(D) and § 503(b)(5). See *In re Worldwide Direct Inc.*, 334 B.R. 112 (Bankr. D DE, 2005) ; *In re American Plumbing & Mechanical, Inc.*, 327 B.R. 273 (Bankr. WD TX, 2005) .



132 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.18

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.18 Bondholders' Role in Enforcing Indenture Provisions

The Trust Indenture Act provides for direct action to be taken by the indenture security holders to enforce their rights, such as requirements that facilitate communications between bondholders and guarantee the bondholder's right to sue for principal and interest, and permissive provisions that authorize bondholders to postpone interest payments, waive past defaults, direct the trustee in conducting remedial proceedings, and remove the trustee. The Act also includes protective provisions to prevent small numbers of bondholders from acting contrary to the best interests of bondholders in general.

While the Trust Indenture Act attempts to assure the availability of a responsible indenture trustee to enforce the rights of the indenture security holders, it also provides mechanisms for direct action by the security holders themselves. The relevant provisions of the Trust Indenture Act are delicately balanced. In general, security holders have the ultimate decision making authority regarding the enforcement of their rights. However, protective provisions are included to prevent small numbers of bondholders from acting contrary to the best interests of bondholders in general.

[1] Communications among Bondholders

Section 312(b) contains provisions that facilitate communications among indenture security holders. n1 Under Section 312(b), certain action must be taken by the institutional trustee after it receives a written application from three or more indenture security holders stating that they desire to communicate with other indenture security holders as to their rights. The security holders' application must be accompanied by a copy of the proxy or other communication that they propose to transmit to other bondholders. It must also be accompanied by reasonable proof that each applicant has owned an indenture security for at least six months prior to the application.

When the institutional trustee receives this application, within five business days it must (at the trustee's election) either afford the applicants access to the security holder lists that it is required to maintain under the provisions of Section 312(a), n2 or else furnish information that will lead to the trustee's mailing of the communication to the indenture

security holders.

If the trustee chooses to mail the communication, it must, within the five business day period, inform the applicants of the approximate number of indenture security holders and the approximate cost of mailing the proposed communication to them. Then, if the applicants furnish the trustee the material to be mailed and make or provide for payment of the reasonable expenses of mailing, the trustee must mail the material with reasonable promptness to all indenture security holders on the list in its possession.

If the trustee believes that the requested mailing would be contrary to the best interests of the indenture security holders, or would be in violation of law, Section 312(b) permits the trustee to temporarily delay mailing and seek a ruling by the Commission. Within five days after the tender by the applicant bondholders of the communication that they desire the trustee to mail, the trustee may mail to the applicants and file with the Commission a written statement specifying the basis of its opinion as to why the mailing would be contrary to the security holders' best interests or in violation of law. After an opportunity for hearing, the Commission may, and if demanded by the trustee or applicants must, enter an order either sustaining or refusing to sustain the trustee's objections. The trustee must mail the material only if the Commission refuses to sustain its objections or if, after sustaining its objections, the Commission later, after notice and opportunity for hearing, finds that the applicants have met the objections.

Bondholders may use the Section 312(b) procedures to communicate as to various concerns. For example, they may wish to exercise their rights to accelerate the due date after an event of default, to direct the trustee to enforce certain remedies, or to remove the trustee. n3

While Section 312(b) would appear to be concerned only with the trustee's duty, one court has held that Section 312(b) affirmatively prohibits indenture security holders from mailing a communication to their fellow security holders without first making application to the indenture trustee. n4 Thus, in the court's view, the trustee may prevent any mailing of incomplete or misleading communications under its power to refuse to transmit communications that it and the Commission find to be contrary to the best interests of the indenture security holders or in violation of law. n5

Communications by bondholders pursuant to the provisions of Section 312(b) may be subject to the Commission's proxy rules under Securities Exchange Act Section 14. Where the indenture securities are listed on an exchange, n6 or where convertible debt securities of an issuer with over \$10 million in assets are traded over-the-counter and are held of record by at least 500 persons, n7 the securities are required to be registered under Section 12 of the Exchange Act, and thereby become subject to the proxy rules. n8 The solicitation of any proxy, consent, or authorization concerning such indenture securities is subject to the provisions of Exchange Act Rule 14a-9 prohibiting material misstatements or omissions. In any solicitation of ten or more persons, n9 each security holder must be furnished a proxy statement meeting the requirements of Schedule 14A. n10

In *Matter of W. T. Grant Co.*, n11 a group of debenture holders who had appealed the bankruptcy court's approval of a settlement offer proposed to distribute a letter seeking written evidence of support from other debenture holders, and to have the responses entered in the court record. The court held that this was a proxy solicitation.

In a no action letter, the Commission staff found that a proxy solicitation would be involved if a debenture holder were to solicit other holders to give notice of default to the issuer. Under the indenture, redemption could be forced if 25% of the holders notified the issuer of a default and of their rights. The soliciting debenture holder intended to enclose in his communication a card that other debenture holders would complete in duplicate and send to the issuer and to the soliciting debenture holder. n12

Section 312(c) of the Trust Indenture Act protects the indenture trustee from liability for disclosing the names of bondholders under provisions mandated by Section 312(b), regardless of the source of the names. n13 It also protects the trustee from liability that might otherwise arise from its mailing of material pursuant to a request under Section

312(b). Thus, the trustee will not be in violation of the proxy rules if it mails noncomplying material furnished by an indenture security holder.

[2] No-Action Clauses

In centralizing enforcement responsibilities in the indenture trustee, the linchpin is the no-action clause. n14 This clause, common in indentures, generally prohibits individual bondholders from instituting suit unless the trustee has refused to do so after a request from at least 25% in principal amount of the bondholders who have offered reasonable indemnity against costs, expenses, and liabilities. n15 In older indentures, the typical clause required bondholders to give the trustee 60 days to comply with their request. n16 The drafters of the Revised Model Simplified Indenture suggest shortening this to 15, or at most 30, days, since a "pre-packaged" bankruptcy plan can often be completely taken from filing to confirmation in less than 60 days. n17 The Revised Model Simplified Indenture also contains an optional clause which, if included, requires the trustee to mail to debenture holders any notice it receives from other debenture holders requesting it to take action, and also to mail to them any notice it has sent back to requesting debenture holders refusing to comply with their request. n18

Often one, or a few, institutional investors hold the requisite 25% of the bonds needed under the no-action clause to request the trustee to pursue a remedy. n19 However, the added requirement that the requesting bondholders offer the trustee indemnity requires one, or a few, institutions alone to provide for costs, expenses and liabilities that should be borne proportionately by all bondholders. Even where that indemnity is offered, problems exist if the trustee does not then respond by taking action. At least unless the trustee waives the requirement, the institutional investors cannot proceed on their own under the typical no-action clause until 60 days have elapsed. Often judicial intervention is needed much sooner if the bondholders' interests are to be protected. n20

Recognizing the problems posed by the indemnity requirement, the Revised Model Simplified Indenture has removed that requirement from its no-action clause. While the trustee can still insist on indemnity before it agrees to file suit, the debenture holders are not precluded from bringing suit or taking other action merely because they fail to offer indemnity. n21

Section 316(b) places limits on the permissible scope of no-action clauses by prohibiting their application to bondholder suits for payment of principal or interest, except for a limited postponement of interest. n22 Even where the claim for principal and interest is asserted against the issuer's parent on a "piercing the corporate veil" theory, still a no-action clause may not be invoked to preclude suit. n23

No action clauses are designed to prevent spurious litigation, multiple suits, and premature assertion of claims when delay might be more beneficial to the bondholders as a group. n24 While suits within the scope of the no-action clause are typically against the issuer, some suits against third parties may also be barred. n25 However, no-action clauses have uniformly been read to permit suits by bondholders against the indenture trustee for wrongdoing. n26 The anti-exculpation provisions of TIA Section 315(d) would presumably preclude a no-action clause that purported to insulate the indenture trustee from its own negligence or its own willful misconduct. n27

Some courts have also permitted bondholders to ignore no-action clauses when the indenture trustee has a conflicting interest and demand upon it to bring suit against the issuer or a third party would presumably be futile. n28 However, in *Murray v. U.S. Bank Trust Nat'l. Ass'n.*, n29 the Eleventh Circuit enforced a no-action clause against bondholders who claimed that the trustee had a conflict of interest. Shareholders claimed that the trustee should not have the sole right to sue its predecessor trustees for their negligence and breach of fiduciary duty in permitting a security interest in collateral to lapse. The bond proceeds had been loaned to a third party and the loan had been secured by the borrower's accounts receivable and inventory. Prior trustees failed to file a continuation statement and the current trustee failed to discover the fact that the collateral had been lost. Bondholders claimed that a conflict of interest stemmed from the fact that the current trustee would be liable if the losses could not be recovered from the prior trustees. The court held that the

current trustee should be permitted to complete its litigation. Any conflict of interest was not significant enough to create an exception. After that litigation was completed, bondholders could sue the current trustee for negligence if there were still unrecovered losses. n30

A typical no-action clause precludes the bondholder from instituting proceedings "with respect to this Indenture, or for the appointment of a receiver or trustee, or for any other remedy hereunder." n31 Sometimes the no-action clause merely refers to any "remedy with respect to this Indenture or the Securities." n32 No-action clauses have been described as applying to "any claim that can be enforced by the trustee on behalf of all bonds" except for payment defaults, "no matter what legal theory a plaintiff advances." n33 Thus, they have been held to apply not only to claims arising from breach of specific provisions in the indenture, but to claims for breach of implied covenants of good faith and fair dealing, to claims that the issuer made fraudulent conveyances of assets, and to claims that fraud by the issuer prevented the filing of a suit to enjoin a corporate restructuring that increased the risk of a default on the indenture securities. However, the typical no-action clause does not prohibit a suit claiming fraudulent inducement to purchase or sell the indenture securities. In the case of a purchase, the claim goes to the question of whether the bondholder ever effectively agreed to be bound by the no-action clause. In the case of a sale, the seller no longer has a relationship with the trustee that permits the trustee to assert his claim. Moreover, fraud in connection with plaintiff's purchase or sale of securities does not necessarily involve an injury shared by all bondholders, which is the only sort of claim that the trustee may assert. n34

Also, the typical no-action clause permits a direct action seeking rescission of the purchase of indenture securities or damages where their sale violated the federal securities laws. n35 Sometimes, however, a no-action clause may, by its terms, be broad enough to cover a claim asserted by bondholders under the Securities Act of 1933 or the Securities Exchange Act of 1934. Even if that is the case, the Second Circuit has held that

The statutory framework of the 1933 and 1934 Acts compels the conclusion that individual security holders may not be forced to forego their rights under the federal securities laws due to a contract provision [A]ctions based on federal securities laws may not be precluded by the no-action clause. n36

Where indenture security holders may bring a direct action to enforce indenture provisions, Section 315(e) deems automatically included in the indenture, unless expressly excluded by language in the indenture, the security holders' agreement to the court's imposing on them an undertaking to pay costs. n37 This permits the court, in its discretion, to assess reasonable costs, including reasonable attorney's fees, having due regard to the merits and good faith of the claims or defenses made by the litigant. n38 This provision calling for an undertaking for costs, however, may not apply to a suit instituted by any indenture security holder, or group of holders, who hold in the aggregate more than 10% of the indenture securities outstanding, nor may it apply to a suit by any bondholder for payment of principal or interest, on or after their respective due dates. n39

[3] Right to Sue for Principal and Interest

Section 316(b) guarantees certain rights to each indenture security holder. The right of any bondholder to receive principal and interest, n40 or to institute suit for their enforcement, n41 on or after their respective due dates expressed in the indenture security n42 must not be impaired or affected n43 without the consent of the holder. n44 However, a limited postponement of interest, effected in accordance with Section 316(a)(2), is permitted. n45

The right to sue for principal on or after the due date set out in the bond instrument is a right separate from the right normally included in indentures to accelerate the due date of the debt security upon various events of default. According to the Tenth Circuit, this means that even though the statute of limitations period has expired as measured from the accelerated due date, it begins to run again as to suits by individual investors once the later original due date arrives. n46

In many situations, it is unclear whether a particular claim is for principal and interest when due, or whether the claim does not meet that definition and is thus subject to the constraints of the indenture's no-action clause. Where a note had a provision for interest to be reset by the issuer on a specified date and gave note holders the option for 30 days after the reset date to require the issuer to repurchase their notes for the outstanding principal amount plus accrued interest, a suit to enforce a note holder's repurchase rights was a suit to enforce payment of principal protected by TIA Section 316(b). The indenture defined this repurchase obligation in a way that created a demand obligation in favor of the note holder. n47 However where an indenture gave debenture holders the right to tender their debentures for repurchase at a premium upon the occurrence of certain triggering events, including certain hostile takeovers, a suit attempting to enforce their right to tender was barred by the indenture's no-action clause. TIA Section 316(b) was found to apply only to failure to pay after an explicit date on which a principal or interest payment has become absolutely and unconditionally due. Plaintiff's right to tender debentures before their due date was found analogous to an indenture provision providing for acceleration of principal and interest upon default. n48 An earlier case had held that acceleration is a collection remedy, and failure to pay the full amount due under an acceleration clause is not to be considered a payment default. n49

Another issue that arises under Section 316(b) is whether (despite an indenture's no-action clause) the TIA assures individual bond holders the right to file an involuntary petition in bankruptcy against the obligor when there has been a payment default. Some courts have applied no-action clauses to preclude bondholders from filing involuntary bankruptcy petitions against a defaulting issuer. n50 However, in *In re Envirodyne Industries, Inc.*, n51 the bankruptcy court in the Northern District of Illinois distinguished earlier cases and held that Section 316(b) covers not only individual claims for interest and principal, but also the type of collective action involved in forcing the issuer into bankruptcy.

An indenture provision limiting or denying the right to institute a suit to receive principal or interest is permitted by Section 316(b) if the prosecution or the entry of judgment would result in the surrender, impairment, waiver, or loss of the indenture's lien on collateral. This exception stems from a peculiarity of California law n52 that permits only one action to foreclose a mortgage on real property. n53 If a bondholder recovers judgment on the bond without foreclosing on the mortgage, he waives the mortgage's security for all bondholders. n54 Thus, whenever an indenture is secured by real property located in California, this permissive provision is likely to be included.

The provisions of Section 316(b) were not designed to prevent a majority of bondholders from binding dissenters to changes in the indenture that do not relate to principal or interest payments, nor to prevent a majority from waiving defaults other than non-payment, n55 even if the waivers indirectly affect the assets available for payment. n56 Similarly, Section 316(b) has not been interpreted to prevent a majority from amending sinking fund provisions in an indenture. n57

Section 316(b) does, however, permit individual bondholders to dissent from an issuer's plan of debt readjustment and instead sue on their bonds. n58 In the view of some courts, this is true even when the reorganization, while not technically changing the amount of interest or principal owed to bondholders, does as a practical matter impair or affect the holders' rights to sue for or receive payment. Thus in *Federated Strategic Income Fund v. Mechala Group Jamaica, Ltd.*, n59 the court granted a preliminary injunction to prevent the consummation of an issuer's tender offer for its notes which had been accepted by 77% of its note holders. The offer involved the purchase of the notes for a fraction of their principal amount from holders who also consented to various amendments to the indenture that would govern the remaining untendered notes. Those amendments would have eliminated the guarantees of the notes by the issuer's subsidiaries and would have allowed the issuer (which was the only remaining obligor) to proceed with a reorganization that would have stripped it of all its meaningful assets. In the court's view, these changes "as a practical matter" would have impaired note holders' right to sue for payment when the notes matured. n60

Other courts, however, interpret Section 316(b) as applying only to security holders' legal rights to the payment of

principal and interest, not to impairment of merely their *practical* ability to receive payment. So a fraudulent transfer of assets that left the issuer of debt securities insolvent may not be attacked on the ground that it was not approved by all of the indenture security holders. n61

The effect of Section 316(b) is to force recapitalizations into bankruptcy court. n62 The drafters of the TIA understood this and saw this result as assuring "judicial scrutiny of the fairness of debt-readjustment plans." n63 With the enactment of the 1978 Bankruptcy Code, however, judicial examination of fairness in bankruptcy was largely eliminated when a reorganization plan was approved by two-thirds in amount and a majority in number of bondholders voting. n64 Particularly with the development of procedures for prepackaged bankruptcies, the constraints imposed by Section 316(b) on negotiated recapitalizations were, as a practical matter, largely eliminated. n65 An important concern of the original drafters of TIA Section 316(b) was that insiders might dominate the reorganization process if an absolute right to sue for principal and interest were not maintained. n66 That concern was alleviated by the 1978 Bankruptcy Code's provisions permitting the bankruptcy court to exclude from the approval vote bonds held by persons that have a conflict of interest in voting. n67

The Bankruptcy Code permits U.S. courts to recognize and enforce the results of insolvency proceedings brought in the courts of foreign countries. While a foreign proceeding is pending, the foreign representative may file a petition for recognition of a foreign proceeding in a U.S. Bankruptcy Court in order to stay proceedings in the United States against property involved in the foreign proceedings and obtain an order for the turnover of U.S. property to the foreign court. n68 TIA Section 316(b) does not prevent the impairment of a bondholder's right to principal and interest through a foreign proceeding. An ancillary proceeding under the U.S. Bankruptcy Code may enforce the foreign restructuring plan. n69

In debentures covering subordinated debt securities, the subordination clauses must be drafted carefully in order to avoid a conflict between the rights of the subordinated debt holders under Section 316(b) to sue for principal and interest and the rights of senior security holders to be paid before payment is made to holders of subordinated debt. Typical indenture provisions deal with this by providing that any amounts otherwise due to subordinated debt holders must instead be paid to senior security holders until they are paid in full. The rights of the subordinated debt holders to eventually enforce their judgments are protected through subrogation. n70

The ABA's Model Debenture Indenture provides, in response to the requirements of TIA Section 316(b), not only that indenture security holders have the right to receive payment of principal and interest on their due dates, but that such right "is absolute and unconditional." That provision was inserted to assure that the indenture securities would be negotiable instruments under former Article 3 of the Uniform Commercial Code. n71 Under today's UCC, Article 8, not Article 3, governs investment securities, and Article 8 applies to notes whether or not they evidence an "unconditional" right to payment. n72 In *Bank of N.Y. v. First Millennium, Inc.*, n73 an indenture provision giving the right to unconditional payment was read by the court--as a matter of New York contract law--to allow holders of limited recourse notes to collect their unpaid principal from any of the issuer's assets, not just from the collateral securing the notes. The court noted that the drafters of the indenture, consistent with Section 316(b), could have modified the Model Indenture provisions to limit claimants on the notes to the collateral securing them. However they did not do so and the court was unwilling to revise their language for them. The court also concluded that in states that have adopted Revised Article 3 of the UCC, a different result would be reached because it provides that a promise is not made conditional because payment is limited to resort to a particular fund or source. n74

[4] Postponement of Interest and Waiver of Past Defaults by Vote of Bondholders

Section 316(a)(2) permits the indenture to contain provisions authorizing the holders of at least 75% in principal amount of the outstanding indenture securities, or of any outstanding series of securities, n75 to consent to the postponement of any interest payment for a period not exceeding three years from its due date. n76 In computing the requisite 75% vote,

securities owned by any obligor or by any person directly or indirectly controlling or controlled by or under direct or indirect common control with any obligor are to be disregarded. In this way, voting by persons with clear conflicting interests is avoided. n77 Permitting a limited postponement of interest may facilitate temporary readjustments in times of cash flow crises without triggering a payment default and acceleration of the principal amount. n78

Subject to contrary provisions in the indenture, Section 316(a)(1)(B) permits holders of not less than a majority in principal amount of the outstanding indenture securities to consent on behalf of all holders to the waiver of any past default and its consequences. n79 The indenture may permit a majority of any outstanding series of securities to similarly consent to the waiver of past defaults and their consequences on behalf of all holders of the series. n80 In computing the votes needed, securities owned by obligors or their affiliates are disregarded in the identical manner as in voting on interest postponements. While the Trust Indenture Act permits waivers of default by a majority vote, indentures sometimes require a 66 2/3 % vote. n81 This power to waive defaults permits the requisite majority of bondholders to effect a settlement without resorting to the bankruptcy courts. n82

The majority's power to waive past defaults is subject to the overriding provision of Section 316(b) assuring each bondholder the right to receive or sue for principal and interest after their respective due dates. n83 Since Section 316(b) refers to the maturity date expressed in the indenture security, it is permissible to include in a qualified indenture a provision for a majority to rescind an acceleration of the due date. The American Bar Foundation's Model Debenture Indenture n84 provides for rescission of an acceleration before the trustee has obtained a judgment for payment n85 if a majority of debenture holders give written notice to the issuer and the trustee and if certain other conditions are met. The conditions require the issuer to pay or deposit with the trustee an amount sufficient to cover overdue payments plus interest on them and the trustee's expenses and compensation. They also require all other events of default to be cured or waived. Since rescission of acceleration would appear to be the waiver of the consequences of a past default as that term is used in Section 316(a)(1)(B), securities held by the obligor or its affiliates presumably must be disregarded in determining whether the requisite majority has agreed. n86

Solicitation of bondholders to consent to interest postponements or waivers of default may be subject to the Commission's proxy rules if the bonds are listed on an exchange or where convertible debentures are involved. n87

Section 316(c) permits the obligor to set a record date for purposes of determining the security holders entitled to vote on the postponement of interest or the waiver of past defaults. Unless the indenture provides otherwise, the record date is to be the later of (1) thirty days before the first solicitation of security holders or (2) the date prior to the first solicitation when the most recent list of holders was furnished to the trustee pursuant to Section 312. n88

[5] Directions to Trustee by Bondholders

Subject to contrary provisions in the indenture, Section 316(a)(1)(A) permits the holders of not less than a majority in principal amount of the outstanding indenture securities to direct the time, method, and place of conducting any proceeding for any remedy available to the trustee under the indenture, or exercising any trust or power conferred on the trustee under the indenture. n89 The Revised Model Simplified Indenture contains a provision permitting a beneficial owner, instead of the record owner, of the indenture securities to give directions to the trustee if the beneficial owner furnishes an affidavit of beneficial ownership and satisfactory indemnity to the trustee against any loss, liability or expense that may result from the trustee's acting on the basis of the affidavit. This clause permits, for example, an institutional owner whose securities are ultimately held of record by a depository to act quickly in providing direction to the trustee. n90

Under Section 315(d)(3), unless the indenture provides to the contrary, the trustee is protected as to any action taken or omitted in good faith in accordance with the direction of bondholders so given. n91

In determining under Section 316(a)(1)(A) whether the requisite majority has given directions, securities owned by any

obligor, or by any person directly or indirectly controlling or controlled by or under direct or indirect common control with the obligor, are to be disregarded. In determining whether the trustee is protected by Section 315(d)(3), only securities that the trustee knows are owned by the obligor or affiliates need to be disregarded in determining if a requisite majority of bondholders has given directions. n92

Section 316(a)(1)(A) permits the indenture to provide for directions to be given by a majority vote of any outstanding series of securities. For this purpose, "series" is defined by Section 310(b) to mean any group of securities whose terms permit holders to vote separately to direct the indenture trustee, or to otherwise take action pursuant to a separate vote. However securities that rank equally and are wholly unsecured may not be treated as separate series. n93

Section 316(c) allows the obligor to set a record date for purposes of determining the security holders entitled to vote or consent in giving permitted directions to the trustee. Unless the indenture provides otherwise, the record date is to be the later of (1) thirty days before the first solicitation of security holders or (2) the date prior to the first solicitation when the most recent list of holders was furnished to the trustee pursuant to Section 312. n94 The record date procedure may also be used for any other vote of indenture security holders, so long as the action they take is not prohibited by the Trust Indenture Act. n95

Section 316(a)(1)(A) does not prevent the indenture from giving less than a majority of bondholders the power to directly, rather than through the trustee, take action such as accelerating maturity after default, ripening a breach of a covenant into an event of default, causing an investigation to be made, or calling a meeting of bondholders. n96

Even though Section 316(a)(1) is permissive, it has been interpreted as prohibiting provisions not consistent with its requirements. n97 However, permitting the trustee to refuse to follow the bondholders' direction when the direction is in conflict with requirements of law or other provisions in the indenture, or where it would involve the trustee in personal liability, or would unduly prejudice the other bondholders, is allowed as consistent with Section 316(a)(1)(A). n98

Section 316(a)(1)(A) may not be used to circumvent the right of bondholders to sue for principal and interest n99 granted by Section 316(b). n100

Where debt securities that are not issued under a qualified indenture are listed on the New York Stock Exchange, NYSE rules prohibit the indenture from containing any provision requiring a request or demand of holders of more than 30% of the outstanding bonds to compel the trustee to proceed with the enforcement of any remedy provided by the indenture upon an event of default. However, the indenture may permit holders of a majority of the bonds to rescind any minority action. n101 Such a provision would be inconsistent with Section 316(a)(2)(A) in a qualified indenture.

The right of bondholders to act directly and their right to give directions to the trustee preserves their option to form a protective committee to represent their interests when default is imminent or has occurred. n102

[6] Removal of Trustee

An ultimate power of bondholders to control the trustee is generally granted by indenture provisions permitting bondholders to remove the trustee. Both the American Bar Foundation's Model Debenture Indenture and the Revised Model Simplified Indenture provide for removal of the trustee by a majority in principal amount of the outstanding indenture securities. n103

FOOTNOTES:

(n1)Footnote 1. See ABF, Model Debenture Indenture--All Registered Issues, Section 702(b), (c) (1967); Revised Model Simplified Indenture, Section 12.02, 55 *Bus. Law.* 1115, 1162 (2000).

(n2)Footnote 2. *See* § 8.14[1] *supra*.

(n3)Footnote 3. *See* American Bar Foundation, *Commentaries On Indentures* 283-84 (1971).

(n4)Footnote 4. *In the Matter of W. T. Grant Co.* 6 B.R. 762, 771-72, C.C.H. Fed. Sec. L.Rep. P 97,636 at p. 98,410 (S.D.N.Y. 1980) , transferred to Suspense Docket 13 B.R. 1001 (S.D.N.Y. 1981) .

(n5)Footnote 5. *Id.*

(n6)Footnote 6. Exchange Act Section 12(b).

(n7)Footnote 7. Exchange Act Section 12(g) and Rule 12g-1. Convertible debt is defined as an equity security for these purposes, Exchange Act Section 3(a)(11).

(n8)Footnote 8. Exchange Act Section 14 and Rules 14a-1 to 14a-12.

(n9)Footnote 9. Exchange Act Rule 14a-2(b)(1).

(n10)Footnote 10. Exchange Act Rule 14a-3(a); Rule 14a-16.

For discussion of the Exchange Act proxy rules, see Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, Ch. 7 (Matthew Bender).

(n11)Footnote 11. 6 B.R. 762, C.C.H. Fed. Sec. L. Rep. P 97,636 (S.D.N.Y. 1980) , transferred to Suspense Docket 13 B.R. 1001 (S.D.N.Y. 1981) .

(n12)Footnote 12. American Controlled Industries, Inc. (No Action Letter, Nov. 30,1973).

(n13)Footnote 13. The intent of this provision was "to exempt from the nondisclosure provisions of the Revenue Act the disclosure of information as to the names and addresses of the bondholders in accordance with the provisions of the indenture." Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 51 (1939). As discussed in *Section 8.14[1] supra*, it was contemplated that bondholder lists would be compiled from ownership certificates filed under the Revenue Act of 1936.

(n14)Footnote 14. For an extensive criticism of the scope of current no-action clauses and a suggestion for narrowing them, see Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. Rev. 1040 (2002).

(n15)Footnote 15. For an example of a no-action clause requiring a majority, rather than only 25%, in principal amount of holders to request that the trustee take action, see *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *17- *20 (1992) .

(n16)Footnote 16. *See* ABF, Model Debenture Indenture-- All Registered Issues, Section 507 (1967); Model Simplified Indenture, Section 6.06, 38 Bus. Law. 741, 757 (1953).

(n17)Footnote 17. Revised Model Simplified Indenture, Section 6.06 and Note 4. to Section 6.06, 55 Bus. Law. 1115, 1192 (2000).

(n18)Footnote 18. Revised Model Simplified Indenture, Section 7.05, 55 Bus. Law. 1115, 1141 (2000).

(n19)Footnote 19. Even where the bonds were originally distributed more widely, when the issuer approaches bankruptcy, its bonds tend to move into the hands of a small number of "vulture funds." *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *19 n.9 (1992) .

(n20)Footnote 20. ABA Section of Business Law, Repeal of the Trust Indenture Act? Issues For Reform (Spring Meeting, Boston, 1997), ABA-724 (Tape Recording of Panel) at Side 3.

(n21)Footnote 21. Revised Model Simplified Indenture, Section 6.06 and Note 2 to Section 6.06, 55 *Bus. Law.* 1115, 1137-38, 1192 (2000).

(n22)Footnote 22. *Great Plains Trust Co. v. Union Pacific Railroad Co.*, 492 F.3d 986, 990-91 (8th Cir., 2007) ; *UPIC & Co. v. Kinder-Care Learning Centers, Inc.*, 793 F. Supp. 448, 453-55 (S.D.N.Y. 1992) . See § 8.18[3]- [4] *infra*.

(n23)Footnote 23. *Mabon, Nugent & Co. v. Texas American Energy Corp.*, C.C.H. Fed. Sec. L. Rep P 93,674 (Del. Ch. 1988). However, the court went on to hold that insofar as a claim against the parent was contractual, *i.e.*, was based on an allegation that the parent caused the issuer to violate terms of the indenture, the separate "no recourse" clause in the indenture, which limited contractual liability to the issuer itself, was a basis for dismissal of such claim. *Id.* at p. 98,092.

(n24)Footnote 24. See American Bar Foundation, *Commentaries On Indentures* 232-34 (1971); Note, *Conflict of Interest Between Indenture Trustees and Bondholders: Avoidance of "No-Action" Clauses Prohibiting Bondholder Suits Against the Obligor*, 62 *Yale L.J.* 1097, 1098-99 (1953); *Quirke v. St. Louis- San Francisco Ry Co.*, 277 F.2d 705, 709-10 (8th Cir.) , cert. denied, 363 U.S. 845 (1960) ; *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *20-*21 (1992) .

(n25)Footnote 25. *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *25 (1992) ; *In re South Fulton Hospital Certificate Holder Litig.*, 2003 U.S. Dist. LEXIS 25567 (N.D. Ga 2003) (suit against prior indenture trustees); *In re Enron Corporation Securities, Derivative & "ERISA" Litigation*, 2008 U.S. Dist. LEXIS 21560 (March 19, 2008) .

(n26)Footnote 26. See *Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992) ; *Argonaut Partnership, L.P. v. Bankers Trust Company, Ltd.*, 1997 U.S. Dist. LEXIS 1092 at *18-*22 (S.D.N.Y. 1997) .

(n27)Footnote 27. See *Argonaut Partnership, L.P. v. Bankers Trust Company, Ltd.*, 1997 U.S. Dist. LEXIS 1092 at *20-*21 (S.D.N.Y. 1997) . For discussion of TIA Section 315(d), see Section 8.15[2] *supra*.

(n28)Footnote 28. See, e.g., *Rabinowitz v. Kaiser-Frazer Corp.*, 111 N.Y.S.2d 539 (Sup. Ct. 1952) . Cf. *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *23- *24 (1992) .

(n29)Footnote 29. 365 F.3d 1284 (11th Cir. 2004) .

(n30)Footnote 30. See also *In re South Fulton Hospital Certificate Holder Litig.*, 2003 U.S. Dist. LEXIS 25567 (N.D. Ga 2003) (suit against current trustee while trustee is pursuing claims against predecessors is barred by standing and ripeness doctrines).

(n31)Footnote 31. ABF, Model Debenture Indenture-- All Registered Issues, Section 507 (1967).

(n32)Footnote 32. Revised Model Simplified Indenture, Section 6.06, 55 *Bus. Law.* 1115, 1137 (2000).

(n33)Footnote 33. *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *22 (1992) . For discussion of the impact of no-action clauses on involuntary bankruptcy petitions filed by bondholders, see § 8.18[3] *infra*.

(n34)Footnote 34. *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *22-*33 (1992) . However, the application of the no-action clause to a claim that the issuer has breached terms of the indenture may not be avoided by converting the breach of contract claim into a claim that bondholders were fraudulently induced to hold their securities through the issuer's failing to disclose that the indenture had been breached. *Id.* at *33- *34 .

(n35)Footnote 35. *Hunter v. Southern Indemnity Underwriters*, 47 F. Supp. 242, 2 S.E.C. Jud. Dec. 771 (E.D. Ky. 1942); *Kusner v. First Pennsylvania Corp.* 531 F.2d 1234, 1239 (3d Cir. 1976) .

(n36)Footnote 36. *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 65 F.3d 1044, 1051 (2d Cir. 1995) , cert. denied, 116 S. Ct. 1678 (1996) , affirming in part and reversing in part on other grounds *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 859 F. Supp. 743 (S.D.N.Y. 1994) .

(n37)Footnote 37. See ABF, Model Debenture Indenture--All Registered Issues, Section 514 (1967); Revised Model Simplified Indenture, Section 6.09, 55 Bus. Law. 1115, 1139 (2000).

(n38)Footnote 38. See *Browning Debenture Holders' Committee v. DASA Corp.*, 560 F.2d 1078, 1083, 1088, C.C.H. Fed. Sec. L. Rep. P 96,131 at pp. 92,083, 92,088 (2d Cir. 1977) .

(n39)Footnote 39. For further discussion, see § 8.19 *infra*.

(n40)Footnote 40. The Commission takes the position that Section 316(b) precludes qualification where indenture securities provide for payment of principal or interest in a medium other than cash, *e.g.*, common stock, upon default, or upon the happening of any other event that is not in the indenture security holder's control. See *American Campgrounds, Inc.*, N.A. (No Action Letter, April 17, 1975). In *Daimler-Benz Aktiengesellschaft*, SEC Rel. No. 39-2353 (Apr. 25, 1997), 1997 LEXIS 909, the SEC granted an exemption from the provisions of § 316(b) for Notes that were mandatorily convertible into the issuer's stock at maturity. See *Daimler Benz to Offer Mandatory Convertible Bonds*, Business Wire, Apr. 16, 1997.

(n41)Footnote 41. See *Continental Bank & Trust Co. v. First Nat. Petroleum Trust*, 67 F. Supp. 859, 4 S.E.C. Jud. Dec. 643, C.C.H. Fed. Sec. L. Rep. P 90,364 (D.R.I. 1946) . However, the automatic stay imposed by 11 U.S.C. § 362(a)(1) upon the filing of a federal bankruptcy petition applies to suits for payment of principal or interest instituted by bondholders before the bankruptcy filing. See *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *38-*39 (1992) .

(n42)Footnote 42. One court has suggested that TIA § 316(b) might protect a bondholder's right to sue when there has been anticipatory repudiation of the indenture by the issuer announcing a suspension of future interest payments. *Feldbaum v. McCrory Corp.* Del. Ch. LEXIS 113 at *38 (1992). This conclusion seems questionable in light of the language in § 316(b) limiting its protection to suits instituted after the due date of payments.

(n43)Footnote 43. An attempt to circumvent these requirements through forcing indenture security holders to be part of a class action has been found improper. See *Continental Assurance Co. v. Macleod-Stedman, Inc.*, 694 F. Supp. 449, 455-56 (N.D. Ill., 1988) .

(n44)Footnote 44. The provisions of TIA Section 315(e) permitting the indenture to provide for an undertaking for costs, including attorney's fees, in litigation relating to the indenture's provisions do not permit an undertaking to be required in any suit by an indenture security holder to enforce the payment of principal or interest on or after their respective due dates as expressed in the indenture security.

For further discussion of Section 315(e), see § 8.18[2] *supra*.

(n45)Footnote 45. Section 316(a)(2) is discussed in § 8.18[4] *infra*.

For clauses complying with Section 316(b), see ABF, Model Debenture Indenture--All Registered Issues, Section 508 (1967); Revised Model Simplified Indenture, Section 6.07, 55 Bus. Law. 1115, 1138 (2000).

(n46)Footnote 46. *Brady v. USB Financial Services, Inc.*, 538 F.3d 1319 (10th Cir., 2008) .

(n47)Footnote 47. *UPIC v. Kinder-Care Learning Centers, Inc.*, 793 F. Supp. 448, 454-56 (S.D.N.Y. 1992) .

(n48)Footnote 48. *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 859 F. Supp. 743, 747-48 (S.D.N.Y. 1994) , *aff'd in part, rev'd in part on other grounds*, 65 F.3d 1044 (2d Cir. 1995) , *cert. denied*, 116 S. Ct. 1678 (1996) .

(n49)Footnote 49. *Jackson National Life Insurance Co. v. Ladish Company, Inc.*, 1993 U.S. Dist. LEXIS 1785 at *14- *21 (S.D.N.Y. 1993) . As to the power of a majority of bondholder to rescind an acceleration of the due date, see § 8.18[4] *infra*.

(n50)Footnote 50. *In re Iroquois Brands, Ltd.*, 1991 Bankr. LEXIS 1915 (Bankr. S.D. Tex. 1991) , *vacated* Case No. 91-01018-H3-11 (Bankr. S.D. Tex, March 7, 1991). *See also* *In re The Marcade Group*, Case No. 92B43920 (S.D.N.Y. Aug. 7, 1992), discussed in *In re Envirodyne Industries, Inc.*, 174 B.R. 986, 993-97 (Bkrtcy. N.D. Ill. 1994) , and *In re The Federated Group, Inc.*, No. 92-50412 JRG (Bankr. N.D. Cal. July 25, 1992), discussed in Harold L. Kaplan, *The Role of Indenture Trustees In Protecting Bondholder Rights-- Pre- and Post-Default* 43 at 50, in ABA Committee on Trust Indentures and Indenture Trustees, *Repeal of the Trust Indenture Act? Issues for Reform* (Apr. 4, 1997).

(n51)Footnote 51. 174 B.R. 986, 993-97 (Bkrtcy. N.D. Ill., 1994) . *See also* *Feldbaum v. McCrory Corp.*, 1992 Del. Ch. LEXIS 113 at *38 (1991) (indicating that in the related federal bankruptcy case, an involuntary petition had been filed by three bondholders).

(n52)Footnote 52. *See* 84 Cong. Rec. 9528 (July 19, 1939) (remarks of Rep. Hinshaw).

(n53)Footnote 53. West's Ann. Cal. Civil Procedure Code § 726. Prior to 1965 (Stats. 1963, c. 819, p. 2007, § 26) the rule also applied to mortgages on personal property. *See id.*; Historical Note at pp. 11-12.

(n54)Footnote 54. *See Commercial Bank of Santa Ana v. Kershner*, 120 Cal. 495, 52 P. 848 (1898) .

(n55)Footnote 55. Trust Indenture bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 56 (1939).

(n56)Footnote 56. *Schallitz v. Starrett Corp.*, 82 N.Y.S. 2d 89 , C.C.H. Fed. Sec. L. Rep. P 90,440 (Sup. Ct. 1948).

(n57)Footnote 57. SEC Manual--Trust Indenture Act of 1939 at p. 148.

(n58)Footnote 58. *Id.*, at p. 143. *Cf. Haas v. Palace Hotel Co. of San Francisco* 101 Cal. App. 2d 83, 224 P.2d 783 (1950) , *cert. denied*, 342 U.S. 813 (1951) .

(n59)Footnote 59. CCH Fed. Sec. L. Rep., P 90,707 (S.D.N.Y. 1999).

(n60)Footnote 60. *See also Oaktree Capital Mgmt. LLC v. SpectraSite Holdings, Inc.*, 2002 U.S. Dist. LEXIS 12761 (D. Del. 2002) (incurring significant amounts of senior debt near the time of a bankruptcy filing may violate TIA § 316(b)).

(n61)Footnote 61. *Magten Asset Mgmt. Corp. v. Northwestern Corp.*, 313 B.R. 595 (Bktrptcy. Del. 2004) .

(n62)Footnote 62. *UPIC & Co. v. Kinder-Care Learning Centers, Inc.*, 793 F. Supp. 448, 453 (S.D.N.Y. 1992) . *Cf. Order Granting Application for Exemption: Petroleos Mexicanos and the Pemex*, SEC Rel. No. 39-2430 (Oct. 13, 2004) (granting exemption from § 316(b) to permit amendment of payment terms by 75% vote where issuer is not subject to bankruptcy laws for debt restructuring).

(n63)Footnote 63. Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong. 1st Sess. 56 (1939).

(n64)Footnote 64. Where this vote is obtained, the court need only determine that bondholders are receiving at

least as much as they would have in a liquidation under Chapter 7 of the Bankruptcy Code. 11 U.S.C. §§ 1126(c), 1129(a)(7)(A). See Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L. J. 232 (1987), arguing that since the original rationale of § 316(b) has been undercut by the 1978 Bankruptcy Code, § 316(b) should be repealed (subject to certain safeguards implemented by SEC rulemaking) in order to encourage voluntary workouts by distressed companies.

(n65)Footnote 65. See 4 Norton Bankruptcy Law and Practice 2d § 86:1, § 86:7, §§ 86:20- 86:24 (1997 rev.).

(n66)Footnote 66. See Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L. J. 232, 251-56 (1987). Also see, *In re Delta Airlines, Inc.*, 374 B.R. 516, 527-28 (SDNY, 2007) .

(n67)Footnote 67. 11 U.S.C. § 1126(e): "the court may designate any entity whose acceptance or rejection of such plan was not in good faith."

(n68)Footnote 68. 11 U.S.C. § 1501 ff. (the Model Law on Cross-Border Insolvency).

(n69)Footnote 69. *In re Board of Directors of Telecom Argentina, S.A.*, 528 F.3d 162 (2d Cir., 2008) ; *In re Board of Directors of Multicanal S.A.*, 314 B.R. 486 (Bankr. S.D.N.Y. 2004); *In re Board of Directors of Multicanal S.A.*, 307 B.R. 384 (Bankr. S.D.N.Y. 2004) . Also see, George W. Shuster, Jr., *The Trust Indenture Act and International Debt Restructurings*, 14 Am. Bankr. Inst. L. Rev. 431 (2006) (stressing the role of comity in recognition proceedings).

(n70)Footnote 70. *UPIC & Co. v. Kinder-Care Learning Centers, Inc.*, 793 F. Supp. 448, 456-60 (S.D.N.Y. 1992) ; *Chicago Title and Trust Co. v. Telco Capital Corp.*, 1997 Ill. App. LEXIS 629 (1997) . See, generally, American Bar Foundation, *Commentaries on Indentures* 558-83 (1971). Properly drafted subordination clauses prevent a substantial risk that the issuer will be subject to multiple or otherwise inconsistent obligations, and therefore preclude the need for compulsory joinder of the trustee in a suit by an individual subordinated debt security holder against the issuer for payment of principal or interest. *UPIC & Co. v. Kinder-Care Learning Centers, Inc.*, 793 F. Supp. at 460-61 .

(n71)Footnote 71. See, American Bar Foundation, *Commentaries on Indentures* 234-35 (1971).

(n72)Footnote 72. See, *UCC Secs. 8-102(a)(15)*., 8-103(d).

(n73)Footnote 73. 598 F. Supp.2d 550 (SDNY, 2009).

(n74)Footnote 74. See, *UCC Secs. 3-104(a)*, 3-106(b).

(n75)Footnote 75. "Series" is defined by § 310(b) as any group of securities whose terms permit holders to vote separately to direct the indenture trustee, or to otherwise take action pursuant to a separate vote. However, securities that rank equally and are wholly unsecured may not be treated as a separate series.

(n76)Footnote 76. See Suggested Provisions for Corporate Mortgages and Indentures, 4 C.C.H. Fed. Sec. L. Rep. P 43,530. The provision permitted by Section 316(a)(2) is not included in either the ABF, Model Debenture Indenture--All Registered Issues (1967) or the Revised Model Simplified Indenture, 55 Bus. Law. 1115 (2000).

(n77)Footnote 77. Cf. *Aladdin Hotel Co. v. Bloom*, 200 F.2d 627 (8th Cir. 1953) .

Where bonds owned by the obligor or an affiliate are pledged in good faith to a non-affiliate that has the right to vote them, the indenture may provide for these bonds to be counted in determining the requisite vote. SEC Manual--Trust Indenture Act of 1939 at p. 139 (June 1958).

(n78)Footnote 78. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 241 (2d ed., 1975).

(n79)Footnote 79. See ABF, Model Debenture Indenture--All Registered Issues, Section 513 (1967); Revised Model Simplified Indenture, Section 6.04, 55 *Bus. Law.* 1115, 1137 (2000).

See also § 8.10 *supra*, relating to amendments through the use of supplemental indentures.

Despite the permissive language of Section 316(a)(1)(B), it has been interpreted as prohibiting provisions inconsistent with its requirements. SEC Manual--Trust Indenture Act of 1939 at pp. 133-34 (June 1958).

(n80)Footnote 80. "Series" is defined by § 310(b).

(n81)Footnote 81. American Bar Foundation, *Commentaries On Indentures* 240(1971); *cf.* Revised Model Simplified Indenture, Note 3. to Section 6.04, 55 *Bus. Law.* 1115, 1191 (2000).

(n82)Footnote 82. American Bar Foundation, *Commentaries On Indentures* 239-40 (1971); Johnson, "Default Administration of Corporate Trust Indentures: Alternatives to Default Remedial Provisions and Judicial Arrangements and Reorganizations," 15 *St. Louis U.L. J.* 509, 509-17 (1971).

(n83)Footnote 83. *Continental Bank & Trust Co. v. First Nat. Petroleum Trust*, 67 *F. Supp.* 859, 4 *S.E.C. Jud. Dec.* 643, C.C.H. Fed. Sec. L. Rep. P 90,364 (D.R.I. 1946).

(n84)Footnote 84. ABF, Model Debenture Indenture--All Registered Issues, Section 502 (1967).

(n85)Footnote 85. A difficult conflict may occur if a few indenture security holders obtain a judgment based on the accelerated maturity date and subsequently the requisite majority rescind the acceleration. See American Bar Foundation, *Commentaries On Indentures* 234-35 (1971). One commentator states that "[t]he provision giving the trustee or bondholders the right to accelerate maturity is a right incident to the enforcement of the remedies and does not give an individual holder the right to sue for principal following such acceleration." J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 240 (2d ed., 1975).

(n86)Footnote 86. See SEC Manual--Trust Indenture Act of 1939 at p. 138 (June 1958).

(n87)Footnote 87. See § 8.18[1] *supra*.

(n88)Footnote 88. See § 8.14[1] *supra*. For discussion of other voting situations to which the record date provisions of § 316(c) apply, see § 8.14[5] *infra*.

(n89)Footnote 89. See ABF, Model Debenture Indenture--All Registered Issues, Section 512 (1967); Revised Model Simplified Indenture, Section 6.05, 55 *Bus. Law.* 1115, 1137 (2000).

(n90)Footnote 90. Revised Model Simplified Indenture, Section 6.11 and Note 1. to Section 6.11, 55 *Bus. Law.* 1115, 1139, 1195 (2000).

(n91)Footnote 91. See ABF, Model Debenture Indenture--All Registered Issues, Section 601(c)(3)(1967); Revised Model Simplified Indenture, Section 7.01(c)(3), 55 *Bus. Law.* 1115, 1140 (2000).

(n92)Footnote 92. TIA Section 316(a) (last clause). This special provision for calculating votes does not apply to matters outside of Sections 315(d)(3) and 316(a), such as a vote to permit substitution of collateral. Division of Corporation Finance, *Trust Indenture Act of 1939 Interpretations*, Sec. 215.01, 216.01, (March 30, 2007), <www.sec.gov/divisions/corpfina/guidance/tiainterp.htm>.

(n93)Footnote 93. See § 8.13[1] *supra*.

(n94)Footnote 94. See § 8.14[1] *supra*.

2-8 Federal Securities Act of 1933 § 8.18

(n95)Footnote 95. See S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess. pp. 50-51.

(n96)Footnote 96. SEC Manual--Trust Indenture Act of 1939 at pp. 134-35 (June 1958).

(n97)Footnote 97. *Id.* at 133-34 .

(n98)Footnote 98. See *id.* at p. 130 ; Suggested Provisions for Corporate Mortgages and Indentures, 4 C.C.H. Fed. Sec. L. Rep. P 43,530; Revised Model Simplified Indenture, Section 6.05, 55 *Bus. Law.* 1115, 1137 (2000); American Bar Foundation, *Commentaries On Indentures* 236-37 (1971).

(n99)Footnote 99. *Continental Bank & Trust Co. v. First Nat. Petroleum Trust*, 67 *F. Supp.* 859, 4 *S.E.C. Jud. Dec.* 643 , C.C.H. Fed. Sec. L. Rep. P 90,364 (D.R.I. 1946).

(n100)Footnote 100. See § 8.18[3] *supra*.

(n101)Footnote 101. NYSE Listed Company Manual, Sec. 603.03 (June, 1983).

(n102)Footnote 102. See J. Kennedy & R. Landau, *Corporate Trust Administration and Management* 243-44 (2d ed., 1975).

(n103)Footnote 103. ABF, Model Debenture Indenture--All Registered Issues, Section 610(c) (1967); Revised Model Simplified Indenture, Section 7.08, 55 *Bus. Law.* 1115, 1142 (2000).



133 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.19

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.19 Liability of Indenture Trustee to Bondholders

The indenture trustee who fails to carry out its obligations under a qualified indenture may be liable to injured bondholders under state law breach of fiduciary duty or breach of contract claims or under a federal private right of action explicitly recognized by the 1990 amendments to the Trust Indenture Act. n1

The indenture trustee plays a central role in protecting the rights of indenture security holders. Where the trustee fails to adequately carry out its obligations, liability to injured bondholders has been imposed. n2 Courts have regularly entertained the assertion of state law breach of duty claims against indenture trustees under qualified indentures, n3 supported by Section 323(b), which states that "[t]he rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist ... at law or in equity." n4

In addition, a private right of action exists in favor of indenture security holders when trustees have failed to comply with obligations imposed by the Trust Indenture Act. In 1990, Congress amended Section 322(b) to provide that federal courts have jurisdiction over actions brought to enforce any duty created by the Act. The Senate Report explicitly stated that this language was intended to codify those judicial holdings which had found private rights of action for enforcement of mandatory indenture terms. n5 A judgment against an indenture trustee based on a violation of the TIA (unlike one based on breach of contract or fiduciary duty) is non-dischargeable in bankruptcy under the Sarbanes-Oxley Act of 2002. n6

Courts began a number of years ago to imply federal private rights of action in favor of indenture security holders when trustees failed to comply with obligations imposed through indenture provisions required by the Trust Indenture Act. n7 The most elaborate analysis of the factors which supported a finding before the 1990 amendments that a federal private right of action existed for breach of federally mandated terms of the indenture is found in the Third Circuit's opinion in *Zeffiro v. First Pennsylvania Banking and Trust Co.* n8

In *Zeffiro*, it was alleged that the trustee failed to set aside assets it received as a direct creditor within four months of

the obligor's default as required by provisions in Section 311(a), n9 that it failed to transmit reports to debenture holders as required by provisions in Section 313, n10 that it made misleading statements in reports it did transmit, and that the trustee failed to disqualify itself when a conflict of interest arose, in violation of provisions required by Section 310(b). n11 Further, it was claimed that the trustee failed to notify debenture holders of defaults by the obligor as was required by provisions in Section 315(b), n12 and that it failed to take adequate action after default, in violation of provisions in Section 315(c). n13

Using the widely accepted four part test of *Cort v. Ash*, n14 the court found strong reasons to imply a private right of action. The statutory language and history made it clear that indenture security holders are the special beneficiaries of the Trust Indenture Act. n15 The legislative history suggested that Congress intended to permit suits by indenture security holders against trustees who violated the mandatory indenture provisions, and that there was no intent to limit these suits to state court. n16 A federal private right of action was consistent with the overall structure and jurisdictional language of the Trust Indenture Act. A private right of action furthered Congress' goal of creating a uniform national standard for indenture trustees, and was necessary because of the lack of federal administrative enforcement authority under the Trust Indenture Act. n17 Finally, the cause of action was not one traditionally relegated to state law since interpretation of the mandatory indenture terms is dependent upon the meaning of federal law, not, as in traditional contract cases, on the intent of the parties. n18

The rationale of *Zeffiro* was carried a step further in *Morris v. Cantor*, n19 although *Morris* was decided prior to *Zeffiro*. The provision in Section 315(d) prohibiting exculpatory clauses that purport to relieve the trustee from liability for negligence or willful misconduct n20 was at issue in *Morris*. Judge Ward held that Section 315(d) creates a uniform standard of care governing the conduct of indenture trustees, violation of which gave rise to a private right of action under federal law. n21

The trustee will be liable only if its breach of duty proximately caused the bondholders' injuries. In *Semi-Tech Litigation, LLC v. Bankers Trust Company*, the court held that the plaintiff has the burden to show proximate cause. In that case, note holders failed to prove that their losses would have been avoided even if the trustee had properly carried out its duty to examine the non-conforming certificates of compliance with indenture conditions that the obligor had furnished to the trustee. n22

In *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, it was alleged that the indenture trustees breached the prudent person standard imposed by the TIA when they failed to file a motion in Eastern Airlines' bankruptcy reorganization to lift the automatic stay imposed under the Bankruptcy Code which prevented the trustees from obtaining the collateral underlying the equipment trust certificates covered by the indentures. The district court instructed the jury that this failure proximately caused the bondholders' damages only if the bondholders had relied on the trustees to act prudently. On appeal, the court held that reliance was not required for the bondholders' breach of contract and fiduciary duty claims against the trustees, but that the question of whether reliance was required for their Trust Indenture Act claim had not been preserved for appeal. n23 Subsequently, after the case was reassigned to a different judge, the district court held that even in the TIA claim, reliance was not a necessary element of proximate cause. n24 The district court also held that even though the bondholders' injury crystallized after one of the defendant trustees had resigned and been replaced by a new trustee, if the original trustee's failure to file a "lift stay" motion was a substantial factor in causing the injury, it is liable. The successor trustee's failure to file a lift stay motion was a concurrent, not a superseding, cause of the loss. n25

Despite the fact that co-trustees, or the original and a successor trustee, could both be liable under the TIA, the *LNC Investments* trial court, in a separate opinion, found that one trustee had no right to obtain contribution from another trustee for liability imposed under the TIA. While some language in the court's opinion suggests that the TIA merely does not impose a uniform national standard regarding the right of a trustee to obtain contribution, the court's holding goes further. Later language makes clear that since the TIA creates no federal right to obtain contribution, there also can be no right of contribution under state law for TIA violations. Any contribution under state law must be based upon

breach of a state law obligation. n26

TIA Section 323(b) provides that in suits for damages under the TIA, "no person ... shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." This has been interpreted to mean that plaintiffs may recover only their out-of-pocket losses, defined as the difference between what they paid for their securities and what they received for them. Where a plaintiff purchased debt securities at a discount, damages may not be measured on the basis of the securities' full principal amount. Nor may damages be measured by the amount that plaintiff would have received in a bankruptcy reorganization had the trustee fulfilled its duties. n27

One express limitation on the trustee's liability is imposed by Section 309(d). No trustee under a qualified indenture may be subject to liability because the indenture itself fails to comply with Trust Indenture Act requirements. This safe harbor seems largely unnecessary since the 1990 amendments which automatically incorporate the Act's mandatory terms into each qualified indenture. However, only requirements of the statute are automatically incorporated; Section 309(d) also protects against failure of the indenture to comply with any rule, regulation, or order under the Act.

Section 309(d) shields the indenture trustee when the indenture has been qualified under the TIA. *Vernon Johnson Family Ltd. Partnership v. Bank One Texas* further shields trustees by holding that a claim by note holders that notes issued under an unqualified indenture should have in fact been registered under the Securities Act and qualified under the TIA is not a claim that may be asserted against the indenture trustee. n28

Once it is found that the Trust Indenture Act, or any rule or order under it, has "created" liability on the part of an indenture trustee, Section 322(b) gives concurrent jurisdiction to state and federal courts for suits brought to enforce this liability. n29 However, Section 322(b) incorporates the anti-removal provision of Securities Act Section 22(a) so that a TIA suit instituted in state court may not be removed by defendant to federal court. This anti-removal provision may not be circumvented by attempting to obtain from a federal court a declaratory judgment regarding a TIA claim pending in state court. n30

The provision made part of the indenture by Section 315(e) providing for an undertaking for costs, including attorneys fees, n31 applies to any suit by bondholders against the trustee for action taken or omitted by it as trustee, except where instituted by one or a group of bondholders holding in the aggregate more than 10% of the principal amount of indenture securities outstanding. n32 In *LNC Investments, Inc. v. First Fidelity Bank*, n33 the court found that for purposes of computing whether plaintiffs held more than 10% of the "outstanding" indenture securities, distributions made during a bankruptcy reorganization to indenture security holders did not operate to reduce the principal amount of securities "outstanding" when the court's order directing the distribution did not mention redemption of any of the securities as a result of the distribution.

Venue for actions brought to enforce any liability or duty created by the Trust Indenture Act or by rules or orders under it, is specified in Section 322(b) by reference to Section 22(a) of the Securities Act. Venue lies in the district in which the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place if the defendant participated therein. Presumably, Section 322(b) also incorporates the Securities Act Section 22(a) provisions permitting service of process in any other district in which the defendant is an inhabitant or wherever he may be found. n34

Prior to 1982, suits against indenture trustees which were national banks could be brought only in the district in which the bank was established or in state court in the county or city in which the bank was located. n35 In 1982, Congress eliminated this restriction except for national banks that are in FDIC receivership proceedings. n36

The bondholders' cause of action against the indenture trustee may not be brought on their behalf in a bankruptcy reorganization by the bankruptcy trustee. The Supreme Court in *Caplin v. Marine Midland Grace Trust Co.* n37 held

that Congress had not intended to grant the bankruptcy trustee standing to assert bondholders' claims. This result has not been changed by the Bankruptcy Reform Act of 1978. A provision in the bill as originally proposed would have overruled *Caplin*, but this language was deleted in the final version of the Act. n38

A bondholder who has purchased bonds after the acts which give rise to a claim under the TIA against the indenture trustee lacks standing to assert the claim. Federal law governs the assignability of claims under the TIA. The cause of action which prior bondholders had against the trustee for the trustee's failure to carry out its obligations under the TIA are not automatically assigned to subsequent purchasers of the bonds. n39 However, if the trustee is engaged in a continuing course of wrongful conduct which began before the purchase of the indenture securities but continues after the purchase, purchasers will have standing to sue under the TIA for the losses flowing from the post-purchase breach that were not reflected in the price of their securities when they purchased them. n40 Also, while TIA claims are not automatically transferred along with bonds, where TIA claims have been explicitly assigned, the assignee (here an entity created by the reorganization plan) has been held to have standing to bring suit on those claims against trustee. n41

The Trust Indenture Act is silent as to the statute of limitations period to be applied to actions against the trustee for violation of duties imposed upon the trustee by the TIA. Until the 1991 United States Supreme Court decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson* n42 courts traditionally had borrowed the analogous state statute of limitations period when the federal securities laws were silent about the limitations period to be applied. *Lampf, Pleva* held that a uniform federal statute of limitations should be applied to actions under Securities Exchange Act Rule 10b-5. It would seem that courts should also apply the *Lampf, Pleva* analysis to claims brought to enforce duties of the trustee under the TIA. Given the close relationship between the TIA and the Securities Act of 1933, perhaps a variant of the one year/three year limitations period found in Section 13 of the 1933 Act should be applied, *e.g.*, one year after discovery of the trustee's violation or after discovery should have been made in the exercise of reasonable diligence, but no more than three years after the violation.

So far, courts have been unwilling to apply *Lampf, Pleva* to TIA claims. In *Cruden v. Bank of New York*, n43 the Second Circuit affirmed the district court's pre-*Lampf, Pleva* holding n44 that New York's six year limitations period for breaches of contract applied to claims against trustees under the TIA. In *Cruden*, plaintiff had alleged both that the trustees had breached terms of the indenture contract and the trustees had violated duties imposed by the Trust Indenture Act. The court stated that because the contract and the statutory claims were so intertwined, "it appears prudent in this case to continue to borrow state statutes of limitations for suits arising out of indenture agreements." n45

Cruden also explored the issue of when the limitations period begins to run on claims that trustees violated their duties under the TIA in entering into supplemental indentures. It held that the statute began to run only when the plaintiffs were entitled to a remedy, regardless of when the trustees' actual breach occurred. The indentures' "no-action" clauses tolled the statute until that time. A remedy was available only when the issuer defaulted in payment of principal and interest. Had suit been brought at the time the supplemental indentures were entered, debenture holders would have had no remedy. Damages could not have been ascertained, since there had been no default in principal or interest. Equitable relief could not have been fashioned without the trustees joining the issuer as an indispensable party. However, such joinder would have impermissibly circumvented the indentures' "no-action" clauses n46 which precluded suit against the issuer at that earlier time.

FOOTNOTES:

(n1)Footnote 1. See *LNC Investments v. First Fidelity Bank, N.A.*, 173 F.3d 454 (2d Cir. 1999) .

(n2)Footnote 2. TIA Section 327 precludes the trustee or any other person from obtaining a waiver of its obligations under the Trust Indenture Act, or under any rule or order thereunder. Section 327 declares such waivers to

be void.

(n3)Footnote 3. See *Meckel v. Continental Resources Co.*, 758 F.2d 811 , C.C.H. Fed. Sec. L.Rep. P 91,980 (2d Cir. 1985); *Broad v. Rockwell*, 614 F.2d 418, 432 , C.C.H. Fed. Sec. L.Rep. P 97,326 at pp. 97,192-93 (5th Cir. 1980), vacated and hearing en banc granted, 618 F.2d 396 (5th Cir. 1980) , opinion en banc 642 F.2d 929, C.C.H. Fed. Sec. L. Rep. P 97,956 (5th Cir. 1980) , cert. denied, 454 U.S. 956 (1981) ; *VanGemert v. Boeing Co.*, 520 F.2d 1373, C.C.H. Fed. Sec. L. Rep. P 95,234 (2d Cir. 1975) , cert. denied, 423 U.S. 947 (1975) ; *United States Trust Co. of New York v. First National City Bank*, 57 A.D. 2d 285, 296-97, 394 N.Y.S.2d 653, 661, C.C.H. Fed. Sec. L.Rep. P 96,065 at pp. 91,-798-99 (1977) , aff'd, 45 N.Y.2d 869, 410 N.Y.S.2d 580, 382 N.E.2d 1355 (1978) . As to pendent federal jurisdiction for state law claims, see *In re Nucorp Energy Securities Litigation*, 772 F.2d 1486 , C.C.H. Fed. Sec. L. Rep. P 92,306 (9th Cir. 1985).

(n4)Footnote 4. See *First Interstate Bank of Denver, N.A., v. Pring*, 969 F.2d 891 (10th Cir. 1992) (indenture trustee may be held as aider-and-abettor to violation of Securities Exchange Act Rule 10b-5).

(n5)Footnote 5. S. Rep. No. 101-155 (1989) 101st Cong., 1st Sess. p. 31.

(n6)Footnote 6. 11 USC §523(a) as amended by the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §803, 116 Stat. 745, 801 (2002).

(n7)Footnote 7. The Supreme Court suggested in *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 426 n.433, 92 S. Ct. 1678, 32 L. Ed. 2d 195 (1972) that such a private right of action might well exist.

(n8)Footnote 8. 623 F.2d 290 (3rd Cir. 1980) , cert. denied, 456 U.S. 1005 (1982) . See also *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, 935 F. Supp. 1333, 1338-40 (S.D.N.Y. 1996) .

For later proceedings in the *Zeffiro* matter awarding attorneys fees to plaintiffs' counsel, see *Zeffiro v. First Pennsylvania Bank, N.A.*, 574 F. Supp. 443 , C.C.H. Fed. Sec. L. Rep. P 91,411 (E.D. Pa. 1983).

Accord, *Mathews v. Fisher*, C.C.H. Fed. Sec. L. Rep. P 97,336 (S.D. Ohio 1978) at pp. 97,228-29. See also *Dropkin, Implied Civil Liability Under the Trust Indenture Act: Trends and Prospects*, 52 *Tulane L. Rev.* 299 (1978).

(n9)Footnote 9. Section 311(a) is discussed in § 8.17[3] *supra*.

(n10)Footnote 10. Section 313 is discussed in § 8.15[1] *supra*.

(n11)Footnote 11. Section 310(b) is discussed in § 8.13 *supra*.

(n12)Footnote 12. Section 315(b) is discussed in § 8.15[3] *supra*.

(n13)Footnote 13. Section 315(c) is discussed in § 8.17[1] *supra*.

(n14)Footnote 14. 422 U.S. 66, 78 (1975) .

(n15)Footnote 15. 623 F.2d at 296-97 .

(n16)Footnote 16. 623 F.2d at 297-99 .

(n17)Footnote 17. 623 F.2d at 299-300 .

(n18)Footnote 18. 623 F.2d at 300-01 .

(n19)Footnote 19. 390 F. Supp. 817 , C.C.H. Fed. Sec. L. Rep. P 94,996 (S.D.N.Y. 1975).

(n20)Footnote 20. See § 8.15[2] *supra*.

(n21)Footnote 21. 390 F. Supp. at 822, C.C.H. Fed. Sec. L. Rep. P 94,996 at p.97,450.

Accord, *In re Equity Funding Corp. of America Securities Litigation*, 416 F. Supp. 161, 203 (C.D. Cal. 1976) .

See also Note, *The Trust Indenture Act of 1939: The Corporate Trustee As Creditor*, 24 UCLA L. Rev. 131 (1976).

(n22)Footnote 22. 353 F. Supp.2d 460, 482-87 (S.D.N.Y., 2005) , *affd.* 450 F.3d 121, 126-27 (2d Cir., 2006) .

(n23)Footnote 23. *LNC Investments v. First Fidelity Bank, N.A. N.J.*, 173 F.3d 454, 460-62 (2d Cir. 1999) .

(n24)Footnote 24. *LNC Investments, Inc. v. First Fidelity Bank*, 2000 U.S. Dist. LEXIS 4754 (S.D. NY, 2000) .

(n25)Footnote 25. *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, 1997 U.S. Dist. LEXIS 12858 at *88- *103, *119- *122 (S.D.N.Y. 1997).

(n26)Footnote 26. *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, 935 F. Supp. 1333, 1346, 1349 (S.D.N.Y. 1996) .

(n27)Footnote 27. *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, 1997 U.S. Dist. LEXIS 12858 at *103- *119 (S.D.N.Y. 1997) . On appeal, the court explicitly stated that it was expressing no view on the trial court's holding that damages under the TIA are limited to out-of-pocket losses. *LNC Investments v. First Fidelity Bank, N.A.*, 173 F.3d 454, 464 n.7 (2d Cir. 1999) . See also *Bluebird Partners, L.P. v. First Fidelity Bank*, 279 A.D.2d 223, 746 N.Y.S.2d 475 (Sup. Ct. App. Div., 2002) discussing, but not deciding, whether investor who has been permitted to maintain suit under the TIA may through state law claims recover additional amounts in excess of actual damages.

(n28)Footnote 28. *Vernon Johnson Family Ltd. Partnership v. Bank One Texas*, 80 F. Supp. 2d 1127, 1131 (W.D. Wash. 2000) .

(n29)Footnote 29. TIA Section 322(b) provides that jurisdiction and venue "shall be as provided in section 22(a) of the Securities Act of 1933." The nationwide service of process provisions in section 22(a) confer personal jurisdiction over defendants in all federal district courts. See *Vernon Johnson Family Ltd. Partnership v. Bank One Texas*, 80 F. Supp. 2d 1127, 1131 (W.D. Wash. 2000) .

(n30)Footnote 30. *May Dept. Stores v. Employees Retirement System of Alabama*, 1993 U.S. Dist. LEXIS 12716 (S.D.N.Y. 1993) .

(n31)Footnote 31. See § 8.18[2] *supra*.

(n32)Footnote 32. See, *Semi-Tech Litigation, LLC v. Bankers Trust Company*, 300 Fed. Appx. 123 (2d Cir., 2008) .

(n33)Footnote 33. *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, C.C.H. Fed. Sec. L. Rep. P 98,151 (S.D.N.Y. 1994).

(n34)Footnote 34. See Trust Indenture Bill of 1939, H. Rep. No. 1016, 76th Cong., 1st Sess. 58 (1939).

(n35)Footnote 35. 12 USC § 94 (1976); *Rome v. Eltra Corp*, 297 F. Supp. 314 (E.D. PA, 1969) . Also see *Radzanower v. Touche Ross & Co.*, 426 U.S. 148 (1976) .

(n36)Footnote 36. 12 USC § 94 as amended by the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 406, 96 Stat. 1469, 1512 (1982).

(n37)Footnote 37. 406 U.S. 416 (1972) .

(n38)Footnote 38. See 3 Bkr. L. Ed., Code, Commentary and Analysis § 23:29.

(n39)Footnote 39. *Bluebird Partners v. First Fidelity Bank, N.A.*, 85 F.3d 970 (2d Cir. 1996) . However some state statutes protecting bondholders provide that transferees are automatically assigned claims which their transferors had against the indenture trustee. See N.Y. Gen. Oblig. § 13-107(1) (McKinney 1989), discussed in *Bluebird Partners, L.P. v. First Fidelity Bank*, 97, N.Y.2d 456, 767 N.E.2d 672 (NY Ct. App., 2002) ; *LNC Investments v. First Fidelity Bank, N.A., N.J.*, 173 F.3d 454, 463 (2d Cir. 1999) ; *Semi-Tech Litig., LLC v. Bankers Trust Co.*, 272 F. Supp. 2d 319, 330-31 (S.D.N.Y. 2003) , *affd.* 450 F.3d 121, 126-27 (2d Cir., 2006) .

(n40)Footnote 40. *LNC Investments, Inc. v. First Fidelity Bank, N.A.*, 1997 U.S. Dist. LEXIS 12858 at *28- *43 (S.D.N.Y. 1997) .

(n41)Footnote 41. *Semi-Tech Litig., LLC v. Bankers Trust Co.*, 272 F. Supp. 2d 319 (S.D.N.Y. 2003) . *But cf.* *Williams v. California 1[st] Bank*, 859 F.2d 664 (9th Cir. 1988) (bankruptcy trustee lacks standing to bring securities claims against third parties, even when claims have been specifically assigned to the trustee in bankruptcy).

(n42)Footnote 42. 111 S. Ct. 2773 (1991) .

(n43)Footnote 43. 957 F.2d 961 (2d Cir. 1992) .

(n44)Footnote 44. C.C.H. Fed. Sec. L. Rep. P 95,466 (S.D.N.Y. 1990).

(n45)Footnote 45. 957 F.2d at 967 . *Accord*, *LNC Investments, Inc. v. First Fidelity Bank*, C.C.H. Fed. Sec. L. Rep. P 98,151 (S.D.N.Y. 1994).

(n46)Footnote 46. 957 F.2d at 968-69 .



134 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.20

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.20 Civil Liability under Section 323(a); Commission Enforcement; Criminal Reference

The Trust Indenture Act creates a private right of action for damages in favor of a person who relies on a materially false or misleading statement in a Trust Indenture Act document. The 1990 amendments to the Trust Indenture Act create some uncertainty as to whether the Commission's enforcement power extends beyond ensuring initial indenture qualification and enforcing prohibitions against false or misleading statements in filings made with the Commission. Willful violations of the Trust Indenture Act, presumably including failure to comply with mandatory obligations imposed by law under the 1990 amendments, may result in criminal prosecution.

[1] Civil Liability under Section 323(a)

Section 323(a) of the Trust Indenture Act creates a private right of action for damages. Any person who makes, or causes to be made, a materially false or misleading statement, or who omits any material fact, in any Trust Indenture Act application, report, or document filed with the Commission, is liable to any person who, not knowing of the untruth or omission, in reliance on it purchases or sells a security issued under the indenture to which the application, report, or document relates. n1 The defendant is liable for the damages caused by reliance on the statement or omission, unless the defendant proves that he acted in good faith and without knowledge of the statement's falsity or of the omission. However, such a cause of action does not follow the securities when they are resold to purchasers who were not themselves defrauded. As a matter of federal law, no such automatic assignment occurs. n2

Concurrent state and federal court jurisdiction over these suits is granted by Section 323(a), and the court may require an undertaking for costs, including attorneys' fees, against either party, having due regard to the merits and good faith of the suit or defense.

Section 323(a) imposes a statute of limitations on these actions of one year after discovery of the facts and of no more than three years after the accrual of the cause of action.

Section 305(d) excludes certain information describing the indenture securities from the operation of Section 323. n3

[2] Commission Enforcement

The Commission's investigatory and enforcement roles under the Trust Indenture Act have traditionally been seen as limited. However, the 1990 amendments to the Act appear to have created the potential for expansion of the Commission's traditional role. Section 309(e) precludes the Commission from conducting any investigation or proceeding to determine whether there is compliance with the provisions of an indenture that has already been qualified, or to enforce the indenture's provisions. n4 Those provisions would appear to limit the Commission's enforcement role to assuring initial indenture qualification and enforcing prohibitions against false or misleading statements in filings made with the Commission under the Trust Indenture Act.

This limited role is reinforced in the pre-qualification period by the provisions of Section 321(c) that specifically limit the scope of any investigation of, or information gathering regarding, a prospective trustee. The commission is limited to:

- (1) determining whether the prospective trustee is qualified under Section 310(b); n5
- (2) requiring inclusion in the registration statement or Form T-3 of information regarding the trustee's eligibility under Section 310(a)(1); n6 and
- (3) requiring inclusion in the registration statement or Form T-3 of the trustee's most recent report of condition to regulatory authorities, or otherwise determining that the trustee meets the capital and surplus requirements of Section 310(a)(2). n7

The Commission is authorized to issue refusal orders to prevent the effectiveness of a Securities Act registration statement when there has not been full Trust Indenture Act compliance. n8 It may also issue stop orders or refusal orders to prevent the offering or sale of securities in violation of the Trust Indenture Act when qualification, but not Securities Act registration, is required. n9 These and other Commission orders under the Trust Indenture Act are appealable to the U.S. Court of Appeals for the District of Columbia or for the circuit in which the appellant resides or has his principal place of business. n10

Section 321(a) grants the Commission the authority found in Securities Act Section 20 to investigate violations and to enforce the Trust Indenture Act through injunctive actions. n11 The basic prohibitions, violation of which may serve as a predicate for an injunction, are found in Section 325, which prohibits willful violation of any provision of the Act, or rules or orders under it, and prohibits the willful making of material misstatements or omissions in applications, reports, or documents filed or required to be filed under the Trust Indenture Act. It is here that the 1990 amendments create confusion. The TIA now imposes as a direct requirement of law various obligations which previously were binding only because they appeared in the indenture. n12 Now violation of mandatory indenture provisions is also a violation of the Act itself and thus, seemingly, the basis for an injunction unless the limitations of Section 309(e) are seen as precluding this result. Injunctions may also be predicated on violations of Section 306, which prohibits certain offers and sales of debt securities that should have been qualified under the Trust Indenture Act on Form T-3. n13

If it appears to the Commission that any person is engaged, or is about to engage in a Trust Indenture Act violation, the Commission may bring an action for a permanent or temporary injunction in federal district court. Upon a proper showing, an injunction or restraining order will be granted, without bond. n14 The primary element of a "proper showing" after proof of the predicate violation is demonstration of the reasonable likelihood of future violations. n15 Broad ancillary relief is also available in injunctive actions. n16

Section 321(a) gives the Commission all enforcement powers in Trust Indenture Act matters that are granted under

Section 20 of the Securities Act. In the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, n17 Section 20(d) was added to the Securities Act, giving the Commission broad authority to seek civil monetary penalties for violations of the statute or rules. Presumably the same penalties may be sought for violations of the Trust Indenture Act or the rules thereunder.

To conduct investigations, the Commission is given subpoena power by Section 321(a). By reference to Securities Act Section 22(b), n18 Trust Indenture Act Section 321(a) permits the Commission to seek judicial enforcement of its subpoenas. n19

Section 321(b) contains a special provision authorizing Commission access to reports, records, and information in the possession of federal banking regulatory agencies relating to indenture trustees or prospective indenture trustees, and authorizing these banking regulatory agencies to examine trustees or prospective trustees for the Commission. The section requires every trustee, as a condition precedent to indenture qualification, to consent to the Commission's receiving upon request from federal or state banking authorities copies of their reports of examinations of the trustee. n20 Under Section 321(b), none of the information received by the Commission from banking regulatory authorities may be divulged to persons outside the Commission, except that this information may be made available to the Department of Justice in confidence in connection with criminal reference of Trust Indenture Act cases.

[3] Criminal Reference

Section 325 imposes a fine of up to \$10,000, or imprisonment up to five years, or both, for persons convicted of willful violation of the Trust Indenture Act, or the rules or orders under it, or for persons convicted of willfully making material misstatements or omissions in any Trust Indenture Act application, report, or document filed or required to be filed with the Commission. However, proof of specific intent to commit a violation is not required. n21

Securities Act Section 20(b), which is made applicable to Trust Indenture Act violations by Section 321(a), provides for the Commission to transmit evidence of violations to the Attorney General for prosecution. Since the mid-1970s, the Commission, in recommendations for criminal prosecution under various of the statutes it administers, has used an expedited procedure by which files are sent directly to U.S. Attorneys' offices, by passing the Department of Justice. n22

Whatever the effect of Section 309(e) on the Commission's enforcement of duties made a part of positive law by the 1990 TIA amendments, n23 Section 309(e) appears to have no application to investigations or proceedings by the Department of Justice or the U.S. Attorneys' offices. Thus willful violations of obligations imposed by the Trust Indenture Act upon trustees, obligors or paying agents would seem to create the basis for criminal prosecutions under Section 325, even though prior to 1990 this would not have been the case because such obligations were then binding only because they were a part of the indenture contract. n24

FOOTNOTES:

(n1)Footnote 1. *See In re Nucorp Energy Securities Litigation*, C.C.H. Fed. Sec. L. Rep. P 99,539 (S.D. Cal. 1983); *Browning Debenture Holders' Committee v. DASA Corp.*, 357 F. Supp. 1010 , C.C.H. Fed. Sec. L. Rep. P 93,473 (S.D.N.Y. 1972); *Harris v. Union Electric Co.* 622 S.W. 2d 239 (Mo. App. 1981) ; *Steinberg v. Pennzoil United, Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,519 (E.D. Mo. 1974) (summary of complaint). TIA Rule 0-11 provides a safe harbor for certain forward-looking statements made with a reasonable basis and disclosed in good faith.

(n2)Footnote 2. *In re Nucorp Energy Securities Litigation*, 772 F.2d 1486 , C.C.H. Fed. Sec. L. Rep. P 92,306 (9th Cir. 1985). The lower court in *Nucorp* had held that any state law provision for automatic transfer of state law fraud claims against the trustee to purchasers of the securities would be pre-empted by the holding as to federal law. Any such

construction of state law "would hamper the accomplishment and execution" of federal law. In re Nucorp Energy Securities Litigation, C.C.H. Fed. Sec. L. Rep. P 99,577 at p. 97,261 (S.D. Cal. 1983). On appeal, the court avoided deciding the pre-emption issue. 772 F.2d at 1491-92, C.C.H. Fed. Sec. L. Rep. P 92,306 at p. 92,101.

(n3)Footnote 3. See § 8.09[3] *supra*.

(n4)Footnote 4. See Merchants National Bank & Trust Co. (No Action Letter, April 26,1990). But note the Commission's authority under Section 312(b), discussed in § 8.18[1] *supra*, to determine whether the trustee may refuse to mail security holder communications to fellow bondholders.

(n5)Footnote 5. See § 8.13 *supra*.

(n6)Footnote 6. See § 8.12 *supra*.

(n7)Footnote 7. See § 8.12 *supra*.

(n8)Footnote 8. See § 8.09[4] *supra*.

(n9)Footnote 9. See § 8.11 *supra*.

(n10)Footnote 10. TIA Section 322(a), applying Securities Act Section 9 to orders under the Trust Indenture Act.

(n11)Footnote 11. TIA Section 321(a) also incorporates the Commission's authority under Securities Act Section 20(c) to seek writs of mandamus to obtain compliance.

Securities Act Section 20 is discussed in § 10.02 *infra*.

(n12)Footnote 12. See § 8.03 *supra*.

(n13)Footnote 13. TIA Section 306 is discussed in § 8.11 *supra*.

(n14)Footnote 14. TIA Section 312(a), incorporating Securities Act Section 20(b).

(n15)Footnote 15. See H. Friedman, *Securities and Commodities Enforcement* 35-37 (1981).

(n16)Footnote 16. *Id.* at 53-67.

(n17)Footnote 17. P.L. 101-429, 104 Stat. 931 (1990).

(n18)Footnote 18. The reference in TIA Section 321(a) to Securities Act Section 22(c) is obsolete. In 1970, Section 22(c), relating to granting immunity from prosecution was repealed and replaced by 18 U.S.C. § 6001 *et. seq.*, Organized Crime Control Act of 1970, P. L.91-452, 213, 84 Stat. 922, 929 (1970).

(n19)Footnote 19. As to Commission investigations generally, see H. Friedman, *Securities and Commodities Enforcement* 5-32 (1981).

(n20)Footnote 20. See Form T-1, Instruction As To Exhibits, paragraph 6.

(n21)Footnote 21. *United States v. Brashier*, 548 F.2d 1315, 1328, C.C.H. Fed. Sec. L. Rep. P 95,827 at p. 90,984 (n. 23) (9th Cir. 1976). See generally H. Friedman, *Securities and Commodities Enforcement* 83-92 (1981).

(n22)Footnote 22. See H. Friedman, *Securities and Commodities Enforcement* 6-7 (1981).

(n23)Footnote 23. See § 8.20[2] *supra*.

(n24)Footnote 24. *See § 8.03 supra.*



135 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 8 The Trust Indenture Act of 1939

2-8 Federal Securities Act of 1933 § 8.21

AUTHOR: Howard M. Friedman This chapter was prepared by Howard M. Friedman, Professor of Law, Emeritus, University of Toledo. The author wishes to thank Mr. John Brousseau for his valuable research assistance in preparing the original version of this chapter and the University of Toledo for its research support through its Faculty Research Awards and Fellowships Program.

§ 8.21 State Trust Indenture Requirements

The Trust Indenture Act does not preempt state jurisdiction provided the state law does not conflict with federal law. Several states have adopted trust indenture requirements for securities offered or sold in the state.

Section 316 provides that the Trust Indenture Act shall not preempt state jurisdiction over any person or security, insofar as state law is not in conflict with federal provisions. n1 Several states have imposed trust indenture requirements for securities offered or sold in the state. Some states require that debt securities generally be issued under an indenture. n2 At least four states require compliance with the provisions of the Trust Indenture Act in some or all offerings. n3 New York has enacted a separate group of provisions relating to the content of indentures secured by a mortgage on real property and the conduct of trustees and bondholder committees. n4 Many of the New York provisions apply only to indentures that have not been qualified under the Trust Indenture Act of 1939. n5

Securities Act Section 18, as amended by the National Securities Markets Improvement Act of 1996, n6 preempts state qualification and merit review requirements for "covered securities," including state trust indenture requirements that are preconditions for state registration or qualification of covered securities. Debt securities which themselves are listed on the New York Stock Exchange, American Stock Exchange or Nasdaq, or which are issued by companies that have stock listed on these exchanges, are all covered securities. n7 New York's trust indenture provisions, which are part of its real property law, probably are not preempted since they are not requirements "with respect to registration or qualification of securities or ... of securities transactions." n8

FOOTNOTES:

(n1)Footnote 1. See *Bluebird Partners, L.P. v. First Fidelity Bank*, 279 A.D.2d 223, 746 N.Y.S.2d 475 (Sup. Ct. App. Div., 2002) (rule that TIA claims are not automatically assigned by sale of the bonds does not preclude contrary state law rule for state claims). But cf. *Baker v. Summit Bank*, 64 F. Supp. 2d 466, 468-69 (E.D. Pa. 1999) which held that

Pennsylvania's Unfair Trade Practices and Consumer Protection Act did not apply to a bank's activities as an indenture trustee in part because the federal Trust Indenture Act offers a full remedial scheme.

(n2)Footnote 2. Fla. Rules of the Department of Banking and Finance, Division of Securities, Rule 3E-700.10(4) (1982), 1A C.C.H. Blue Sky L. Rep. P 17,480 (also requiring a sinking fund); 15 Mo. Code of State Regulations, Sec. 30-52.120(4) (1974), 2A C.C.H. Blue Sky L. Rep. P 35,462.

(n3)Footnote 3. 10 Cal. Adm. Code, Rule 260.140.5, 1A C.C.H. Blue Sky L. Rep. P 11,855; Rules of Securities Division, Iowa Insurance Dept., Sec. 191-50.26. (502) (1976), 2 C.C.H. Blue Sky L. Rep. P 25,426; Texas Adm. Code. Sec. 113.25(f) (1998); 3A C.C.H. Blue Sky L. Rep. P 55,590O.Wis. Adm. Code, Sec. SEC 3.24 (1981), 3A C.C.H. Blue Sky L. Rep. P 64,544.

(n4)Footnote 4. *N.Y. Real Property Law §§ 124-130k.*

(n5)Footnote 5. *N.Y. Real Property Law § 130k.*

(n6)Footnote 6. Pub. L. No. 104-290, § 102, 110 Stat. 3416, 3417 (1996).

(n7)Footnote 7. Securities Act § 18(b)(1), Securities Act Rule 146.

(n8)Footnote 8. *See* Securities Act § 18(a)(1). *Cf.* SEC Staff Legal Bulletin No. 3 (CF) (July 25, 1997), C.C.H. Fed. Sec. L. Rep. P 60,003 (provisions on fairness hearings in reorganizations involving covered securities not pre-empted when the provisions are outside the state's securities laws).



136 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 9.syn

§ 9.syn Synopsis to Chapter 9: Civil Liabilities under the Securities Act *

§ 9.01 Introduction

§ 9.02 Section 11--Liability for False Registration Statement

[1] Introduction

[2] The Statute

[3] Elements of Plaintiff's Affirmative Case

[4] Plaintiff's Standing and the Problem of Tracing

[a] Direct Trace Method.

[b] Fungible Mass Method.

[c] Contrabroker Method.

[d] Heritage Method.

[5] Persons Liable

[a] Primary Defendants: those listed in Section 11(a).

[b] Controlling Persons.

[6] Transactions Covered by Section 11

[a] Misrepresentations and Omissions.

[b] Materiality.

[c] As of the Effective Date of the Registration Statement.

[7] Statute of Limitations

[8] The "Missing" Elements of Reliance, Causation and Scienter

[9] Affirmative Defenses

[10] Plaintiff's Knowledge

[11] Non-causation Defense

[12] Due Diligence Defense

[a] Congressional Intent.

[b] SEC Guidance.

[c] Applicability to Issuers.

[d] Applicability to Non-Experts.

[i] Due Diligence Defense as to Non-Expertised Portions of the Registration Statement.

[A] Inside Directors.

[B] Specialist Outside Directors.

[C] Non-Specialist Outside Directors.

[D] Underwriters.

[ii] Due Diligence Defense as to Expertised Portions of the Registration Statement.

[A] Inside Directors.

[B] Outside Directors and Specialist Outside Directors.

[C] Underwriters.

[e] Applicability to Experts.

[f] Lessons of BarChris and WorldCom.

[13] Damages

[14] Contribution

[15] Procedural Issues Common to Sections 11 and 12

2-9 Federal Securities Act of 1933 9.syn

[a] Forum.

[b] Costs and Attorney's Fees.

[c] Rule 9(b).

[d] Stay of Discovery.

§ 9.03 Section 12(a)(1) Liability for Offers and Sales of Unregistered Securities

[1] Introduction

[2] The Statute

[3] Elements of the Action

[4] Plaintiff's Standing

[5] Persons Liable

[a] General Standards.

[b] Specific Applications.

[i] Accountants

[ii] Attorneys

[iii] Banks/Lenders

[iv] Brokers

[v] Directors and Officers

[vi] Issuers

[vii] Underwriters

[6] Rescission and Damages

[7] In Pari Delicto

§ 9.04 Section 12(a)(2)--General Civil Liability Provision

[1] Introduction

[2] The Statute

[3] Plaintiff's Standing Generally

[4] Elements of the Action

[a] By Means of a Prospectus or Oral Communication.

[b] Misrepresentations or Omissions.

[c] Materiality.

[d] Plaintiff's Ignorance of the Untruth or Omission.

[5] Persons Liable

[6] Reasonable Care Defense

[7] Rescission and Damages

[a] Tender of Security.

[b] Offset.

[8] Indemnification and Contribution

§ 9.05 Statute of Limitations-Section 13

[1] Introduction

[2] The Statute

[3] Pleading Requirements

[4] Commencement of the Statute

[a] Section 11.

[i] One-Year Period.

[ii] Three-Year Period.

[b] Section 12(a)(1).

[i] One-Year Period.

[ii] Three-Year Period.

[c] Section 12(a)(2)

[i] One-Year Period

[ii] Three-Year Period

[5] Absence of Tolling

[6] Statute of Limitations under the Sarbanes-Oxley Act

§ 9.06 Absence of Implied Right of Action under Section 17(a)

§ 9.07 Arbitration of Securities Act Claims

§ 9.08 Class Actions

[1] Introduction

[2] Requirements

[a] PSLRA Requirements

[b] Rule 23 Requirements

[3] Numerosity

[4] Commonality

[5] Typicality

[6] Adequacy

[7] Predominance

[8] Superiority

[9] Removal



137 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.01

§ 9.01 Introduction

The Securities Act of 1933 ("Securities Act" or "1933 Act") was enacted in reaction to the stock market crash of 1929. Its purpose was to ensure that investors had the information necessary to make informed decisions and to protect them from fraud and misrepresentation. The 1933 Act ensured that adequate information would be available by federalizing the requirement that investors be provided with a registration statement upon the initial distribution of most securities and a prospectus upon offering securities to the public. n1 Although most states had adopted blue sky laws requiring the registration of securities well before the enactment of the 1933 Act, these laws did not provide private remedies for those harmed by false and misleading registration statements. n2

The 1933 Act filled that void by providing express civil damage remedies designed to protect investors from fraud and misrepresentation. Specifically, Sections 11 and 12 impose the following:

- strict liability for an issuer of securities sold pursuant to a materially misleading registration statement;
- liability for other persons--principally officers who sign the registration statement, directors, underwriters, and certain experts--for a materially misleading registration statement, unless they prove that they exercised due diligence in assuring the accuracy of the registration statement;
- strict liability for the seller of securities sold without any registration statement, unless the seller proves that the securities are exempt from registration because of an exemption;
- liability for the seller of securities, without regard to whether they are exempt from registration, for material misrepresentations and omissions in a prospectus or oral communication, unless the seller affirmatively proves that he or she did not know and in the exercise of reasonable care could not have known of the untruth or omission; and
- liability for "controlling persons" for violations committed by other persons, unless the controlling person proves that there was no reasonable ground to believe in the existence of the facts giving rise to the controlled person's liability.

The 1933 Act greatly expanded the remedies available under the common law.ⁿ³ For example, common law actions for fraud and deceit protected against material misrepresentations and omissions, but generally required the plaintiff to prove scienter, which the 1933 Act does not require. Also, negligent misstatements often provided a basis for relief only if the plaintiff and defendant were in privity. In addition, innocent misrepresentations led only to a rescission remedy, not damages. Finally, many common law actions required proof of reliance, which the civil liability provisions of the 1933 Act do not require.

The 1933 Act provisions impose liability on a narrower class of defendants and apply to a narrower class of transactions than Section 10(b) of the Securities Exchange Act, by far the most widely litigated provision of the federal securities laws. However, the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*ⁿ⁴ that a private plaintiff must prove scienter to prevail under Section 10(b) greatly increased the importance of the 1933 Act provisions, which do not require that the plaintiff prove scienter. The absence of scienter as an element under a 1933 Act cause of action is a significant advantage for plaintiffs seeking a civil recovery.

The purpose of this chapter is to examine in detail the civil liability provisions of the 1933 Act--Sections 11, 12(a)(1), and 12(a)(2). In addition, this chapter discusses the absence of an implied right of action under Section 17(a) and briefly examines arbitration of securities claimsⁿ⁵ and class actions.

FOOTNOTES:

(n1)Footnote 1. See Section 6 of the 1933 Act reprinted in *Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender 1996). The term "registration" statement means the statement provided for in Section 6 of the Securities Act, and includes any amendment thereto and any report, document, or memorandum filed as a part of such statement or incorporated therein by reference. 15 U.S.C. § 77.

(n2)Footnote 2. Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

(n3)Footnote 3. Common law remedies as of the time the 1933 Act was passed are discussed in Shulman, *Civil Liability*, 43 YALE L.J. 227; Note, *Liability for Misrepresentations in Corporate Prospectuses*, 40 Yale L.J. 987 (1931); and F. Harper, *A Treatise on the Law of Torts* (1933).

(n4)Footnote 4. 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,479 (1976).

(n5)Footnote 5. See generally D. Robbins, *Securities Arbitration Procedure Manual*, (Matthew Bender) for complete discussion of arbitration of securities claims.

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



138 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.02

§ 9.02 Section 11--Liability for False Registration Statement

[1] Introduction

Section 11 of the 1933 Act provides an express remedy for persons who purchased securities issued pursuant to a registration statement affected by material misrepresentations or omissions. Section 11's overriding purpose is "to assure compliance with the disclosure provisions of the [1933] Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering." n1 It accomplishes this by holding issuers strictly liable for the accuracy of the registration statement, and imposing on others a duty of "reasonable investigation," and a standard of "reasonable grounds to believe" that the registration statement is accurate. n2

After briefly describing Section 11's structure, this section describes the elements of plaintiff's affirmative case, including standing, the persons who may be held liable for violations, and the transactions covered by Section 11. n3 This section also examines the affirmative defenses available to defendants other than the issuer. In addition, it discusses the relief available if violations are established as well as the defendant's ability to seek contribution from other parties. Finally, it addresses various procedural and related matters pertinent to Section 11 claims.

[2] The Statute

Section 11 is the most detailed civil liability provision in the 1933 Act. Subsection (a) defines the class of transactions to which Section 11 extends, the persons who may be liable, and the potential class of plaintiffs. Subsections (b) and (c) set forth the various due diligence defenses available to particular defendants. Subsection (e) sets forth the measure of damages for Section 11 violations. In addition, it provides an affirmative defense to defendants who can prove that the damages suffered by the plaintiffs were not caused by that portion of the registration statement as to which the defendant's liability is asserted. Finally, subsection (e) authorizes a court to require plaintiffs to post bond in a suit under any provision of the 1933 Act and to award attorney's fees if the court believes the suit "to have been without merit." n4

[3] Elements of Plaintiff's Affirmative Case

Proof of the plaintiff's affirmative case under Section 11 is considerably simpler than under Section 10(b) of the Securities Exchange Act. n5 Scienter, causation, and reliance--frequent roadblocks in Section 10(b) litigation--are not elements of the plaintiff's cause of action under Section 11. n6 Indeed, in *Herman & MacLean v. Huddleston*, the Supreme Court acknowledged that, compared to section 10(b), "[s]ection 11 places a relatively minimal burden on a

plaintiff." n7

Specifically, a Section 11 plaintiff must prove that:

- he or she has standing (*i.e.*, that he or she acquired a security issued pursuant to the allegedly misleading registration statement);
- the defendants are among those covered by Sections 11(a)(1)-11(a)(5);
- when the registration statement became effective, it "contained an untrue statement of a material fact or omitted to state a material fact necessary to make the statements therein not misleading;" and
- the suit is brought within the statute of limitations. n8

The first three elements are discussed in greater detail below.

[4] Plaintiff's Standing and the Problem of Tracing

Although Section 11(a) defines the class of plaintiffs as "any person acquiring such security," not everyone who purchases securities at a price affected by a material misrepresentation or omission in the registration statement has standing to sue under Section 11. For example, Section 11(a) provides that a plaintiff may not recover if, at the time of the purchase, he or she knew of the untruth or omission.

Standing also may be limited by how the security was purchased. Clearly, plaintiffs who make purchases in the initial offering have standing to sue. The law is less clear with respect to secondary market purchases. This lack of clarity follows from the Supreme Court's decision in *Gustafson v. Alloyd Co.*, n9 which limited standing under another provision of the 1933 Act, Section 12, to only those who purchased in the initial offering, not secondary market purchasers. Following *Gustafson*, at least one district court has also limited standing under Section 11 to those who purchase in an initial offering. n10 Most courts, however, have limited *Gustafson* to Section 12 causes of action. For example, all circuit courts to address the issue (including the Second Circuit) have refused to expand *Gustafson* to Section 11. n11 Following these circuit court decisions, most district courts have held that Section 11 actions may be brought by secondary market purchasers. n12

However, secondary market purchasers pursuing a Section 11 claim must be able to "trace" their specific securities to a false or misleading registration statement. n13 If, for example, a post-effective amendment rather than the registration statement is misleading, then plaintiffs whose shares were purchased before the post-effective amendment could not sustain a Section 11 claim. n14 Post-*Gustafson* cases have not provided much guidance concerning how a plaintiff can demonstrate tracing. *Kirkwood v. Taylor*, n15 a pre-*Gustafson* case that extensively discussed tracing methods, provides some guidance.

In *Kirkwood*, the court decertified a Section 11 class because the plaintiffs were unable to trace their shares back to the misleading registration statement. The *Kirkwood* court discussed four different tracing methods and the difficulties associated with each: (1) direct trace; (2) fungible mass; (3) contrabroker; and (4) heritage methods. n16 Each method is discussed below; however, it is important to note that no court has ever accepted the fungible mass, contrabroker or heritage methods.

[a] Direct Trace Method. The direct trace method requires proof that the stock now held by the plaintiff was originally purchased in the registered offering. Typically a number of indicia are present, such as the initial customer's receipt of a preliminary prospectus, a notation on the purchase order ticket showing purchase in the offering, purchase at the offering price, lack of commission, language regarding the prospectus on the customer's confirmation slip, and

special coding of the transaction by the brokerage firm. While the *Kirkwood* court acknowledged that this is an appropriate method of tracing, none of the plaintiffs in that case could trace their shares under this method.

[b] Fungible Mass Method. Under the "fungible mass method," plaintiffs whose shares were held in a nominee account (typically Cede & Co., the nominee name of the Depository Trust Company) may identify the proportion of shares held by the nominee that are purchased by the nominee in the registered offering and assert that the same proportion of their shares held by the nominee should be deemed to have been purchased in the registered offering. *Kirkwood* rejected this approach because it showed only that the plaintiffs might have purchased shares issued pursuant to the allegedly misleading registration statement, not that they did purchase such shares. For purposes of Section 11, shares are not fungible. n17

[c] Contrabroker Method. Under the "contrabroker method," plaintiffs attempted to trace their purchases to brokers who participated as underwriters of the registered offering. The court rejected this approach because plaintiffs were unable to prove that the brokers only sold shares issued pursuant to the registration statement.

[d] Heritage Method. Under the "heritage method," plaintiffs who purchased stock on the over-the-counter market and who received stock certificates registered in their individual names attempted to trace the certificates back until they determined the ultimate origin of their certificates. The court rejected this approach principally because the plaintiffs were unable to show that the certificates covered only newly issued shares.

The fifth circuit recently addressed yet another method of tracing which it labeled "statistical tracing." In *Krim v. PcOrder.com, Inc.*, n18 the plaintiffs attempted to satisfy the tracing requirement by demonstrating that at the time they purchased their shares, 99.85% of the shares comprising the pool from which they purchased could be traced to the tainted offering. Thus, they argued, it was virtually guaranteed that some or all of the plaintiffs' shares came from the tainted offering (although they could offer no particularized evidence with respect to their shares). n19 The court rejected this method, finding that it would impermissibly expand the statute by effectively eliminating the tracing requirement in situations where more than 50% of the outstanding shares of a security could be traced to the initial offering. n20 Thus, the court held, statistical evidence alone is insufficient to satisfy the tracing requirement where there is any likelihood (no matter how slight) that the plaintiff's shares did not come from the tainted offering. n21

The "tracing" requirement poses a significant and sometimes insuperable obstacle for secondary market purchasers of securities, particularly where more than one registered offering has been made and not all the registration statements are alleged to be misleading. Proof that the shares *might* have been the subject of a false or misleading registration statement, or even that it is statistically probable that the shares were issued pursuant to such a registration statement, is insufficient to survive a motion for summary judgment. Allegations that *some* or all of the shares were issued pursuant to a false or misleading registration statement, however, might survive a motion to dismiss. n22

[5] Persons Liable

After establishing standing, the plaintiff must prove that the defendant falls under one of two categories:

- those listed in Section 11(a): individuals "who are signators of the registration statement, directors or partners of the issuer, experts named as preparing or certifying a portion of the registration statement, or underwriters of that issue;" n23
- under Section 15 of the 1933 Act, controlling persons (*i.e.*, any person who "controls any person liable under Section 11 or 12"). n24

Each of these categories are discussed below.

[a] Primary Defendants: those listed in Section 11(a). Unlike Section 10(b) of the 1934 Act, which applies to "any person" who engages in the prohibited conduct, Section 11(a) carefully limits the potential defendants. The first category of potential defendants listed in Section 11(a) consists of persons who sign the registration statement. n25 Section 6(a) of the 1933 Act requires that a registration statement be signed by "each issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions" n26

The other principal categories of defendants listed in Section 11(a) are the following: directors (Section 11(a)(2)); persons who are named in the registration statement with their consent as about to become directors (Section 11(a)(3)); professionals who are named in the registration statement as having prepared or certified part of the registration statement or any report used in connection with the registration statement (Section 11(a)(4)); and every underwriter of the securities (Section 11(a)(5)). n27

Among those who are not listed in Section 11(a) are non-signing officers, lawyers and other professionals who do not sign the registration statement or certify allegedly misleading information in it, broker-dealers who are not members of the underwriting syndicate, transfer agents, registrars, employees of the issuer, personnel of the underwriters, and persons who are scheduled to become directors but are not referred to as such in the registration statement. n28

[b] Controlling Persons. Section 15 of the 1933 Act imposes liability on "[e]very person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency or otherwise, controls any person liable under Section 11 or 12." n29 Congress intentionally chose not to define "control", believing that "[i]t would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted." n30 Predictably Congress' abdication has produced conflicting interpretations by the lower courts.

Many courts follow the SEC's broad formulation of control set forth in 1933 Act Rule 405 and Exchange Act Rule 12b-2, which define control as "the possession, direct or indirect, 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." n31 Under this test, once it is shown that the defendant participates in the operations of the corporation in general, it is sufficient that the "controlling person" possesses the power to control the specific activity upon which the primary violation is based even if he or she does not exercise that control. n32

Other courts require that the plaintiff allege "some kind of participation by the controlling person in the activities of the controlled person which are claimed to be violative of the securities laws." Some courts require that the participation in the violative conduct be "culpable" in order to provide a basis for controlling person liability. Under this approach, the plaintiff must prove: that the defendant (1) possessed the power to control or influence the primary violator and (2) was a culpable participant in the alleged illegal activity. n33 This reflects sensitivity to the fact that without such a limitation, a plaintiff could easily bring into the litigation entirely nonculpable defendants with no more than the allegation that they had the power to exercise control over one or more of the primary defendants. However, nothing in the specific language of Section 15, Exchange Act Rule 12b-2, or 1933 Act Rule 405 supports this interpretation. In fact, the courts that have required a showing of "culpable" conduct appear to confuse the issue of control with the separate issue of whether the controlling person has established a statutory defense. n34

Section 15 provides that a controlling person who "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist" may avoid liability. n35 The defendant bears the burden of proving that he or she lacked such knowledge. n36

[6] Transactions Covered by Section 11

The plaintiff must also prove that the alleged conduct is covered by Section 11. In other words, there must be: (1) a

misrepresentation or omission that (2) is material and (3) affects the registration statement as of its effective date. n37 Each of these elements are discussed below.

[a] Misrepresentations and Omissions. The registration statement must be affected by a material misrepresentation or omission. Although mere allegations of unfairness or breach of fiduciary duty are not actionable under Section 11, n38 liability under Section 11 may result from a failure either to meet affirmative disclosure obligations or to disclose facts necessary to make other statements in the registration statement not misleading. n39

[b] Materiality. Section 11(a) imposes liability when a registration statement contains "an untrue statement of a *material* fact or omit[s] to state a *material* fact required to be stated therein or necessary to make the statements therein not misleading." (italics added). n40 Prior to 1976, the precise formulation of the materiality standard was the subject of much debate and conflicting interpretations. n41 At least on the semantic level, however, the Supreme Court's decision in *TSC Indus., Inc. v. Northway, Inc.* largely resolved the issue. n42

In *TSC Indus.*, the Supreme Court held that an omitted fact is material "if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." n43 The Court also stated that in view of the remedial purposes of the statute, "it is appropriate that these doubts [regarding materiality] be resolved in favor of those the statute is designed to protect." n44 Although *TSC Indus.* involved civil liability under the proxy provisions of the Securities Exchange Act, the materiality standard articulated there has been applied by courts under Section 11 and other civil liability provisions of the securities laws. n45

As one might expect, however, articulation of the legal standard has left open the question of how that legal standard is to be applied to the facts of particular cases. Indeed, the most general principle to emerge is that materiality issues rarely can be resolved as a matter of law, but rather must be resolved by the fact finder in light of the importance of a particular fact or facts in the context of the total mix of information available in a given case. n46 In *SEC v. Seaboard Corp.*, the court noted materiality is "normally a jury question and should not be taken from it unless the court has engaged in meticulous and well articulated analysis of each item of withheld or misrepresented information." n47 However, if a court concludes that, as a matter of law, there is no material misrepresentation in the registration statement, it will dismiss the Section 11 claim. n48

Further complicating matters is the notion of "qualitative" materiality. In recent years, the duty to disclose information bearing on the competency or integrity of management has received renewed interest by the SEC and the courts. Although such information may not be quantitatively material, because it may not significantly affect the issuer's financial status in an easily measurable way, it frequently is qualitatively material because it reflects on the quality of corporate management. This incongruity is recognized in the SEC's Staff Accounting Bulletin No. 99, rejecting exclusive reliance on quantitative benchmarks to determine materiality. n49 As the SEC stated many years ago, "[e]valuation of the quality of management--to whatever extent it is possible--is an essential ingredient of informed investment decision[s]." n50

Although there is no assurance that different courts will take a consistent approach to materiality issues, some common themes have emerged from case law. For example, misrepresentations and omissions that are unlikely to affect the market price of securities ordinarily are considered immaterial. Also, the registration statement is not required "to set forth legal conclusions, engage in speculation, characterize the basic underlying facts with pejorative descriptions or verbalize all adverse inferences expressly" and the omission of these items does not give rise to liability. n51 Similarly, defendants "are not required to admit wrongdoing before it is properly determined in a court of law," n52 are not required to accuse themselves of mismanagement and poor business judgment, n53 are not required to disclose "that which should be obvious to the average investor," n54 and are not required to "[foretell] the future." n55 Accordingly, omission of these items does not give rise to civil liability. In addition, inaccurate projections are not actionable where there was a reasonable basis for the projection at the time it was made. n56 In addition, the principal focus of disclosure

requirements is "firm specific information" rather than more general information about, for example, "the competition, regulatory conditions, and the economy as a whole." n57 "Market knowledge" of related facts may lessen the likelihood that particular undisclosed facts will be deemed material. n58 Finally, a statement may not be material if there are warnings, or disclaimers attached to the predictive statements (the "bespeaks caution" defense). n59

Specifically, the court *In re Donald J. Trump Casino Securities Litigation-Taj Mahal Litigation* noted that for a defendant to utilize the bespeaks caution defense, "the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge." n60 For the bespeaks caution defense to apply, there must have been a reasonable basis to make the forward-looking statement. n61

The PSLRA codified the "bespeaks caution" defense by amending the 1933 Act to add a new Section 27A. Section 27A generally provides issuers with a safe harbor from liability in private actions for certain forward-looking statements (e.g., projections). The safe harbor applies to both written and oral statements, as long as:

- (1) the statement is identified as a forward-looking statement and is accompanied by meaningful cautionary language; n62
- (2) the statement is immaterial; or
- (3) the plaintiff fails to prove that the statement was made with actual knowledge of its falsity (no matter whether cautionary language was used). This safe harbor applies only to private actions, not to SEC enforcement actions. n63

The safe harbor also contains specified provisions for oral forward-looking statements made by an issuer. Such oral forward-looking statements are protected if they are identified as forward-looking statements, are accompanied by meaningful cautionary language, and identify "readily available" documentation that sets forth important factors that could cause results to differ materially from those projected. The legislation provides that such documentation is to be deemed "readily available" if it is either filed with the SEC or otherwise generally disseminated.

According to Section 27A(d), the safe harbor provision does not impose a duty to update a forward-looking statement. Although it is not entirely clear whether this provision is meant to eliminate any such duty that otherwise exists under law, or merely to clarify that no implied "duty to update" may be gleaned from Section 27A, it appears from the language of the statute--which refers explicitly to the fact that "[n]othing in this section shall impose 'a duty to update' "--that the latter meaning is intended.

[c] As of the Effective Date of the Registration Statement. Section 11 provides relief only for misstatements or omissions that affect a registration statement as of its effective date. Misstatements in a preliminary prospectus that are corrected before the prospectus is finalized are not actionable. Similarly, a registration statement that becomes misleading because of events occurring after its effective date is not actionable. Although the failure to correct may in some circumstances violate Section 12(a)(2) of the 1933 Act or Section 10(b) of the Securities Exchange Act, n64 Section 11 provides no liability unless the misrepresentations and omissions were present "when [the registration statement] became effective." n65

Special problems arise in shelf registrations made under SEC Rule 415 pursuant to which securities are registered for a continuous or delayed offering. n66 Rule 415 requires an issuer to keep information in the shelf registration statement accurate and up-to-date while offers or sales are being made. Also, item 512 of Regulation S-K requires a specific undertaking in shelf registrations that a post-effective amendment will be filed to reflect "fundamental changes" occurring after the effective date of the registration statement. In *Gallagher v. Abbott Laboratories*, the court noted that "the issuer must file and distribute an addendum to that document bringing matters up to date" and that this applied to both the issuance of new securities and the selling of stock. n67 Thus, in the case of shelf registrations, post-effective

events could theoretically give rise to Section 11 liability if the post-effective amendments are misleading.

[7] Statute of Limitations

Finally, the plaintiff must prove that the action is brought within the statute of limitations. This requirement is discussed *infra* at Section 9.05.

[8] The "Missing" Elements of Reliance, Causation and Scienter

Unlike Section 10(b) of the Securities Exchange Act, Section 11 does not require a plaintiff to prove reliance, causation, or scienter. n68 Indeed, in *Herman & MacLean v. Huddleston*, n69 the Supreme Court observed that the principal difference between Section 11 of the 1933 Act and Section 10(b) of the Securities Exchange Act is that under Section 10(b) a plaintiff "must prove that the defendant acted with scienter, *i.e.*, with intent to deceive, manipulate, or defraud." n70

There are, however, qualifications to this general statement. For example, reliance must be proven if the plaintiff's purchase occurs after the issuer has made generally available an earnings statement for a twelve month period beginning after the effective date of the registration statement. In that case, Section 11(a) conditions the right of recovery on "proof that such person acquired the securities relying on such untrue statement in the registration statement or relying upon the registration and not knowing of such omission." n71 This requirement reflects Congress' recognition that "in all likelihood the purchase and price of the security purchased after publication of such an earning statement will be predicated on that statement rather than upon the information disclosed upon registration." n72 Such reliance need not be direct; it "may be established without proof of the reading of the registration statement by such person." n73 Additionally, lack of reliance will bar recovery by sophisticated plaintiffs who entered into a binding commitment to purchase securities before the filing of the defective registration statement. n74

Also, although causation is not an element of the plaintiff's case, lack of causation is an affirmative defense, as discussed in Section 9.02[11] below.

[9] Affirmative Defenses

Once the plaintiff proves the affirmative elements of a Section 11 case, the defendant can still avoid liability if he or she can prove one of the available affirmative defenses:

- plaintiff's knowledge of the untruth or omission (Section 11(a));
- non-causation (Section 11(e));
- due diligence (Section 11(b))

We discuss each of these in more detail below.

[10] Plaintiff's Knowledge

Although reliance is not part of a plaintiff's affirmative case, Section 11(a) grants a complete defense upon proof that "at the time he acquired his stock [the plaintiff] knew of such untruth or omission." This defense is available to all defendants, including the issuer. Defendants must show actual, not constructive, knowledge. n75

[11] Non-causation Defense

Section 11(e) provides an affirmative defense to any defendant, including the issuer, who proves there was no loss

causation. n76 The defense applies to any damage that the defendant proves "represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which liability is asserted." n77 For example, a defendant may prove that there was no loss causation if he can establish that the decline in a security's value was due to a general decline in the market. n78 Although the burden of proving the absence of loss causation is a difficult one, in *Akerman v. Oryx Communications, Inc.* n79 the court granted summary judgment to the defendants on this ground where they demonstrated that (1) the market price of the security did not significantly change after the corrected facts were disclosed; and (2) unrebutted expert testimony showed that the decline in the price of the securities was consistent with the change in price of comparable stocks during the same time. n80

[12] Due Diligence Defense

Generally, Section 11(b) provides an affirmative defense against liability for persons (other than the issuer) if the individual engaged in reasonable investigation and had reasonable grounds to believe that the statements were true and that there was no material omission. Section 11(c) provides that "the standard of reasonableness shall be that required of a prudent man in the management of his own property." Application of these defenses varies depending on whether an expert or non-expert defendant is involved and on whether an expertised, non-expertised, or official portion of the registration statement is at issue. The WorldCom case, for instance, recently drove home this point and set out the potential consequences of a failure adequately to plan and implement a due diligence process. While the amount and form of diligence required will vary from deal to deal, prudent practice would be to employ a general due diligence checklist which includes (but is not limited to) the following areas:

- **Background Overview:** Parties should review the pertinent market, primary and potential competitors, operating history, and the company's organizational and management structure;
- **Business Information:** Parties should review the company's operations, growth strategy and objectives, historical performance and financial projections (including assessing the reasonableness of assumptions), key risks within and outside the company, and potential acquisitions;
- **Finance and Accounting:** Parties should review and understand the company's audited and unaudited financial statements (discussing them with auditors if necessary), significant accounting policies (paying particular attention to any material weaknesses or significant deficiencies noted by auditors), internal controls, and auditor independence issues;
- **Legal and Regulatory:** Parties should review the company's corporate governance documents, pending and/or threatened litigation, Sarbanes-Oxley compliance procedures, existing contracts (paying particular attention to representations and warranties), pending material transactions, and any licenses, trademarks, or patents held by the company.

The due diligence defense in Section 11(b) and the extent to which the 1933 Act should hold persons liable for unintentional violations were controversial issues during the debate preceding the enactment of the 1933 Act. In this section, we provide some background on the Congressional intent on Sections 11(b) and (c) and a summary of SEC guidance in this area. Next, we discuss how the defense applies to issuers, experts, and non-experts and the distinction between expertised and non-expertised portions of the registration statement.

[a] Congressional Intent. Three factors are important in understanding Congressional intent with respect to the due diligence defense. First, Congress believed that requiring defendants to establish the applicability of the defense was "indispensable to make the buyer's remedies under these sections particularly effective," n81 and that "it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance." These statements, it should be remembered, were made in

1933--several years before the adoption of federal rules of civil procedure providing extensive discovery rights. Thus, at the time that the statement was made, it was far more difficult than it is today to prove that the defendant's conduct was culpable.

Second, Congress wanted to assure that corporations making public offerings of securities were directed not merely by honest directors, but also by competent directors. A continuing theme running throughout the legislative history was to stop the practice of using "dummy directors" and to place upon the originators of securities "a duty of competence and innocence." n82

Third, Congress intended that the duty of care imposed on defendants under Section 11 would vary depending on their role in the distribution. As stated in the House Report, "[t]he duty of care to discover varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect." n83

Finally, although the House Report condemned the practice of using "dummy directors" with no actual oversight responsibilities, n84 it also rejected as an "impossible burden" compelling directors to "guarantee the absolute accuracy of every statement that they are called upon to make." n85 The Conference Report, in adopting the House approach and rejecting a Senate version of Section 11 that would have provided no due diligence defense, stressed the duty of reasonable care and the reasonableness of a defendant's delegating certain duties of investigation, especially where "the character of the acts involves professional skill or facilities not possessed by the fiduciary himself." n86

[b] SEC Guidance. The SEC has attempted to give some guidance on what constitutes due diligence through Rule 176, which was adopted as part of the Commission's integrated disclosure program. n87 Essentially, Rule 176 attempts to define the principal circumstances relevant in determining whether the due diligence requirements have been satisfied. Although it provides a convenient checklist of factors to consider, the general language of Rule 176 does not address specific issues in particular cases. It provides that the relevant circumstances in determining whether due diligence requirements have been met include:

- the type of issuer, since disclosure requirements vary depending on the characteristics of the issuer;
- the type of security, since this may be relevant in evaluating the financial condition and prospects of the issuer;
- the type of person, since the thoroughness of the required investigation depends on the importance of the person's place in the scheme of distribution;
- in the case of an officer, the actual office held since the investigation will vary depending on the person's position and responsibilities;
- in the case of a director or a proposed director, the presence or absence of another relationship with the issuer giving the director expertise, knowledge or responsibility with respect to particular matters;
- reasonable reliance on others whose duties should have given them knowledge of the particular facts;
- in the case of an underwriter, the type of underwriter involved (*i.e.*, managing underwriter, participating underwriter, or merely a statutory underwriter); and
- with respect to a fact or document incorporated by reference, whether the person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

[c] Applicability to Issuers. The *in terrorem* effect of Section 11 is most starkly seen in the case of issuer liability. Subsection (b) expressly limits the due diligence defense to persons "other than the issuer." The issuer's responsibility comes close to insuring the material accuracy of the registration statement. n88 The only defenses available to the issuer are to prove that (1) the plaintiff knew of the untruth or omission at the time of his acquisition, or (2) the decline in the value of the securities was due to factors other than misrepresentations or omissions in the registration statement.

[d] Applicability to Non-Experts.

For purposes of defining the availability of the due diligence defense to different categories of non-issuer defendants, Section 11 and related caselaw draw a clear distinction between "experts" and "non-experts," and between "expertised" and "non-expertised" portions of a registration statement. Under Section 11(a)(4), an expert means "[e]very accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him." It has been held, for example, that an attorney who provides a legal opinion used in connection with a registration statement is an expert under Section 11. n89 An expert's liability is limited to the "expertised" portion of the registration statement. n90 Section 11(b)(3) defines the expertised portion of a registration statement as any "part of the registration statement purporting to be made on the authority of an expert ... or purporting to be a copy of or extract from a report or valuation of an expert." n91

Accordingly, the remainder of the registration statement (that is, everything other than the expertised portion) is known under Section 11 and applicable caselaw as the "non-expertised" portion of the registration statement.

In contrast to an expert, a non-expert (*i.e.*, an officer, director, or other defendant outside the scope of Section 11(a)(4)) may be liable for false or misleading statements in both the expertised and non-expertised portions of the registration statement.

[i] Due Diligence Defense as to Non-Expertised Portions of the Registration Statement.

A non-expert defendant may escape liability for a non-expertised portion of the registration statement by proving that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading" n92 In other words, the non-expert must prove not only that he undertook a reasonable investigation, but also that as a result of that investigation he had reasonable ground to believe that the registration statement was accurate.

Through an analysis of *BarChris* and more recent cases, we discuss the due diligence defense as it applies to different categories of defendants. n93

[A] Inside Directors. The "reasonable investigation" and "reasonable ground to believe" standards vary "with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data." n94 Because reasonableness varies with the role of the defendant, "inside" directors, *i.e.*, directors who are also officers of the corporation or who have a particularly close affiliation with the corporation, are subject to a particularly high standard of reasonableness. Existing case law imposes "such stringent requirements of knowledge of corporate affairs on inside directors that one is led to the conclusion that liability will lie in practically all cases of misrepresentation." n95

Inside directors find themselves in a "catch-22" position under Section 11. If they are diligent and knowledgeable about corporate affairs, their knowledge is deemed inconsistent with a reasonable ground to believe that the registration statement is accurate. If they are not diligent and not knowledgeable about corporate affairs, then their ignorance is deemed inconsistent with a reasonable ground to believe in the accuracy of the registration statement. The liability of a director who signs a registration statement "does not depend upon whether or not he read it or, if he did, whether or not

he understood what he was reading." n96 The five inside directors in *BarChris* covered the gamut in terms of their education and knowledge of and involvement in the corporation's affairs. All were held liable, and it is apparent from the tenor of the opinion that the court did not consider the liability of the inside directors for inaccuracies in the non-expertised portions of the registration statement to present a close issue.

The fact that a director cooperated fully in frankly disclosing to persons preparing the registration statement all the facts known to him, and then relied on such persons to make adequate disclosures, is largely irrelevant. An inside director is "not entitled to sit back and place the blame on the lawyers for not advising him about [inaccuracies in the registration statement]." n97 Rather, the director must "make a reasonable investigation of the truth of all the statements in the unexpertised portion of the document which he signed." n98

[B] Specialist Outside Directors. Specialist directors, *i.e.*, directors having particular expertise or involvement in matters related to the registration statement, also are subject to a stringent standard of diligence. An outside attorney-director who helped prepare the registration statement in *BarChris* was held liable in part because his very involvement meant "more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work." n99

Although the attorney-director argued that he was entitled to rely on the officers who had first hand knowledge of the company's affairs, the court held that "to require a check of matters easily verifiable is not unreasonable." n100 It went on to fault the director for failing to read various contracts and minutes of subsidiaries, preparing inadequate written questionnaires, and failing to check the books of the company. After making some allowance for the fact that the attorney-director had been misled by the company's officers, the court nevertheless found that there were "too many instances in which [the attorney-director] failed to make an inquiry which he could easily have made which, if pursued, would have put him on his guard." n101 In *Feit*, the court treated lawyer-directors as insiders because they were involved intimately with operation of the company. n102

[C] Non-Specialist Outside Directors. Non-specialist outside directors are subject to a less rigorous standard of diligence than either inside directors or specialist directors. n103 This does not mean, however, that their burden is satisfied easily.

In *BarChris* the two non-specialized outside directors also failed to establish their due diligence defenses as to the non-expertised portion of the registration statement. They had joined the company shortly before the effective date of the amended registration statement. They did little more than ask one or two general questions about the registration statement and accept management's answers at face value. This failed to satisfy the prudent man standard because, in the court's words, "a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case." n104

Outside directors fared better in *Laven v. Flanagan*. n105 In *Laven*, Western Union issued a registration statement in connection with its sale of \$50 million of preferred shares. After the offering, Western Union's banks cancelled a \$100 million line of credit, its largest shareholder sold its holdings, Western Union wrote down its assets, and the price of its stock plummeted. Shareholder suits alleging violations of Section 11 of the 1933 Act and other provisions of the federal securities laws followed. The court granted summary judgment to the outside directors, holding that as a matter of law they had established their due diligence defense under Section 11. It found that they had reviewed the prospectus, and had reasonably relied on the representations of the independent auditor, the underwriter, and Western Union's management. Because their activities "were a far cry from the passive and total reliance on company management that defeated the due diligence defense in [*BarChris*]," the court granted summary judgment. n106 The cases make clear that outside directors cannot merely rely on inside directors. They must undertake their own effort to verify that the company's statements are accurate and complete.

[D] Underwriters. As the summary judgment decision in *In re WorldCom, Inc. Securities Litigation* n107 ("WorldCom") makes clear, underwriters continue to be held to a very high standard with respect to due diligence. This decision outlined the pitfalls which underwriters must avoid in establishing the foundation for a due diligence defense.

WorldCom bondholders sued the underwriters of two public debt offerings under sections 11 and 12(a)(2) after WorldCom announced in 2002 that it had improperly overstated earnings totaling at least \$11 billion. Moving for summary judgment, the underwriters asserted reliance on Arthur Andersen's audits of WorldCom's year-end financial statements, and with respect to the company's unaudited interim financial statements, the underwriters argued that their reliance on Andersen's comfort letters (based on quarterly reviews) gave rise to a due diligence defense. In denying the motion, the court held that although audited financial statements qualify as expertised information, unaudited financial statements (even if the subject of an auditor's comfort letter) do not. n108 After discussing SEC rules that make clear that accountants are not subject to liability as experts for financial statements that they merely review but do not audit, the court held that an accountant's comfort letter as to interim financial statements "[does] not expertise any portion of the registration statement that is non-expertised" and that underwriters may not rely upon such a letter to establish a due diligence defense. n109 Thus, to assert a successful due diligence defense, the underwriters had to show that they undertook reasonable independent verification of the non-expertised portions of the registration statements (including interim financial information), and had reasonable grounds to believe in their accuracy. n110 Furthermore, as discussed more fully in Section 9.02[12][D][ii][C], the court held that even with respect to audited financial statements, blind reliance on an auditor's opinion is insufficient to avoid liability where "red flags" exist. n111

BarChris also remains a key decision on the issue of underwriter due diligence. In that case the managing underwriter, which had read BarChris' prospectuses and annual reports, reviewed similar documents of other companies in the industry, and checked BarChris' reputation with banks and other financial institutions (among other procedures), was held liable because the court found that it had not attempted to verify the information supplied by the company's officers. The court emphasized that "the positions of the underwriter and the company's officers are adverse" and that "statements made by company officers to an underwriter to induce him to underwrite may be self-serving." n112 Therefore, underwriters "must make some reasonable attempt to verify the data submitted to them." n113

With little explanation, the court went on to hold that the participating underwriters were also liable since they had relied solely on the lead underwriter. n114 This should not, however, be interpreted as either prohibiting participating underwriters from delegating responsibilities to the managing underwriter, n115 or automatically holding the participating underwriters liable for deficiencies in the managing underwriter's investigation.

Congress recognized that Section 11 permits reasonable delegation. n116 An interpretation of Section 11 that requires participating underwriters to duplicate all of or portions of the investigation conducted by the managing underwriter would result in needless waste and expense. The more sensible interpretation is contained in a 1972 Securities Act release, which sets forth the SEC's view that although a participating underwriter may delegate responsibilities to a managing underwriter and thus "may relieve himself of the task of actually verifying the representations in the registration statement," he must satisfy himself "that the managing underwriter makes the kind of investigation the participant would have performed if he were the manager." n117 The obligation of a participating underwriter under section 11 is not to avoid delegating investigatory responsibilities to the managing underwriter, but to assure himself that the manager's program of investigation and actual investigative performance is adequate.

[iii] Due Diligence Defense as to Expertised Portions of the Registration Statement. Section 11(b)(3)(C) sets forth the non-expert's due diligence defense for expertised portions of the registration statement. In contrast to the Section 11(b)(3)(B) due diligence defense for non-expertised portions of the registration statement, Section 11(b)(3)(C) does not contain an explicit "reasonable investigation" requirement and does not affirmatively require a "reasonable ground to believe" in the accuracy of the registration statement. Instead, it is stated in the negative, requiring proof that the defendant "had no reasonable ground to believe and did not believe ... that the statements therein were untrue or that there was an omission to state a material fact; or that such part of the registration statement did not fairly represent the

statement of the expert" n118

[A] Inside Directors. Inside directors typically have, and are expected to have, relatively detailed knowledge of the more material matters concerning the corporation. The larger the number of misrepresentations and omissions in a registration statement and the more material the matters misrepresented or omitted, the greater is the likelihood that an inside director will be unable to establish the due diligence defense even as to the expertised portions of the registration statement. Four of the five inside directors in *BarChris* failed to establish their due diligence defense with respect to the expertised portions of the registration statement. They were found to have known too much of the corporation's affairs to have reasonably believed that there were no untrue statements or material omissions in the certified financial statements.

The one inside director who did establish due diligence as to the expertised portion of the registration statement was a lawyer who became a director late in the registration process. The court found that he merely attended to legal matters of a routine nature, did not participate in the management of the company, and had no personal knowledge of the corporation's affairs. In light of his limited role in the corporation and his limited knowledge, the court found that it was reasonable for him to rely on the accountant's certification of the company's financial statements.

[B] Outside Directors and Specialist Outside Directors. Each of the outside directors in *BarChris*, including the so-called "specialist director" who helped prepare the registration statement, was able to assert a successful due diligence defense as to the expertised portion of the registration statement. Their knowledge about the corporation was not extensive enough to give them reason to question the accuracy of the certified financial statements, and they were entitled to rely on the company's accountants with respect to such statements rather than conduct their own independent investigation.

[C] Underwriters. The underwriters in *BarChris* were held not liable for the expertised portions of the registration statement. As with the outside directors, their knowledge of the corporation was not found to be inconsistent with the certification provided by the accountants, and they were not found to have any further duty of investigation with respect to the certified financial statements. In contrast, the *Worldcom* court found that the underwriters were not entitled to rely upon financial statements that had been reviewed but not audited by the company's independent auditors, nor could they rely upon "comfort letters" provided by the auditors without undertaking their own independent inquiry as to the reliability of the company's financial information. Even as to the company's audited financial statements, which the *Worldcom* court acknowledged would qualify as "expertised" portions of the registration statement, the court held that the underwriters' reliance may not be blind. Rather, "where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability." n119

The court characterized as a red flag "any information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements." n120 In the *Worldcom* case, the court saw potential red flags in the fact that certain of WorldCom's financial ratios were out-of-step with its industry competitors and that a number of the underwriters had themselves recently downgraded the company's credit rating. n121 Beyond undue reliance on audit opinions, the court was troubled by other aspects of the underwriters' due diligence as well, citing "superficial" and "cursory" questioning of management, poor documentation of the diligence process, and an overall failure to play "devil's advocate" in gaining an understanding of the company's business. n122

[e] Applicability to Experts. With respect to the matters that an expert certifies, the due diligence defense is similar to that of non-experts for non-expertised portions of the registration statement. The expert must prove that at the time the expertised portion of the registration statement became effective, "he had, after reasonable investigation, reasonable ground to believe and did believe ... that the statements therein were true and that there was no omission to state a material fact required to be stated therein ... or necessary to make the statements therein not misleading." n123 What constitutes a reasonable investigation will be determined, in part, by prevailing industry standards. n124 Alternatively, under Section 11(b)(3)(B)(ii), the expert may prove that the expertised portion of the registration statement does not represent fairly his statement as an expert.

In *BarChris* the accountants were held liable for certifying false financial statements principally because they were "too easily satisfied with glib answers to [their] inquiries" and "there were enough danger signals in the materials which [they] did examine to require some further investigation." n125

Similarly, the *WorldCom* court acknowledged the fact-intensive nature of the inquiry, particularly given the minimal case law guidance defining the contours of the due diligence defense for accountants. n126 In denying Arthur Andersen's motion for summary judgment, the court held that the plaintiffs had "presented evidence that raises questions of fact as to whether each of [the accounting decisions questioned by the plaintiffs] complied with GAAP individually and in the context of their impact on the financial statements of WorldCom taken as a whole." n127 Thus, Andersen faced liability for its unqualified audit opinion where the court found that the auditors appreciated the risk of fraud at WorldCom (citing, among other things, aggressive accounting and undue emphasis on maintaining a high stock price) but did not take adequate steps to prevent it. n128

[f] Lessons of *BarChris* and *WorldCom*. The *BarChris* decision is important, not for hard and fast black-letter rules on how to satisfy the Section 11 due diligence requirements, but for its general approach. Above all, two principles emerge from the decision: first, reliance on others to "get it right" generally will not, by itself, excuse one from liability under Section 11; second, in determining whether due diligence has in fact been exercised, courts will not elevate form over substance. *BarChris* noted that the key to due diligence is the independent verification of the facts, and that the "reasonableness" varies depending on the defendant's role with the issuer. Courts will focus not merely on the mechanics of asking questions and getting answers, but on what steps were taken to verify the information contained in those answers. Delegation of responsibilities, while clearly permissible in many circumstances, will be looked upon with suspicion when used to excuse liability.

Counsel for the company is similarly well advised to be thoroughly familiar with the company's affairs. Corporate officials, including outside directors, should be advised to be familiar with the company's business and to ask specific questions tailored to the contents of the registration statement. Reliance on others "to get it right" does not avoid liability under the Act, nor does asking superficial questions concerning the general nature of the company's business.

WorldCom, in addition to reiterating the lessons learned from *BarChris*, further defined and narrowed the contours of the due diligence defense. Like *BarChris*, *WorldCom* is significant in its approach to the defense on the basis of the bedrock principle that "tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate." n129

The *WorldCom* court borrowed the "devil's advocate" language from *BarChris*, and shaped this theme throughout its due diligence commentary. For example, the *WorldCom* court limited the reliance that can be placed on audited financial information by requiring underwriters to watch for warning signs which may indicate a lack of reliability as to the information being presented. "[W]here 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability." n130 With respect to unaudited financial information, meanwhile, reliance on an auditor's comfort letter, without more, constitutes no defense at all to section 11 liability. n131 The courts will continue to parse out these issues, but underwriters would be wise to heed the lessons of the past in performing due diligence going forward.

[13] Damages

Section 11(e) provides three alternative measures of damages, all essentially compensatory in nature. Where plaintiff has not sold the stock, the measure is the difference between the amount paid for the stock when purchased and its "value" at the time suit is brought. n132 Where the stock has been sold before the action is brought, the measure is the difference between the amount paid for the stock when purchased and the "price" at which it was disposed of in the market. n133 Where the stock is sold after suit is brought but before judgment is rendered, the measure is the difference

between the amount paid for the stock when purchased and the price at which it was disposed of so long as this does not exceed the difference between the purchase price and the value at the time of suit. n134 In other words, price increases after a suit is filed may reduce damages, but price decreases after a suit is filed will not increase damages. n135

The term "value," as used in the first of the three measures, is not necessarily synonymous with market price. If the market price has been affected by misrepresentations or omissions of material fact, value may be either higher or lower than the market price. n136 Ordinarily, "value" is the market price after the facts have been disclosed to the public. n137

A number of other qualifications should be noted with respect to the measure of damages. First, in determining the "amount paid" for the security, the statute provides that this amount shall not exceed the price at which the security was offered to the public. Thus, for example, if the stock is first sold to the public at \$10 a share, but plaintiff buys in the secondary market at \$15 a share, and the value of plaintiff's share is only \$5 a share when suit is brought, plaintiff's maximum damages are \$5 a share rather than \$10 a share. n138 Second, the statute also provides that each underwriter may not be liable for damages in excess of the total price at which the securities underwritten by him were offered to the public unless the underwriter knowingly receives extra compensation from the issuer. n139 Third, no defendant is liable for any portion of the damages that he proves was caused by matters other than the misrepresentations or omissions in that part of the registration statement as to which liability is asserted. Fourth, price declines before disclosure of the allegedly omitted facts generally may not be charged to defendants. n140 Finally, benefit-of-the-bargain damages are not available under Section 11. n141

[14] Contribution

Section 11(f) provides an express cause of action for contribution against a defendant who becomes liable under Section 11. n142 Contribution may be obtained from any other person who, if sued separately, would have been liable for the same payment except that a person who has engaged in fraud is not entitled to contribution from a person who has not engaged in fraud. n143

[15] Procedural Issues Common to Sections 11 and 12

There are certain procedural issues common to Section 11 and Section 12 claims. They are as follows.

[a] Forum. Under Section 22(a), a plaintiff may bring a Section 11 or 12 action in a federal district court, or a state court. Section 22(a) provides that a Section 11 claim filed in a state court cannot be removed to federal court. n144 However, there is a split of authority among federal circuit courts as to whether Section 22(a)'s removal bar was superceded by the Class Action Fairness Act of 2005 (CAFA), n145 which permits removal of class actions that exceed \$5 million in claimed damages and involve at least partial diversity between plaintiffs and defendants. n146

[b] Costs and Attorney's Fees. Section 11(e) authorizes a court, "in its discretion,"

- to "require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees," and
- to award such costs to the prevailing party "if the court believes the suit or the defense to have been without merit." n147

These provisions are applicable to any suit brought under any section of the 1933 Act.

If applied broadly, Section 11(e) could have a serious deterrent effect on suits brought under the 1933 Act, particularly in class actions where reasonable attorney's fees of six and seven figures are not unusual. However, courts have generally applied these provisions narrowly. Courts frequently recognize that they should require security only upon ruling that "an eventual finding of bad faith or obvious lack of merit appear[s] likely" n148 Few courts would make

such a finding in the early stages of litigation. n149

Similarly, although the statute authorizes the award of attorney's fees merely upon a showing that the suit or defense was "without merit," this standard has also been interpreted narrowly to require a finding that the suit "borders on the frivolous" or has been "brought in bad faith." n150 Courts have awarded fees under this provision only on rare occasions. n151 On the other hand, taxable costs are awarded as a matter of course to the prevailing party in Section 11 and 12 litigation. n152

The impact of the PSLRA on Section 11(e) remains an open issue. Upon final adjudication of a 1933 Act claim, the PSLRA requires courts to assess the parties' compliance with Rule 11(b) of the Federal Rules of Civil Procedure and to impose sanctions for any violations. The PSLRA also creates a rebuttable presumption that an award of attorney's fees and expenses is the appropriate sanction. There is an argument that the PSLRA's mandatory language supercedes the discretionary power to award fees that courts formerly enjoyed under Section 11(e). Nor is there clear guidance on whether, or to what extent, Section 11(e)'s "without merit" standard overlaps the "violation of Rule 11(b)" standard in the PSLRA. Both these issues await resolution by the courts.

[c] Rule 9(b). Another procedural issue applicable to Sections 11 and 12 merits particular mention. In contrast to the general notice pleading permitted under the Federal Rules of Civil Procedure, Rule 9(b) of the Federal Rules of Civil Procedure requires that all allegations of fraud be pleaded "with particularity."

The rule has been interpreted to require the plaintiff to specify:

- precisely what written statements, oral misrepresentations, or omissions were made;
- the time and place of each such statement or omission and the person responsible for making (or, in the case of omissions, not making) the same;
- the context of such statements and the manner in which they misled the plaintiffs; and
- what the defendants obtained as a consequence of the fraud. n153

Where applicable, this provision may impose significant obstacles for a plaintiff who, particularly at the beginning stages of litigation, often is not able to satisfy the requirements of the rule. Indeed, one of the most frequent bases for dismissal of Section 10(b) actions is the inability of a plaintiff to comply with Rule 9(b).

Strictly speaking, Sections 11 and 12(a)(2) do not create fraud claims because they do not require proof of scienter; rather, they are predicated on false or misleading disclosures regardless of intent. Thus, at least at first blush, Rule 9(b) would appear to be inapplicable to alleged violations of Sections 11 and 12(a)(2). However, plaintiffs sometimes combine Section 11 and 12(a)(2) allegations with Section 10(b) allegations and use the same scienter allegations for all claims. The issue that arises in such cases is whether Rule 9(b) becomes applicable to claims under Section 11 and 12(a)(2) if the plaintiff includes allegations of scienter.

Some courts maintain that Rule 9(b) does not apply to Section 11 and 12(a)(2) claims even when these claims incorporate factual allegations of scienter. n154 Other courts disagree, citing the language in Rule 9(b) referring to "all *averments* of fraud or mistake." n155

In *Rombach v. Chang*, n156 the Second Circuit finally settled a long standing difference of opinion among the lower courts of that Circuit as to the applicability of Rule 9(b) to Section 11 and 12(a)(2) claims that include scienter allegations. Coming down firmly on the side of those Circuits, such as the Third, Fifth, and Ninth, that have held Rule 9(b) applies to Section 11 and Section 12(a)(2) claims grounded in fraud, the Second Circuit observed that "[b]y its

terms, Rule 9(b) applies to 'all averments of fraud' ... " and held that "while a plaintiff need allege no more than negligence to proceed under Section 11 and Section 12(a)(2), claims that do rely upon averments of fraud are subject to the test of Rule 9(b)." n157

Although some courts n158 continue to hold that Rule 9(b) is inapplicable to Section 11 and 12(a)(2) claims, plaintiffs should not assume the burden of complying with Rule 9(b) when that burden can be avoided. A plaintiff should frame his or her Section 11 and 12(a)(2) allegations carefully by not combining them with fraud allegations that may be necessary to support other alleged violations in the complaint. If the plaintiff fails to separate the Section 11 and 12(a)(2) allegations from the fraud allegations, the defendant is on firm ground to demand compliance with Rule 9(b) in most jurisdictions.

A distinct but related issue is the applicability of the PSLRA's heightened pleading standards, which go beyond the requirements of Rule 9(b), to Section 11 and 12(a)(2) claims. The PSLRA amended the Exchange Act to require plaintiffs to state with particularity both the reason why a statement was misleading and "facts giving rise to a strong inference that the defendant acted with the required state of mind." n159 However, Section 21D of the Exchange Act states that these standards apply only to private actions "arising under this chapter;" that is, under the Exchange Act. n160 Section 21D further restricts the applicability of the scienter standard to actions in which the plaintiff may recover money damages "only on proof that the defendant acted with a particular state of mind." n161 Based on this text, the heightened pleading standards clearly do not apply to Section 11 and 12(a)(2) claims, which arise under the 1933 Act and do not require scienter. However, among the few courts that have explicitly considered the issue, more have held that the PSLRA does apply n162 than have held that it does not. n163

[d] Stay of Discovery. Section 27(b) of the 1933 Act, added as part of the PSLRA, seeks to control discovery costs. It provides that in any private action arising under the 1933 Act, including Sections 11 and 12, "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss." n164 The provision authorizes a court to permit discovery upon the motion of any party "that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." n165

While the stay is in place, the parties to the action are required to preserve evidence. n166 The willful failure by any party to comply with the statutory directive to preserve evidence can result in court-ordered sanctions. n167

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78k. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82, 103 S. Ct. 683, 687, 74 L. Ed. 2d 548, 555, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,058, at 95, 014-15 (1983); *Verysys Inc. v. Coopers & Lybrand*, 982 F.2d 653, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,309 (1st Cir. 1992).

(n2)Footnote 2. 15 U.S.C. § 77k.

(n3)Footnote 3. The statute of limitations is described in § 9.02[7] *infra*.

(n4)Footnote 4. 15 U.S.C. § 77k.

(n5)Footnote 5. Section 10(b) requires proof that, "in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff] injury." *See, e.g., Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001); *ZVI Trading Corp. Employees' Money Purchase Pension Plan & Trust v. Ross (In re Time Warner Inc. Sec. Litig.)*, 9 F.3d 259, 264, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,824 (2d Cir. 1993) (quoting *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 61, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,922 (2d Cir. 1985)).

2-9 Federal Securities Act of 1933 § 9.02

(n6)Footnote 6. However, where the security is purchased after the issuer makes publicly available an earning statement that covers at least a 12 month period beginning after the effective date of the registration statement, the plaintiff must prove that he or she relied upon the misrepresentation or omission in the registration statement in order to bring a claim under Section 11. Section 11(a). *See* § 9.02[8] for a discussion of this requirement.

(n7)Footnote 7. 459 U.S. 375, 382, 103 S. Ct. 683, 74 L. Ed. 2d 548 , [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,058 (1983).

(n8)Footnote 8. 15 U.S.C. § 78k. The statute of limitations is discussed *infra* at § 9.02[7].

(n9)Footnote 9. 513 U.S. 561, 115 S. Ct. 1061, 131 L. Ed. 2d 1 , [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,531 (1995).

(n10)Footnote 10. *See, e.g., In re Summit Med. Sys., Inc., Sec. Litig.*, 10 F. Supp. 2d 1068, 1070 (D. Minn. 1998) , *rev'd sub nom, Lee v. Ernst & Young, LLP*, 294 F.3d 969 , [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,929 (8th Cir. 2002).

(n11)Footnote 11. *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 274 , [2006-2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,694 (3d Cir 2006); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 872-73 (5th Cir. 2003) ; *DeMaria v. Andersen*, 318 F.3d 170, 178 , [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,256 (2d Cir. 2003); *Ernst & Young LLP*, 294 F.3d 969 ; *Joseph v. Wiles*, 223 F.3d 1155 , [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,036 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999) . *See also*, Brian Murray, *Aftermarket Purchaser Standing Under § 11 of the Securities Act of 1933*, 73 ST. JOHN'S L. REV. 633, 643-44 (Summer 1999) (recent trend is to give standing to aftermarket purchasers).

(n12)Footnote 12. *See, e.g., Milman v. Box Hill Sys. Corp.*, 192 F.R.D. 105, 109 (S.D.N.Y. 2000) ; *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 202 (E.D.N.Y. 2000) ; *In re Prison Realty Secs. Litig.*, 117 F. Supp. 2d 681 (M.D. Tenn. 2000) .

(n13)Footnote 13. *See, e.g., Krim v. PcOrder.com, Inc.*, 402 F.3d 489, 495-96 (5th Cir. 2005) ; *Lee v. Ernst & Young LLP*, 294 F.3d 969, 976-77 (8th Cir. 2002) ; *Joseph v. Wiles*, 223 F.3d 1155, 1160 (10th Cir. 2000) ; *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999) ; *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1119 (D. Nev. 1998) .

(n14)Footnote 14. *See Guenther v. Cooper Life Sciences, Inc.*, 759 F. Supp. 1437 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,882 (N.D. Cal. 1990).

(n15)Footnote 15. 590 F. Supp. 1375 (D. Minn. 1984) , *aff'd*, 760 F.2d 272 (8th Cir. 1985) .

(n16)Footnote 16. *Kirkwood*, 590 F. Supp. 1375 .

(n17)Footnote 17. The "fungible mass" method was also rejected by *Harden v. Raffensperger, Hughes & Co.*, 933 F. Supp. 763, 767 (S.D. Ind. 1996) . In *Krim v. PCOrder.com, Inc.*, No. 03-503737, 2005 U.S. App. LEXIS 3471 ; *Fed. Sec. L. Rep. (CCH) P 93,126* (5th Cir. Mar. 1, 2005), the Fifth Circuit, employing somewhat different terminology, also rejected the "fungible mass" tracing method.

(n18)Footnote 18. 402 F.3d 489 (5th Cir. 2005) .

(n19)Footnote 19. *Id.* at 492 .

(n20)Footnote 20. *Id.* at 496-97 .

(n21)Footnote 21. *Id.*

(n22)Footnote 22. See *Schwartz v. Celestial Seasonings, Inc.*, 178 F.R.D. 545, 557 (D. Col. 1998) ; *In re ZZZZ Best Sec. Litig.*, No. CV-87-3574-RSWL, 1989 U.S. Dist. LEXIS 8083 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,485 at 93,093 (C.D. Cal. May 19, 1989); but see *Grand Lodge of Pa. v. Peters*, 550 F.Supp. 2d 1363, 1375-76 , [2007-2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,607, at 94,223-24 (M.D. Fla. 2008) (holding that more than mere allegation of traceability is needed to survive a motion to dismiss; plaintiff must at least state what evidence they intend to use to show traceability).

(n23)Footnote 23. 15 U.S.C. § 77k(a).

(n24)Footnote 24. 15 U.S.C. § 77o. In actions brought by the SEC, aiders and abettors may also be liable.

(n25)Footnote 25. See Section 11(a)(1) reprinted in *Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender).

(n26)Footnote 26. 15 U.S.C. § 77f(a).

(n27)Footnote 27. Occasionally, issuers offer unregistered securities through a private placement under Rule 144A promulgated pursuant to the 1933 Act to qualified purchasers, and subsequently offer to exchange the unregistered 144A securities for registered securities--a procedure known as an "Exxon capital exchange offer." In *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 430-31 (S.D.N.Y. 2001) , the court confronted the question of whether initial purchasers pursuant to an "Exxon capital exchange offer" are subject to underwriter liability under Section 11. Finding that the imposition of Section 11 liability on such persons would "defeat the capital market financing objectives the Rule 144A exemption was designed to achieve," "the *In re Livent* court held that such liability did not apply to initial purchasers of unregistered securities who were not directly involved in the preparation of the registration statement or in the subsequent exchange of their unregistered securities for registered securities. *Id.* at 431-32 .

See also *American High-Income Trust v. Allied Signal*, 329 F. Supp. 2d 534, 541-42 (S.D.N.Y. 2004) .

(n28)Footnote 28. See *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 , [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,864 (7th Cir. 1986) (neither a law firm nor an accounting firm could be held liable under Section 11 or Section 12 since neither firm was an issuer, director, signatory of a prospectus, offeror or seller of securities, neither firm reviewed or approved any material used to sell the securities that were the subject of the action, and neither firm controlled the issuer). See also *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386, 103 S. Ct. 683, 74 L. Ed. 2d 548 , [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,058 (1983); *In re ZZZZ Best Sec. Litig.*, No. CV-87-3574-RSWL, 1989 U.S. Dist. LEXIS 8083 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,485 at 93,093 (C.D. Cal. May 25, 1989).

(n29)Footnote 29. 15 U.S.C. § 77o.

(n30)Footnote 30. H.R. Rep. No. 1383, 73d Cong., § 19 (1934).

(n31)Footnote 31. See e.g., *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,214 (10th Cir. 1998) (internal quotations and citation omitted); *Brown v. Enstar Group, Inc.*, 84 F.3d 393 , [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,234 (11th Cir. 1996); *Sheinkopf v. Stone*, 927 F.2d 1259 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,865 (1st Cir. 1991); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,500 (9th Cir. 1990); *S.F.-Okla. Petroleum Exploration Corp. v. Carstan Oil Co.*, 765 F.2d 962 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,094 (10th Cir. 1985); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945 , [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,862 (5th Cir. 1981); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880 , [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,313 (3d Cir. 1975); *In re MicroStrategy, Inc. Secs. Litig.*, 115 F. Supp. 2d 620 , [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,213 (E.D. Va. 2000); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193 , [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,012 (E.D.N.Y. 2000); *In re Baan Co. Sec. Litig.*, 103 F.

Supp. 2d 1 , [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,010 (D. D.C. 2000); *In re Centennial Tech. Litig.*, 52 F. Supp. 2d 178 , [1999 Transfer Binder] Fed. Sec. L. Rep. P 90,484 (D. Mass. 1999); *Kaufman v. Motorola, Inc.*, No. 95 CV 1069, 1999 U.S. Dist. LEXIS 6303 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,481 (N.D. Ill. April 7, 1999).

(n32)Footnote 32. See e.g., *Brown v. Enstar Group, Inc.*, 84 F.3d 393 (11th Cir. 1996) (noting that the Eleventh Circuit provides a two prong test: "(1) the defendant had the power to control the general affairs of the entity primarily liable at the time the securities laws were violated, and (2) the defendant had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability.") See also, *G.A. Thompson & Co., v. Partridge*, 636 F.2d 945 (5th Cir. 1981) ; *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873 (7th Cir. 1992) ; *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985) ; *S.F.-Okla. Petroleum Exploration Corp. v. Carstan Oil Co.*, 765 F.2d 962 (10th Cir. 1985) ; *Brown v. Enstar Group, Inc.*, 84 F.3d 393, (11th Cir. 1996) ; *Travelers Ins. Co. v. Lewis*, 756 F. Supp. 172 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,785 (S.D.N.Y. 1991). But see *Bray v. R. W. Tech., Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,225 (D. Mass. Apr. 3, 1990) (president of company was liable as a controlling person because he had opportunity to know about wrongful transactions and power to control the operations of the company. Lack of participation in violative conduct did not excuse liability).

(n33)Footnote 33. *Orloff v. Allman*, 819 F.2d 904 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,276 (9th Cir 1987); see also, *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 889-90 , [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,313 at 98,595 (3d Cir. 1975). But see *American High-Income Trust v. Alliedsignal*, 329 F. Supp. 2d 534, 549, n.10 (S.D.N.Y. 2004) (noting that there is a split among district courts in the Second Circuit regarding whether there is a "culpable participation" element in a Section 15 claim, but choosing to join the "apparent majority of judges in the Southern District that have determined that culpable participation is not an element of § 15.").

(n34)Footnote 34. This is in contrast to Section 20(a) of the 1934 Act, which courts in some jurisdictions have held requires an allegation that the control person defendant culpably participated in the alleged fraud. See, e.g., *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998) ("In order to establish a prima facie case of liability under § 20(a), a plaintiff must show ... 'that the controlling person was in some meaningful sense a culpable participant' in the primary violation.") (quoting *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996)) ; *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890 , [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,313 at 98,595 (3d Cir. 1975) ("We hold, therefore, that secondary liability cannot be found under Section 20(a) unless it can be shown that the defendant was a culpable participant in the fraud."); *American High-Income Trust v. Alliedsignal*, 329 F. Supp. 2d 534, 549 (S.D.N.Y. 2004) ("To state a 'controlling person' claim under Section 20(a), Plaintiffs must plead 1) a primary violation by [the defendant]; 2) that each defendant was a controlling person; and 3) that each defendant was [a] culpable participant in the fraud."); see also *In re Global Crossing, LTD. Sec. Litig.*, 322 F. Supp. 2d 319, 349, n.24 (S.D.N.Y. 2004) (holding that culpable participation is an element of a Section 20(a) claim but noting a Second Circuit split on the issue).

(n35)Footnote 35. See, e.g., *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1578 (9th Cir. 1990) .

(n36)Footnote 36. *Hollinger*, 914 F.2d 1564 ; *San Francisco-Oklahoma Petroleum Exploration Corp. v. Carstan Oil Co.*, 765 F.2d 962 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,094 (10th Cir. 1985); *Demarco v. Edens*, 390 F.2d 836 (2d Cir. 1968) ; *Mauriber v. Shearson/Am. Express, Inc.*, 567 F. Supp. 1231, 1238 , [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,444 at 96,529 (S.D.N.Y. 1983).

(n37)Footnote 37. See *Morse v. McWhorter*, 290 F.3d 795, 797 (6th Cir. 2002) (noting that Section 11 prohibits "material misstatements or omissions in registration statements"); *In re Ziff-Davis, Inc.*, No. 98 Civ. 7158 (SWK), 2000 U.S. Dist. LEXIS 9076 , [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,006 (S.D.N.Y. June 27, 2000).

(n38)Footnote 38. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478, 97 S. Ct. 1292, 51 L. Ed. 2d 480 , [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,914 (1977); *Dirks v. SEC*, 463 U.S. 646, 656-59, 103 S.

Ct. 3255, 77 L. Ed. 2d 911, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. P 99,255 (1983); *Bus. Roundtable v. SEC*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,291 at 96,343 (D.C. Cir. 1990); *Doll v. James Martin Assoc. (Holdings) Ltd.*, 600 F. Supp. 510, 526, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,968 at 90,831 (E.D. Mich. 1984) (Section 12(a)(2) of the 1933 Act).

(n39)Footnote 39. See *Lindsay v. Morgan Stanley & Co. (In re Morgan Stanley Info. Fund Sec. Litig.)*, 592 F.3d 347, 360-66 (2d Cir. 2010) (noting that two types of omissions can give rise to liability: affirmative disclosure obligations and the duty to avoid misleading statements); *In re Fuwei Films Sec. Litig.*, 634 F. Supp. 2d 419, 437-39 (S.D.N.Y. 2009) (noting "[a] duty to disclose may arise from the obligation to make statements contained in the Registration Statement 'not misleading'").

(n40)Footnote 40. 15 U.S.C. § 77k.

(n41)Footnote 41. See, e.g., *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 569-72, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,163 at 91,188-93 (E.D.N.Y. 1971).

(n42)Footnote 42. 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed. 2d 757, [1976-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,615 (1976).

(n43)Footnote 43. *TSC Indus., Inc.*, 426 U.S. 438.

(n44)Footnote 44. *TSC Indus., Inc.*, 426 U.S. at 448.

(n45)Footnote 45. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. P 93,645 (1988) (Section 10(b) of the Exchange Act); *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 656 (4th Cir. 2004) (Sections 10(b) and 11); *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 934, Fed. Sec. L. Rep. P 92,278, 3 Cal. Daily Op. Serv. 1328, 1328, 2003 Daily Journal D.A.R. 1721, 1721 (9th Cir. 2003) (Section 10(b)); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 555-56, Fed. Sec. L. Rep. P 91,445, 2001 Fed. App. 0179P (6th Cir. 2001) (Section 10(b)); *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 161-62, Fed. Sec. L. Rep. P 91,210 (2d Cir. 2000) (Section 10(b)); *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 641, Fed. Sec. L. Rep. P 94,805, 94805, 15 Fed. R. Serv. 3d 948 (3d Cir. 1989) (Sections 10(b), 11 and 12); *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 826, Fed. Sec. L. Rep. P 93,018, 93018 (S.D.Tex. 2004) (Section 11).

(n46)Footnote 46. See, e.g., *Giarraputo v. UnImprovden Corp.*, No. 99-301-P-C, 2000 U.S. Dist. LEXIS 19138, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,296 (D. Me. Nov. 8, 2000). *Anderson v. Aurotek*, 774 F.2d 927, 931, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,377 at 92,367 (9th Cir. 1985); *Griffin v. Arthur Young, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,543 at 93,475 (N.D. Cal. 1989); *In re Fortune Sys. Sec. Litig.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,390 (N.D. Cal. 1987); *Seidel v. Public Service Co. of N.H.*, 616 F. Supp. 1342, 1353, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,383 at 92,385 (D. N.H. 1985). *But see* *Comeau v. Rupp*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,804 (D. Kan. 1988) (deciding materiality issues as a matter of law).

(n47)Footnote 47. 677 F.2d 1301, 1306 (9th Cir. 1982).

(n48)Footnote 48. See, e.g., *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650 (4th Cir. 2004); *Klein v. Gen. Nutrition Cos.*, 186 F.3d 338 (3d Cir. 1999); *Krim v. Banc Texas Group, Inc.*, 989 F.2d 1435 (5th Cir. 1993).

(n49)Footnote 49. Staff Accounting Bulletin No. 99, 17 C.F.R. Pt. 211, Subpt. B, 64 Fed. Reg. 45150, 45150 (August 19, 1999) ("exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold"). For a more detailed discussion of quantitative materiality, see

Federal Securities Exchange Act of 1934, § 5.04[2][a][i] (Matthew Bender).

(n50)Footnote 50. *In re Franchard Corp.*, Sec. Act Rel. No. 4710, [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,113 at 82,042 (July 31, 1964). The SEC also has asserted that investors should be concerned with the quality and integrity of management, stressing that disclosure of conflicts of interest and special perks to management underscores "the deeply held belief that the management of corporations are stewards acting on behalf of the shareholders." Senate Comm. On Banking, Housing And Urban Affairs, 94TH CONG., 2D SESS., Report Of The Securities And Exchange Commission On Questionable And Illegal Corporate Payments Practices 20 (Comm. Print 1976). *See also* SEC Staff Accounting Bulletin No. 99 (Materiality), 17 C.F.R. Part 211, Aug. 12, 1999.

(n51)Footnote 51. *McMahan & Co. v. Warehouse Entm't, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,510 at 93,243 (S.D.N.Y. May 25, 1989) (collecting cases), *rev'd on other grounds*, 900 F.2d 576, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,267 (2d Cir. 1990).

(n52)Footnote 52. *Glaser v. Norris*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,433 at 97,209 (Del. Ch. July 13, 1989).

(n53)Footnote 53. *Craftmatic v. Kraftsow*, (*In re Craftmatic Sec. Litig.*) 890 F.2d 628, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,805 (3d Cir. 1989).

(n54)Footnote 54. *In re Ultimate Corp. Sec. Litig.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,522 at 93,318 (S.D.N.Y. July 11, 1989).

(n55)Footnote 55. *Ultimate Corp.*, Fed. Sec. L. Rep. P 94,522 at 93,318.

(n56)Footnote 56. *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 513, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,809 (7th Cir. 1989); *Glaser v. Norris*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,433 (Del. Ch. July 13, 1989).

(n57)Footnote 57. Sec. Act Rel. No. 97, Fed. Sec. L. Rep. (CCH) P 1028 (Dec. 28, 1933).

(n58)Footnote 58. *Wielgos*, 892 F.2d at 517.

(n59)Footnote 59. *Wielgos*, 892 F.2d at 516. *See also* *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004); *P. Stolz Family Partnership L.P. v. Daum*, 355 F.3d 92 (2d Cir. 2004); *In re Worlds of Wonder Secs. Litig.*, 35 F.3d 1407 (9th Cir. 1994); *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990).

(n60)Footnote 60. *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371-72 (3d Cir. 1993). *See also*, *In re Royal Appliance Sec. Litig.*, 64 F.3d 663 (6th Cir. 1995) (cautionary statements must be "substantive and tailored" to the specific future projections, estimates or opinions challenged by plaintiffs).

(n61)Footnote 61. *Warshaw v. Xoma Corp.*, 74 F.3d 955, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,013, 34 Fed. R. Serv. 3d 502 (9th Cir. 1996) (*Rule 10b-5*); *Salomon Smith Barney v. Asset Securitization Corp.*, 98 Civ. 4186(BSJ), 1999 U.S. Dist. LEXIS 19030, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,723 (S.D.N.Y. Dec. 3, 1999).

(n62)Footnote 62. In *Asher v. Baxter Int'l, Inc.*, 377 F.3d 727 (7th Cir. 2004), the Seventh Circuit, in an opinion authored by Judge Easterbrook, held that the safe harbor for forward-looking statements was not enough to obtain dismissal of a complaint where the allegations were sufficient to permit a reasonable inference that the cautionary statements omitted important cautionary factors that affected the reliability of the company's financial forecasts.

(n63)Footnote 63. For decisions interpreting the parameters of Section 27A's safe harbor, *see generally* *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 273, Fed. Sec. L. Rep. (CCH) P93606 (3d Cir. 2005); *Nathenson v. Zonagen*

Inc., 267 F.3d 400, 409, *Fed. Sec. L. Rep. (CCH) P91548* (5th Cir. 2001) ; *Geffon v. Micrion Corp.*, [2001 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 91,419* (1st Cir. 2001); *Helwig v. Vencor, Inc.*, [2001 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 91,445* (6th Cir. 2001); *Ehlert v. Singer*, 245 F.3d 1313 , [2001 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 91,407* (11th Cir. 2000); *Harris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999) ; *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999) ; *In re Metro. Secs. Litig.*, No. CV-04-0025- FVS, 2007 U.S. Dist. LEXIS 84392, (E.D. Wash. Nov. 7, 2007) ; *In re BP Prudhoe Bay Royalty Trust Secs. Litig.*, CASE NO. C06-1505 MJP, 2007 U.S. Dist. LEXIS 83007, (W.D. Wash. Oct. 26, 2007) ; *Gargiulo v. Demartino*, MDL NO. 06-01741, 2007 U.S. Dist. LEXIS 71316, 10-13; *Fed. Sec. L. Rep. (CCH) P94,406*, (E.D. Pa. Sept. 26, 2007) ; *Oppenheim Pramerica Asset Mgmt. S.a.r.l. v. Encysive Pharms., Inc.*, CA-No. H-06-3022, 2007 U.S. Dist. LEXIS 69121, 10-11 (S.D. Tex Sept. 18, 2007) ; *In re Wet Seal, Inc. Secs. Litig.*, Case No. CV 04-7159 GAF (CTx), 2007 U.S. Dist. LEXIS 84757, 51-60 (C.D. Cal. Aug. 30, 2007) ; *In re Aegon N.V. Sec. Litig.*, *Fed. Sec. L. Rep. (CCH) P92,853* (S.D.N.Y. 2001) .

(n64)Footnote 64. *In re Bank of Boston Corp. Sec. Litig.*, 762 F. Supp. 1525 , [1991 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 96,243* (D. Mass. 1991).

(n65)Footnote 65. See Section 15 reprinted in *Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender 1996).

(n66)Footnote 66. Shelf registration is discussed in § 7A.03 *supra*.

(n67)Footnote 67. *Gallagher v. Abbott Laboratories*, 269 F.3d 806, 811 (7th Cir. 2001) .

(n68)Footnote 68. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382, 103 S. Ct. 683, 74 L. Ed. 2d 548 , [1982-1983 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 99,058* (1983); *ESI Montgomery Cty., Inc. v. Mountenay Int'l Corp.*, [1995 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 98,817* (S.D.N.Y. 1995); *Pollack v. Laidlaw Holdings*, [1995 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 98,741* (S.D.N.Y. 1995); *Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212 , [1993 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 97,647* at 96,982 (S.D.N.Y. 1993); *In re Am. Continental Corp./Lincoln Sav. and Loan Sec. Litig.*, 794 F. Supp. 1424 , [1992 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 97,005* at 94,396 (D. Ariz. 1992); *In re Worlds of Wonder Sec. Litig.*, 694 F. Supp. 1427, 1434 (N.D. Cal. 1988) ; *In re The Gap Stores Sec. Litig.*, 79 F.R.D. 283 , [1978 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 96,486* (N.D. Cal. 1978).

(n69)Footnote 69. 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 , [1982-1983 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 99,058* (1983).

(n70)Footnote 70. *Herman*, 459 U.S. at 382 .

(n71)Footnote 71. 15 U.S.C. § 77k.

(n72)Footnote 72. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 41 (1934).

(n73)Footnote 73. See *Shores v. Sklar*, 647 F.2d 462, 470 n.7 , [1980-1981 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 98,033* at 91,344 n.7 (5th Cir. 1981).

(n74)Footnote 74. See *APA Excelsior III L.P. v. Premiere Techs., Inc.*, 476 F.3d 1261, 1277 , [2006-2007 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 94,148*, at 91,631 (11th Cir. 2007) ("[T]he Section 11 presumption of reliance does not apply in the limited and narrow situation where sophisticated investors participating in an arms-length corporate merger make a legally binding investment commitment months before the filing of a defective registration statement."); *In re HealthSouth Corp. Secs. Litig.*, 261 F.R.D. 616, 623 (N.D. Ala. 2009) ("A plaintiff cannot recover under Section 11 when his investment decision occurred prior to the filing of the registration statement.").

(n75)Footnote 75. *Greenwald v. Integrated Energy*, 102 F.R.D. 65 (S.D. Tex. 1984) ; *Mayer v. Oil Field Sys.*

Corp., 611 F. Supp. 635 (S.D.N.Y. 1985) ; but see *In re Fuwei Films Sec. Litig.*, 634 F. Supp. 2d 419, 437-39 (S.D.N.Y. 2009) (holding that "a party can be relieved of a duty to disclose when certain developments affecting a corporation become matters of general public knowledge." (citing *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 687 , [2004-2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,057, at 95,196 (S.D.N.Y. 2004)) (internal quotation marks omitted).

(n76)Footnote 76. *Lyne v. Arthur Anderson & Co.*, 772 F. Supp. 1064 , [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,484 at 92,137 (N.D. Ill. 1991).

(n77)Footnote 77. Section 11(e) reprinted in *Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender 1996).

(n78)Footnote 78. *Fiet v. Leasio Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971) .

(n79)Footnote 79. 609 F. Supp. 363, 371-72 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,680 at 99,440 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987). Similar results were reached in *Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212, 219 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,647 (S.D.N.Y. 1993); *In re Fortune Sys. Sec. Litig.*, 680 F. Supp. 1360, 1364-65 (N.D. Cal. 1987) . But see, *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1422 (9th Cir. 1994) (9th Circuit reversed the lower court's determination that defendant had established a non-causation defense).

(n80)Footnote 80. See *Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212, 219 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,647 at 96,982 (S.D.N.Y. 1993) (noting that the defendants were able to prove that a defective registration statement was not responsible for the decrease in market value for some, but not all, of the securities purchased by the plaintiffs). See also *Emmi v. First-Manfs. Nat. Bank of Lewiston and Auburn*, 336 F. Supp. 629 (D. Me. 1971) .

(n81)Footnote 81. H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

(n82)Footnote 82. H.R. Rep. No. 85.

(n83)Footnote 83. H.R. Rep. No. 85.

(n84)Footnote 84. H.R. Rep. No. 85.

(n85)Footnote 85. H.R. Rep. No. 152 at 5.

(n86)Footnote 86. H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933).

(n87)Footnote 87. The integrated disclosure program is discussed in § 7.02[3] *supra*. See also Federal Securities Exchange Act of 1934 (A.A. Sommer, Jr., General Editor) § 4.03 (Matthew Bender 1996).

(n88)Footnote 88. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382, 103 S. Ct. 683, 74 L. Ed. 2d 548 , [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,058 (1983); *Degulis v. LXR Biotechnology*, 928 F. Supp. 1301 , [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,260 (S.D.N.Y. 1996); *In re Worlds of Wonder Sec. Litig.*, 694 F. Supp. 1427, 1434 (N.D. Cal. 1988) ; *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 575 , [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,163 at 91,167 (E.D.N.Y. 1971).

(n89)Footnote 89. *In re Am. Cont'l Corp./Lincoln Sav. & Loan Sec. Litig.*, 794 F. Supp. 1424, 1453 , [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,005 at 94,410 (D. Ariz. 1992); *Schneider v. Traweek*, No. CV 88-0905 RG (Kx), 1990 U.S. Dist. LEXIS 15563 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,507 at 97,652 (C.D. Cal. Aug. 28, 1990).

(n90)Footnote 90. Section 11(a)(4) provides that an expert may be liable under Section 11 only "with respect to the statement, in such registration statement, report, or valuation, which purports to have been prepared or certified by him." See also *Nutmeg Sec., Ltd. v. McGladrey & Pullen*, 92 Cal. App. 4th 1435, 1445 (Cal. Ct. App. 2001) ; *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1510 [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,631 (N.D. Cal. 1992); *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 643 , [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,368 (N.D. Cal. 1980), *modified on other grounds*, 581 F. Supp. 878 (N.D. Cal. 1984) , [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,635 (N.D. Cal. Jan. 17, 1984).

(n91)Footnote 91. The leading Section 11 decision, *Escott v. BarChris Construction Corp.*, however, holds that only that part of the registration statement that explicitly purports to have been prepared or certified by an expert in accordance with Section 11(a)(4) may be deemed to be expertised. 283 F. Supp. 643, 683 , [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,179 at 96,854 (S.D.N.Y. 1968). Typically, this includes only the certified financial statements. See *In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 665-666 (S.D.N.Y. 2004) (holding that unaudited financial statements that have been merely reviewed by a professional auditing firm are not sufficient to "expertise" that portion of the registration statement that incorporates them). The mere fact that, for example, the issuer's or underwriter's lawyer has prepared a portion or all of the registration statement does not expertise it. See, e.g., *In re New York City Shoes Sec. Litig.*, No. 87-4677, 1988 U.S. Dist. LEXIS 7283 at 9 (E.D. Pa. July 7, 1988) .

(n92)Footnote 92. Section 11(b)(3)(A) reprinted in *Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender 1996).

(n93)Footnote 93. *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 683 , [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,179 (S.D.N.Y. 1968). The *BarChris* decision is discussed comprehensively in Folk, *Civil Liabilities Under the Federal 1933 Act: The BarChris Case*, 55 VA. L. REV. 1 (1969). It appears that prior to *BarChris* only two court decisions discussed the Section 11 due diligence defense even in a general way. *Martin v. Hull*, 92 F.2d 208 (D.C. Cir. 1937) ; *Shonts v. Hirleman*, 28 F. Supp. 478 (S.D. Cal. 1939) . Next in importance after *BarChris* is Judge Weinstein's opinion in *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 , [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,163 (E.D.N.Y. 1971).

(n94)Footnote 94. *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 577 , [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,163 (E.D.N.Y. 1971).

(n95)Footnote 95. *Feit*, 332 F. Supp. at 578 .

(n96)Footnote 96. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 684 , [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,179 at 96,855 (S.D.N.Y. 1968).

(n97)Footnote 97. *Escott*, 283 F. Supp. at 685.

(n98)Footnote 98. *Escott*, 283 F. Supp. at 687.

(n99)Footnote 99. *Escott*, 283 F. Supp. at 690.

(n100)Footnote 100. *Escott*, 283 F. Supp. at 691.

(n101)Footnote 101. *Escott*, 283 F. Supp. at 693.

(n102)Footnote 102. *Feit* 332 F. Supp. at 577 .

(n103)Footnote 103. *Laven v. Flanagan*, 695 F. Supp. 800, 812 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,257 at 96,173 (D.N.J. 1988); *Goldstein v. Alodex Corp.*, 409 F. Supp. 1201, 1203 n.1 , [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,152 (E.D. Pa. 1971).

(n104)Footnote 104. *Escott*, 283 F. Supp. at 688.

(n105)Footnote 105. *Laven*, 695 F. Supp. at 812 .

(n106)Footnote 106. *Laven*, 695 F. Supp. at 812 . See also *Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 U.S. Dist. LEXIS 18394 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,693 at 98,253 (N.D. Cal. Oct. 12, 1990) (Section 11 claim against an outside director could not be sustained because the director met the standards of due diligence and reasonable inquiry); but see *In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004) , (holding, as to underwriters, that reliance upon reviewed but unaudited financial statements and comfort letter issued by independent auditor was insufficient to establish a due diligence defense).

(n107)Footnote 107. *In re WorldCom, Inc. Securities Litigation* 346 F. Supp. 2d 628 (S.D.N.Y. 2004) .

(n108)Footnote 108. *WorldCom*, 346 F. Supp. 2d at 666 .

(n109)Footnote 109. *WorldCom*, 346 F. Supp. 2d at 666 (internal quotations omitted).

(n110)Footnote 110. *WorldCom*, 346 F. Supp. 2d at 683 .

(n111)Footnote 111. *WorldCom*, 346 F. Supp. 2d at 672 .

(n112)Footnote 112. *Escott*, 283 F. Supp. at 696.

(n113)Footnote 113. *Escott*, 283 F. Supp. at 697. See also *In re Hamilton Grant & Co., Exch. Act Rel. No. 24679*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,146 at 88,793-94 (July 7, 1987).

(n114)Footnote 114. *Escott*, 283 F. Supp. at 697. Similarly, the district court in *In re Worldcom, Inc. Securities Litigation* did not distinguish between the role of the managing underwriters and the participating underwriters in describing the "reasonable investigation" necessary for underwriters to invoke the due diligence defense to Section 11 liability. *In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 674-678 (S.D.N.Y. 2004) .

(n115)Footnote 115. In fact, it had been held that underwriters may rely on a successful due diligence defense of lead underwriters. *Competitive Associates, Inc. v. Int'l Health Scis, Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,966 at 97,321 (S.D.N.Y. Jan. 22, 1975).

(n116)Footnote 116. H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933).

(n117)Footnote 117. *Sec. Act Rel. No. 5275*, 1972 SEC LEXIS 89, at *20 (July 26, 1972) .

(n118)Footnote 118. 15 U.S.C. § 77k(b)(3)(C).

(n119)Footnote 119. *Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 672. The court also held that, in order for an accountant's opinion to qualify as an expert opinion under Section 11(b)(3)(C), three prerequisites must be met: (1) it must be reported in the Registration Statement, (2) it must be an audit opinion, and (3) the accountant must consent to inclusion of the audit opinion in the Registration Statement. *Id.* at 665-666.

(n120)Footnote 120. *WorldCom*, 346 F. Supp. 2d at 673 .

(n121)Footnote 121. *WorldCom*, 346 F. Supp. 2d at 683 .

(n122)Footnote 122. *WorldCom*, 346 F. Supp. 2d at 683 .

(n123)Footnote 123. 15 U.S.C. § 77k(b)(3)(B)(i).

(n124)Footnote 124. *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489 , rev'd in part on other grounds, 38 F.3d 1078 , Fed. Sec. L. Rep. P 98,426 (9th Cir. 1994); *Escott*, 283 F. Supp. at 703.

(n125)Footnote 125. *Escott*, 283 F. Supp. at 703.

(n126)Footnote 126. *In re WorldCom, Inc. Securities Litigation*, 352 F. Supp. 2d 472, 492 (S.D.N.Y. 2005) .

(n127)Footnote 127. *WorldCom*, 352 F. Supp. 2d at 493 .

(n128)Footnote 128. *WorldCom*, 352 F. Supp. 2d at 483 .

(n129)Footnote 129. *WorldCom*, 346 F. Supp. 2d at 675 (quoting *BarChris*, 283 F. Supp. at 682).

(n130)Footnote 130. *WorldCom*, 346 F. Supp. 2d at 672 .

(n131)Footnote 131. *WorldCom*, 346 F. Supp. 2d at 683 . The court did note that, while insufficient to establish the due diligence defense, the underwriters' receipt of auditor comfort letters would be "important evidence" in assessing the reasonableness of the underwriters' due diligence efforts.

(n132)Footnote 132. Section 11(e)(1), *reprinted in Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender 1996).

(n133)Footnote 133. 15 U.S.C. § 77k(e)(2). Investors who sold their securities above the offering price could not have incurred damages and therefore may not maintain a claim under Section 11. *See In re Initial Public Offering Sec. Litig.*, 544 F. Supp. 2d 277, 299-300 (S.D.N.Y. 2008) .

(n134)Footnote 134. 15 U.S.C. § 77k(e)(3). *See generally*, *Goldkrantz v. Griffin*, 97 CIV. 9075, 1999 U.S. Dist. LEXIS 4445, at *7-9 (S.D.N.Y. April 6, 1999) , *aff'd*, 201 F.3d 431 (2d Cir. 1999) ; *In re Cendant Corp. Litig.*, 264 F.3d 201, 228 (3d Cir. 2001) ; *Akerman v. Oryx Comm., Inc.*, 609 F. Supp. 363, 368 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,680 at 99,439 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987).

(n135)Footnote 135. For a detailed discussion on calculating damages under Section 11, *see* Paul Grier, Ph.D., *A Methodology for the Calculation of Section 11 Damages*, 5 STAN. L. BUS. & FIN. 99 (1999).

(n136)Footnote 136. *E.g.*, *Freedman v. Value Health, Inc.*, 190 F.R.D. 33, 35-36 (D. Conn. 1999) ; *Adair v. Kaye Kotts Assocs.*, No. 97 Civ. 3375, 1998 U.S. Dist. LEXIS 3900, at *20 (S.D.N.Y. March 24, 1998) ; *Akerman v. Oryx Comm., Inc.*, 609 F. Supp. 363, 368-69 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,680 at 99,440 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987); *Grossman v. Waste Mgmt., Inc.*, 589 F. Supp. 395 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,550 (N.D. Ill. 1984); *Beecher v. Able*, 435 F. Supp. 397, 404 , [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,104 (S.D.N.Y. 1975).

(n137)Footnote 137. *In re Executive Telecard Sec. Litig.*, 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997) .

(n138)Footnote 138. *See Freedman v. Value Health, Inc.*, 190 F.R.D. 33, 35-36 (D. Conn. 1999) .

(n139)Footnote 139. As the District of New Jersey recently made clear, this provision does not limit the liability of each underwriter to the value of the shares that particular underwriter personally distributed to the public; rather, damages are limited to the total price at which the shares underwritten by him were offered to the public, regardless of who ultimately distributed those shares. *Special Situations Fund III L.P. v. Cocchiola*, Civ. No. 02-3099, 2007 U.S. Dist. LEXIS 56627 (D.N.J. August 2, 2007) .

(n140)Footnote 140. *McMahan & Co. v. Warehouse Entm't, Inc.*, 65 F.3d 1044 (2d Cir. 1995) .

(n141)Footnote 141. See *Goldkrantz v. Griffin*, No. 97 CIV. 9075, 1999 U.S. Dist. LEXIS 4445, at *8 (S.D.N.Y. Apr. 5, 1999) .

(n142)Footnote 142. See generally *Harden v. Raffensperger, Hughes & Co.*, 933 F. Supp. 763, 770 (S.D. Ind. 1996) .

(n143)Footnote 143. Note that pursuant to Section 11(f)(2)(A), the liability of "outside directors" under subsection 11(e) of the 1933 Act is to be determined in accordance with the "proportionate liability" provision of Section 21D(f) of the Exchange Act, which provides for the use of special interrogatories to allocate liability among the defendants in proportion to their culpability.

(n144)Footnote 144. 15 U.S.C. § 77(v)(a); see also *Cal. Public Employees' Ret. Sys. v. Worldcom, Inc.*, 368 F.3d 86, 98 (2d Cir. 2004) (stating that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which generally mandates removal to federal court of federal securities class action litigations, did not in any way alter Section 22(a)'s bar on the removal of individual Securities Act claims).

(n145)Footnote 145. 28 U.S.C. §§ 1332(d) & 1452(b).

(n146)Footnote 146. Compare *Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031, 1034 [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,777, at 95,063 (9th Cir. 2008) (holding that Section 22(a)'s removal bar trumps the more recently enacted CAFA) with *Katz v. Gerardi*, 552 F.3d 558, 561-63 [2008-2009 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,029, at 91, 372-73 (7th Cir. 2009) (holding that class actions arising under the Securities Act are subject to removal under CAFA provided they meet the requirements and none of the exceptions enumerated in CAFA apply) and *N.J. Carpenters Vacation Fund v. HarborView Mortgage Loan Trust*, 581 F. Supp. 2d 581, 587-88 (S.D.N.Y. 2008) (holding that "CAFA overrides the Securities Act's anti-removal provision").

(n147)Footnote 147. 15 U.S.C. § 77k(e).

(n148)Footnote 148. *Weil v. Inv./Indicators Research & Mgmt Inc.*, 647 F.2d 18, 22 , [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,023 at 91,282 (9th Cir. 1981); *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1137 , [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,372 (W.D. Mich. 1996); *Lyne v. Arthur Anderson & Co.*, 772 F. Supp. 1064, 1069 , [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,484 at 92,138 (N.D. Ill. 1991); *Seidel v. Pub. Serv. Co.*, 616 F. Supp. 1342, 1359 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,383 at 92,389 (D. N.H. 1985).

(n149)Footnote 149. *Phillips v. Kidder, Peabody & Co.*, 686 F. Supp. 413, 416 (S.D.N.Y. 1988) .

(n150)Footnote 150. *Layman v. Combs*, 994 F.2d 1344, 1353 (9th Cir. 1992) ; *Healey v. Chelsea Res., Ltd.*, 947 F.2d 611, 622 , [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,289 at 91,558 (2d Cir. 1991); *Aid Auto Stores, Inc. v. Cannon*, 525 F.2d 468, 471 , [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,247 at 98,277 (2d Cir. 1975); *Klein v. Shields & Co.*, 470 F.2d 1344, 1347 , [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,692 at 93,054 (2d Cir. 1972); *Katz v. Amos Treat & Co.*, 411 F.2d 1046, 1056 , [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,409 at 97,946 (2d Cir. 1969); *Can-Am Petroleum Co. v. Beck*, 331 F.2d 371, 374 , [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,365 at 94,541 (10th Cir. 1964); see also *Aizuss v. Commonwealth Equity Trust*, 847 F. Supp. 1482, 1491 , [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,311 at 90,145 (E.D. Cal. 1993) (stating that Section 11(e) "without merit" standard is easier to satisfy than Rule 11 "frivolous" test).

(n151)Footnote 151. E.g., *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75, 80 , [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,995 at 94,880 (2d Cir. 1986); *W. Fed. Corp. v. Erickson*, 739 F.2d 1439, 1444 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,611 at 99,121 (9th Cir. 1984); *Shaw v. Merritt-Chapman & Scott Corp.*, 554

F.2d 786, 788, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,044 at 91,688 (6th Cir. 1977).

(n152)Footnote 152. *Friedman v. Ganassi*, 853 *F.2d* 207, 211, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,944 at 90,371 (3d Cir. 1988).

(n153)Footnote 153. *Shields v. Citytrust Bancorp, Inc.*, 25 *F.3d* 1124, 1128 (2d Cir. 1994); *Komanoff v. Mabon, Nugent & Co.*, 884 *F. Supp.* 848, 856, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,745 at 92,529 (S.D.N.Y. 1995); *Todd v. Oppenheimer & Co., Inc.*, 78 *F.R.D.* 415, 420-21, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,385 at 93,341 (S.D.N.Y. 1978).

(n154)Footnote 154. *Carlton v. Thaman (In re NationsMart Corp. Sec. Litig.)*, 130 *F.3d* 309, 314-15, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,574 at 97,840 (8th Cir. 1997); *In re Prison Realty Secs. Litig.*, 117 *F. Supp. 2d* 681, 687-89, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,903 at 93,812 (M.D. Tenn. 2000); *In re Jiffy Lube Sec. Litig.*, 772 *F. Supp.* 258, 260, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,203 at 91,062 (D. Md. 1991); *Steiner v. Southmark Corp.*, 734 *F. Supp.* 269, 278, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,001 at 95,597 (N.D. Tex. 1990); *In re Consumers Power Co. Sec. Litig.*, 105 *F.R.D.* 583, 594 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,251 at 91,758 (E.D. Mich. 1985); *Seidel v. Pub. Serv. Co.*, 616 *F. Supp.* 1342, 1356-57, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,383 at 92,387 (D. N.H. 1985).

(n155)Footnote 155. *Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc.*, 583 *F.3d* 935, 948, [2009 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,384, at 93,516 (6th Cir. 2009); *ACA Fin. Guar. Corp. v. Advest, Inc.*, 512 *F.3d* 46, 68, [2008-2009 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,554, at 93,905 (1st Cir. 2008); *Wagner v. First Horizon Pharm. Corp.*, 464 *F.3d* 1273, 1277, [2006-2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,957 at 91,046-47 (11th Cir. 2006); *Anderson v. Clow (In re Stac Elecs. Sec. Litig.)*, 89 *F.3d* 1399, 1404-05, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,272 (9th Cir. 1996)) (emphasis added); *Melder v. Morris*, 27 *F.3d* 1097, 1100, n.6, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,350 at 90,414 (5th Cir. 1994); *Shapiro v. UJB Fin. Corp.*, 964 *F.2d* 272, 287-88 [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,651 at 93,073 (3d Cir. 1992); *In re Ultrafem Inc. Sec. Litig.*, 91 *F. Supp. 2d* 678, 690-91, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,931 at 93,966 (S.D.N.Y. 2000); *Rhodes v. Omega Research, Inc.*, 38 *F. Supp. 2d* 1353, 1359-62, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,451 at 92,090 (S.D. Fla. 1999); *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 *F. Supp.* 1101, 1115, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,372 (W.D. Mich. 1996); *UBS Asset Mgmt, Inc. v. Wood Gundy Corp.*, 914 *F. Supp.* 66, 71, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,102 at 94,646 (S.D.N.Y. 1996); *Drexel Burnham Lambert Group, Inc. v. Microgenesys, Inc.*, 775 *F. Supp.* 660, 666-67, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,418 at 91,814 (S.D.N.Y. 1991); *Lucia v. Prospect St. High Income Portfolio, Inc.*, 769 *F. Supp.* 410, 416-17, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,101 at 90,571 (D. Mass. 1991); *Haft v. Eastland Fin. Corp.*, 755 *F. Supp.* 1123, 1131-33, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,787 at 98,793 (D. R.I. 1991); *Hershey v. MNC Fin. Corp.*, 774 *F. Supp.* 367, 374-76 (D. Md. 1991); *Moran v. Kidder Peabody & Co.*, 609 *F. Supp.* 661, 666, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,341 at 92,241 (S.D.N.Y. 1985).

(n156)Footnote 156. 355 *F.3d* 164 (2d Cir. 2004)

(n157)Footnote 157. *Rombach*, 355 *F.3d* at 171 (citation omitted).

(n158)Footnote 158. Denyse Finn Clancy, *Fraud Claims Under Sections 11 and 12(a) (2) of the 1933 Act of 1933: Should Pleading with Particularity be Required?*, 27 SEC. REG. L.J. 411, 447-53 (1999).

(n159)Footnote 159. 15 U.S.C. § 78u-4(b)(2). The Supreme Court recently interpreted this clause to require an inference of scienter that is "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007). In addition, allegations attributed to "confidential" witnesses are to be steeply discounted by courts when

evaluating whether a securities plaintiff has pled a strong inference of scienter. See *Higginbotham v. Baxter Int'l Inc.*, 495 F.3d 753, 756-57 (7th Cir. 2007) .

(n160)Footnote 160. 15 U.S.C. § 78u-4(a)(1).

(n161)Footnote 161. 15 U.S.C. § 78u-4(b)(2).

(n162)Footnote 162. *Tracinda Corp. v. DaimlerChrysler AG*, Fed. Sec. L. Rep. (CCH) 91,776, 98,712, 197 F. Supp. 2d 42, 70-71 (D. Del. 2002) ; *In re Am. Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424, 439-40 , [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,956 at 94,174 (S.D.N.Y. 2000); *In re Number Nine Visual Tech. Corp. Sec. Litig.*, 51 F. Supp. 2d 1, 13 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,504 at 92,450 (D. Mass. 1999); see *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1109-10, [1998 Supp. Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,198 at 90,743 (D. Nev. 1998) (applying scienter standard only to forward looking statements).

(n163)Footnote 163. *Knollenberg v. Harmonic, Inc.*, Fed. Sec. L. Rep. (CCH) P93,554 (9th Cir 2005) ; See also *Sparling v. Daou*, 411 F.3d 1006 (9th Cir. 2005) ; *Tracinda Corp. v. DaimlerChrysler AG*, Fed. Sec. L. Rep. (CCH) 91,776, 98,712, 197 F. Supp. 2d 42, 70-71 (D. Del. 2002) ; *In re Am. Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424, 439-40 , [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,956 at 94,174 (S.D.N.Y. 2000); *In re Number Nine Visual Tech. Corp. Sec. Litig.*, 51 F. Supp. 2d 1, 13 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,504 at 92,450 (D. Mass. 1999); *In re Adams Golf, Inc. Sec. Litig.*, 176 F. Supp. 2d 216, 229-31, [Current Binder] Fed. Sec. L. Rep. (CCH) P 91,651 at 97,901 (D. Del. 2001) , *aff'd in part, rev'd in part*, 381 F.3d 267, 274 (3d Cir. 2004) ("Sections 11 and 12(a)(2) are virtually absolute liability provisions, which do not require plaintiffs to allege that defendants possessed any scienter.")"]

(n164)Footnote 164. Section 27(b)(1) *reprinted in Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender 1996).

(n165)Footnote 165. Section 27(b)(1) *See also In re Rational Software Sec. Litig.*, 28 F. Supp. 2d 562 , [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,334 (N.D. Cal. 1998), *vacated*, *SG Cowen Sec. Corp. v. United States Dist. Ct. for N. Dist. Cal.*, 189 F.3d 909 (9th Cir. 1999) (explaining "undue prejudice" required before permitting discovery to proceed).

(n166)Footnote 166. Section 27(b)(2) *reprinted in Securities Primary Law Sourcebook*, Volume A, Chapter B (Matthew Bender 1996).

(n167)Footnote 167. Section 27(b)(3).

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



139 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.03

§ 9.03 Section 12(a)(1) Liability for Offers and Sales of Unregistered Securities

[1] Introduction

Section 11 prohibits the filing of a misleading registration statement. Section 12(a)(1) n1 of the 1933 Act complements Section 11 by providing a private damage remedy against persons who offer or sell unregistered securities in violation of Section 5 of the Act.

A person who sells securities in violation of the registration provisions of the Securities Act is strictly liable under Section 12(a)(1). n2 Thus, as under Section 11, a Section 12(a)(1) plaintiff need not prove scienter or any other form of culpability as part of his or her affirmative case. Unlike Section 11, however, Section 12(a)(1) does not provide a due diligence defense. If the sold instruments are nonexempt securities, n3 and the transaction is not exempt from registration, n4 the seller is liable regardless of the care exercised.

Section 12(a)(1), by its terms, covers a narrower class of defendants than Section 11, only providing a remedy against a person who "offers or sells" a security. That said, the term "seller" extends not only to defendants who pass title, but also to defendants who solicit the purchase of securities. n5

[2] The Statute

In contrast to the detailed and lengthy provisions of Section 11, Section 12(a)(1) is brief. It provides:

Any person who

(1) offers or sells a security in violation of Section 5 ... shall be liable, subject to subsection (b) to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

While most Section 12(a)(1) litigation involves the offer or sale of unregistered securities in violation of Section 5(a) of the 1933 Act, Section 5 (and therefore Section 12(a)(1)) is not limited to the offer and sale of unregistered securities. n6

[3] Elements of the Action

The plaintiff's affirmative case under Section 12(a)(1) is straightforward. To state a claim, the plaintiff must prove that:

- defendants sold or offered to sell securities;
- by the use of the mails or means of interstate transportation or communication; and
- the securities were not sold pursuant to an effective registration statements. n7

Once the plaintiff has established these three basic elements, the burden then shifts to the defendant to show that the securities are exempt from the registration requirements. n8 A seller who cannot establish that the securities are exempt from registration is strictly liable regardless of whether the plaintiff relied on the seller.

[4] Plaintiff's Standing

Section 12(a)(1) limits standing to the person purchasing the security from the defendant. n9 Thus, at a minimum the plaintiff must both be a purchaser of securities, and have purchased those securities from the defendant. n10 The plaintiff's standing requirements are the same under Sections 12(a)(1) and 12(a)(2). n11

[5] Persons Liable

[a] General Standards. Section 12 imposes liability only against a person who "offers or sells a security." The key issue is the conduct that makes one a "seller" (or "offeror") within the meaning of Section 12.

Pinter v. Dahl, n12 decided by the Supreme Court in 1988, rejected long-standing lower court interpretations, both broad and restrictive, of the term "seller" under Section 12. The Court rejected the argument, accepted by a few courts, that "sellers" are limited to persons who pass title to securities. n13 The Court also rejected the view of most lower courts that the term broadly extends to persons with lesser involvement, including those who are "substantial factors," or the "proximate cause" of, or "participants" in the transaction. n14

Instead, the Supreme Court held that Section 12(a)(1) applies not only to persons who pass title, but also to persons "who solicit securities purchases," provided that they are "motivated at least in part by a desire to serve [their] own financial interests or those of the securities owner." n15 To state a claim, the plaintiff must demonstrate "not only that [the defendant] actively solicited investors, but that [the] plaintiff purchased the securities as a result of [the defendant's] solicitation. n16 The Court also made clear that remote sellers are not covered under Section 12(a)(1):

Remote purchasers are precluded from bringing actions against remote sellers. Thus, a buyer cannot recover against his seller's seller unless the remote seller solicits the purchase. n17

Neither does Section 12(a)(1) impose liability "on a person who urges the purchase but whose motivation is solely to benefit the buyer." n18 Thus, a person "who gratuitously urges another to make a particular investment decision" is not a seller. n19

Generally speaking, according to the *Pinter* court, Congress did not intend Section 12 primary liability to extend to "collateral participants" in an unlawful securities transaction, such as "participants in the activities leading up to the sale." n20 Indeed, unlike Section 11, Section 12 does not specifically identify such persons among those who are subject to suit. n21 The Court therefore reasoned that Section 12 is not intended to embrace "those who merely assist in another's solicitation efforts." n22 In practice, *Pinter* suggests considering the relationship between the defendant and purchaser rather than the degree of the defendant's involvement in the sale. n23

A "seller" within the meaning of Section 12 typically "will have sought or received a personal financial benefit from the sale, such as where he 'anticipat[es] a share of the profits,' or receives a brokerage commission." n24 However, "a person who solicits the buyer's purchase in order to serve the financial interests of the owner may properly be liable under [Section 12(a)(1)] without showing that he expects personally to participate in the benefit the owner enjoys." n25 One indication of sufficient involvement in solicitation for Section 12 liability is the defendant's control over the content of the information that potential investors receive, n26 as well as over which potential investors will be solicited. n27

Pinter declined to decide whether liability can also arise under Section 12(a)(1) for aiding and abetting. n28 The Supreme Court later resolved this issue in *Central Bank of Denver v. First Interstate Bank of Denver*, n29 holding that there is no liability for aiding and abetting under Sections 11 or 12. n30

[b] Specific Applications.

The sections below discuss the following categories of defendants typically named in Section 12 actions: accountants, attorneys, banks, brokers, directors, issuers, and underwriters. n31

[i] Accountants

Before *Pinter*, many courts had declined to dismiss accountants from Section 12 claims because, although accountants do not "sell" securities in the traditional sense, their representations about various financial matters often contribute to a plaintiff's purchasing decision. n32

Not all courts, however, took such an approach. In *Ahern v. Gaussoin*, n33 the court held that the accountants' preparation of portions of a registration statement alleged to be materially misleading, as well as a comment by one accountant giving the company a "clean bill of health," did not constitute sufficient participation in the sale to make the accountants sellers under Section 12. Accordingly, the court granted summary judgment to the accountants on the Section 12 claim. Similarly, in *Farlow v. Peat, Marwick, Mitchell & Co.*, the court held that the mere fact that an accounting firm had not disclaimed, qualified, or footnoted allegedly misleading financial statements did not make the firm a "seller" under Section 12(a)(2). n34 And, in at least one instance, claims against accountants arising under Section 12 were dismissed by a court adhering to a strict privity approach. n35

In *Pinter*, the Supreme Court limited the exposure of accountants under Section 12. In most cases, the Court determined, accountants are merely "participants in the activities leading up to the sale." n36 The Court deemed this level of involvement inadequate to achieve seller status. n37 Post-*Pinter* cases overwhelmingly hold that accountants are not "sellers" for Section 12 purposes. n38

[ii] Attorneys

Prior to *Pinter*, a number of cases considered the liability of attorneys as "sellers" under Section 12. In *Croy v. Campbell*, n39 the court held that an attorney who introduced plaintiffs to the seller of a security and told the plaintiffs that the security was the best investment they could make from a tax standpoint was not a seller under Section 12. The court based its conclusion on the following factors:

- the attorney made no representations about the operational or construction aspects of the project and had nothing to do with the sales brochure;
- in delivering the sales brochure to the plaintiffs, the attorney acted as the purchaser's agent, not the seller's;
- the attorney did not attempt to persuade the plaintiffs to purchase the securities;

- the statement about the benefits of the investment was limited to the beneficial tax consequences; and
- the plaintiffs made their decision to invest only after obtaining independent advice, talking with the seller, and reviewing the projects themselves. n40

Conversely, some courts have included attorneys as Section 12 sellers where there was an allegation that they engaged in their own culpable behavior or that they solicited the plaintiffs to invest. Thus, in *Junker v. Crory*, n41 the same court that dismissed claims against an attorney in *Croy v. Campbell* upheld such claims where the attorney intentionally or recklessly misrepresented to the purchasers the true value of the securities and actively solicited their participation in the transaction. Similarly, in *Ahern v. Gaussoin*, n42 the court held that although mere performance of routine legal services would not make an attorney a seller, urging plaintiffs to invest in securities would. n43

Pinter supports these decisions. An attorney who solicits purchases is a seller, whereas an attorney who simply provides assistance to others who solicit is not a seller. n44

In practice, however, attorneys typically do not solicit purchases in the manner contemplated by Section 12, and most post-*Pinter* cases have dismissed Section 12 claims against attorneys. n45

[iii] Banks/Lenders

As with attorneys, banks and other lenders have been held liable under Section 12 where they actively solicited investments. In *Davis v. Avco Fin. Servs., Inc.*, n46 for example, the manager of a finance company that was providing loans to investors to invest in a fraudulent securities scheme attended meetings of investors, provided them with blank loan application forms, represented that the investment was of good quality, and ultimately provided loans to 45 investors. The court found that the manager's participation in the selling process could be deemed sufficient to make the finance company a seller. n47

On the other hand, in *In re Rexplore, Inc. Sec. Litig.*, n48 the court held that allegations that a lender and two insurance companies accepted the investors' promissory notes and approved the investors as participants in a private offering were insufficient to impose "seller" status. The court held that these allegations indicated that the defendants only "conducted routine ordinary business activities in providing services needed by [the company] to finalize the sales transactions." n49

Since *Pinter*, the court in *Ryder Int'l Corp. v. First Am. Nat'l Bank* n50 held that a bank that provided financial information concerning commercial paper for sale by others and mechanically executed orders to buy was not an "offeror" or a "seller" under Section 12. *Ryder* was distinguished in *In re NBW Commercial Paper Litig.*, n51 which held that where a bank did solicit the purchase of commercial paper issued by its parent holding company, the bank was a Section 12 seller. In another case, *Smith v. Am. Nat'l Bank and Trust Co.*, n52 a bank that guaranteed a dealership's overdrafts and never disclosed the dealership's problems to the plaintiff was held not to be a Section 12 seller. The court stated that the bank could not be a seller unless it "urges a prospective purchaser to buy." n53

[iv] Brokers

Brokers are among the most frequent targets of Section 12 actions. Indeed, *Pinter* expressly identifies brokers as potential Section 12 defendants. n54 Where a broker acts as a principal, the broker is the immediate seller under Section 12 and therefore may be liable. Indeed, post-*Pinter* cases have often held that brokers are sellers under Section 12. n55 Where a broker neither passes title nor makes solicitations, however, post-*Pinter* cases continue to hold that brokers are not sellers. n56 This is true even where the broker collects commissions on the transactions at issue. n57

[v] Directors and Officers

Directors and officers, as long as they stay one or two steps removed from the direct selling process, generally have avoided seller status under Section 12. n58 For example, in *In re Activision Sec. Litig.* n59 plaintiffs alleged that the directors and officers were sellers because they helped draft the allegedly misleading prospectus, participated in "roadshow" presentations of information to analysts and brokers, set the price for the securities, and negotiated fees with the underwriters. The court found that these activities were typical for a director in a public offering and that, as a matter of law, such activities were insufficient to make one a seller. n60

Conversely, in *In re Craftmatic Sec. Litig.*, a post-*Pinter* appellate court decision, the court appeared to agree with the proposition that directors of a company "could be held liable under Section 12(a)(2) because they were allegedly responsible for the preparation and dissemination of the allegedly fraudulent prospectus used in the marketing of the securities and because their involvement in the solicitation process served their own financial interests." n61 Similarly, other post-*Pinter* cases have found officers to be proper Section 12 defendants if they prepared and disseminated an allegedly false prospectus. n62 For example, one case held that officers and directors who were managers of the consolidated partnership for which investors were being solicited and were members of the managing committee that recommended approval of the transaction could be sellers under Section 12. n63 Directors and officers can also be subject to liability as "control persons" under Section 15 for an underlying violation of Section 12(a)(2). n64 Both before and after *Pinter*, where directors or officers actively solicited plaintiffs to purchase securities, they have been held liable as sellers. n65

[vi] Issuers

Where an issuer directly sells its securities, it is, of course, a seller with respect to persons who purchase from it. n66 However, issuers who sell securities through a firm commitment underwriting have been held not to be sellers under Section 12 with respect to persons who purchase from the underwriter. n67 By analogy, issuers also should not be deemed sellers with respect to open market purchasers. This is supported by the Supreme Court's statement in *Pinter* that "a buyer cannot recover against his seller's seller." n68

On the other hand, in *Craftmatic Securities Litigation*, a case involving a firm commitment offering, the court stated that although an issuer's involvement in preparing the prospectus "is not, alone, sufficient to demonstrate seller status under Section 12, "direct and active participation in the solicitation of the immediate sale [may result in holding] the issuer liable as a Section 12(a)(2) seller." n69 The *Craftmatic* court cited, with seeming approval, cases standing for the following propositions:

- one who prepares documents for an offering is a Section 12(a)(2) seller if a commission was earned from the actual seller for persuading an investor to make a particular investment; n70
- issuers are sellers to the extent they utilize a system analogous to that of automobile manufacturers, that is, to the extent they create distribution chains and engage in intensive marketing to convince the public to purchase their securities. n71

Similarly, in *Norman v. Paco Pharmaceutical Services, Inc.*, n72 a state court held that after *Pinter* an issuer and other defendants might be Section 12 sellers "if they had any role in the preparation and dissemination of the allegedly fraudulent Prospectus used to market the securities." n73

[vii] Underwriters

Underwriters are sellers with respect to the persons who purchase directly from them. n74 The issue that the courts struggled with prior to *Pinter* was whether lead underwriters, whose involvement in an offering is typically extensive,

may be held liable to persons who purchase from other members of the underwriting syndicate. Notwithstanding the fact that the extensive involvement of lead underwriters in the entire selling effort could reasonably have led courts prior to *Pinter* to conclude that they were "substantial factors" or "substantial participants" in sales by the members of the underwriting syndicate, decisions before and after *Pinter* have limited the underwriter's Section 12 seller status to direct sales of that underwriter. n75 Underlying the courts' treatment of the lead underwriter's seller status was that Section 11(e) limits an underwriter's liability under Section 11 to the total price at which the securities underwritten by that underwriter were sold to the public. If Section 12 were interpreted to extend an underwriter's liability to securities sold by others, the Section 11(e) restriction could easily be circumvented. *Pinter* further supports limiting seller status to the underwriters who actually solicit purchases.

[6] Rescission and Damages

Section 12(a)(1) provides for rescission or, if the securities are no longer owned, damages. The same relief is available for Section 12(a)(2) violations. n76

[7] In Pari Delicto

In *Bateman Eichler, Hill, Richards, Inc. v. Berner*, n77 the Supreme Court held that the common law defense of *in pari delicto*--literally, "in equal fault"--applies to actions under Section 10(b) of the Exchange Act. In *Pinter v. Dahl*, the Supreme Court held that the defense also applies to actions under Section 12 of the Securities Act. n78

Despite its potential applicability, however, the defense is unlikely to succeed in many Section 12 cases. The first element of the *in pari delicto* defense requires proof that the plaintiff bears at least substantially equal responsibility for the underlying illegality. In the context of a Section 12(a)(1) violation, this is satisfied only if the plaintiff is at least equally responsible for the issuer's failure to (i) register the securities before offering them for sale or (ii) conduct the sale in such a manner as to meet the requirements for an exemption. The Supreme Court specifically stated in *Pinter* that "a purchaser's knowledge that the securities are unregistered cannot, by itself, constitute equal culpability, even where the investor is a sophisticated buyer who may not necessarily need the protection of the Securities Act." n79 Rather, courts must focus on the extent to which the plaintiff and the defendant cooperated in developing and carrying out the scheme to distribute unregistered securities.

The second element of the test is proof that preclusion of the suit would not offend the underlying policies of the 1933 Act. In *Pinter*, the Supreme Court stated that preclusion of a Section 12(a)(1) suit would interfere significantly with the policies of the securities laws if the Section 12(a)(1) plaintiff "is primarily an investor." n80 In fact, the Court stated that "even where a plaintiff actively participates in the distribution of unregistered securities, his suit should not be barred where his promotional efforts are incidental to his role as an investor." n81 These requirements negate an *in pari delicto* defense to a Section 12(a)(1) action except where the plaintiff's role as a promoter in the offering is equal to or greater than his role as an investor. n82 This will rarely be the case.

The *in pari delicto* defense is not the only potential common law defense to a Section 12 claim. In *Murken v. Barrow*, n83 the plaintiff sought rescission under Section 12(a)(1) on the ground that he had never received a copy of the required prospectus. The court dismissed the claim because plaintiff delayed asserting his rights by almost one year during which time the value of his shares had decreased. The court stated that the claim was barred under principles of estoppel, noting that "[t]here is nothing in the language of Section 12 or its legislative history to indicate that Congress intended to create a right enforceable in law or in equity not subject to defenses available at law or in equity to an action based on a voidable contract." n84 A Section 12 defendant has "the defenses normally available to him according to the exigencies of the particular case." n85

FOOTNOTES:

(n1)Footnote 1. In 1995, Congress amended Section 12 of the Act. Consequently, former Section 12(1) claims are now

Section 12(a)(1) claims. Private Securities Litigation Reform Act of 1995, H.R. 1058, 104th Cong. (1995) (codified at 15 U.S.C. § 771).

(n2)Footnote 2. *Pinter v. Dahl*, 486 U.S. 622, 638, 108 S. Ct. 2063, 100 L. Ed. 2d 658 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,790 (1988); *Raiford v. Buslease, Inc.*, 825 F.2d 351, 354 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,363 (11th Cir. 1987); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 899 , [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,844 (5th Cir. 1977); *Ellison v. Am. Image Motor Co.*, 36 F. Supp. 2d 628, 638 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90, 436 (S.D.N.Y. 1999); *Am. Fed'n of State, County, & Mun. Employees v. FDIC (In re NBW Comm. Paper Litig.*, 813 F. Supp. 7 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,278 at 95,312 (D. D.C. 1992).

(n3)Footnote 3. *See* 15 U.S.C. § 77c.

(n4)Footnote 4. *See* 15 U.S.C. § 77d.

(n5)Footnote 5. *In re Am. Bank Note Holographics Secs. Litig.*, 93 F. Supp. 2d 424, 437-38 , [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,957 (S.D.N.Y. 2000); *Ellison v. Am. Image Motor Co.*, 36 F. Supp. 2d 628, 638 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,436 (S.D.N.Y. 1999).

(n6)Footnote 6. Section 5 also places limitations on the timing and content of communications between issuers and the market, with different rules applying to different categories of issuers.

(n7)Footnote 7. *See, e.g., Ellison v. Am. Image Motor Co.*, 36 F. Supp. 2d 628 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,436 (S.D.N.Y. 1999).

(n8)Footnote 8. *Pharo v. Smith*, 621 F.2d 656, 665 n.3 ; *Baldwin v. Kulch Assocs., Inc.*, 39 F. Supp. 2d 111, 115 , [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,321 (D. N.H. 1998).

(n9)Footnote 9. *See, e.g., Am. Nursing Care of Toledo, Inc. v. Leisure*, 609 F. Supp. 419 (N.D. Ohio 1984) (holding that plaintiffs who were not "purchasers" lacked standing to sue under Section 12(a)(1)).

(n10)Footnote 10. *See, e.g., Leonard v. Merrill Lynch*, 64 F.R.D. 432 (S.D.N.Y. 1974) (granting defendants' summary judgment motions and holding that recovery under Section 12(a)(1) is limited to those who purchased from the seller).

(n11)Footnote 11. *See, e.g., Capri v. Murphy*, 856 F.2d 473 (2d Cir. 1988) (holding that language of Sections 12(1) and 12(2) is identical in meaning). Accordingly, the discussion of standing under Section 12(a)(2) in Section 9.04[3] applies equally to Section 12(a)(1).

(n12)Footnote 12. 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,790 (1988).

(n13)Footnote 13. Prior to *Pinter*, several courts had held that Section 12 applies only to a defendant in strict privity with the plaintiff because it grants relief only to a person "purchasing such security from him." *See, e.g., Sanders v. John Nuveen & Co., Inc.*, 619 F.2d 1222, 1226, [1979-1980] Fed. Sec. L. Rep. (CCH) P 97,372 (7th Cir. 1980) ; *Collins v. Signetics Corp.*, 605 F.2d 110, 113-14 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,110 at 96,165 (3d Cir. 1979). *Accord, Steinberg v. Illinois Co., Inc.*, 659 F. Supp. 58 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,236 at 96,128 (N.D. Ill. 1987); *Soderberg v. Gens*, 652 F. Supp. 560 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,194 (N.D. Ill. 1987); *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089 , [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,431 (E.D. Pa. 1972); *Beck v. Cantor Fitzgerald & Co.*, 621 F. Supp. 1547 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,455 (N.D. Ill. 1985).

(n14)Footnote 14. Most courts prior to *Pinter* extended liability to persons who were a "substantial factor" or "proximate cause" in causing the sale to take place; a test that connotes the element of causation. The precise formulation was articulated differently by different courts. See, e.g., *Jett v. Sunderman*, 840 F.2d 1487, 1491 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,653 (9th Cir. 1988); *Adalman v. Baker*, 807 F.2d 359, [1986-1987] Fed. Sec. L. Rep. (CCH) P 92,987 (4th Cir. 1986) ; *Foster v. Jessup & Lamont Sec. Co.*, 759 F.2d 838, 844 (11th Cir. 1985) ; *Davis v. Avco Fin. Servs., Inc.*, 739 F.2d 1057 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,569 at 92,789 (6th Cir. 1984); *Lewis v. Walston & Co.*, 487 F.2d 617, 622 , [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,315 at 95,066 (5th Cir. 1974); *Lennerth v. Mendenhall*, 234 F. Supp. 59, 65 , [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,435 at 94,717 (N.D. Ohio 1964). The Supreme Court rejected this test because it bore too little relationship to the statutory language.

(n15)Footnote 15. 486 U.S. 622, 647, 108 S. Ct. 2063, 100 L. Ed. 2d 658 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,790 (1988). See *Sparling v. Daou (In re Daou Sys., Inc.)*, 411 F.3d 1006, 1029 (9th Cir. 2005) ; *Steed Finance LDC v. Nomura Secs. Int'l, Inc.*, No. 00 Civ. 8058 (NRB), 2001 U.S. Dist. LEXIS 14761 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,552 (S.D.N.Y. Sept. 19, 2001).

(n16)Footnote 16. *Steed Finance LDC v. Nomura Secs. Int'l, Inc.*, No. 00 Civ. 8058 (NRB), 2001 U.S. Dist. LEXIS 14761, at *24 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,552 (S.D.N.Y. Sept. 19, 2001) ("[t]he purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issue liable" as a Section 12 seller) (citations omitted); see also *Capri v. Murphy*, 856 F. 2d 473, 479 (2d Cir. 1988) , *vacated sub nom*, *Fryar v. Abell*, 492 U.S. 914 (1989) ("plaintiffs must show that [defendant] actually solicited their investment"); *In re Worlds of Wonder Sec. Litig.*, 721 F. Supp. 1140, 1148 ("the defendant himself must have solicited the sale in question").

(n17)Footnote 17. *Pinter v. Dahl*, 486 U.S. 622, 644 n.21, 108 S. Ct. 2063, 100 L. Ed. 2d 658 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,790 (1988). See also *Cortec Indus., Inc. v. Sum Holding, L.P.*, 949 F.2d 42 , [1991-1992 Transfer Binding] Fed. Sec. L. Rep. (CCH) P 96,406 (2d Cir. 1991); *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363 , [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,298 (5th Cir. 2001); *In re Deutsche Telekom AG Sec. Litig.*, 00 Civ. 9475 (SHS), 2002 U.S. Dist. LEXIS 2627 , [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,703 (S.D.N.Y. Feb. 20, 2002); *In re Unicapital Corp. Sec. Litig.*, 149 F. Supp. 2d 1353 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,512 (S.D. Fla. 2001); *Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, 00 Civ. 8058 (NRB) 2001 U.S. Dist. LEXIS 14761 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,552 (S.D.N.Y. Sept. 20, 2001).

(n18)Footnote 18. *Pinter*, 486 U.S. at 647 .

(n19)Footnote 19. *Pinter*, 486 U.S. at 647 .

(n20)Footnote 20. *Pinter*, 486 U.S. at 650 . This includes participation in the preparation of the prospectus, which, by itself, will not impose "seller" liability. See *In re Gas Reclamation, Inc. Sec. Litig.*, 733 F. Supp. 713, 724 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,268 (S.D.N.Y. 1990) ("Section 12 liability does not extend to everyone involved in the preparation of a prospectus"); but see *Capri v. Murphy*, 856 F.2d 473, 478 , [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,007 (2d Cir. 1988), *vacated sub nom*, *Fryar v. Abell*, 492 U.S. 914 (1989) (general partners of company were "sellers" where defendants prepared and circulated the prospectus to plaintiffs, where all promotional efforts were done "at the behest of" defendants, where all information provided to investors was supplied by defendants, and where no action was taken in relation to investors other than that contemplated and authorized by the defendants).

(n21)Footnote 21. *Pinter*, 486 U.S. at 650 n.26, 108 S. Ct. 2063, 100 L. Ed. 2d 658 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,790 (1988). Even prior to *Pinter*, courts had held that there must be significant participation in the sale itself, and not, for example, in the mere preparation of a prospectus, for a defendant to be a

seller under Section 12. *See, e.g., Fine v. Rubin*, 623 F. Supp. 171, 173, [1986-1986 Transfer Binding] Fed. Sec. L. Rep. (CCH) P 92,342 (N.D. Cal. 1985); *In re Diasonics Sec. Litig.*, 599 F. Supp. 447, 458, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,815 (N.D. Cal. 1984). The same result has been reached after *Pinter*. *See, e.g., Persky v. Turley*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,483 at 92,134 (D. Ariz. 1991).

(n22)Footnote 22. *Pinter*, 486 U.S. at 651 n.27, 108 S. Ct. 2063, 100 L. Ed. 2d 658, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,790 (1988).

(n23)Footnote 23. *Pinter*, 486 U.S. at 651. *See also In re Am. Bank Note Holographics, Inc. Secs. Litig.*, 93 F. Supp. 2d 424, 438, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,957 (S.D.N.Y. 2000).

(n24)Footnote 24. *Pinter*, 486 U.S. at 654.

(n25)Footnote 25. *Pinter*, 486 U.S. at 654-55.

(n26)Footnote 26. *Capri v. Murphy*, 856 F.2d 473, 478, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,007 (2d Cir. 1988), *vacated sub nom, Fryar v. Abell*, 492 U.S. 914 (1989); *Polycast Tech. Corp. v. Uniroyal, Inc.*, 728 F. Supp. 926, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,833 (S.D.N.Y. 1989).

(n27)Footnote 27. *Polycast Tech. Corp.*, 728 F. Supp. 926.

(n28)Footnote 28. *Pinter*, 486 U.S. at 648 n.24.

(n29)Footnote 29. 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,178 (1994).

(n30)Footnote 30. *See also In re Am. Bank Note Holographics, Inc. Secs. Litig.*, 93 F. Supp. 2d 424, 438 n.3 (S.D.N.Y. 2000); *In re Worlds of Wonder Sec. Litig.*, 721 F. Supp. 1140, 1148 (N.D. Cal. 1989); *Lycan v. Walters*, 904 F. Supp. 884, 907, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,034 (S.D. Ind. 1995).

(n31)Footnote 31. The cases discussed include those arising under Section 12(a)(1) and Section 12(a)(2). Though the Supreme Court in *Pinter* limited its analysis to Section 12(a)(1), expressly reserving the question whether the same test would apply to a claim under Section 12(a)(2), almost all of the post-*Pinter* courts have held or assumed that the meaning of seller is the same under both subsections of Section 12. *See, e.g., Smith v. Am. Nat. Bank & Trust Co.*, 982 F.2d 936, 941-42 (6th Cir. 1992); *Ryder Int'l Corp. v. First Am. Nat'l Bank*, 943 F.2d 1521, 1528 (11th Cir. 1991); *Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,406 at 91,732 (2d Cir. 1991); *Ackerman v. Schwartz*, 947 F.2d 841, 844-45 (7th Cir. 1991); *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,805 at 94,319 (3d Cir. 1989); *Wilson v. Saintine Explor. and Drilling Corp.*, 872 F.2d 1124, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,358 (2d Cir. 1989); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 940, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,174 (7th Cir. 1989); *Moore v. Kayport Package Exp.*, 885 F.2d 531, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,922 (9th Cir. 1989); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1115, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,094 (5th Cir.), *reh'g en banc denied*, 863 F.2d 882 (5th Cir. 1988), *vacated*, 492 U.S. 914 (1989); *Capri v. Murphy*, 856 F.2d 473, 478, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,007 (2d Cir. 1988), *vacated sub nom, Fryar v. Abell*, 492 U.S. 914 (1989); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875, 878 (2d Cir. 1943); *Steed Finance LDC v. Nomura Secs. Int'l, Inc.*, No. 00 Civ. 8058 (NRB), 2001 U.S. Dist. LEXIS 14761, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,552 (S.D.N.Y. Sept. 19, 2001); *Kensington Capital Mgmt. v. Oakley Inc.*, No. SA CV 97-808-GLT(EEEx), 1999 U.S. Dist. LEXIS 385, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,411 (C.D. Cal. Jan. 14, 1999).

(n32)Footnote 32. *Lewis v. Schultz*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,363 (E.D. Ark. 1985); *Ackerman v. Clinical Data Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,207 (S.D.N.Y.

1985); *Hsu v. Leaseway Transp. Corp.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,043 (N.D. Cal., 1985).

(n33)Footnote 33. *611 F. Supp. 1465, 1486*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,332 at 92,207 (D. Or. 1985).

(n34)Footnote 34. *666 F. Supp. 1500*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,546 at 97,461 (W.D. Okla. 1987), *aff'd*, *956 F.2d 982*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,536 (10th Cir. 1992). *See also In re Gas Reclamation, Inc. Sec. Litig.*, *659 F. Supp. 493*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,217 at 96,020 (S.D.N.Y. 1987); *In re Victor Technologies Sec. Litig.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,158 at 95,716 (N.D. Cal. 1987).

(n35)Footnote 35. *See Beck v. Cantor, Fitzgerald & Co.*, *621 F. Supp. 1547*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,455 (N.D. Ill. 1985).

(n36)Footnote 36. *Pinter*, *486 U.S. at 650*.

(n37)Footnote 37. *Pinter*, *486 U.S. at 651*.

(n38)Footnote 38. *See, e.g., Moore v. Kayport Package Express, Inc.*, *885 F.2d 531*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,922 (9th Cir. 1989); *Zupnick v. Thompson Parking Partners*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,388 (S.D.N.Y. 1990), *appeal dismissed*, *989 F.2d 93 (2d Cir. 1993)*; *Griffin v. PaineWebber, Inc.*, 99 Civ. 2292 (VM), *2001 U.S. Dist. LEXIS 8937*, at *11, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,492 (S.D.N.Y. June 29, 2001) (an accountant's "mere participation in the preparation of a prospectus" is not sufficient to qualify an accountant as a seller); *Silverman v. Ernst & Young, LLP*, No. 99-856, *1999 U.S. Dist. LEXIS 17703 (D. N.J. Aug. 3, 1999)*; *Dawe v. Main St. Mgmt. Co.*, *738 F. Supp. 36*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,288 (D. Mass. 1990); *Friedman v. Arizona World Nurseries Ltd. P'ship*, *730 F. Supp. 521*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,902 (S.D.N.Y. 1990); *In re Crazy Eddie Sec. Litig.*, *714 F. Supp. 1285*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,508 (E.D.N.Y. 1989); *In re ZZZZ Best Sec. Litig.*, No. CV-87-3574-RSWL, 1989 U.S. Dist. LEXIS 8083, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,485 (C.D. Cal. May 25, 1989); *Bernstein v. Crazy Eddie, Inc.*, *702 F. Supp. 962* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,381 (E.D.N.Y. 1988).

(n39)Footnote 39. *624 F.2d 709*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,615 (5th Cir. 1980).

(n40)Footnote 40. *In re North Am. Acceptance Corp. Sec. Cases*, *513 F. Supp. 608*, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,961 (N.D. Ga. 1981); *Westlake v. Abrams*, *504 F. Supp. 337*, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,963 (N.D. Ga. 1980) (mere performance of legal services in connection with the sale of securities does not give rise to Section 12 liability). *Cf. Stokes v. Lokken*, *644 F.2d 779*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,209 at 91,461 (8th Cir. 1981) (attorney who prepared opinion letter stating that transaction would not involve the sale of securities was not a substantial factor in causing the sale to take place).

(n41)Footnote 41. *650 F.2d 1349*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,236 (5th Cir. 1981).

(n42)Footnote 42. *611 F. Supp. 1465, 1486*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,332 at 92,207 (D. Or. 1985), *abrogated on other grounds*, *Securities Investor Protection Corp. v. Poirier*, *653 F.Supp. 63*, Fed. Sec. L. Rep. P 92,752 (D.Or. 1986).

(n43)Footnote 43. *See also Excalibur Oil, Inc. v. Sullivan*, *616 F. Supp. 458*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,398 (N.D. Ill. 1985); *Koehler v. Pulvers*, *606 F. Supp. 164*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,232 (S.D. Cal. 1985).

(n44)Footnote 44. *Pinter*, 486 U.S. at n.27; *Sassoon v. Atgeld, 777, Inc.*, 822 F. Supp. 1303 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,704 at 97,283, (N.D. Ill. 1993); *In re Am. Cont'l Corp./Lincoln Sav. and Loan Sec. Litig.*, 794 F. Supp. 1424 , [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,005 at 94,411 (D. Ariz. 1992).

(n45)Footnote 45. *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,922 (9th Cir. 1989); *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011 , [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,565 (2d Cir. 1989); *Wilson v. Saintine Exploration and Drilling Corp.*, 872 F.2d 1124 , [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,358 (2d Cir. 1989); *Ellison v. Am. Image Motor Co.*, 36 F. Supp. 2d 628 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,436 (S.D.N.Y. 1999); *Lycan v. Walters*, 904 F. Supp. 884, 905 , [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,034 (S.D. Ind. 1995); *Buford White Lumber Co. Profit Sharing and Sav. Plan & Trust v. Octagon Properties, Ltd.*, 740 F. Supp. 1553 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,837 (W.D. Okla. 1989); *Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.*, 713 F. Supp. 1019 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,218 (W.D. Mich. 1989); *Sellin v. Rx Plus, Inc.*, 730 F. Supp. 1289 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,940 (S.D.N.Y. 1990); *In re ZZZZ Best Sec. Litig.*, No. CV-87-3574-RSWL, 1989 U.S. Dist. LEXIS 8083 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,485 at 93,093 (C.D. Cal. May 25, 1989); *Marshall v. Quinn & L Equities, Inc.*, 704 F. Supp. 1384 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,812 (N.D. Tex. 1988).

(n46)Footnote 46. 739 F.2d 1057 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,569 (6th Cir. 1984), *cert. denied*, 470 U.S. 1005 (1985) .

(n47)Footnote 47. 739 F.2d 1057 (6th Cir. 1984) , *overruled in part*, *Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L.Ed.2d 658, 56 USLW 4579 , Fed. Sec. L. Rep. P 93,790 (1988).

(n48)Footnote 48. 671 F. Supp. 679 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,561 at 97,517 (N.D. Cal. 1987); *see also Schlifke v. Seafirst Corp.*, No. 83 C 8591, 1987 U.S. Dist. LEXIS 532 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,107 (N.D. Ill. 1987).

(n49)Footnote 49. *In re Rexplore, Inc. Sec. Litig.*, 671 F. Supp. 679, 686 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,561 at 97,517 (N.D. Cal. 1987).

(n50)Footnote 50. 943 F.2d 1521 (11th Cir. 1991) .

(n51)Footnote 51. 813 F. Supp. 7 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,278 (D. D.C. 1992).

(n52)Footnote 52. 982 F.2d 936 (6th Cir. 1992) .

(n53)Footnote 53. *Smith*, 982 F.2d at 941 .

(n54)Footnote 54. *Pinter*, 486 U.S. at 646 .

(n55)Footnote 55. *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,922 (9th Cir. 1989); *Ellison v. Am. Image Motor Co.*, 36 F. Supp. 2d 628 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,436 (S.D.N.Y. 1999) (court denied brokers' motion to dismiss); *Scotch v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 709 F. Supp. 95 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,375 (M.D. Pa.); *Lambers v. Total Health Sys., Inc.*, No. CA 88-0670-Z, 1990 U.S. Dist. LEXIS 8554 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,366 (D. Mass. 1990); *Cook v. Goldman Sachs & Co.*, 726 F. Supp. 151 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,916 (S.D. Tex. 1989).

(n56)Footnote 56. *Montcalm County Bd. of Comm'rs v. McDonald & Co. Sec., Inc.*, 833 F. Supp. 1225 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,730 at 97,460 (W.D. Mich. 1993). *See also Craig v. First Am. Capital*

Res., Inc., 740 F. Supp. 530 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,817 (N.D. Ill. 1990) (president of broker dealer who did not participate in the solicitation of the purchase was not a seller). *Cf. Lambergs v. Total Health Sys., Inc.*, No. CA 88-0670-Z, 1990 U.S. Dist. LEXIS 8554 [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,366 (D. Mass. July 3, 1990) (broker that did not solicit was not liable as a seller but could be liable as a controlling person of the representative who did solicit).

(n57)Footnote 57. *Montcalm County Bd. of Comm'rs v. McDonald & Co. Sec., Inc.*, 833 F. Supp. 1225 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,730 (W.D. Mich. 1993).

(n58)Footnote 58. *Lalor v. Omtool, Ltd.*, No. 99-469-M, 2000 U.S. Dist. LEXIS 18675 , [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,286 (D. N.H. Dec. 14, 2000).

(n59)Footnote 59. No. C-83-4639 AMHP, 1985 U.S. Dist. LEXIS 19901 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,270 (N.D. Cal. May 10, 1985).

(n60)Footnote 60. *See also Busch v. Carpenter*, 827 F.2d 653 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,355 at 96,828 (10th Cir. 1987); *Anderson v. Aurotek*, 774 F.2d 927 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,377 (9th Cir. 1985); *In re Newbridge Networks Sec. Litig.*, 767 F. Supp. 275 , [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,039 at 90,230 (D. D.C. 1991); *Mabon, Nugent & Co. v. Borey*, 127 B.R. 727 , [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,030 (S.D.N.Y. 1991); *In re Disonics Sec. Litig.*, 599 F. Supp. 447 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,815 (N.D. Cal. 1984).

(n61)Footnote 61. 890 F.2d 628, 636 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,805 at 94,320 (3d Cir. 1989).

(n62)Footnote 62. *In re Charles Schwab Corp. Sec. Litig.*, 257 F.R.D. 534, 549-550, 555 (N.D. Cal. 2009) ; *In re Ulta Salon, Cosmetics & Fragrance, Inc. Sec. Litig.*, 604 F. Supp. 2d 1188, 1194 , [2009 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,223, at 92,349-50 (N.D. Ill. 2009); *Suppa v. Montano*, No. 87-0636-CV-W-3, 1989 U.S. Dist. LEXIS 5682 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,348 at 92,307 (W.D. Mo. 1989); *Norman v. Paco Pharmaceutical Servs., Inc.*, No. 10417, 1989 Del. Ch. LEXIS 131 [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,739 at 93,997-98 (Del. Ch. Sept. 22, 1989).

(n63)Footnote 63. *Maywalt v. Parker & Parsley Petroleum Co.*, 808 F. Supp. 1037 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,229 at 94,993 (S.D.N.Y. 1992).

(n64)Footnote 64. *In re Unicapital Corp. Sec. Litig.*, 149 F. Supp. 2d 1353, 1367 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,512 (S.D. Fla. 2001).

(n65)Footnote 65. *SEC v. Murphy*, 626 F.2d 633 , [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,588 (9th Cir. 1980).

(n66)Footnote 66. *Maywalt v. Parker & Parsley Petroleum Co.*, 808 F. Supp. 1037 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,229 at 94,992 (S.D.N.Y. 1992); *S.F.-Okla. Petroleum Exploration Corp. v. Carstan Oil Co.*, 765 F.2d 962 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,094 (10th Cir. 1985).

(n67)Footnote 67. *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194 (1st Cir. 1996) , *superseded by statute on other grounds, as noted in Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999) (no issuer liability, absent active solicitation); *Akerman v. Oryx Communications, Inc.*, 609 F. Supp. 363, 372-74 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,680 at 99,440 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987); *PPM Am., Inc. v. Marriott Corp.*, 853 F. Supp. 860, 874 (D. Md. 1994) ; *In re Wicat Sec. Litig.*, 600 F. Supp. 1236 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,886 (D. Utah 1984). *Accord, Lalor v. Omtool, Ltd.*, Civil No. 99-469-M, 2000 U.S. Dist. LEXIS 18675 , [2000-2001 Transfer Binder] Fed. Sec. L.

Rep. (CCH) P 91,286 (D. N.H. Dec. 14, 2000). *But see Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 369-70, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,298 (5th Cir. 2001) (issuers generally cannot be held liable when securities are sold through a firm commitment underwriting, but plaintiffs can show that the issuer's role exceeded normal bounds and that the issuer became the vendor's agent, thus invoking section 12 liability). *See also In re Disonics Sec. Litig.*, 599 F. Supp. 447, 458, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,815 at 90,103 (N.D. Cal. 1984).

(n68)Footnote 68. *Pinter*, 486 U.S. at 644 n.21 ; *see also In re Thortec Sec. Litig.*, No. 88-2470-FMS, 1989 U.S. Dist. LEXIS 6003 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,330 at 92,158 (N.D. Cal. Jan. 25, 1989).

(n69)Footnote 69. 890 F.2d 628, 636, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,805 at 94,320 (3d Cir. 1989).

(n70)Footnote 70. *Craftmatic Sec. Litig.*, 890 F.2d at 636 .

(n71)Footnote 71. *Craftmatic Sec. Litig.*, 890 F.2d at 636 .

(n72)Footnote 72. No. 10417, 1989 Del. Ch. LEXIS 131 [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,739 (Del. Ch. Sept. 22, 1989).

(n73)Footnote 73. *Norman*, 1989 Del. Ch. LEXIS 131, at 93,998 ; *see also Griffin v. PaineWebber, Inc.*, 99 Civ. 2292 (VM), 2001 U.S. Dist. LEXIS 8937, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,492 (S.D.N.Y. June 29, 2001); *In re V.S.A. Classic Sec. Litig.*, No. 93 CIV 6667, 1995 U.S. Dist. LEXIS 8327 [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,837 (S.D.N.Y. June 16, 1995).

(n74)Footnote 74. *In re Am. Bank Note Holographics, Inc. Secs. Litig.*, 93 F. Supp. 2d 424, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,957 (S.D.N.Y. 2000).

(n75)Footnote 75. *In re Activision Sec. Litig.*, 621 F. Supp. 415, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,270 (N.D. Cal. 1985); *Klein v. Computer Devices, Inc.*, 602 F. Supp. 837, 842-43, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,958 at 90,789 (S.D.N.Y. 1985); *Akerman v. Oryx Communications, Inc.*, 609 F. Supp. 363, 373, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,680 at 99,441 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987); *Fine v. Rubin*, 623 F. Supp. 171, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,342 (N.D. Cal. 1985); *Feiner v. SS&C Techs.*, 47 F. Supp. 2d 250, 254 (D. Conn. 1999) .

(n76)Footnote 76. *See § 9.04[7] infra* for discussion of rescission and damages under Sections 12(a)(1) and 12(a)(2).

(n77)Footnote 77. 472 U.S. 299, 105 S. Ct. 2622, 86 L. Ed. 2d 215 (1985) .

(n78)Footnote 78. *Pinter*, 486 U.S. 622 ; *see also Silva Run Worldwide Ltd. v. Gaming Lottery Corp.*, No. 96 Civ. 3231, 1998 U.S. Dist. LEXIS 4699, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,196 (S.D.N.Y. Apr. 8, 1998).

(n79)Footnote 79. *Pinter*, 486 U.S. at 636 .

(n80)Footnote 80. *Pinter*, 486 U.S. at 638 .

(n81)Footnote 81. *Pinter*, 486 U.S. at 638-39 .

(n82)Footnote 82. *Silva Run Worldwide Ltd.*, 1998 U.S. Dist. LEXIS 4699 .

(n83)Footnote 83. No. CV88-2492-PAR, 1989 U.S. Dist. LEXIS 16537 [1989-1990 Transfer Binder] Fed. Sec. L.

Rep. (CCH) P 94,815 (C.D. Cal. Oct. 30, 1989).

(n84)Footnote 84. *Murken, 1989 U.S. Dist. LEXIS 16537, at *9* .

(n85)Footnote 85. *Murken, 1989 U.S. Dist. LEXIS 16537, at *9* ; *see also Straley v. Universal Uranium & Milling Corp., 289 F.2d 370 (9th Cir. 1961)* (defenses of waiver, laches, and estoppel); *Royal Air Props., Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962)* (defenses of waiver and estoppel).

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



140 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.04

§ 9.04 Section 12(a)(2)--General Civil Liability Provision

[1] Introduction

Sections 11 and 12(a)(1) essentially are limited to registration violations; the former applies to misleading registration statements and the latter to the failure to file a registration statement. Thus, both provide remedies only with respect to securities that are required to be registered. Section 12(a)(2), on the other hand, applies to both registered and unregistered securities. It supplements Section 11 by extending liability for misleading registration statements to persons who sell registered securities, regardless of whether such persons are within the categories of defendants specified by Section 11. In addition, and more importantly, it covers misrepresentations and omissions in "prospectuses" and "oral communications" even where no registration statement is required.

[2] The Statute

Section 12(a)(2) provides:

Any person who offers or sells a security (whether or not exempted by the provisions of Section 3, other than paragraphs (2) and (14) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omissions, shall be liable subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

[3] Plaintiff's Standing Generally

In 1995, in *Gustafson v. Alloyd Co.*,ⁿ¹ the Supreme Court limited Section 12 liability to "public offerings." Following that decision, courts have held that "plaintiffs have standing under Section 12(a)(2) ... only if they purchase their securities in a public offering rather than in a private transaction or in the secondary market." ⁿ²

In addition, like Section 12(a)(1), Section 12(a)(2) limits standing to the person "purchasing such security" from the defendant. Thus, at a minimum the plaintiff must both be a purchaser of securities, n3 and have purchased those securities from the defendant. On close questions, courts have generally resolved the issue in favor of standing. n4

[4] Elements of the Action

To recover under Section 12(a)(2), a plaintiff must prove that the defendant, through the mails or means of interstate commerce or transportation:

- offered or sold a security;
- by means of a prospectus or oral communication;
- which included a material misrepresentation or omission; and
- the plaintiff did not know of the untruth or omission. n5

[a] By Means of a Prospectus or Oral Communication. With the exception of government and bank securities exempt from registration under Section 3(a)(2) of the 1933 Act, Section 12(a)(2) applies to all securities, whether or not they are exempt from registration. The securities, however, must be sold "by means of" a "prospectus" or oral communication. The phrase "oral communication" is restricted to those oral communications related to a prospectus. n6 An oral communication that is innocuous when viewed in isolation may nevertheless be actionable if it is used to induce reliance on some other representation that is false or misleading. n7 Note that this is further clarified by new Rule 159, which specifies that the communication must take place on or before the date of the sale. n8

The "by means of" language does not require proof of plaintiff's reliance. n9 Indeed, a plaintiff need never have received, much less reviewed, the prospectus alleged to be misleading. Moreover, under Section 12(a)(2), "Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud." n10 Most courts have held that the "by means of" language does require some causal connection between the prospectus or oral communication and the plaintiff's purchase. n11 Thus, where a communication is neither intended to be, nor is perceived as, instrumental in effecting a sale, recovery has been denied due to the absence of causation. n12 Further, where a defendant's allegedly violative conduct occurs after the sale, the "by means of" requirement is not satisfied. n13

The last point, that liability under Section 12(a)(2) cannot be premised upon communications to investors which take place after the time of sale, was recently re-affirmed by the SEC in its new Rule 159. n14 The flipside, however, is that corrective disclosures made after the time of sale (in a final prospectus, prospectus supplement, or other filing or communication) will not shield the issuer from liability for pre-sale misstatements. The SEC views the "time of sale" as being the time when an investor contractually commits to purchasing a security. n15 Thus, for example, if information necessary to make a pre-sale statement not misleading is contained in a final prospectus issued after an investor enters into a contract of sale, the issuer will nevertheless face liability for the misstatement under Section 12(a)(2), assuming the other elements of the statute are satisfied.

The limits of the term "prospectus" for purposes of the statute has been the subject of debate. In *Gustafson v. Alloyd Co., Inc.*, n16 the Supreme Court held that the term "prospectus," as used throughout the 1933 Act, is limited to the type of document that Section 10 of the Act requires to be made in a public offering by an issuer or its controlling shareholders. By its holding, the Court effectively limited the applicability of Section 12(a)(2) to public offerings and eliminated Section 12(a)(2) as a remedy in secondary market transactions. n17

But the analysis does not end there. The definition of a "public offering" is itself highly fact specific and is similar to that which is employed in other contexts under the federal securities laws. Such factors that should be considered in determining whether an offer of securities is a "public offering" include: 1) the number of persons to whom the securities were offered and sold; 2) the amount of securities acquired; 3) the manner of sale; 4) the adequacy of the then available information about the issuer; and 5) the needs of the offerees at that time for the protection afforded by the registration requirements of the 1933 Act. n18 Unless it is clear that the transaction is non-public, some courts have held it is inappropriate to resolve the applicability of Section 12(a)(2) on a motion to dismiss. n19

[b] Misrepresentations or Omissions. Like other sections of the federal securities laws, Section 12(a)(2) is directed at deception through misrepresentations or omissions, not mere breaches of fiduciary duty or corporate unfairness. n20 Thus, the failure to allege misrepresentations or omissions is fatal to a Section 12(a)(2) claim. n21

[c] Materiality. Only "material" misrepresentations and omissions are actionable under Section 12(a)(2). n22 Courts use the same materiality standard under Section 12(a)(2) as they do under Section 11, namely that an omission is material if there is a substantial likelihood that "disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of the information made available." n23

[d] Plaintiff's Ignorance of the Untruth or Omission. Section 12(a)(2) explicitly limits recovery to persons "not knowing of such untruth or omission," and plaintiffs must affirmatively plead this lack of knowledge. The courts, however, differ on how plaintiffs may satisfy this requirement. Some older decisions have held that plaintiffs must prove "excusable" ignorance. n24 More recently, courts have held that actual ignorance is all that Section 12(a)(2) requires and that plaintiffs have no due diligence obligation of their own. n25

[5] Persons Liable

As is true under Section 12(a)(1), Section 12(a)(2) provides a remedy only against a defendant who "offers or sells" a security and only as to the plaintiff purchasing the security from the defendant. n26 In *Pinter v. Dahl*, n27 the Supreme Court set forth the test for seller status under Section 12(a)(1) and indicated that such principles were also relevant to Section 12(a)(2). It did not, however, decide whether the standards under Section 12(a)(1) equally applied under Section 12(a)(2). Both prior to and subsequent to the Supreme Court's decision, however, lower courts have held that the meaning of seller is the same in Section 12(a)(2) as it is in Section 12(a)(1). n28

[6] Reasonable Care Defense

In contrast to Section 11, which provides separate defenses to certain defendants depending on whether expertised or non-expertised portions of the registration statement are at issue, Section 12(a)(2) grants the same defense to every defendant. The defendant may avoid liability by proving that he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. n29 Some courts have been willing to resolve this reasonable care issue as a matter of law. n30

As a practical matter, the reasonable care defense available under Section 12(a)(2) is substantially similar to the due diligence defense available under Section 11 and discussed above at *Section 9.02[12]*. Significantly, the House Committee Report on the bill that ultimately became the 1933 Act described the defenses in Section 11 and 12 in the same way:

All who sell securities with such a flaw [a misleading statement or omission], who cannot prove that they did not know; or who in the exercise of reasonable care could not have known; of such misstatement or omission, are liable under Sections 11 and 12. n31

The Conference Report also referenced the defenses in similar language. n32

Congress' omission in Section 12(a)(2) of the "reasonable investigation" language used in parts of Section 11(b) has not prevented courts from finding that reasonable care required an investigation into the circumstances of a particular case. In *Sanders v. John Nuveen & Co.*, the court found that an underwriter of commercial paper failed to satisfy its reasonable care defense under Section 12(a)(2) because it did not examine the issuer's tax returns, corporate minutes, or contracts and did not meet with any representatives of the auditor. n33

The defendant argued that the court was effectively imposing Section 11 standards in a Section 12 action. The court responded:

It is not at all clear that Congress intended to impose a higher standard of care under Section 11 than under [Section 12(a)(2)]; in the circumstances of this case, the reasonable care standard required the reasonable investigation. n34

The court went on to state that "[s]ince what constitutes reasonable care under Section 12(a)(2) depends upon the circumstances, we, of course, do not intimate that the duty of a seller under Section 12(a)(2) is always the same as that of an underwriter in a registered offering under Section 11." n35 Other courts have also concluded that defendants failed to establish a reasonable care defense under Section 12(a)(2) because they failed to make the inquiry that would have put them on notice (particularly where "warning signals" existed). n36

One appellate decision suggests that the reasonable care standard under Section 12 may vary according to at least five factors:

- the amount of planning and promotional participation by the defendant;
- the defendant's access to source data;
- the relative skill of the defendant and plaintiff in ferreting out the truth;
- the defendant's pecuniary interest in the completion of the transaction; and
- the existence of a relationship of trust and confidence between the plaintiff and the defendant. n37

Thus, the same factors that courts look at in determining whether a Section 11 defendant's investigation was reasonable inform a reasonable care inquiry under Section 12(a)(2).

[7] Rescission and Damages

Section 12 provides alternative forms of recovery. A plaintiff who still owns the security may obtain rescission, consisting of "the consideration paid for such security with interest thereon, less the amount of any income received thereon" n38 A party seeking rescission must make a demand promptly upon learning of the misrepresentation. n39 On the other hand, a plaintiff no longer owning the security may obtain "damages." n40 In contrast to Section 11, n41 Section 12 does not itself specify the measure of damages.

[a] Tender of Security. Section 12 conditions rescission upon tender of the security. n42 It prescribes no time for tender, and the courts have often been generous in finding that the tender requirement has been satisfied. Thus, a rescission demand under Section 12 has been held to constitute an implicit tender. n43 A recitation in the complaint that a tender is being made "subject only to the condition that the defendants pay in full any judgment that plaintiff may acquire" has also been held to be sufficient. n44 Such recitation, however, must be "explicit." n45

[b] Offset. Section 12 provides that, upon tender, the defendant must refund the consideration paid for the security "less the amount of any income received thereon." n46 At a minimum, the "income received thereon" includes dividend

income paid to the plaintiff. n47 In *Randall v. Loftsgaarden*, n48 the Supreme Court resolved a split among the circuits and held that tax savings to the purchaser could not be offset under Section 12(a)(2).

[8] Indemnification and Contribution

Courts have generally held that a party who is subject to a dispositive finding of liability cannot bring a claim for indemnification under the 1933 Act. n49

However, courts have widely held that there is an implied right to contribution under the federal securities laws, n50 although, relying on Supreme Court cases rejecting implied contribution claims under other federal statutes, some courts have held that there is no right to contribution under Section 12(a)(2). n51 Moreover, in *Pinter v. Dahl*, n52 the Supreme Court observed that unlike Section 11, Section 12 contains no express right of contribution, and Justice Stevens (in dissent) specifically drew attention to the Court's decisions declining to recognize an implied right to contribution in other statutes that are silent on the issue. n53 The Court, however, did not decide the issue. In *Musick, Peeler & Garrett v. Employer's Ins. of Wausau*, n54 the Supreme Court found an implied right of contribution under Section 10(b). Unlike Section 12(a)(2), however, Section 10(b) is an implied cause of action. In the case of an implied cause of action, the Supreme Court looks to analogous express causes of action to determine the elements of the implied claim. In the case of an express cause of action, however, the fact that other express causes of action contain rights of contribution may suggest that Congress' omission of a right of contribution under Section 12(a)(2) reflects an intent not to permit contribution under that section. Thus, even after *Musick*, it may still be argued that the absence of a provision for contribution in Section 12(a)(2) evidences an intent not to permit contribution under that section.

FOOTNOTES:

(n1)Footnote 1. 513 U.S. 561, 578 (1995) .

(n2)Footnote 2. *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 165 F. Supp. 2d 615 (S.D.N.Y. 2001) ; see also *Dafofin Holdings S.A. v. Hotelworks.com, Inc.*, No. 00 Civ. 7861, 2001 U.S. Dist. LEXIS 12347 at * 20 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,529 (S.D.N.Y. Aug. 16, 2001) ("Courts within this circuit have consistently interpreted *Gustafson* to exclude purchasers in private or secondary market offerings from bringing actions under Section 12(a)(2)"); *In re Ultrafem, Inc. Sec. Litig.*, 91 F. Supp. 2d 678, 693 (S.D.N.Y. 2000) (plaintiffs who purchased shares in the aftermarket "clearly [were] precluded from asserting Section 12(2) violations").

(n3)Footnote 3. *Cathedral Trading, LLC v. Chicago Board Options Exch.*, 199 F. Supp. 2d 851, 858 , [2001-2002 Transfer Binder] Fed. Sec. L. Rep. P 91,793 (N.D. Ill. 2002); *Dafofin Holdings S.A. v. Hotelworks.com, Inc.*, No. 00 Civ. 7861, 2001 U.S. Dist. LEXIS 12347 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,529 (S.D.N.Y. Aug. 17, 2001); *Rudd v. Suburban Lodges of Am., Inc.*, 67 F. Supp. 2d 1366, 1369 (N.D. Ga. 1999) ; *Panek v. Bogucz*, 718 F. Supp. 1228 [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,842 (D. N.J. 1989) (writer of option contracts is not a purchaser under Section 12(a)(2) even if he ultimately purchases securities to meet option requirements); *Prudential-Bache Sec., Inc. v. Cullather*, 678 F. Supp. 601 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,421 at 97,191 (E.D. Va. 1987) (options seller is not a "purchaser" for Section 12(a)(2) purposes); *Midamerica Fed. Sav. & Loan Ass'n v. Shearson-Am. Express, Inc.*, No. 84-C-10-C, 1987 U.S. Dist. LEXIS 15389 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,333 at 96,692 (D. P.R. 1987) (officer of brokerage firm not a purchaser for Section 12(a)(2) purposes). But see *Doll v. James Martin Associates (Holdings), Ltd.*, 600 F. Supp. 510, 523 [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,968 (E.D. Mich. 1984) (stating that because Section 12(a)(2) provides a remedy against anyone who "offers or sells a security" the "purchaser/seller requirement is inapplicable to an action brought under" Section 12(a)(2)").

(n4)Footnote 4. Thus, for example, an agent who purchases securities for a client has Section 12 standing even though the agent does not beneficially own the securities. See, e.g., *EZRA Charitable Trust v. Rent-Way, Inc.*, 136 F. Supp. 2d 435, 442 , [2000-2001 Transfer Binder] Fed. Sec. L. Rep. P 91,370 (W.D. Pa. 2001); *Summers v. Welltech, Inc.*, 935 S.W.2d 228, 233 (Tex. Ct. App. 1996) ; *Monetary Mgmt. Group, Inc. v. Kidder, Peabody & Co., Inc.*, 604 F.

Supp. 764 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,248 (E.D. Mo. 1985).

(n5)Footnote 5. See *Morse v. McWhorter*, 290 F.3d 795, 798 (6th Cir. 2002) ; *Lewis v. Fresne*, 252 F.3d 352, 357 , [2001 Transfer Binder] Fed. Sec. L. Rep. P 91,427 (5th Cir. 2001); *Ehlert v. Singer*, 245 F.3d 1313, 1315-1316 , [2001 Transfer Binder] Fed. Sec. L. Rep. P 91,407 (11th Cir. 2001); *Med Safe N.W., Inc. v. Medvial, Inc.*, 1 Fed. Appx. 795, 803 , [2000-2001 Transfer Binder] Fed. Sec. L. Rep. P 91,301 (10th Cir. 2001); *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 , [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,127 (8th Cir. 1977); *Schaffer v. Evolving Sys., Inc.*, 29 F. Supp. 2d 1213, 1220 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,401 (D. Colo. 1998); *Monetary Mgmt. Group, Inc. v. Kidder, Peabody & Co., Inc.*, 604 F. Supp. 764 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,248 (E.D. Mo. 1985); *B.K. Med. Sys., Inc. v. Clesh*, Nos. Civil Action 82-905, 82-906, 82-2494, 1984 U.S. Dist. LEXIS 17460 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,301 (W.D. Pa. Apr. 19, 1984); *Gridley v. Sayre & Fisher Co.*, 409 F. Supp. 1266, 1272-73 , [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,518 at 99,647 (D.S.D. 1976), *aff'd*, 550 F.2d 551 (8th Cir. 1977) .

(n6)Footnote 6. See, e.g., *Kowal v. IBM Corp. (In re IBM Corp. Sec. Litig.)*, 163 F.3d 102, 111 , [1998 Transfer Binder] Fed. Sec. L. Rep. P 90,328 (2d Cir. 1998); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 688 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,783 (3d Cir. 1991); *Abbell Credit Corp. v. Banc of Am. Sec., L.L.C.*, [2001 Transfer Binder] Fed. Sec. L. Rep. P 91,543 (N.D. Ill. 2001); *Eureka Homestead Society v. Howard, Weil, Labouisse, Friedrichs Inc.*, No. 94-452 Section "D" (4), 1996 U.S. Dist. LEXIS 19474 (E.D. La. Dec. 31, 1996) .

(n7)Footnote 7. *Metromedia Co. v. Fugazy*, 983 F.2d 350 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,266 at 95,205 (2d Cir. 1992), *cert. denied*, 508 U.S. 952 (1993) ; *Conn. Nat'l Bank v. Giacomi*, 699 A.2d 101, 122 , Blue Sky L. Rep. P 74,157 (1997).

(n8)Footnote 8. 17 C.F.R. 230.159.

(n9)Footnote 9. *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir. 2002) ; *Wright v. Nat'l Warranty Co.*, 953 F.2d 256 , [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,466 at 92,064 (6th Cir. 1992); *Currie v. Cayman Res. Corp.*, 835 F.2d 780 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,591 at 97,645 (11th Cir. 1988); *Akerman v. Oryx Comm., Inc.*, 810 F.2d 336, 344 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987); *Junker v. Crory*, 650 F.2d 1349, 1359 , [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,236 (5th Cir. 1981); *Sanders v. John Nuveen & Co., Inc.*, 619 F.2d 1222, 1225 , [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,372 at 97,480 (7th Cir. 1980); *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1034 , [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,149 at 96,343 (2d Cir. 1979); *Alton Box Bd. Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 924 n.12 , [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,127 at 92,072 (8th Cir. 1977); *Gilbert v. Nixon*, 429 F.2d 348, 356-57 , [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,625 at 98,814 (10th Cir. 1970); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129 , [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,582 at 98,658 (4th Cir. 1970); *Demarco v. Edens*, Fed. Sec. L. Rep. (CCH) 92,162, 96,735, 390 F.2d 836, 841 (2d Cir. 1968) ; *Woodward v. Wright*, 266 F.2d 108, 116 , [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,907 (10th Cir. 1959); *Abrams v. Van Kampen Funds, Inc.*, No. 01 C 7538, 2002 U.S. Dist. LEXIS 9814 (N.D. Ill. May 29, 2002) ; *Tracinda Corp. v. DaimlerChryslerAG*, 197 F. Supp. 2d 42, [Current Transfer Binder] Fed. Sec. L. Rep. P 91,776 (D. Del. 2002).

(n10)Footnote 10. *Randall v. Loftsgaarden*, 478 U.S. 647, 659, 106 S. Ct. 3143, 92 L. Ed.2d 525 , [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,801 (1986).

(n11)Footnote 11. See *Metromedia Co. v. Fugazy*, 983 F.2d 350 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,266 at 95,204-05 (2d Cir. 1992), *cert. denied*, 508 U.S. 952 (1993) ; *Sanders v. John Nuveen & Co., Inc.*, 619 F.2d 1222, 1225 , [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,372 (7th Cir. 1980); *Jackson v. Oppenheim*, 533 F.2d 826 , [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,497 (2d Cir. 1976); *Austin v. Loftsgaarden*, 675 F.2d 168, 178 , [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,628 at 93,107 (8th Cir. 1982);

Alton Box Bd. Co. v. Goldman, Sachs & Co., 560 F.2d 916, 924 , [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,127 at 92,072 (8th Cir. 1977); *Barnes v. Resource Royalties, Inc.*, 610 F. Supp. 499 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,293 (E.D. Mo. 1985), *aff'd in part, rev'd in part*, 795 F.2d 1359 (8th Cir. 1986) ; *Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 234 , [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,619 (S.D.N.Y. 1999);

(n12)Footnote 12. *Jackson v. Oppenheim*, 533 F.2d 826, 829-30 , [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,497 at 99,529 (2d Cir. 1976); *Polycast Tech. Corp. v. Uniroyal, Inc.*, 792 F. Supp. 244, 259-260 , [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,803 (S.D.N.Y. 1992).

(n13)Footnote 13. *Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 234 , [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,619 (S.D.N.Y. 1999); *Rudd v. Suburban Lodges of Am., Inc.*, 67 F. Supp. 2d 1366, 1370 (N.D. Ga. 1999) ; *Manela v. Gottlieb*, No. 91 Civ. 5510, 1992 U.S. Dist. LEXIS [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,285 at 95,372 (S.D.N.Y. Dec. 30, 1992); *Pell v. Weinstein*, 759 F. Supp. 1107 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,893 at 99,394-95 (M.D. Pa. 1991), *aff'd without op.*, 961 F.2d 1568 (3d Cir. 1992) .

(n14)Footnote 14. 17 C.F.R. 230.159.

(n15)Footnote 15. *Id.* See also Release No. 33-8591 at 173-192.

(n16)Footnote 16. 513 U.S. 561, 115 S. Ct. 1061, 131 L. Ed. 2d 1 , [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,531 (1995).

(n17)Footnote 17. *First Union Disc. Broker Servs., Inc. v. Milos*, 997 F.2d 835 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,703 (11th Cir. 1993); *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,783 (3d Cir. 1991); *In re Adams Golf, Inc. Sec. Litig.*, 176 F. Supp. 2d 216 , [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,651 (D. Del. 2001), *aff'd in part, rev'd in part*, 381 F.3d 267 (3d Cir. 2004) ; *Emergent Capital Invest. Mgmt., LLC v. Stonepath Group, Inc.*, 165 F. Supp. 2d 615, 622 , [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,623 (S.D.N.Y. 2001); *Tregenza v. Greater Am. Communications Co.*, 823 F. Supp. 1409 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,745 (N.D. Ill. 1993); *Bank of Denver v. Southeastern Capital Group, Inc.*, 763 F. Supp. 1552 , [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,073 at 90,408-09 (D. Colo. 1991); *In re Delmarva Sec. Litig.*, 794 F. Supp. 1293 , [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) 96,905 (D. Del. 1992); *Budget Rent a Car Sys., Inc. v. Hirsch*, 810 F. Supp. 1253 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,406 (S.D. Fla. 1992); *Leonard v. Stuart-James Co., Inc.*, 742 F. Supp. 653 , [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,442 at 97,255 (N.D. Ga. 1990); *Mix v. E.F. Hutton & Co.*, 720 F. Supp. 8, 11 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,763 (D. D.C. 1989); *Panek v. Bogucz*, 718 F. Supp. 1228 [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,842 (D. N.J. 1989); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, No. 88-856-CIV-5, 1989 U.S. Dist. LEXIS 6329 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,391 (E.D.N.C. Feb. 15, 1989); *Strong v. Paine Webber, Inc.*, 700 F. Supp. 4 , [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,053 (S.D.N.Y. 1988); *Ralph v. Prudential Bache Sec., Inc.*, 692 F. Supp. 1322 , [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,964 (S.D. Fla. 1988); *SSH Co. Ltd. v. Shearson Lehman Bros., Inc.*, 678 F. Supp. 1055, 1059 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,647 (S.D.N.Y. 1987). *But see Feiner, M.D., v. SS&C Technologies, Inc.*, 47 F. Supp. 2d 250, 252-253 (D. Conn. 1999) (stating that the Supreme Court's statement in *Gustafson* that § 12(a)(2) liability is limited to public offerings cannot be read categorically to exclude aftermarket trading).

(n18)Footnote 18. See § 6.03[3][a] *supra*.

(n19)Footnote 19. See, e.g., *Steed Finance LDC v. Nomura Secs. Int'l, Inc.*, No. 00 Civ. 8058, 2001 U.S. Dist. LEXIS 14761 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,552 (S.D.N.Y. Sept. 19, 2001).

(n20)Footnote 20. *Doll v. James Martin Assoc. (Holdings), Ltd.*, 600 F. Supp. 510, 526 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,968 at 90,831 (E.D. Mich. 1984). *See also* 7547 Corp. v. Parker & Parsley Dev. Partners, L.P., 38 F.3d 211, 231 , [1994-1995 Transfer Binder] Fed. Sec. L. Rep. P 98,460 (5th Cir. 1994). *Cf.* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed.2d 480 , [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,914 (1977). *See* § 9.02[6][a], *supra*.

(n21)Footnote 21. *See* § 9.02[6][a] *supra*.

(n22)Footnote 22. *E.g.*, *Lewis v. Fresne*, 252 F.3d 352, 357 , [2001 Transfer Binder] Fed. Sec. L. Rep. P 91,427 (5th Cir. 2001); *Sheldon v. Vermonty*, 246 F.3d 682 (10th Cir. 2000) ; *Joseph v. Q.T. Wiles*, 223 F.3d 1155, 1161 , [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,036 (10th Cir. 2000); *Akerman v. Oryx Comm., Inc.*, 609 F. Supp. 363, 366-68 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,680 at 99,436 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987); *see also* Bamco 15 v. Buchanan Residential Real Estate Ltd. P'ship 2410, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,062 (S.D.N.Y. 1986); *Feinberg v. Leighton*, No. 80 Civ. 4398 (MGC), 1987 U.S. Dist. LEXIS 580 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,117 (S.D.N.Y. Jan. 30, 1987).

(n23)Footnote 23. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-232, 108 S. Ct. 978, 99 L. Ed. 2d 194 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. P 93,645 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed. 2d 757 , [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,615 (1976); *Castelanno v. Young & Rubicam, Inc.*, 257 F.3d 171, 180 , [2001 Transfer Binder] Fed. Sec. L. Rep. P 91,477 (2d Cir. 2001); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 , [2000-2001 Transfer Binder] Fed. Sec. L. Rep. P 91,210 (2d Cir. 2000). *See also* *Steinberg v. PRT Group Inc.*, 88 F. Supp. 2d 294, 300 , [2000 Transfer Binder] Fed. Sec. L. Rep. P 90,924 (S.D.N.Y. 2000) (citing the standard set forth in *TSC Indus.*). The discussion of materiality in § 9.02[6][b] *supra* also applies to Section 12.

(n24)Footnote 24. *M.P. Gilbert v. Nixon*, 429 F.2d 348, 356 , [1970-1971 Transfer Binder] Fed. Sec. L. Rep. P 92,625 (10th Cir. 1970); *Woodward v. Wright*, 266 F.2d 108 , [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,907 (10th Cir. 1959).

(n25)Footnote 25. *E.g.*, *Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989) ; *Parkhurst v. North American Financial Services Companies, Inc.*, 919 F.Supp. 270, 275 (E.D. Mich. 1996) ; *In re Jenny Craig Sec. Litig.*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. P 97,337 (S.D. Cal 1992); *Aronson v. TPO, Inc.*, 410 F.Supp. 1375 (S.D.N.Y. 1976) (stating that the availability of the relevant information to plaintiffs through sources other than defendants is immaterial to 12(2) claim).

(n26)Footnote 26. *Schaffer v. Evolving Sys., Inc.*, 29 F. Supp. 2d 1213, 1220 , [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,401 (D. Colo. 1998).

(n27)Footnote 27. *Pinter*, 486 U.S. at 642 n.20 .

(n28)Footnote 28. *See* *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1307 , [1998 Transfer Binder] Fed. Sec. L. Rep. P 90,214 (10th Cir. 1998); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1214 , [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,217 (1st Cir. 1996); *Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42 , [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,406 at 91,732 (2d Cir. 1991); *Moore v. Kayport Package Exp.*, 885 F.2d 531 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,922 (9th Cir. 1989); *Craftmatic v. Kraftsow (In re Craftmatic Secs. Litig.)*, 890 F.2d 628, 635 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,805 (3rd Cir. 1989); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1115 , [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,094 (5th Cir.), *reh'g en banc denied*, 863 F.2d 882 (5th Cir. 1988) , *vacated*, 492 U.S. 914 (1989) ; *Capri v. Murphy*, 856 F.2d 473, 478 , [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,007 (2d Cir. 1988), *vacated sub nom*, *Fryar v. Abell*, 492 U.S. 914 (1989) ; *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875, 878 (2d Cir.

1943); *Spielgel v. Tenfold Corp.*, 192 F. Supp. 2d 1261, 1268-1269, [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,736 (D. Utah 2002); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 204, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,012 (E.D.N.Y. 2000); *Persky v. Turley*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,483 at 92,133 (D. Ariz. 1991). The discussion in § 9.03[5][a] *supra* with respect to the standards applicable to determining "seller" liability under Section 12(a)(1) applies equally to Section 12(a)(2).

(n29)Footnote 29. *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 567, 115 S. Ct. 1061, 131 L. Ed. 2d 1, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,531 (1995); *Webster v. Omnitron Int'l, Inc.*, 79 F.3d 776, 786, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. P 99,071 (9th Cir. 1996); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 205, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,012 (E.D.N.Y. 2000).

(n30)Footnote 30. *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,631 (N.D. Cal. 1992), *aff'd in part and rev'd in part*, 50 F.3d 615 (9th Cir. 1994).

(n31)Footnote 31. H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

(n32)Footnote 32. H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933).

(n33)Footnote 33. 619 F.2d 1222, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,372 (7th Cir. 1980). *But see* dissent of Justices Powell and Rehnquist from the Supreme Court's denial of certiorari in *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, [1979-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,372 (7th Cir. 1980), on grounds that the court of appeals should not have imposed a reasonable investigation requirement under a reasonable care standard.

(n34)Footnote 34. *Sanders*, 619 F.2d at 1228.

(n35)Footnote 35. *Sanders*, 619 F.2d at 1228.

(n36)Footnote 36. *See In re Worldcom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 665-666 (S.D.N.Y. 2004); *Univ. Hill Found v. Goldman, Sachs & Co.*, 422 F. Supp. 879, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,749 (S.D.N.Y. 1976). *See also First Trust & Sav. Bank of Zanesville, Ohio v. Fidelity--Philadelphia Trust Co.*, 214 F.2d 320, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,669 (3d Cir.).

(n37)Footnote 37. *Davis v. Avco Fin. Svcs., Inc.*, 739 F.2d 1057, 1068, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,569 at 98,916 (6th Cir. 1984). *See also Riedel v. Acutote of Colorado*, 773 F. Supp. 1055, 1068 (S.D. Ohio 1991); *Univ. Hill Foundation v. Goldman Sachs & Co.*, 422 F. Supp. 879, 900, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,749 at 90,652 (S.D.N.Y. 1976) ("what is required is a close consideration of the facts of the relationship between [the issuer and the defendant], the [defendant's] access to information, the nature of the data it relied upon and the presence or absence of 'warning signals?'" (citation omitted). *But see Picard Chem., Inc. v. Perrigo Co.*, Nos. 1:95-CV-141, 1:95-CV-290, 1998 U.S. Dist. LEXIS 11783 (W.D. Mich. June 15, 1998) (disregarding five factor test set forth in *Davis* and holding that the ultimate question is whether the defendant performed a reasonable investigation and had a reasonable belief that the information regarding the offering was true and accurate).

(n38)Footnote 38. 15 U.S.C.A. § 77l(a)(2).

(n39)Footnote 39. *Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,647 at 96,985 (S.D.N.Y. 1993); *Gannett Co. v. Register Pub. Co.*, 428 F. Supp. 818, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,042 (D. Conn. 1977). The purpose of this requirement is to prevent a party from sitting back without notice to the wrongdoer, watch whether the market goes up or down, and thereby place the entire risk of loss on the wrongdoer. In *Randall v. Loftsgaarden*, 478 U.S. 647, 666, 106 S. Ct. 3143, 92 L. Ed. 2d 525, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,801 (1986), the Supreme Court stated that barring recovery where plaintiffs delay making a tender or filing suit may well be appropriate where plaintiffs delay

tender or suit in order to obtain additional tax benefits; but see *Gould v. Harris*, 929 F. Supp. 353, 360, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. P 99,297 (C.D. Ca. 1996) (rejecting the "prompt" requirement under Westinghouse); *T. Rowe Price Small-Cap Value Fund, Inc. v. Oppenheimer & Co.*, 95 Civ. 1925 (DC) 1995 U.S. Dist. LEXIS 18486 (S.D.N.Y. Dec. 14, 1995) (refusing to hold that the three month requirement under Westinghouse is a hard and fast time requirement).

(n40)Footnote 40. *In re Metlife Demutualization Litig.*, 156 F. Supp. 2d 254, 269, [2001 Transfer Binder] Fed. Sec. L. Rep. P 91,513 (E.D.N.Y. 2001); *Laser Mortgage Mgmt., Inc. v. Asset Securitization Corp.*, No. 00 Civ. 8100, Fed. Sec. L. Rep. (CCH) 91,535, 2001 U.S. Dist. LEXIS 13746 (S.D.N.Y. Sept. 5, 2001); see also *In re Bank One Sec. Litig./First Chicago Shareholder Claims*, Case No. 00 CV 0767, 2002 U.S. Dist. LEXIS 8709 (N.D. Ill. May 14, 2002).

(n41)Footnote 41. See § 9.02[13] *supra*.

(n42)Footnote 42. See *Goldkrantz v. Griffin*, No. 97 Civ. 9075 (DLC), 1999 U.S. Dist. LEXIS 4445, Fed. Sec. L. Rep. P 90,462 (S.D.N.Y. Apr. 5, 1999); *Bresson v. Thomson McKinnon Sec., Inc.*, 641 F. Supp. 338 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,855 at 94,154 (S.D.N.Y. 1986); *Anisfield v. Cantor Fitzgerald & Co.*, 631 F. Supp. 1461, 1464, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,713 (S.D.N.Y. 1986).

(n43)Footnote 43. E.g., *Metz v. United Counties Bancorp*, 61 F. Supp. 2d 364, 379, Fed. Sec. L. Rep. P 90,631 (D. N.J. 1999); *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,149 (2d Cir. 1979); *Alfaro v. E.F. Hutton & Co.*, 606 F. Supp. 1100, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,074 (E.D. Pa. 1985); *Adair v. Hunt Int'l Res. Corp.*, 526 F. Supp. 736, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,474 (N.D. Ill. 1981).

(n44)Footnote 44. *Chapman v. Dunn*, 414 F.2d 153, 160-61 (6th Cir. 1969); *Stadia Oil & Uranium Co. v. Wheelis*, Fed. Sec. L. Rep. (CCH) 90,838, 251 F.2d 269, 274 (10th Cir. 1957). See also *Rochambeau v. Brent Exploration, Inc.*, 79 F.R.D. 381, 388-89 (D.Colo. 1978).

(n45)Footnote 45. *Metz v. United Counties Bancorp*, 61 F. Supp. 2d 364, 379, Fed. Sec. L. Rep. (CCH) P 90,631 (D. N.J. 1999).

(n46)Footnote 46. See *In re Bank One Sec. Litig./First Chicago Shareholder Claims*, No. 00 CV 0767, 2002 U.S. Dist. LEXIS 8709 (N.D. Ill. May 14, 2002).

(n47)Footnote 47. *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1036 n.8, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,149 at 96,344 (2d Cir. 1979).

(n48)Footnote 48. 478 U.S. 647, 656, 106 S. Ct. 3143, 92 L. Ed. 2d 525, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,801 (1986); see also *Wolkowitz v. Lerner (In re Imperial Credit Indus., Inc.)*, No. 07-777CAS, 2008 U.S. Dist. LEXIS 71984, at *37 (C.D. Cal. Sept. 18, 2008) (declining to find an exception to Supreme Court's holding in *Randall* where tax benefits were primary motivation for plaintiff's investment and represented large portion of purchase price).

(n49)Footnote 49. E.g., *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000); *Eichenholz v. Brennan*, 52 F.3d 478 (3d Cir. 1995); *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672, 676, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,810 (9th Cir. 1980); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975).

There is, however, some support for the proposition that indemnification under the federal securities laws is available where a party settles without an admission of liability. See, e.g., *In re Cendant Corp. Securities Litig.*, 109 F.Supp. 2d 273, 284 (D.N.J. 2000); *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1177, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,223, at 99,534-35 (N.D. Cal. 1994).

(n50)Footnote 50. E.g., *Alexander Grant & Co. v. McAlister*, 669 F. Supp. 163, 165-66 (S.D. Ohio 1987) ; *In re Nat'l Student Mktg. Litig.*, 517 F. Supp. 1345, 1348-49 , [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,229 (D. D.C. 1981); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975) .

(n51)Footnote 51. *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101 , [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,454 (4th Cir. 1989); *Andrews v. Fitzgerald*, No. C-89-649-G, 1992 U.S. Dist. LEXIS 9315 [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,628 at 92,944 (M.D.N.C. Feb. 7, 1992); *First Fin. Sav. Bank, Inc. v. Am. Bankers Ins. Co.*, Nos. 88-33-Civ-5, et. al., 1989 U.S. Dist. LEXIS 16400 [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,824 (E.D.N.C. Aug. 4, 1989); *In re* at 683 F. Supp. 1283 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,716 (D. Minn. 1988).

(n52)Footnote 52. *Pinter*, 486 U.S. at 630 n.9 .

(n53)Footnote 53. *Pinter*, 486 U.S. at 628 n.5 .

(n54)Footnote 54. 508 U.S. 286, 113 S. Ct. 2085, 124 L. Ed. 2d 194 , Fed. Sec. L. Rep. P 97,456 (1993).

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



141 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.05

§ 9.05 Statute of Limitations-Section 13

[1] Introduction

Section 13 provides the statute of limitations applicable to Sections 11, 12(a)(1), and 12(a)(2). For each section, there is a one-year and a three-year limitation period. Section 13's one-year and three-year limitation periods are cumulative rather than alternative. n1 This means suit must be brought within both the one-year period and the three-year period. After quoting the text of the statute, we discuss the pleading requirements applicable to the statute of limitations. We then describe the circumstances that trigger the commencement of the statute for each of the Sections. We then discuss tolling of the statute of limitations.

One issue that has arisen in connection with Section 13 is the extent to which the Sarbanes-Oxley Act of 2002 changed the statute of limitations applicable to claims under the 1933 Act. This issue will be addressed in Section 9.05[4].

[2] The Statute

Specifically, Section 13 provides as follows:

No action shall be maintained to enforce any liability under Section 11 or Section 12(a)(2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under Section 12(a)(1), unless brought within one year after the violation upon which it is based. In no event shall any such action under Section 11 or Section 12(a)(1) be brought more than three years after the security was bona fide offered to the public, or under Section 12(a)(2) more than three years after the sale.

[3] Pleading Requirements

Compliance with the statute of limitations generally is regarded an affirmative part of the plaintiff's case. n2 Courts require that the plaintiff set forth the time and circumstances of the discovery of the fraudulent statements, the reason why discovery was not made earlier if more than one year has elapsed since the fraudulent conduct occurred, and the diligent efforts that plaintiff undertook in making or seeking such discovery. n3 These courts consider the statute of limitations not merely a procedural requirement; failure to meet the requirements of Section 13 can thus result in a

dismissal as a matter of law. n4

Conclusory allegations that the defendant concealed the fraud, n5 or that the plaintiff did not and could not have discovered the violations within one year of the complaint, or that plaintiff exercised due diligence and was lulled into a false sense of security because of a fiduciary relationship with the defendant n6 are usually considered insufficient to satisfy the plaintiff's pleading and proof requirements. Instead, due diligence requires plaintiffs to make a reasonable inquiry about their investment and to take affirmative steps to inform themselves of the facts. n7

Some courts are very careful to distinguish the plaintiff's pleading requirements from the plaintiff's ultimate burden. For example, the Seventh Circuit noted that "although courts ... commonly entertain statute of limitations defenses that have been submitted under the guise of a 'motion to dismiss,' such defenses are technically affirmative defenses under Fed. R. Civ. P. 8(c); and the pleading of an affirmative defense does not relieve a defendant from the obligation of answering the allegations of the complaint." n8

[4] Commencement of the Statute

When the statute of limitations commences depends on the type of action brought and the limitation being examined.

[a] Section 11.

Section 11 actions must be brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, and no more than three years after the security was bona fide offered to the public. n9

[i] One-Year Period. The one year limitation period begins to run at the earlier of when the purchaser (i) actually discovered the untrue statement or omission, or (ii) should have discovered the untrue statement or omission by the exercise of reasonable diligence. Courts generally hold that the plaintiff should have discovered the untruth when he or she has enough information to place him on "inquiry notice" (*i.e.*, enough notice that a reasonable person would diligently investigate further). n10 This is an objective test.

Some items, so-called "storm warnings," are sufficient, as a matter of law, to constitute inquiry notice:

- publication of news articles and analysts' reports; n11
- precipitous stock slides or other indication of poor performance inconsistent with a defendant's representations; n12
- receipt of a Schedule K-1 tax form showing that cash distributions and tax losses on an investment were different than the distributions and losses represented by a broker; n13
- disclosure of a major regulatory action; n14
- information contained in the prospectus; n15
- the suspension of trading in the issuer's stock; n16
- notice that the issuer has filed for reorganization in bankruptcy; n17 and
- defaulting on interest payments. n18

The court in *In re CBT Group PLC Securities Litigation* noted that the cumulative effect of more than one event can provide enough information to trigger the statute of limitations. n19 The full extent of the fraud need not have been uncovered to trigger Section 13. "An investor need not have notice of the full extent of the fraud or misstatements to be put on inquiry notice." n20

There is a split of authority among the federal circuit courts as to what constitutes inquiry notice. In particular, the circuit courts disagree on whether evidence merely suggesting the possibility of a misstatement is sufficient to trigger the duty to investigate, or whether the plaintiff must be on notice of facts supporting all elements of a fraud claim, including scienter. n21 This precise issue is currently before the Supreme Court in *In re Merck & Co., Inc. Securities, Derivative & "ERISA" Litigation*. n22

Plaintiffs charged with a duty of investigation arising from inquiry notice may not satisfy that duty "merely [by relying] on reassurances given by management." n23

Courts often decide inquiry notice on summary judgment motions, n24 and sometimes decide the issue on motions to dismiss. n25 Some courts, however, have held that whether a plaintiff exercised reasonable diligence in investigating a fraud claim is a question of fact for the jury. n26

[ii] Three-Year Period. Section 11 actions must also be brought within three years of the bona fide offering of the security to the public. Most courts hold that this means when the securities were first offered to the public. n27 A few courts, however have held that the statute begins to run only after the securities were *last* offered to the public, n28 or even when the securities were first offered *to the plaintiff*. n29 The three year limit is absolute. n30

[b] Section 12(a)(1).

A Section 12(a)(1) action must be brought within one year of the violation upon which it is based and no more than three years after the security was bona fide offered to the public. n31

[i] One-Year Period. The one-year period begins to run when the Section 5 violation on which it is based occurs. A Section 5 violation may involve an illegal offer, an illegal sale, and/or an illegal delivery. Since the use of the mails or other means of interstate commerce to sell, confirm the sale, or deliver an unregistered security violates Section 12(a)(1), the statute ordinarily begins to run from the latest of these dates. n32 Some courts hold that the statute begins to run at the time the mail is used "to complete any integral stage of the sale of an unregistered security, including remittance of the funds for purchase." n33 The Eleventh Circuit, for example, held that even though the plaintiffs filed suit more than one year after they became committed to purchase unregistered securities and more than one year after the defendant accepted the plaintiffs' offer to buy, the suit was timely because it was brought within one year of the time the defendants made use of the means of interstate commerce to transfer the purchase price of securities from the escrow account. n34

Where the only violation alleged is an unlawful sale, one court has held that the statute begins to run on the date of the defendant's last sales-related activity. n35 Other courts have held that it begins to run when the plaintiff purchased his securities. n36 Another has held that it begins to run from the time the offer to purchase is accepted. n37 Where the purchaser of the securities pays for the securities through installment payments, it has been held that the sale is complete for statute of limitations purposes once a firm agreement to sell is reached even though the actual payments are made later. n38 Where multiple purchases of unregistered securities are involved, the action may be barred as to some purchases but not others. n39

[ii] Three-Year Period. Like Section, 11, Section 12(a)(1) actions must be brought within three years of the bona fide offering of the security to the public. Since Section 12(a)(1) complaints are usually predicated on an allegation that the securities should have been but were not registered, it may be asked how a party can claim that such securities could have been "bona fide" offered to the public for purposes of starting the running of the statute of limitations purposes.

One court has held that the three-year limitation period does not apply to Section 12(a)(1) actions alleging the sale of *unregistered* securities because such securities were not bona fide offered to the public. n40 Others, however, have concluded that the term "bona fide" does not mean compliance with registration requirements, but rather that the term merely means an offering "that the issuer is prepared to honor," n41 or a genuine offering of securities. n42 A plaintiff who purchases an unregistered security more than three years after the security is first offered to the public may find that his or her claim under Section 12(a)(1) was barred by the statute of limitations even before acquisition of the security. n43

[c] Section 12(a)(2)

A plaintiff must bring a Section 12(a)(2) claim within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or no more than three years after the sale. n44

[i] One-Year Period The one-year statute of limitations for Section 12(a)(2) actions is the same as that for Section 11. n45

[ii] Three-Year Period A Section 12(a)(2) action also must be brought within three years of the sale of the particular security. Generally, a purchase or sale is deemed to occur on the date that a party enters into a binding commitment to undertake a securities transaction. n46 In certain circumstances, however, it is difficult to determine exactly when a sale took place. For example, where the purchaser possesses the power to terminate the agreement prior to full performance, he or she may be viewed as making a new investment decision at each point at which he or she chooses to go forward, and each such investment decision may be viewed as a separate sale and purchase. n47 This is referred to as the investment decision doctrine. Not all courts have been willing to apply the investment decision doctrine to statute of limitation issues under Section 12(a)(2). n48

A few courts have used the "integrated offering" doctrine which was initially articulated by the SEC as a basis for determining whether an offering of securities should be regarded as separate or part of a larger offering for registration purposes. Under this doctrine, separate offerings of securities may be integrated depending on whether:

- they are part of a single plan of financing;
- they involve issuance of the same class of securities;
- they were made at or about the same time;
- the same type of consideration was received; and
- the offerings were made for the same general purpose. n49

Where the integrated offering doctrine is applied and the offerings are integrated, the statute of limitations may not begin to run as to any of the sales until the plaintiff makes the last purchasing decision in the integrated offering. n50 Although some courts have applied the integration doctrine to statute of limitations decisions under Section 13, the only appellate court to reach the issue concluded that the doctrine may not be used to extend the statute of limitations. n51 The court explained, "[t]he concept of integrating sales and offerings was developed by the Securities and Exchange Commission in a totally different context and for the totally different purpose of determining whether the effect of multiple sales on the marketplace merits regulation or exemption from registration, and it has no application to the commencement of the statute of limitations." n52

[5] Absence of Tolling

The one-year limitation period for Sections 11 and 12(a)(2) is based on when discovery of the untruth or omission was made or "should have been made." In contrast, the three-year periods for each section and the one-year period for Section 12(a)(1) actions contain no "should have" language. One question that arises is whether the limitation periods are nevertheless tolled until the plaintiff should have known of the violation.

Almost all the courts that have considered the issue have held that the three-year period cannot be tolled for any of the actions. n53 This is consistent with the statutory language that "in no event" may the action be brought outside the three-year period. With respect to the one-year limitation period for Section 12(a)(1) actions, there is no language comparable to the "in no event" language applicable to the three-year periods. Some courts nevertheless have held that there can be no tolling, n54 while others have held that this one-year period can be tolled. n55

It is also important to note that, with respect to claims or defenses not raised in the original complaint which are added later, these claims or defenses may be held to "relate back" to the date of the original complaint for statute of limitations purposes. n56

[6] Statute of Limitations under the Sarbanes-Oxley Act

As part of the sweeping reforms enacted pursuant to the Sarbanes-Oxley Act of 2002, Congress amended the statutes of limitations applicable to securities fraud claims. Specifically, in Section 804 of the Sarbanes-Oxley Act, Congress lengthened the period of time after discovery of the facts constituting a violation from one year to two years, and lengthened the period of time after a violation in which a claim must be brought from three years to five years. n57

The amended statute of limitations is, by its terms, limited to claims of "fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in Section 3(a)(47) of the Securities Exchange Act of 1934" n58 Section 3(a)(47) of the 1934 Act, in turn, defines "securities laws" to include the Securities Act of 1933. n59 Accordingly, even though the only "private rights of action" available under the 1933 Act--Sections 11, 12, and 15--do not, on their face, require fraud as an element, some courts have held that application of the longer statute of limitations enacted by Sarbanes-Oxley to claims under the 1933 Act depends on whether the claims include allegations of fraud, deceit, manipulation, or contrivance. n60

As a practical matter, therefore, one must consider whether claims brought nominally under Sections 11, 12, or 15 of the Securities Act are subject to the old one year to three years statute of limitations or the new two year to five years statute, based upon whether the claims are supported by allegations of fraud, deceit, manipulation, or contrivance, as such claims often are. This consideration is especially important in jurisdictions, such as the Second Circuit, which have held that allegations pursuant to Sections 11 and 12 of the 1933 Act that "sound in fraud" are subject to the particularity requirement of Rule 9(b). After all, defendants who benefit from the more stringent pleading requirements of Rule 9(b), as applied to 1933 Act claims, should expect as the flipside of such a benefit the more lax limitations period applicable to fraud claims under the securities laws. n61

FOOTNOTES:

(n1)Footnote 1. *Ballenger v. Applied Digital Solutions Inc.*, 189 F. Supp. 2d 196 (D. Del. 2002) ; *Morley v. Cohen*, 610 F. Supp. 798 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,277 at 91,914 (D. Md. 1985); *LeCroy v. Dean Witter Reynolds, Inc.*, 585 F. Supp. 753, 760 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,503 at 98,528 (E.D. Ark. 1984); *Osborne v. Mallory*, 86 F. Supp. 869, 873-74, Fed. Sec. L. Rep. (CCH) P 90,461 (S.D.N.Y. 1949).

(n2)Footnote 2. See, e.g., *In re Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314 (S.D.N.Y. 2001) ; *Davidson v. Wilson*, 973 F.2d 1391, 1402 n.8 , [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,979 (8th Cir. 1992); *Tregenza v. Great Am. Communications Co.*, 823 F. Supp. 1409 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,745 at 97,560 (N.D. Ill. 1993); *In re VMS Sec. Litig.*, 752 F. Supp. 1373, 1389 , [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,278 (N.D. Ill. 1990); *Seidel v. Pub. Serv. Co.*, 616 F. Supp. 1342, 1357 , [1985-1986 Transfer Binder] Fed.

Sec. L. Rep. (CCH) P 92,383 at 92,387 (D. N.H. 1985); *Allred v. Whatley*, No. C 83-2449 A, 1985 U.S. Dist. LEXIS 19174 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,259 (N.D. Ga. June 5, 1985); *Piper Acceptance Corp. v. Slaughter*, 600 F. Supp. 169, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,948 (D. Colo. 1985); *Caliber Partners, Ltd. v. Affeld*, 583 F. Supp. 1308, 1312, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,618 (N.D. Ill. 1984); *Adair v. Hunt Int'l Res. Corp.*, 526 F. Supp. 736, 748-49, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,474 (N.D. Ill. 1981). See also *Finne v. Dain Bosworth Inc.*, 648 F. Supp. 337, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,147 (D. Minn. 1986) (compliance with Section 13 is an essential element of a Section 12 action, and thus compliance is a substantive matter that must be plead affirmatively). See *Morris v. Bischoff*, No. 96-1384-Civ-T-17A, 1997 U.S. Dist. LEXIS 3176 (M.D. Fla. Mar. 4, 1997) (noting that the Eleventh Circuit has yet to decide whether Section 13 creates an affirmative pleading requirement). Contra *Tregenza v. Great Am. Communications Co.*, 12 F.3d 717, 718 (7th Cir. 1993) (stating that the court could see no reason for the rule that a plaintiff must plead facts demonstrating that their suit is timely, but noting that the plaintiff may, of course, "plead[] facts that show that his suit is time-barred or otherwise without merit," and thereby "plead[] himself out of court.").

(n3)Footnote 3. See, e.g., *Cary Oil Co. v. MG Ref. & Mktg., Inc.*, 90 F. Supp. 2d 401 (S.D.N.Y. 2000); *In re IKON Office Solutions, Inc.*, 66 F. Supp. 2d 622 (E.D. Pa. 1999); *Hardy v. First Am. Bank, N.A.*, 774 F. Supp. 1078, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,426 (M.D. Tenn. 1991); *Hill v. Der*, 521 F. Supp. 1370, 1389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,311 at 91,955 (D. Del. 1981). Accord, *In re Chaus Sec. Litig.*, 801 F. Supp. 1257, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,987 at 94,282 (S.D.N.Y. 1992); *Marino v. Global Investor Sec., Inc.*, No. 86 L 2590, 1986 U.S. Dist. LEXIS 16203 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,227 at 96,084 (N.D. Ill. Dec. 19, 1986); *Erickson v. Kiddie*, No. C-85-4789-MHP, 1986 U.S. Dist. LEXIS 28941, Fed. Sec. L. Rep. (CCH) P 93,889 at 95,959 (N.D. Cal. Feb. 24, 1986); *Alfaro v. E.F. Hutton & Co.*, 606 F. Supp. 1100, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,074 (E.D. Pa. 1985); *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 596, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,251 at 91,758 (E.D. Mich. 1985). Contra *Jackson v. Daniels*, No. 84-1329-M Civil, 1985 U.S. Dist. LEXIS 20782, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,045 (D.N.M. 1985).

(n4)Footnote 4. *Anixter v. Home-Stake Prod. Co.*, 939 F.2d 1420 (10th Cir. 1991), vacated sub nom, *Dennler v. Trippet*, 503 U.S. 978 (1992); contra *Tregenza v. Great Am. Communications Co.*, 12 F.3d 717, 718 (7th Cir. 1993).

(n5)Footnote 5. *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 596, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,251 at 91,759 (E.D. Mich. 1985); *Alfaro v. E.F. Hutton & Co.*, 606 F. Supp. 1100, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,074 (E.D. Pa. 1985).

(n6)Footnote 6. *Allred v. Whatley*, No. C83-2449 A, 1985 U.S. Dist. LEXIS 19174, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,259 (N.D. Ga. June 5, 1985); *Davis v. Whatley*, No. C83-865 A, 1985 U.S. Dist. LEXIS 19175, Fed. Sec. L. Rep. (CCH) P 92,260 (N.D. Ga. June 5, 1985).

(n7)Footnote 7. See, e.g., *Cantor Fitzgerald, Inc. v. Lutnick*, 99 Civ. 4008 (LAP), 2001 U.S. Dist. LEXIS 999 (S.D.N.Y. Feb. 8, 2001) (plaintiffs failed to allege adequately their own required due diligence where they alleged no specific inquiry); *In re Rexplore, Inc. Sec. Litig.*, Fed. Sec. L. Rep. (CCH) 93,561, 97,519, 671 F. Supp. 679 (N.D. Cal. 1987). In *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, (2d Cir. 1991), the court held that a shareholder of a closed-end investment company who monitored the market price of the shares after purchase did not exercise reasonable diligence in light of the disclosure in the prospectus that the market price might be maintained artificially.

(n8)Footnote 8. *Lincoln Nat'l Life Ins. Co. v. Silver*, 114 F.3d 1191 (7th Cir. 1997). See also *Morris v. Bischoff*, No. 96-1384-CIV-T-17A, 1997 U.S. Dist. LEXIS 3176 (M.D. Fla. Mar. 4, 1997) (noting that the statute of limitations is an affirmative defense). Contra *In re Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314 (S.D.N.Y. 2001) (stating that the Section 13 statute of limitations is not an affirmative defense against claims of Section 11: "Defendants correctly argue that for § 10(b) claims, failure to comply with the applicable statute of limitations is an affirmative defense, but for § 11

claims the statute is an affirmative pleading requirement." *Id.* at 336 n.15).

(n9)Footnote 9. For a discussion of the extent to which the statute of limitations for claims arising under this section was changed by the Sarbanes-Oxley Act of 2002, see § 9.05[6] of this chapter.

(n10)Footnote 10. See, e.g., *Great Rivers Coop. v. Farmland Indus., Inc.*, 120 F.3d 893 (8th Cir. 1997) ; *Caviness v. Derand Res. Corp.*, 983 F.2d 1295 (4th Cir. 1993) ; *Westinghouse Electric Corp. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,647 at 96,986 (S.D.N.Y. 1993), quoting *In re Ames Dep't Stores, Inc. Note Litig.*, 991 F.2d 968 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. P 97,411 (2d Cir. 1993). See also *In re VMS Sec. Litig.*, 752 F. Supp. 1373 , [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,278 (N.D. Ill. 1990).

(n11)Footnote 11. See, e.g. *In re USEC Sec. Litig.*, 190 F. Supp. 2d 808 (D. Md. 2002) ; *In re Ultrafem Inc. Sec. Litig.*, 91 F. Supp. 2d 678 (S.D.N.Y. 2000) ; *In re Ames Dep't Stores, Inc. Note Litig.*, 991 F.2d 968 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. P 97,411 (2d Cir. 1993); *Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,647 at 96,986 (S.D.N.Y. 1993).

(n12)Footnote 12. See, e.g., *Fuqua v. Ernst & Young L.L.P.*, Fed. Sec. L. Rep. (CCH) 91,768, 33 Fed. Appx. 569 (2d Cir. 2002); *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314 (S.D.N.Y. 2001) ; *Caprin v. Simon Transp. Servs.*, 112 F. Supp. 2d 1251 (D. Utah 2000) ; *Tregenza v. Great Am. Communications Co.*, 823 F. Supp. 1409 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,745 at 97,558 (N.D. Ill. 1993); *Buder v. Merrill Lynch Pierce, Fenner & Smith*, 644 F.2d 690, 692 , [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,879 (8th Cir. 1981); *Koke v. Stifel Nicolaus & Co., Inc.*, 620 F.2d 1340, 1342-45 , [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,391 (8th Cir. 1980); *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 682 , [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,296 (9th Cir. 1980); *Gaudin v. KDI Corp.*, 576 F.2d 708, 712 , [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,453 (6th Cir. 1978); *Murray v. Shearson Hayden Stone, Inc.*, 524 F. Supp. 304, 305-06 , [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,403 (N.D. Ga. 1980); *Bresson v. Thomson McKinnon Sec., Inc.*, 641 F. Supp. 338, 345 , [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,855 (S.D.N.Y. 1986). Of course, not every adverse development is, as a matter of law, sufficient to place investors on inquiry notice. The alleged "storm warning" must directly relate to the misrepresentations or omissions the plaintiff later alleges. "Thus, courts have generally found that a storm warning must contradict the allegedly false or misleading statement." *In re Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314, 337 (S.D.N.Y. 2001) ; see also *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161 (2d Cir. Jan. 20, 2005) (holding, in the context of a Section 10(b) claim, that "non-specific public pronouncements" were not enough and that "inquiry notice can be established only where the triggering data relates directly to the misrepresentations and omissions alleged."); *In re Ames Dep't Stores, Inc. Note Litig.*, 991 F.2d 968 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,411 (2d Cir. 1993).

(n13)Footnote 13. *Davidson v. Wilson*, 973 F.2d 1391 , [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,979 at 94,238-39 (8th Cir. 1992).

(n14)Footnote 14. See, e.g., *In re CBT Group PLC Sec. Litig.*, No. C-98-21014-RMW, 2000 U.S. Dist. LEXIS 19214, Fed. Sec. L. Rep. (CCH) P 91,317 (N.D. Cal. Dec. 29, 2000); *Slavin v. Morgan Stanley & Co., Inc.*, 791 F. Supp. 327 , [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,885 at 93,615 (D. Mass. 1992).

(n15)Footnote 15. *CBT Group PLC Sec. Litig.*, 2000 U.S. Dist. LEXIS 19214, at *18-19 .

(n16)Footnote 16. *CBT Group*, 2000 U.S. Dist. LEXIS 19214, at *18-19 .

(n17)Footnote 17. *CBT Group*, 2000 U.S. Dist. LEXIS 19214, at *18-19 .

(n18)Footnote 18. *Nelson v. Chapman & Cutler*, No. 83 C 8583, 1984 U.S. Dist. LEXIS 14982 [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,808 (N.D. Ill. July 12, 1984).

(n19)Footnote 19. *CBT Group, 2000 U.S. Dist. LEXIS 19214, at *18-19* .

(n20)Footnote 20. *Cross v. 21st Century Holding Co.*, 00 Civ. 4333 (AGS), *2001 U.S. Dist. LEXIS 11189, at *17* (S.D.N.Y. Aug. 6, 2001) (statute began to run "as to their entire section 11 claim" when plaintiffs had notice of some incorrect financial information and misstatements in defendant's registration statement); see also *Sterlin v. Biomune Sys.*, 154 F.3d 1191 (10th Cir. 1998) ; *Kennedy v. Josephthal & Co., Inc.*, 814 F.2d 798 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,186 at 95,861 (1st Cir. 1987) (contradiction between offering memorandum and oral representations started the running of the statute of limitations); *DeBruyne v. Equitable Life Assurance Soc'y*, 920 F.2d 457 , [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,708 (7th Cir. 1990) (retirement plan participants' claims were time barred since the participants possessed, but failed to read, the documents that would have put them on inquiry notice of the fraud); *Wafra Leasing Corp. 1999- A-1 v. Prime Capital Corp.*, 192 F. Supp. 2d 852 (N.D. Ill. 2002) (defendants had not demonstrated how the plaintiff was on inquiry notice, though conceding that the plaintiffs did not need to know all details of the alleged fraud to be charged with knowledge); *Erickson v. Kiddie*, No. C-85-4789-MHP, 1986 U.S. Dist. LEXIS 28941, Fed. Sec. L. Rep. (CCH) P 93,889 at 95,960 (N.D. Cal. Feb. 24, 1986) (discussing the meaning of "inquiry notice").

(n21)Footnote 21. Compare *In re Merck & Co., Inc. Sec. Derivative & "ERISA" Litig.*, 543 F.3d 150 , [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,834 (3d Cir. 2008), cert. granted, 129 S. Ct. 2432, 174 L. Ed. 2d 227 (2009) and *Betz v. Trainer Wortham & Co.*, 519 F.3d 863 , [2007-2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,588 (9th Cir. 2008) (requiring evidence of scienter) with *Theoharous v. Fong*, 256 F.3d 1219 , [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,472 (11th Cir. 2001) and *Sterlin v. Biomune Sys.*, 154 F.3d 1191 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 90,279 (10th Cir. 1998) (not requiring evidence of scienter).

(n22)Footnote 22. 129 S. Ct. 2432, 174 L. Ed. 2d 227 (2009) .

(n23)Footnote 23. *Westinghouse Elec. Corp. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,647 at 96,987 (S.D.N.Y. 1993); *Berry v. Valence Tech., Inc.*, 175 F.3d 699, 706 (9th Cir. 1999) ; *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1204 (10th Cir. 1998) ; *Great Rivers Coop. v. Farmland Indus.*, 120 F.3d 893, 898 (8th Cir. 1997) .

(n24)Footnote 24. See, e.g., *Berry v. Valence Tech., Inc.*, 175 F.3d 699 (9th Cir. 1999) ; *In re Integrated Res. Real Estate Ltd. P'ships Sec. Litig.*, 815 F. Supp. 620 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,311 at 95, 546-47 (S.D.N.Y. 1993) and cases cited therein.

(n25)Footnote 25. See, e.g., *In re USEC Sec. Litig.*, 190 F. Supp. 2d 808 (D. Md. 2002) ; *Giant Group, Ltd. v. Sands*, 142 F. Supp. 2d 503 (S.D.N.Y. 2001) ; *Sterlin v. Biomune Sys.*, 960 F. Supp. 1531 (D. Utah 1997) , rev'd on other grounds by, 154 F.3d 1191 (10th Cir. 1998) .

(n26)Footnote 26. E.g., *Phillips v. Kidder, Peabody & Co.*, 782 F. Supp. 854 , [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,591 at 92,787 (S.D.N.Y. 1991); *In re Chaus Sec. Litig.*, No. 88 Civ. 8641 (SWK), 1990 U.S. Dist. LEXIS 15810 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,646 at 97,999 (S.D.N.Y. Nov. 20, 1990).

(n27)Footnote 27. See, e.g., *P. Stolz Family P'ship, L.P. v. Daum*, 01 Civ. 1254 (JSR), *2002 U.S. Dist. LEXIS 9494* (S.D.N.Y. May 29, 2002) , aff'd in part, rev'd in part, 355 F.3d 92 (2d Cir. 2004) ; *Ballenger v. Applied Digital Solutions Inc.*, 189 F. Supp. 2d 196 (D. Del. 2002) ; *Griffin v. PaineWebber Inc.*, 84 F. Supp. 2d 508 (S.D.N.Y. 2000) ; *Morley v. Cohen*, 610 F. Supp. 798, 815-16 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,277 at 91,912 (D. Md. 1985); *LeCroy v. Dean Witter Reynolds, Inc.*, 585 F. Supp. 753, 760 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,503 at 98,257. (E.D. Ark. 1984); *Campito v. McManus, Longe, Brockwehl, Inc.*, 470 F. Supp. 986, 995 , [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,874 at 95,575 (N.D.N.Y. 1979); *Fischer v. Int'l Tel. & Tel. Corp.*, 391 F. Supp. 744, 747 , [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,027 at 97,590 (E.D.N.Y. 1975); *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154, 1173 , [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P

94,548 at 95,890 (S.D.N.Y. 1974).

(n28)Footnote 28. See, e.g., *Hudson v. Capital Mgmt. Int'l, Inc.*, No. C-81-1737-MHP, 1982 U.S. Dist. LEXIS 10070 [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,221 at 95,896 n.3 (N.D. Cal. Jan. 6, 1982); *In re Bestline Prod. Sec. & Antitrust Litig.*, No. MDL 162-CIV-JLK, 1975 U.S. Dist. LEXIS 13231 [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,070 (S.D. Fla. Mar. 21, 1975).

(n29)Footnote 29. See *Bradford v. Moench*, 809 F. Supp. 1473 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,400 at 96,156-58 (N.D. Utah 1992). But see *Ballenger v. Applied Digital Solutions Inc.*, 189 F. Supp. 2d 196, 200 (D. Del. 2002) (noting that the argument that the statute runs from the time of offering to the plaintiff "has been rejected by several courts").

(n30)Footnote 30. *P. Stolz Family P'ship, L.P. v. Daum*, 01 Civ. 1254 (JSR), 2002 U.S. Dist. LEXIS 9494 (S.D.N.Y. May 29, 2002) , aff'd in part, rev'd in part, 355 F.3d 92 (2d Cir. 2004) ; *Ballenger v. Applied Digital Solutions Inc.*, 189 F. Supp. 2d 196 (D. Del. 2002) ; *Griffin v. PaineWebber Inc.*, 84 F. Supp. 2d 508 (S.D.N.Y. 2000) ; *In re IKON Office Solutions, Inc.*, 66 F. Supp. 2d 622 (E.D. Pa. 1999) . See also § 9.05 [5] infra.

(n31)Footnote 31. For a discussion of the extent to which the statute of limitations for claims arising under this section was changed by the Sarbanes-Oxley Act of 2002, see § 9.05[6] of this chapter.

(n32)Footnote 32. *In re Nat'l Mort. Equity Corp. Mortgage Pool Certificates Sec. Litig.*, 682 F. Supp. 1073 , [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,529 at 97,345 (C.D. Cal. 1987); *Feinberg v. Leighton*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,117 at 95,502 (S.D.N.Y. 1987); *Doran v. Petroleum Mgmt. Corp.*, 576 F.2d 91, 93 , [1978 Transfer Binder] Fed. L. Rep. (CCH) P 96,491 at 93,826 (5th Cir. 1978); *LeCroy v. Dean Witter Reynolds, Inc.*, 585 F. Supp. 753 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,503 (E.D. Ark. 1984).

(n33)Footnote 33. *Raiford v. Buslease, Inc.*, 825 F.2d 351 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,363 at 96,878 (11th Cir. 1987); *Meadows v. Pacific Inland Sec. Corp.*, 36 F. Supp. 2d 1240 (S.D. Cal. 1999) ; *Scott v. Steingold*, No. 97C7871, 1999 U.S. Dist. LEXIS 12426 (N.D. Ill. Aug. 6, 1999) .

(n34)Footnote 34. *Raiford v. Buslease, Inc.*, 825 F.2d 351 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,363 at 96,878 (11th Cir. 1987).

(n35)Footnote 35. *Toombs v. Leone*, 777 F.2d 465 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,394 (9th Cir. 1985).

(n36)Footnote 36. *Sheldon v. Vermonty*, 53 F. Supp. 2d 1157 (D. Kan. 1999) , aff'd in part, rev'd in part, 246 F.3d 682 (10th Cir. 2000) ; *Koehler v. Pulvers*, 606 F. Supp. 164, 166-167 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,935 at 90,654 (S.D. Cal. 1985).

(n37)Footnote 37. *Amoroso v. S.W. Drilling Multi-Rig P'ship No. 1*, 646 F. Supp. 141 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,153 at 95,702 (N.D. Cal. 1986).

(n38)Footnote 38. *Holloway v. Combined Equities, Inc.*, 628 F. Supp. 59 , [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,745 (M.D. La. 1986).

(n39)Footnote 39. *Hsu v. Leaseway Transp. Corp.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,043 (N.D. Cal. 1985). With respect to the application of the "investment decision" and "integrated offering" doctrines, see § 9.05[2][c][ii] infra.

(n40)Footnote 40. *Bradford v. Moench*, 809 F. Supp. 1473 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH)

P 97,400 at 96,156 (D. Utah 1992).

(n41)Footnote 41. *P. Stolz Family P'ship, LP v. Daum*, No. 01 Civ. 1254 (JSR), 2002 U.S. Dist. LEXIS 9494, at *3 (S.D.N.Y. May 29, 2002), aff'd in part, rev'd in part, 355 F.3d 92 (2d Cir. 2004).

(n42)Footnote 42. *Morse v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 619, 621-22, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,444 (S.D.N.Y. 1977).

(n43)Footnote 43. See *Ballenger v. Applied Digital Solutions Inc.*, 189 F. Supp. 2d 196, 200 (D. Del. 2002) (finding that claims were barred where the stock was first offered seven years ago, even though "the ... plaintiffs filed their claim within one year of the alleged violation ..."); *LeCroy v. Dean Witter Reynolds, Inc.*, 585 F. Supp. 753, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,503 (E.D. Ark. 1984).

(n44)Footnote 44. For a discussion of the extent to which the statute of limitations for claims arising under this section was changed by the Sarbanes-Oxley Act of 2002, see § 9.05[6] of this chapter.

(n45)Footnote 45. See § 9.05[2][a][i] *supra*.

(n46)Footnote 46. *Isanaka v. Spectrum Techs. USA Inc.*, 131 F. Supp. 2d 353 (N.D.N.Y. 2001); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890-91 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,548 at 92,610 (2d Cir. 1972); *Bormann v. Applied Vision Sys., Inc.*, 800 F. Supp. 800, (CCH) [1992-1993 Transfer Binder] Fed. Sec. L. Rep. P 97,243 at 95,084 (D. Minn. 1992); *Brantley v. E.F. Hutton & Co.*, 710 F. Supp. 135, 140, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,429 (E.D. Pa. 1989); *Nielsen v. Prof'l Fin. Mgmt., Ltd.*, 682 F. Supp. 429 (D. Minn. 1987).

(n47)Footnote 47. *Goodman v. Epstein*, 582 F.2d 388, 409-14, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,500 at 93,303 (7th Cir. 1978); *Hill v. Equitable Bank, N.A.*, 599 F. Supp. 1062, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,824 at 90,148 (D. Del. 1984); *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154, 1183-84, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,548 at 95,898 (S.D.N.Y. 1974).

(n48)Footnote 48. Compare *Hill v. Equitable Bank, N.A.*, 599 F. Supp. 1062, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,824 (D. Del. 1984) (applying investment decision doctrine) with *Davis v. Whatley*, No. C83-865 A, 1985 U.S. Dist. LEXIS 19175 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,260 (N.D. Ga. June 5, 1985) (refusing to apply the investment decision doctrine). See also *Lewis v. Schultz*, No. LR-C-85-268, 1985 U.S. Dist. LEXIS 15686 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,363 (E.D. Ark. 1985) (payments for securities on an installment basis do not constitute separate sales of securities).

(n49)Footnote 49. Sec. Act Rel. No. 4552, 1 Fed. Sec. L. Rep. (CCH) P 2781 (1962).

(n50)Footnote 50. See *Currie v. Cayman Res. Corp.*, 595 F. Supp. 1364, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,900 (N.D. Ga. 1984), aff'd in part and rev'd in part, 835 F.2d 780, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,591 (11th Cir. 1988); *Hill v. Equitable Bank, N.A.*, 599 F. Supp. 1062, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,824 (D. Del. 1984).

(n51)Footnote 51. See *Caviness v. DeRand Res. Corp.*, 983 F.2d 1295, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,354 at 95,802 (4th Cir. 1993); *Bresson v. Thomson McKinnon Sec., Inc.*, 641 F. Supp. 338, 344, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,855 (S.D.N.Y. 1986).

(n52)Footnote 52. *Caviness v. Derand Res. Corp.*, 983 F.2d 1295, 1301 (4th Cir. 1993).

(n53)Footnote 53. See, e.g., *Rothman v. Gregor*, 220 F.3d 81, 98 n.1 (2d Cir. 2000); *Sterlin v. Biomune Sys., Inc.*, 154 F.3d 1191 (10th Cir. 1998); *Caviness v. DeRand Res. Corp.*, 983 F.2d 1295, [1992-1993 Transfer Binder]

Fed. Sec. L. Rep. (CCH) P 97,354 at 95,803 (4th Cir. 1993); *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385, 1391, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,379 (7th Cir. 1990); *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1308, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,722 (9th Cir. 1982); *Summer v. Land & Leisure, Inc.*, Fed. Sec. L. Rep. (CCH) 98,391, 92,369, 664 F.2d 965, 968 (5th Cir. 1981); *Griffin v. PaineWebber Inc.*, 84 F. Supp. 2d 508 (S.D.N.Y. 2000); *Green v. Fund Asset Mgmt., L.P.*, 19 F. Supp. 2d 227, 232 n.9 (D.N.J. 1998); *Snyder v. Newhard, Cook & Co., Inc.*, 764 F. Supp. 612, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,047 at 90,271 (D. Colo. 1991); *In re Rexplore, Inc. Sec. Litig.*, 671 F. Supp. 679, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,561 at 97,578 (N.D. Cal. 1987); *Turner v. First Wisc. Mortgage Trust*, 454 F. Supp. 899, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,598 (E.D. Wis. 1978); *Brick v. Dominion Mort. & Realty Trust*, 442 F. Supp. 283, 289-91, Fed. Sec. L. Rep. (CCH) P 96,449 (W.D.N.Y. 1977). This is probably subject to an exception for waiver agreements between the parties to the litigation. *ESI Montgomery Cty., Inc. v. Mountenay Int'l Corp.*, Fed. Sec. L. Rep. (CCH) 98,817, 899 F. Supp. 1061 (S.D.N.Y. 1995).

(n54)Footnote 54. See, e.g., *Blatt v. Merrill Lynch, Pierce, Fenner & Smith*, 916 F. Supp. 1343, 1352 (D. N.J. 1996).

(n55)Footnote 55. *McCullough v. Leede Oil & Gas, Inc.*, 617 F. Supp. 384, 386-387, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,475 (W.D. Okla. 1985) (collecting cases); *In re Rexplore, Inc. Sec. Litig.*, 671 F. Supp. 679, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,561 at 97,578 (N.D. Cal. 1987) (one-year period in Section 12(a)(1) cannot be tolled).

(n56)Footnote 56. See Fed. Rule. Civ. P. 15(c)(2); *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 840 (S.D. Tex. 2004); *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 336 (S.D.N.Y. 2001).

(n57)Footnote 57. See 28 U.S.C. § 1658(b).

(n58)Footnote 58. 28 U.S.C. § 1658(b)

(n59)Footnote 59. 15 U.S.C. § 78(c)(a)(47).

(n60)Footnote 60. See *Newby v. Enron Corp. (In re Enron Corp. Sec. Deriv. & ERISA Litig.)*, 2004 U.S. Dist. LEXIS 8158, at *46-51 (S.D.Tex. Feb. 24, 2004). Other courts, however, have held that Sarbanes-Oxley did not change the statute of limitations applicable to these sections because such claims on their face are not claims of "fraud, deceit, manipulation, or contrivance." See *Lawrence E. Jaffe Pension Plan v. Household Intern., Inc.*, No. 02 C 5893, 2004 U.S. Dist. LEXIS 18993, at **31-43 (N.D. Ill. Mar. 19, 2004) (Sections 11 and 12(a)(2)); *Alaska Dep't of Revenue v. Ebbers (In re WorldCom, Inc. Sec. Litig.)*, 294 F. Supp. 2d 431, 439-44 (S.D.N.Y. 2003) (Sections 11 and 12(a)(2)); *In re Interbank Funding Corp. Sec. Litig.*, 329 F. Supp. 2d 84, 95 (D.D.C. 2004) (Section 12(a)(1)). See also *In re Firstenergy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 601 (N.D. Ohio 2004) ("However, the Sarbanes-Oxley Act is expressly limited to 'claim[s] of fraud, deceit, manipulation or contrivance.' Since fraud is not a required element for claims under §§ 11 or 12(a)(2), the court concludes that Sarbanes-Oxley Act does not extend the limitations period for these claims."); *Ato Ram, II, Ltd. v. SMC Multimedia Corp.*, No. 03 Civ. 5569 HB, 2004 U.S. Dist. LEXIS 5810, at *15-16 (S.D.N.Y. April 7, 2004) ("Although the Exchange Act § 3(a)(47) defines securities laws to include both the Securities Act and Exchange Act, Sarbanes-Oxley did not extend the statute of limitations for Securities Act § 12 violations."); *Friedman v. Rayovac Corp.*, 295 F. Supp. 2d 957, 975 (W.D. Wis. 2003) ("I agree with defendant Partners that the statute of limitations has expired for plaintiffs' claims against it under the 1933 Act."); *In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 197 (S.D.N.Y. 2003) ("[B]y its plain text, the amendment does not apply to claims under sections 11 and 15"); *In re Worldcom, Inc. Sec. Litig.*, 294 F. Supp. 2d 431, 444 (S.D.N.Y. 2003) ("This language [Sec. 804] does not encompass Sections 11 and 12(a)(2) claims.").

(n61)Footnote 61. In *Aetna Life Ins. Co. v. Enter. Mortgage Acceptance Co. (In re Enter. Mortgage Acceptance Co.)*, 391 F.3d 401, 408 (2d Cir. 2004), the Second Circuit held, in a case of first impression, that Section 804's two

year/five year statute of limitations did not apply retroactively to revive claims that were time-barred prior to the effective date of the Sarbanes-Oxley statute of July 30, 2002. Consequently, any claim that expired prior to the effective date of Section 804 under the one year/three year statute of limitations will remain time-barred, even if it otherwise would have been timely if the two year/five year statute had been applied. *See also Champion v. Homa, No. 03-275, 2008 U.S. Dist. LEXIS 27374, at *45*, [2007-2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,623, at 94,345 (M.D. Ala. March 31, 2008).

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



142 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.06

§ 9.06 Absence of Implied Right of Action under Section 17(a)

Section 17(a) of the Securities Act applies to secondary market transactions in a company's securities, as well as public offerings and private placements, and makes it unlawful for any person in the offer or sale of securities:

- (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 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. n1

Section 17(a) is a general antifraud provision, similar to Section 10(b) of the Securities Exchange Act and *Rule 10b-5* thereunder. n2 Although the elements of a Section 17(a) claim are similar to the elements for *Rule 10b-5*, there are some important differences. For example, scienter is not required for an action under Section 17(a)(2) or (3), although it is required to establish a violation of Section 17(a)(1). n3 Further, some commentators have found that Section 17(a)'s "in the offer or sale" requirement may be broader than Section 10(b)'s "in connection with the purchase or sale requirement." n4

Another important difference is that courts have consistently held that there is no implied private right of action under Section 17(a). n5 Although the Supreme Court has not reached the issue, it is highly likely that the Court would refuse to find an implied private right of action under Section 17(a). For example, in *Transamerica Mortgage Advisors, Inc. v. Lewis*, n6 the Court held that Section 206 of the Investment Advisers Act of 1940, which contains language closely following that of Section 17(a), did not confer an implied private right of action. In reaching its decision, the Court, noting that "what must ultimately be determined is whether Congress intended to create the private remedy asserted,"

relied on the "elemental canon of statutory construction that where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it." n7 Since the Investment Advisers Act expressly provides for criminal prosecutions and administrative enforcement of Section 206 (just as the 1933 Act provides for criminal prosecutions and administrative enforcement of Section 17(a)), the Court concluded: "In view of these express provisions for enforcing the duties imposed by § 206, it is highly improbable that Congress absentmindedly forgot to mention an intended private action." n8 The Court similarly deduced, from Congress' express provision for private damages actions under other securities laws, that the absence of such express provision under Section 206 demonstrated an intent not to imply such remedies under that statute. "Obviously," the Court noted, "when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly." n9

Five months prior to the *Transamerica* decision the Court decided *Touche Ross & Co. v. Redington*. n10 In *Redington*, the Supreme Court held that the broker-dealer record-keeping provisions of Section 17(a) of the Securities Exchange Act do not confer a private right of action. The Court viewed the fact that Section 17(a) of the Securities Exchange Act (like Section 17(a) of the 1933 Act) is "flanked by provisions ... that explicitly grant private causes of action" n11 as evidence that Congress did not intend to create a similar right under that particular provision." Likewise, many of the provisions surrounding Section 17(a) of the 1933 Act explicitly confer private rights of action. n12

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77(q).

(n2)Footnote 2. See *SEC v. Gottlieb*, 88 Fed. Appx. 476 (2d Cir. 2004) , cert. denied, 125 S. Ct. 629 (2004) (stating that essentially the same elements are required under Section 17(a) as under Section 10(b) of the 1934 Act).

(n3)Footnote 3. See *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980) . See also Loss & Seligman, Fundamentals of Securities Regulation, 1299-1300.

(n4)Footnote 4. See Loss & Seligman, Fundamentals of Securities Regulation, 1299-1300.

(n5)Footnote 5. See, e.g., *Maldonado v. Dominguez*, 137 F.3d 1, 6-7 (1st Cir. 1998) (stating that in recent years every circuit to have addressed the issue has refused to recognize a private right of action under Section 17(a)); *Finkel v. Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992) (concluding that there is no private right of action under Section 17(a) and noting that Circuit courts construing Section 17(a) since the 1980s have uniformly come to this conclusion); see also *Kauther SDN BHD v. Sternberg*, 149 F.3d 659, 662 (7th Cir. 1998) ; *Layman v. Bryant*, No. 94-16391, No. 94-17067, No. 94-17070, No. 95-15343, No. 95-15344, No. 97-15340, 1997 U.S. App. LEXIS 11446, at *5-6 (9th Cir. May 14, 1997) ; *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 942-43 , [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,174 (7th Cir. 1989); *Newcome v. Esrey*, Fed. Sec. L. Rep. (CCH) 94,106, 862 F.2d 1099, 1104-07 (4th Cir. 1988) (en banc); *Krause v. Perryman*, 827 F.2d 346 , [1987 Transfer Binder] Fed. Sec. L. Rep. P 93,356 (8th Cir. 1987); *Brannan v. Eisenstein*, 804 F.2d 1041, 1043, n.1 , [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,978 (8th Cir. 1986); *Abell Credit Corp. v. Bank of Am. Sec., L.L.C.*, No. 01 C 2227, 2001 U.S. Dist. LEXIS 14643, at *13 (N.D. Ill. Sept. 13, 2001) ; *Dafotin Holdings S.A. v. Hotelworks.com, Inc.*, No. 00 Civ. 7861, Fed. Sec. L. Rep. (CCH) 91,529, 2001 U.S. Dist. LEXIS 12347 at * 23 (S.D.N.Y. Aug. 17, 2001); but see *James v. McCoy*, 56 F. Supp. 2d 919, 927-28 (S.D. Ohio 1998) (granting private cause of action for purchasers under Section 17(a)).

(n6)Footnote 6. Fed. Sec. L. Rep. (CCH) 97,163, 444 U.S. 11, 100 S. Ct. 242, 62 L. Ed. 2d 146 (1979).

(n7)Footnote 7. *Transamerica Mortgage Advisors, Inc.*, 444 U.S. at 15-16, 19.

(n8)Footnote 8. *Transamerica Mortgage Advisors, Inc.*, 444 U.S. at 20 (internal quotations and citation omitted).

(n9)Footnote 9. *Transamerica Mortgage Advisors, Inc.*, 444 U.S. at 21, quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 572 (1979) .

(n10)Footnote 10. 442 U.S. 560, 99 S. Ct. 2479, 61 L. Ed. 2d 82 , [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,894 (1979).

(n11)Footnote 11. *Touche Ross & Co.*, 422 U.S. at 571-572.

(n12)Footnote 12. The wording and legislative history of the 1933 Act also weigh against finding a private right of action under Section 17(a). The statutory scheme of the 1933 Act, which provides comprehensive private damage remedies under Sections 11 and 12, is strong proof that additional private damage remedies should not be read into the statute. When describing the specific sections that would give rise to civil liability under the 1933 Act, Congress stated only that "Sections 11 and 12 create and define the civil liabilities imposed by the act," H.R. Rep. No. 73-85, at 9-10 (1933), with no mention of Section 17.

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



143 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.07

§ 9.07 Arbitration of Securities Act Claims

In 1989, in *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*,ⁿ¹ the Supreme Court overruled a thirty-six year old precedent by holding that predispute agreements to arbitrate 1933 Act claims are enforceable. The Court explained that its prior anti-arbitration stance was wrongly predicated on a "judicial hostility" that has "fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes." ⁿ² *Rodriguez* essentially harmonized the treatment of Securities Act arbitration claims with those made pursuant to the Exchange Act. ⁿ³

The increasing application of arbitration clauses to securities claims has led to an upgrading of the arbitration rules issued by the New York Stock Exchange, the American Stock Exchange, and the Financial Industry Regulatory Authority ("FINRA"), which replaced the National Association of Securities Dealers, Inc. ("NASD"). These changes established minimum qualifications for so-called "public arbitrators," compelled arbitrators to disclose background information and potential conflicts of interest, provided broader discovery rights, required that a record be made of each arbitration hearing, and expanded the content and public availability of arbitration awards. Five days before the *Rodriguez* decision, the Securities Exchange Commission announced its approval of these modifications. ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. 490 U.S. 477, 109 S. Ct. 1917, 104 L. Ed. 2d 526 (1989) .

(n2)Footnote 2. *Rodriguez de Quijas*, 490 U.S. at 481.

(n3)Footnote 3. Two years earlier, the Court enforced an arbitration agreement brought under Section 10(b) of the Exchange Act. See *Shearson/Amer. Express, Inc. v. McMahon*, 482 U.S. 220 (1987) . Because the Court did not expressly address the 1933 Act, however, a number of lower courts had continued to hold that agreements to arbitrate claims under the Securities Act remained unenforceable. In conjunction, the Court made clear that both Securities Act and Exchange Act claims are subject to mandatory arbitration agreements.

(n4)Footnote 4. Sec. Exch. Act Rel. 26805, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,414 (SEC May 10, 1989).

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other

matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



144 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 9 Civil Liabilities under the Securities Act *

2-9 Federal Securities Act of 1933 § 9.08

§ 9.08 Class Actions

[1] Introduction

No discussion of the 1933 Act's civil liability provisions would be complete without some mention of the class action. Courts routinely have accepted class actions as a bona fide method for redressing securities law violations. n1 As one court has stated, "[j]udicial sentiment overwhelmingly favors utilizing the expedient of class representation for plaintiffs claiming securities law violations." n2 Whether or not justified, the approach followed by many courts is that "in a doubtful case any error should be committed in favor of allowing the securities class action." n3

[2] Requirements

[a] PSLRA Requirements

Before a class may be certified, the plaintiff must satisfy the requirements of Section 27(a) of the 1933 Act, added as part of the PSLRA in 1995. Section 27(a) sets forth the procedure for the selection of the lead plaintiff who will serve as representative of the class.

Under Section 27(a)(2), each plaintiff seeking to serve as class representative must file with complaint a signed and sworn certification that:

- states that the plaintiff has reviewed the complaint and authorized its filing;
- states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action arising under the 1933 Act;
- states that the plaintiffs is willing to serve as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary;
- sets forth all of the transactions of the plaintiff in the security that is the subject of the complaint during the class period specified in the complaint;
- identifies any other action under the 1933 Act filed within three years of the date on which the

certification is signed by the plaintiff, in which the plaintiff has sought to serve, or has served, as a representative party on behalf of a class; and

- states that the plaintiff will not accept any payment for serving as a class representative beyond the plaintiff's pro rata share of any recovery, except as ordered or approved by the court.

Section 27(a)(2)(B) clarifies that the certification shall not constitute a waiver of the attorney-client privilege.

Beyond the required certification, Section 27(a)(3) sets forth the procedure for the appointment of the lead plaintiff. Specifically, within 20 days of the filing of the complaint, the plaintiffs must provide notice to members of the purported class, in a "widely circulated national business-oriented publication or wire service," n4 (1) of the pendency of the action, the claims asserted therein, and the purported class period, and (2) that within 60 days of the notice, any member of the purported class may move the court to serve as lead plaintiff. n5 Within 90 days of the notice, the court is to appoint a lead plaintiff (from among those moving the court for such designation) that the court determines to be "most capable of adequately representing the interests of class members." n6 The selected lead plaintiff, subject to the approval of the court, is to select and retain counsel to represent the class. n7

In selecting the lead plaintiff, the court applies a rebuttable presumption that the "most adequate plaintiff" is the person or group that has the "largest financial interest in the relief sought by the class." n8 This presumption may be rebutted only by evidence that the purported class representative "will not fairly and adequately protect the interests of the class" or "is subject to unique defenses that render such plaintiff incapable of adequately representing the class." n9 Plaintiffs seeking to rebut the presumption are permitted discovery to support their objection, but only upon demonstrating a "reasonable basis" for their contention that the presumptive lead plaintiff "is incapable of adequately representing the class." n10

Unless otherwise permitted by the court, no person may serve as lead plaintiff (or as an officer, director, or fiduciary of a lead plaintiff) in more than 5 securities class actions brought under the Federal Rules of Civil Procedure during any 3-year period. n11

Courts have highlighted the importance of judicial involvement in the selection of lead plaintiffs and lead counsel. In *In re Razorfish, Inc. Sec. Litig.*, Judge Rakoff of the Southern District of New York acknowledged that "securities class litigation continues to be lawyer-driven in material respects and the reforms Congress contemplated in the Reform Act can be achieved, if at all, only with some help from the courts." n12 In *Razorfish*, Judge Rakoff rejected lead plaintiff bids by three competing groups, each of which he labeled "an artifice cobbled together by cooperating counsel for the obvious purpose of creating a large enough grouping of investors to qualify as 'lead plaintiff'" n13 Selecting one, he held, would "allow and encourage lawyers to direct the litigation." n14 Instead, he chose from the competing "groups" the institutional *investor* with the greatest purported loss and ordered that it fulfill its own fiduciary duty to select lead counsel as required by the PSLRA. The Fifth Circuit in *Berger v. Compaq Computer Corp.* became the first appellate court to endorse this active role mandated by the PSLRA for the courts to ensure that lead plaintiffs are capable of directing the litigation. The *Berger* court determined that "because absent class members are conclusively bound by the judgment in any class action brought on their behalf, the court must be especially vigilant to ensure that the due process rights of all class members are safeguarded through adequate representation at all times." n15

Courts have also taken a more active role in the selection of counsel for lead plaintiffs in securities class actions. Thus, some courts have rejected lead plaintiffs' selections of counsel where they found that the lead plaintiffs had failed to discharge their duty to retain counsel on terms favorable to the class. n16 To this end, some courts have adopted a competitive bidding process for the selection of lead counsel, theorizing that this approach balances the PSLRA's desire to have the lead plaintiff select lead counsel with the class objective of securing cost-effective representation for the class through a competitive selection process. n17 The position is by no means universally accepted, however. At least one appellate court has held the auction approach to be "inappropriate in the typical [PSLRA] case." n18 Instead, as

another court has held, "modest intervention," unlike an auction system, "is fully consistent with the mandate of the Reform Act that the lead plaintiff's selection and retention of counsel be subject to a court approval." n19

Finally, courts recently have considered the role of defendants in the selection process for lead plaintiffs and counsel. Not surprisingly, courts have taken differing positions on this issue. Thus, courts precluding defendants from being heard generally cite to the PSLRA's procedural rules that permit only purported class members to seek lead plaintiff appointment. n20 Decisions permitting defendants to address the issue tend to reference a belief that courts benefit from hearing all views, regardless of whether defendants have official standing. n21 Other courts have expressed a belief that whether defendants should be heard depends on the nature of the objections raised, *i.e.*, whether the objections pertained to procedural irregularities or were merely directed to the choice of lead counsel. n22

[b] Rule 23 Requirements

In addition to the PSLRA, the purported class must also comply with Federal Rule of Civil Procedure 23. Rule 23 requires a party seeking class certification to demonstrate that:

- the class is so numerous that joinder of all members is impracticable;
 - there are questions of law or fact common to the class;
 - the claims or defenses of the representative parties are typical of the claims or defenses of the class;
- and
- the representative parties will fairly and adequately protect the interests of the class.

In addition, class representatives are obligated to satisfy one of Rule 23(b)'s three subsections. Thus, the representative must demonstrate either that:

- (1) the prosecution of separate actions by or against individual members of the class would create a risk of (a) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or (b) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests;
- (2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or
- (3) questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

Most securities class actions are brought under the third of these requirements, 26(b)(3), which requires a showing that questions of law or fact predominate over individual questions, and that the class action is superior to other methods for the fair and efficient adjudication of the controversy. n23

[3] Numerosity

The requirement that a class be so numerous that joinder of all members is impractical rarely poses an obstacle to class

certification in securities cases. In fact, "[n]umerosity is generally presumed when a claim involves nationally traded securities." n24 Because courts are reluctant to establish rigid rules for making numerosity determinations, n25 they usually rely on common sense when deciding if joinder is inconvenient. n26 Factors courts commonly consider include: (1) the nature of the action; (2) the size of the individual claims; (3) the inconvenience of trying individual suits; and (4) the ease with which class members can be identified. n27 When attempting to prove numerosity, a class representative need not provide the precise number or identity of the class members. n28 All that is required is a good faith estimate of class size. n29

[4] Commonality

Like numerosity, the commonality requirement generally is easy to establish in securities class actions. n30 Commonality does not require that class members share identical claims, it only mandates that at least one important question of law or fact exist that affects all members of the class. n31 In a securities case, the requirement usually is satisfied by an allegation that all members of the class were deceived by similar misrepresentations or omissions, and that they have a right to recover under a common theory of liability. n32

[5] Typicality

The typicality requirement focuses on whether the representative's claims or defenses are of the same general nature as those held by the class at large. n33 In other words:

[T]here must be a nexus between the class representative's claims or defenses and the common questions of fact or law which unite the class. A sufficient nexus is established if the claims or defenses of the class and the class representative arise from the same event or pattern or practice and are based on the same legal theory. Typicality, however, does not require identical claims or defenses. A factual variation will not render a class representative's claim atypical unless the factual position of the representative markedly differs from that of other members of the class. n34

This requirement tends to overlap the predominance factor discussed below. At least in Section 11 and 12(a)(2) litigation, a failure to demonstrate typicality rarely results in the denial of class certification, but may result in limiting the class. n35

Like the requirements discussed above, typicality is not a difficult obstacle to overcome in securities class actions. n36 As one court stated: "[t]he typicality requirement should be construed broadly. 'Differences in the amount of damage, the size or manner of [stock] purchase, the nature of the purchaser, and even the specific document influencing the purchase will not render a claim atypical in most securities cases.'" n37

In *Vitiello v. Cicconi (In re Data Access Sys. Sec. Litig.)*, n38 the defendants urged that the claims of 13 of 15 purported class representatives were atypical because they admitted that they did not rely on the company's allegedly false financial statements or prospectus. The court rejected this argument, stating that "differing types of reliance are present in almost every securities class action" and if "factual differences of this nature were sufficient to defeat class action certification, there could never be a class action of securities purchasers." n39

Moreover, with respect to a Section 11 subclass, the court held that a plaintiff who purchased stock directly from an underwriter in the initial public offering could represent persons who purchased in the aftermarket, as well as persons who purchased after the company's 12-month earnings statement was issued, and thus had a significantly more difficult burden of proving reliance. The court stated that it saw "no compelling analytic difference between those cases in which each plaintiff must prove that he or she relied and the present case where some plaintiffs will have to prove reliance and some will not." n40

[6] Adequacy

The adequacy requirement assures that a class representative fairly and adequately protects the interests of the class. Generally, adequacy exists if: "(1) the named representative [does] not have antagonistic or conflicting interests with the unnamed members of the class, and (2) the representative appears able to vigorously prosecute the interests of the class through qualified counsel." n41 A number of factors may persuade a court to deny class certification on adequacy grounds. Some examples include: class representatives being subject to a unique defense, n42 class representatives' ignorance of the case, n43 and class representatives' having not themselves purchased securities from defendants. n44

[7] Predominance

Although predominance is closely linked to commonality, the requirement forces the named plaintiffs to meet a much more demanding burden of proof. n45 The class representative must demonstrate that issues subject to generalized proof, and thus applicable to the class as a whole, are superior to those subject only to individualized proof. n46 The purpose of the predominance requirement is to measure whether a class is sufficiently cohesive to warrant certification. n47

Each predominance determination turns on the facts of the particular case. If the communications that are the subject of the securities fraud action are similar, then common issues about the accuracy of the statement and its materiality likely will predominate. Therefore, when a claim is based on a single allegedly misleading written document or small class of documents, the predominance standard usually is satisfied. n48 If, however, the communications are dissimilar, i.e. contained in non-standardized oral communications, predominance is less easily established. n49

[8] Superiority

For class certification to be granted, a class action must be superior to other means of adjudicating a plaintiff's claims. Federal Rule of Civil Procedure 23(b)(3) provides a nonexhaustive list of factors to consider when conducting a superiority inquiry. n50 These include: (1) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (2) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (3) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and (4) the difficulties likely to be encountered in the management of a class action. n51 Because securities litigation is usually characterized by a vast geographical dispersion of plaintiffs, representing a wide range of investment interests, class actions frequently are held to be superior to individual suits. n52

[9] Removal

Section 22(a) provides for concurrent state and federal jurisdiction over Securities Act claims. Pursuant to that section, claims arising under Sections 11 or 12 may be brought in either state or federal court, and claims brought in state court may not be removed to federal court. While seemingly straightforward, this provision has led to substantial uncertainty when viewed alongside other federal statutes governing jurisdiction and removal of class action claims.

The confusion results, in part, from ambiguity as to the scope of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), n53 which governs class actions based on state law and alleging fraud in connection with the purchase or sale of a "covered security." n54 The purpose of SLUSA was to federalize securities class actions in order to prevent class action plaintiffs from avoiding the stringent pleading standards and discovery stay provisions of the PSLRA by bringing securities class actions in state court under state blue sky laws. Under SLUSA, class actions brought in state court alleging fraud in connection with the purchase or sale of a covered security are removable to federal court, where they become subject to SLUSA preemption. SLUSA also included a conforming amendment to Section 22(a), providing that Securities Act claims are not removable "except as provided in [SLUSA]." n55

Courts and commentators have found SLUSA's removal provision ambiguous, insofar as it is unclear whether all class

actions brought in state court alleging fraud in connection with covered securities are removable, or only those that are based on state law. Some courts, relying on the plain language of Section 16(b), have held that SLUSA is expressly limited to state law claims, and thus Securities Act class actions are not removable under SLUSA. n56 However, other courts have held that Securities Act class actions involving covered securities are removable under SLUSA, despite the wording of Section 16(b), reasoning that if SLUSA's removal provision applied only to state law claims (and Securities Act claims were not removable), then the amendment to Section 22(a) would be meaningless. n57 One way to reconcile these interpretations would be to view SLUSA as allowing for removal of class actions that assert both federal and state law securities fraud claims (which would result in dismissal of the state law claims and litigation of the federal claims in federal court), but not class actions asserting only federal claims. n58

Adding to the confusion is the Class Action Fairness Act of 2005 (CAFA), which provides a uniform basis for removal of all class actions that meet certain requirements. n59 Although class actions involving "covered securities" are exempt from CAFA, n60 class action claims arising under the Securities Act that do not involve covered securities are seemingly subject to its removal provisions, despite Section 22(a)'s bar on removal. As discussed above in *Section 9.02[15][a]*, there is a split of authority among federal circuit courts as to whether Section 22(a)'s removal bar was superseded by CAFA. n61 This split of authority exacerbates the uncertainty already existing with respect to SLUSA's removal provision. The result is that, depending upon the jurisdiction, a Securities Act class action may be removable under SLUSA but not CAFA (if it involves a covered security), n62 or under CAFA but not SLUSA (if it does not involve a covered security), n63 or may not be removable under either statute. n64

FOOTNOTES:

(n1)Footnote 1. *See generally Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076 (9th Cir. 1999) ; *Smith v. Suprema Specialties, Inc.*, 206 F. Supp. 2d 627 (D.N.J. 2002) ; *In re Dreyfus Aggressive Growth Mut. Fund Litig.*, No. 98 Civ. 4318, 2000 U.S. Dist. LEXIS 13469 (S.D.N.Y. Sept. 19, 2000).

(n2)Footnote 2. *Akerman v. Oryx Communications, Inc.*, 609 F. Supp. 363, 377 . [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,680 at 99,445 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 336 , [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,101 (2d Cir. 1987).

(n3)Footnote 3. *Gibb v. Delta Drilling Co.*, 104 F.R.D. 59, 71 , [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,943 at 90,705 (N.D. Tex. 1984).

(n4)Footnote 4. 15 U.S.C. § 77z-1(a)(3)(A)(i).

(n5)Footnote 5. Section 27(a)(3)(A)(ii) clarifies that if multiple actions have been filed asserting substantially the same claims, only the plaintiffs in the first filed action are required to provide the notice to purported class members.

(n6)Footnote 6. 15 U.S.C. § 77z-1(a)(3)(B)(i). Section 27(a)(3)(B)(ii) provides that where there are multiple actions asserted substantially the same claims, and where any party has sought consolidation of the actions, the court must decide the issue of consolidation prior to selecting lead plaintiff for the class.

(n7)Footnote 7. 15 U.S.C. § 77z-1(a)(3)(B)(v). If the selected counsel directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation, the court is to determine whether such ownership or other interests presents a conflict of interest sufficient to disqualify that counsel from representing the class. 15 U.S.C. § 77z-1(a)(8).

(n8)Footnote 8. This presumption, set forth in Section 27(a)(3)(B)(iii), also requires that the selected plaintiff have either filed the complaint or moved the court for selection as lead plaintiff and otherwise complied with the class action requirements of Fed. R. Civ. P. 23, discussed in detail below.

(n9)Footnote 9. 15 U.S.C. § 77z-1(a)(3)(B)(iii)(II). As several courts have noted, the fact that lead plaintiffs may

not have standing to assert all of the claims will not render them incapable of representing the class, so long they identify and include named plaintiffs who have such standing. See *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1157 (C.D. Cal. 2008) (citing *In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 205 (S.D.N.Y. 2003)) .

(n10)Footnote 10. 15 U.S.C. § 77z-1(a)(3)(B)(iv).

(n11)Footnote 11. 15 U.S.C. § 77z-1(a)(3)(B)(iv).

(n12)Footnote 12. *In re Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d 304, 307 (S.D.N.Y. 2001) .

(n13)Footnote 13. *Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d at 308 .

(n14)Footnote 14. *Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d at 309 .

(n15)Footnote 15. *Berger v. Compaq Computer Corp.*, 257 F.3d 475 (5th Cir. 2001). The court further challenged judicial adherence to the presumption in selecting lead plaintiffs. "[a]dequacy is for the plaintiffs to demonstrate; it is not up to the defendants to disprove" *Id.* at *481 .

(n16)Footnote 16. See, e.g., *In re Quintus Sec. Litig.*, 148 F. Supp. 2d 967 (N.D. Cal. 2001) .

(n17)Footnote 17. See, e.g. *In re Quintus Sec. Litig.*, 148 F. Supp. 2d at 967 (court solicited bids from each firm vying for lead counsel position requiring that the bids address specified criteria, including a sliding scale for the firm's portion of any damages recovered based on the amount of recovery and the stage at which the recovery was achieved); see also *In re Comdisco Sec. Litig.*, 150 F. Supp. 2d 943, 949-50 (N.D. Ill. 2001) ("a neutrally conducted and confidential competitive bidding process under the auspices of the court affords the best means--in fact, it would seem the only means--to ... [obtain] the best available combination of highly competent representation at the least cost").

(n18)Footnote 18. *In re Cendant Corp. Litig.*, 264 F.3d 201, 266 n.47 (3d Cir. 2001) , cert. denied, 122 S. Ct. 202 (2002) .

(n19)Footnote 19. *Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d at 311 ; see also e.g., *In re Microstrategy Inc. Sec. Litig.*, 110 F. Supp. 2d 427, 438 (E.D. Va. 2000) (suggesting that what fees plaintiffs' lawyers will keep from any award is an issue best left for the conclusion of the litigation, not to be negotiated up front); *Weltz v. Lee*, 199 F.R.D. 129 (S.D.N.Y. 2001) (refusing to appoint proposed 15-firm lead counsel committee and ordering that lead plaintiff select lead counsel); *Osher v. Guess? Inc.*, No. CV 01-00871 LGB, 2001 U.S. Dist. LEXIS 6057, at *15, Fed. Sec. L. Rep. (CCH) P 91,429 (C.D. Cal. Apr. 26, 2001) (acknowledging court's role, under the PSLRA, to reject lead plaintiffs' selection of counsel "only if it is necessary to protect the interests of the class").

(n20)Footnote 20. See, e.g., *Holley v. Kitty Hawk, Inc.*, 200 F.R.D. 275, 277 (N.D. Tex. 2001) .

(n21)Footnote 21. See, e.g., *Rieger v. Drabinsky*, (*In re Livent, Inc. Noteholders Sec. Litig.*), 151 F. Supp. 2d 371, 436 (S.D.N.Y. 2001) .

(n22)Footnote 22. See, e.g., *Greebel v. FTP Software, Inc.*, 939 F. Supp. 57 (D. Mass. 1996) .

(n23)Footnote 23. These requirements are discussed in detail in A.A. Sommer, Jr. et al., *Securities Law Techniques*, Ch. 42 (Matthew Bender).

(n24)Footnote 24. *In re Theragenics Corp. Sec. Litig.*, 205 F.R.D. 687, 694 (N.D. Ga. 2002) ; *In re Ribozyme Pharms., Inc. Sec. Litig.*, 205 F.R.D. 572, 578 (D. Colo. 2001) ; *Howard's Rexall Stores, Inc. v. Aetna U.S. Healthcare Inc.*, No. 00-CV-31-B, 2001 U.S. Dist. LEXIS 6029, at *17-18 (D. Me. May 8, 2001) .

(n25)Footnote 25. In practice, a class of forty members generally satisfies the numerosity requirement. *See, e.g., Consol. Rail Corp. v. Town of Hyde Park*, 47 F.3d 473 (2d Cir. 1995); *In re Indep. Energy Holdings PLC, Sec. Litig.*, No. 00 Civ. 6689 (SAS), 2002 U.S. Dist. LEXIS 9359 (S.D.N.Y. May 28, 2002); *Paper Sys. v. Mitsubishi Corp.*, 193 F.R.D. 601, 604 (E.D. Wis. 2000); *Chandler v. S.W. Jeep Eagle, Inc.*, 162 F.R.D. 302, 307 (N.D. Ill. 1995). But classes of less than 20 also have been certified. *See, e.g., Cypress v. Newport News Gen. & Nonsectarian Hosp. Ass'n*, 375 F.2d 648 (4th Cir. 1967) (18 class members); *Manning v. Princeton Consumer Discount Co.*, 390 F. Supp. 320 (E.D. Pa. 1975), *aff'd*, 533 F.2d 102 (3d Cir. 1976).

(n26)Footnote 26. *Kennedy v. United Healthcare of Ohio, Inc.*, 206 F.R.D. 191, 195 (S.D. Ohio 2002); *In re Bank One Sec. Litig./First Chi. S'holder Claims*, No. 00 CV 0767, 2002 U.S. Dist. LEXIS 8709, at *9 (N.D. Ill. May 19, 2002); *In re Res. Am. Sec. Litig.*, 202 F.R.D. 177, 181 (E.D. Pa. 2001); *In re Select Comfort Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) 91,554*, 202 F.R.D. 598, 603 (D. Minn. 2001).

(n27)Footnote 27. *Paxton v. Union Nat'l Bank*, 688 F.2d 552, 561 (8th Cir. 1982); *Zeidman v. J. Ray McDermott & Co.*, 651 F.2d 1030, 1038 (5th Cir. 1981); *In re Select Comfort Corp. Sec. Litig., Fed. Sec. L. Rep. (CCH) 91,554*, 202 F.R.D. 598, 603 (D. Minn. 2001); *MacNeal v. Columbine Exploration Corp.*, 123 F.R.D. 181, 185 (E.D. Pa. 1988).

(n28)Footnote 28. *Robidoux v. Celani*, 987 F.2d 931, 935 (2d Cir. 1993); *In re Linerboard Antitrust Litig.*, 203 F.R.D. 197, 205 (E.D. Pa. 2001); *De La Fuente v. DCI Telcomms., Inc.*, 206 F.R.D. 369, 390 (S.D.N.Y. 2002).

(n29)Footnote 29. *Rodriguez v. Ford Motor Credit Co.*, No. 01 C 8526, 2002 U.S. Dist. LEXIS 7280, at *7 (N.D. Ill. Apr. 19, 2002); *Nat'l Org. on Disability v. Tartaglione*, No. 01-1923, 2001 U.S. Dist. LEXIS 16932, at *7 (E.D. Pa. Oct. 22, 2001); *Rosmer v. Pfizer, Inc.*, No. 9:99-2280-18RB, 2001 U.S. Dist. LEXIS 6678, at *10 (D. S.C. Mar. 30, 2001).

(n30)Footnote 30. *See Clark v. Experian Info. Solutions, Inc.*, No. 8:00-1217-24, *et. al.* 2001 U.S. Dist. LEXIS 20024, at **5-6 (D. S.C. Mar. 19, 2001); *Karcich v. Stuart (In re Ikon Office Solutions, Inc. Sec. Litig.)*, 194 F.R.D. 166, 175 (E.D. Pa. 2000); *Clay v. Am. Tobacco Co.*, 188 F.R.D. 483, 490 (S.D. Ill. 1999).

(n31)Footnote 31. *See Kennedy v. United Healthcare of Ohio, Inc.*, 206 F.R.D. 191, 196 (S.D. Ohio 2002); *In re Linerboard Antitrust Litig.*, 203 F.R.D. 197, 205 (E.D. Pa. 2001).

(n32)Footnote 32. *See Blackie v. Barrack*, 524 F.2d 891, 902, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,312 at 98,581 (9th Cir. 1975); *In re Indep. Energy Holdings PLC, Sec. Litig.*, No. 00 Civ. 6689 (SAS), 2002 U.S. Dist. LEXIS 9359, at *10 (S.D.N.Y. May 28, 2002); *Yadlosky v. Grant Thornton L.L.P.*, 197 F.R.D. 292, 298 (E.D. Mich. 2000); *In re Activision Sec. Litig.*, 621 F. Supp. 415, 428, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,270 at 91,865 (N.D. Cal. 1985); *Gibb v. Delta Drilling Co.*, 104 F.R.D. 59, 73, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,943 at 90,706 (N.D. Tex. 1984).

(n33)Footnote 33. *See Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 182 (3rd Cir. 2001); *In re Theragenics Corp. Sec. Litig.*, 205 F.R.D. 687, 695 (N.D. Ga. 2002); *In re Bank One Sec. Litig./First Chicago Shareholder Claims, Case No. 00 CV 0767*, 2002 U.S. Dist. LEXIS 8709, at *13 (N.D. Ill. May 14, 2002).

(n34)Footnote 34. *Kornberg v. Carnival Cruise Lines, Inc.*, 741 F.2d 1332, 1337 (11th Cir. 1984).

(n35)Footnote 35. One exception under Section 12(a)(2) is that if the claims are based on separate oral representations, class treatment may be denied on the ground that each plaintiff must prove the particular misrepresentation made by the particular offeror that cause its alleged injury.

(n36)Footnote 36. *W. States Wholesale, Inc. v. Synthetic Indus., Inc.*, 206 F.R.D. 271, 275 (C.D. Cal. 2002); *Karcich v. Stuart (In re Ikon Office Solutions, Inc. Sec. Litig.)*, 194 F.R.D. 166, 176 (E.D. Pa. 2000).

(n37)Footnote 37. *In re Activision Sec. Litig.*, 621 F. Supp. 415, 428 [1986-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,270 at 91,866 (N.D. Cal. 1985) (citations omitted); *see also Kennedy v. United Healthcare of Ohio, Inc.*, 206 F.R.D. 191, 196 (S.D. Ohio 2002) (stating that "[d]iffering degrees of injury among class members does not necessarily defeat typicality if the basic injury each class member asserts is the same").

(n38)Footnote 38. 103 F.R.D 130 , [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,688 (D.N.J. 1984), *rev'd on other grounds*, 843 F.2d 1537 (3d Cir. 1988) .

(n39)Footnote 39. *Vitiello*, 103 F.R.D 130 at 139 .

(n40)Footnote 40. *Vitiello*, 103 F.R.D. 130 at 147 .

(n41)Footnote 41. *Twelve John Does v. District of Columbia*, 117 F.3d 571, 575 (D.C. Cir. 1997) ; *see also Randle v. GC Servs., LP*, 181 F.R.D. 602, 604 (N.D. Ill. 1998) ; *Brink v. First Credit Res.*, 185 F.R.D. 567, 571 (D. Ariz. 1999) ; *In re Olsten Corp. Sec. Litig.*, 3 F. Supp. 2d 286, 296 (E.D.N.Y. 1998) ; *Queen Uno Ltd. P'ship. v. Coeur D'Alene Mines Corp.*, 183 F.R.D. 687, 694 (D. Colo. 1998) ; *Tolan v. Computervision Corp.*, 696 F. Supp. 771, 780 (D. Mass. 1998) .

(n42)Footnote 42. *See, e.g., Williams v. Balcors Pension Investors*, 150 F.R.D. 109 , [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,651 (N.D. Ill. 1993).

(n43)Footnote 43. *See, e.g., Pasternak v. Colonial Equities Corp. (In re Colonial P'ship Litig.)* No. H-90-829 (JAC), 1993 U.S. Dist. LEXIS 10884, at *49-51 (D. Conn. Feb. 10, 1993) ; *Greenspan v. Brassler*, 78 F.R.D. 130, 133-34 (S.D.N.Y. 1978) ; *Tomkin v. Kaysen*, 69 F.R.D. 541 (S.D.N.Y. 1976) .

(n44)Footnote 44. *See, e.g., Scholes v. Tomlinson*, 145 F.R.D. 485 , [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,332 at 95,687 (N.D. Ill. 1992).

(n45)Footnote 45. *Amchem Prods. v. Windsor*, 521 U.S. 591, 623-24, 117 S. Ct. 2231, 138 L. Ed. 2d 689 (1997) .

(n46)Footnote 46. *Walmart Stores, Inc. v. Visa USA, Inc. (In re Visa Check/MasterMoney Antitrust Litig.)*, 280 F.3d 124, 136 (2d Cir. 2001) ; *Murray v. Auslander*, 244 F.3d 807, 811 (11th Cir. 2001) ; *Nichols v. Mobile Bd. of Realtors, Inc.*, 675 F.2d 671, 676 (5th Cir. 1982) .

(n47)Footnote 47. *Amchem Prods. v. Windsor*, 521 U.S. 591, 623-24, 117 S. Ct. 2231, 138 L. Ed. 2d 689 (1997) .

(n48)Footnote 48. *Korn v. Franchard Corp.*, 456 F.2d 1206, 1212 , [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,397 at 91,997 (2d Cir. 1972); *Mailloux v. Arrow Fin. Servs.*, 204 F.R.D. 38, 42 (E.D.N.Y. 2001) ; *Kleiner v. First Nat'l Bank of Atlanta*, 97 F.R.D. 683, 692 (N.D. Ga. 1983) ; *see also In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 607 , [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,251 at 91,773 (E.D. Mich. 1985) (predominance satisfied in Section 11 action alleging merely that a prospectus contained material misrepresentations or omissions, because each class member "must show the existence of material misstatements or omissions in its prospectus to show liability").

(n49)Footnote 49. *See, e.g., Force v. ITT Hartford Life & Annuity Ins. Co. (In re Hartford Sales Practices Litig.)*, 192 F.R.D. 592 (D. Minn. 1999) ; *Soper v. Valone*, 110 F.R.D. 8 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,470 (W.D.N.Y. 1985); *Miller v. Cent. Chinchilla Group, Inc.*, 66 F.R.D. 411 , [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,077 (S.D. Iowa 1975); *Moscarella v. Stamm*, 288 F. Supp. 453, 462-63 , [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,254 at 97,222 (E.D.N.Y. 1968); *cf. Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718 (11th Cir. 1987) ; *Hanrahan v. Britt*, 174 F.R.D. 356, 365 (E.D. Pa. 1997) .

(n50)Footnote 50. According to Rule 23(b)(3), these factors are similarly pertinent when making a predominance

determination, discussed above.

(n51)Footnote 51. Fed. R. Civ. P. 23(b)(3).

(n52)Footnote 52. See *Karcich v. Stuart (In re Ikon Office Solutions, Inc. Sec. Litig.)*, 194 F.R.D. 166, 178 (E.D. Pa. 2000) (citing *Eisenberg v. Gagnon*, 766 F.2d 770, 785 (3d Cir. 1985)) .

(n53)Footnote 53. 15 U.S.C. §§ 77p & 78bb(f).

(n54)Footnote 54. Under Section 18(b), "covered securities" are securities that trade on a national exchange, are senior to a traded security, or are sold by a registered investment company.

(n55)Footnote 55. 15 U.S.C. § 77v(a).

(n56)Footnote 56. See, e.g., *Nauheim v. Interpublic Group of Cos., Inc.*, No. 02-C-9211, 2003 U.S. Dist. LEXIS 6266 (N.D. Ill. Apr. 16, 2003) ; *In re Waste Mgmt., Inc. Secs. Litig.*, 194 F. Supp. 2d 590 , [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,735 (S.D. Tex. 2002); *In re Tyco Int'l, Ltd.*, 322 F. Supp. 2d 116 , [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,849 (D.N.H. 2004).

(n57)Footnote 57. See, e.g., *Brody v. Homestore, Inc.*, 240 F. Supp. 2d 1122 , [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,276 (C.D. Cal. 2003); *Alkow v. TXU Corp.*, Nos. 3:02-CV-2243-K, 3:02-CV-2738-K, 3:02-CV-2739-K, 2003 U.S. Dist. LEXIS 7900 , [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,495 (N.D. Tex. May 8, 2003); *Rovner v. Vonage Holdings Corp.*, No. 07-178, 2007 U.S. Dist. LEXIS 8656 (D.N.J. Feb. 5, 2007) . One court went a step further, holding that not only does SLUSA permit removal of Securities Act class actions, but it actually strips state courts of jurisdiction over such claims. *Knox v. Agria Corp.*, 613 F. Supp. 2d 419, 423 n.1 (S.D.N.Y. 2009) .

(n58)Footnote 58. See Michael A. Perino, *Securities Litigation After The Reform Act*, 11,011, 11,033-34 (CCH ed., 2009).

(n59)Footnote 59. 28 U.S.C. §§ 1332(d) & 1452(b).

(n60)Footnote 60. According to the legislative history, the purpose of the exemption was "to avoid disturbing in any way the federal vs. state court jurisdictional lines already drawn in the securities litigation class action context by the enactment of the Securities Litigation Uniform Standards Act of 1998." S. Rep. 109-14, at *45 (2005).

(n61)Footnote 61. Compare *Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031, 1034 [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,777, at 95,063 (9th Cir. 2008) (holding that Section 22(a)'s removal bar trumps the more recently enacted CAFA) with *Katz v. Gerardi*, 552 F.3d 558, 561-63 [2008-2009 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,029, at 91, 372-73 (7th Cir. 2009) (holding that class actions arising under the Securities Act are subject to removal under CAFA provided they meet the requirements and do not involve securities traded on a national exchange) and *N.J. Carpenters Vacation Fund v. HarborView Mortgage Loan Trust*, 581 F. Supp. 2d 581, 587-88 (S.D.N.Y. 2008) (holding that "CAFA overrides the Securities Act's anti-removal provision").

(n62)Footnote 62. See, e.g., *Brody*, 240 F. Supp. 2d 1122 ; *Alkow*, 2003 WL 21056750; *Rovner*, 2007 WL 446658; *Knox*, 2009 WL 185436.

(n63)Footnote 63. See, e.g., *Katz*, 552 F.3d 558 ; *N.J. Carpenters Vacation Fund*, 581 F. Supp. 2d 581 .

(n64)Footnote 64. See, e.g., *Luther*, 533 F.3d 1031 ,

* This chapter was prepared by James C. Dugan and Antonio Yanez, Jr., partners at Willkie Farr & Gallagher LLP. Mr. Yanez and Mr. Dugan specialize in federal securities litigation and financial reporting, including representation of

issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, and other matters. Derek M. Schoenmann and Alan A. Stevens, associates at Willkie Farr & Gallagher LLP in New York, assisted in the preparation of this chapter.



145 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 10.syn

§ 10.syn Synopsis to Chapter 10: SEC Enforcement Practice *

§ 10.01 The Securities and Exchange Commission

[1] The Commissioners

[2] The Division of Enforcement

[3] Other Divisions and Offices

§ 10.02 Power of the SEC to Gather Information

§ 10.03 Initial Steps in Responding to SEC Investigation

[1] Alerting Senior Management and Board of Directors

[2] Forming a Response Team

[3] Preserving Documents

[4] Considering Disclosure Matters

[5] Alerting Employees

[6] Alerting Insurance Companies

[7] Alerting Auditors and Others

[8] Setting Priorities

[9] Considering Remedial Action

[10] Not Retaliating Against Whistleblowers

§ 10.04 Gathering Information and Conducting Internal Investigations

- [1] Gathering Information
- [2] Internal Investigations
- [3] Minimum Standards for Attorneys

§ 10.05 Issues in Representing Individuals

- [1] Meeting with the Client
- [2] Fifth Amendment Privilege against Self-Incrimination
- [3] Multiple Representation
- [4] Indemnification of Legal Fees

§ 10.06 Production of Documents and Information to the Division of Enforcement Staff

- [1] Negotiating with the Staff Regarding the Subpoena
- [2] Searching for and Reviewing Documents
- [3] Producing Documents

§ 10.07 Providing Information Compilations to the Staff

§ 10.08 Preparing Witnesses for Testimony

§ 10.09 Defending SEC Testimony

- [1] Authority of the Staff to Take Testimony
- [2] Right of the Witness to be Represented by Counsel
- [3] Representing the Witness During Testimony
- [4] Obtaining a Transcript of the Testimony

§ 10.10 Wells Process

- [1] Anticipating Impact of Possible Wells Call
- [2] Obtaining As Much Information As Possible Regarding the Staff's Case
- [3] Deciding Whether to File a Wells Submission
- [4] Drafting the Wells Submission
- [5] Following Up With the Staff After Submitting a Wells Submission

§ 10.11 Settlement Discussions

§ 10.12 Staff Recommendation Memorandum

§ 10.13 Enforcement Remedies

[1] Federal Court Enforcement Actions

[a] Injunctive Relief

[b] Disgorgement of Unjust Enrichment

[c] Temporary Freezes

[d] Other Ancillary Equitable Relief

[e] Disclosure

[f] Civil Penalties

[g] Orders Barring Service as an Officer or Director of a Public Company

[h] Penny Stock Bars

[2] Administrative Remedies Against Regulated Persons

[a] Bars and Other Limitations

[b] Monetary Penalties and Disgorgement

[3] Other Administrative Remedies

[a] Cease-and-Desist Remedies

[b] Accounting and Disgorgement

[c] Temporary Cease-and-Desist Authority

[d] Administrative Orders Barring Service as an Officer or Director of a Public Company

[e] Refusal Orders, Stop Orders, and Examinations

[f] Disciplining Professionals Who Practice Before the Commission

[g] Deferred Prosecution Agreements and Non-Prosecution Agreements

§ 10.14 Closing an Investigation

§ 10.15 Conclusion



146 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.01

§ 10.01 The Securities and Exchange Commission

The U.S. Securities and Exchange Commission ("SEC" or "Commission") is responsible for civil enforcement of the federal securities laws: the Securities Act of 1933 (the "Securities Act"); n1 the Securities Exchange Act of 1934 (the "Exchange Act"); n2 the Investment Company Act of 1940 (the "Investment Company Act"); n3 and the Investment Advisers Act of 1940 (the "Investment Advisers Act"). n4 As with the other federal securities laws, the SEC has broad authority to conduct investigations regarding possible violations of the Securities Act. Section 19(c) of the Securities Act provides, in relevant part:

For the purpose of all investigations which, in the opinion of the Commission, are necessary and proper for the enforcement of [the Securities Act], any member of the Commission or any officer or officers designated by it are empowered to administer oaths and affirmations, subpoena witnesses, take evidence, and require the production of any books, papers, or other documents which the Commission deems relevant or material to the inquiry, Such attendance of witnesses and the production of such documentary evidence may be required from any place in the United States or any Territory at any designated place of hearing.

15 U.S.C. 77(s)(c). Approximately, 10-20 percent of the enforcement actions brought by the SEC involve securities offerings. n5

[1] The Commissioners

The SEC consists of up to five Commissioners, including a Chairman, nominated by the President and confirmed by the Senate. Historically, the Chairman and no more than two other Commissioners are members of the President's party. Although the Commissioners are rarely involved in the day-to-day supervision of investigations, the Commissioners play a significant role in establishing the Commission's priorities. In addition, the SEC cannot bring an enforcement action unless the Commissioners vote to authorize the action.

[2] The Division of Enforcement

The SEC Staff is organized by function into Divisions and Offices, the largest of which is the Division of Enforcement. The Division of Enforcement consists of approximately 1,300 Staff members. The Enforcement Staff is responsible

both for conducting investigations and for litigating civil enforcement actions in the federal district courts and before administrative law judges. n6 The Enforcement Staff is located in twelve offices.

The largest concentration of SEC Enforcement Staff is at the Washington, D.C. home office, located at 100 F Street, N.E. in Washington, D.C. ("Home Office"). The SEC Enforcement Staff is distributed between the Home Office at 100 F Street, N.E., Washington, D.C. and eleven regional offices. The Enforcement Staff in the Home Office and the eleven regional offices report to the three deputy directors and one director. The Regional Offices are located in New York City, Boston, Philadelphia, Miami, Atlanta, Chicago, Fort Worth, Salt Lake City, Los Angeles and San Francisco. Several factors affect which office conducts an investigation including the resources and expertise of the offices and the location of: the wrongful conduct; the potential wrongdoers; the relevant entities; and the witnesses. n7

In 2009, SEC Enforcement Director Robert Khuzami announced a number of steps intended to make the SEC's enforcement efforts more efficient. The Division established national units dedicated to highly specialized and complex areas of securities laws: asset management; market abuse; structured and new products; foreign corrupt practices; and municipal securities and public pensions. The intention is that the members of these specialized units will obtain enhanced training and improved access to specialists that will make them experts with respect to particular markets, products and transactions and that the unit members will use that expertise to conduct investigations with increased efficiency and effectiveness and will share that expertise with other members of the enforcement Staff who are conducting investigations in these specialized areas.

Historically, the SEC attorneys who conducted investigations were supervised by branch chiefs, branch chiefs in the home office reported to assistant directors and branch chiefs in the regions reported to assistant regional directors. In 2010, the Enforcement Division abolished the branch chief position, promoting many of the branch chiefs to assistant director or assistant regional director slots and redeploying most of the former branch chiefs to conduct investigations. This reorganization eliminated one layer of supervision and freed up experienced staff members to conduct investigations.

[3] Other Divisions and Offices

The General Counsel is the chief legal officer of the SEC and is responsible for representing the SEC in certain civil, private, or appellate proceedings, preparing legislative material, and providing independent advice and assistance to the SEC Commissioners, the divisions, and the offices. The Office of the General Counsel reviews each enforcement recommendation memorandum and advises the Commission regarding legal or policy issues raised by the recommendation.

The Division of Corporation Finance oversees public company disclosure. The Division of Corporation Finance reviews selected disclosure documents filed by public companies and assists public companies in interpreting SEC rules and recommends new rules for adoption. It is a source of referrals and advises the Enforcement Staff and the Commission regarding enforcement matters relating to corporate disclosure, financial reporting, and securities offerings.

The Division of Market Regulation establishes and maintains standards for fair, orderly, and efficient markets. It regulates the major securities market participants including broker-dealers, self-regulatory organizations (SROs), transfer agents, and securities information processors. The Division of Market Regulation advises Enforcement and the Commission regarding enforcement matters relating to the operation of the securities markets.

The Division of Investment Management oversees and regulates the investment management industry and administers the securities laws affecting investment companies, including mutual funds and investment advisers. The Division of Investment Management also administers the Public Utility Holding Company Act of 1935. The Division of Investment Management advises Enforcement and the Commission regarding relevant enforcement matters.

The Office of Compliance Inspections and Examinations administers the SEC's examination and inspection program for SROs, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. This office conducts inspections to promote compliance with the securities laws, to detect violations of the law, and to keep the SEC Commissioners informed of developments in the regulated community. The office is a source of referrals and sometimes provides expertise to support Enforcement investigations.

FOOTNOTES:

(n1)Footnote 1. **15 U.S.C. § 77a et seq.**

(n2)Footnote 2. **15 U.S.C. § 78a et seq.**

(n3)Footnote 3. **15 U.S.C. § 80a-1 et seq.**

(n4)Footnote 4. **15 U.S.C. § 80b-1 et seq.**

(n5)Footnote 5. SEC 2008 Performance and Accountability Report at 32 (November 2008) available at <http://www.sec.gov/about/secpar/secpar2008.pdf#sec2>.

(n6)Footnote 6. The Department of Justice (the "DOJ") is responsible for criminal enforcement of the federal securities laws. The DOJ often coordinates closely with the SEC in investigating potential violations of the federal securities laws.

Attorneys representing individuals and entities in SEC investigations should consider the potential for enforcement activity by DOJ or by state authorities enforcing state laws, or by self-regulatory organizations (e.g., NASD, NYSE) enforcing their rules and regulations.

(n7)Footnote 7. SEC Enforcement Manual at 14 (Office of Chief Counsel Oct. 6, 2008) available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



147 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.02

§ 10.02 Power of the SEC to Gather Information

The SEC Staff has the power to initiate an inquiry without specific authorization of the Commission. As the Commission's rules explain:

Where, from complaints received from members of the public, communications from federal or state agencies, examination of filings made with the Commission, or otherwise, it appears that there may be violation of the acts administered by the Commission or the rules and regulations thereunder, a preliminary investigation is generally made. In such preliminary investigation no process is issued or testimony compelled. n1

Many SEC investigations begin as a "Matter under Inquiry" ("MUI"). A MUI can be opened by an Assistant Director upon a determination that sufficiently credible information suggests that a MUI could lead to an enforcement action that would address a violation of the federal securities laws. In order to make that determination the assistant director must consider a number of factors including: the statutes or rules potentially violated; the egregiousness of the potential violation; the potential magnitude of the violation; the potential losses involved; whether the potentially harmed group is particularly vulnerable or at risk; whether the conduct is ongoing; whether the conduct can be investigated efficiently and within the statute of limitations period; and whether other authorities are better suited to conduct the investigation. n2 The SEC Enforcement Manual recognizes that "the threshold analysis for the opening of a MUI is relatively low" and a MUI "can be opened on the basis of very limited information." n3 A MUI converts into an investigation after sixty days or when the Staff, in consultation with an Associate Director, determines that it is an appropriate use of SEC resources to open an investigation and is supposed to be based on more information-gathering and analysis than a MUI. n4 If the Staff concludes that an MUI should not convert into an investigation, then the Staff, in consultation with an Associate Director, should close the MUI before it converts into an investigation. n5

Companies and individuals often voluntarily produce documents and otherwise provide information in response to an informal inquiry. If the Staff is able to obtain voluntarily the materials and testimony it desires without resorting to compulsory process, it might conduct an entire investigation without ever seeking a formal order from the Commission.

The Commission has the power to compel the production of documents and the taking of testimony to investigate possible violations of the federal securities laws. n6 The Commission delegates that power to the Staff by issuing a Formal Order of Investigation, which authorizes the Staff to subpoena witnesses to provide testimony and produce

documents. A Formal Order "launches the formal investigation, defines its scope, and establishes the limits within which investigative Staff may resort to process." n7 The Staff can obtain a Formal Order without any prior notice to witnesses or counsel. Courts have stated that the Commission has the statutory authority to authorize a formal investigation without any evidence that the federal securities laws have been violated. n8 In 2009, the Commission delegated to the Enforcement Director, who delegated to his senior staff, the power to issue formal orders. n9

The Staff may seek and obtain a Formal Order regardless of the level of cooperation. Other witnesses might decline to produce documents or provide testimony absent a subpoena. Some entities, such as telephone companies and banks, cannot produce customer records without a subpoena. In addition, many Staff members believe that witnesses and individuals respond more promptly and thoroughly to subpoenas than voluntary requests.

SEC investigative subpoenas are not self-enforcing and require the SEC to file a subpoena enforcement action in federal court. n10 The Commissioners have delegated to the Director of Enforcement the power to authorize a subpoena enforcement action. The SEC initiates a subpoena enforcement action by filing an application to show cause with supporting materials in the U.S. District Court.

The application and supporting materials are then available to the media and the public. Accordingly, the filing of a subpoena enforcement action can result in considerable adverse publicity at an early stage of the investigation.

It is difficult, but not necessarily impossible, to challenge an SEC subpoena successfully on the grounds that it seeks irrelevant materials, imposes undue burden or expense, or was issued in bad faith. Because of the adverse publicity likely to be generated by an SEC subpoena enforcement proceeding and the low probability that the courts will uphold a challenge to the subpoena, it usually makes more sense to negotiate with the Staff than to resist the subpoena and attempt to defend a subpoena enforcement action. n11 In addition, although the government has rarely prosecuted failure to comply with an SEC subpoena, it is a misdemeanor to fail to obey an SEC subpoena "without just cause." n12

The Right to Financial Privacy Act (the "RFPA") gives certain customers of "financial institutions" certain rights in connection with SEC subpoenas. n13 The RFPA provides a mechanism by which a customer, subject to limited exceptions, is given notice that the SEC has subpoenaed the customer's financial records from a financial institution and can challenge the subpoena on the ground that the financial records are not relevant to a legitimate law enforcement investigation. n14 While it is difficult to challenge a subpoena successfully, the RFPA does provide customers with notice of certain subpoenas and exposes the SEC Staff to substantial liability if the Staff does not comply with the procedural requirements of the RFPA. n15

FOOTNOTES:

(n1)Footnote 1. Rule 5(c), SEC Informal and Other Procedures, *17 C.F.R. § 202.5(a)*.

(n2)Footnote 2. SEC Enforcement Manual at 14 available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

(n3)Footnote 3. SEC Enforcement Manual at 16-17 available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

(n4)Footnote 4. SEC Enforcement Manual at 16 available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>

(n5)Footnote 5. SEC Enforcement Manual at 18 available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>

(n6)Footnote 6. *See* Securities Act § 20(a), **15 U.S.C. § 77t(a)** ; Exchange Act § 21(a), **15 U.S.C. § 78u(a)** ; Public Utility Holding Company Act § 18(a), **15 U.S.C. § 79r(a)** ; Trust Indenture Act § 321(a), **15 U.S.C. § 77uuu(a)**

; Investment Company Act § 42(a), **15 U.S.C. § 80a-41(a)** ; Investment Advisers Act § 209(a), **15 U.S.C. § 80b-9(a)** .

(n7)Footnote 7. *SEC v. Jerry T. O'Brien*, 704 F.2d 1065, 1066 (9th Cir. 1983) , rev'd, 467 U.S. 735 (1984)

(n8)Footnote 8. See *United States v. Morton Salt Co.*, 338 U.S. 632 (1950) ; *SEC v. Howatt*, 525 F.2d 226, 229 (1st Cir. 1975) .

(n9)Footnote 9. Robert Khuzami, "Remarks Before the New York City Bar: My First 100 Days," (Aug. 5, 2009), available at <http://www.sec.gov/news/speech/2009/spch080509rk.htm>.

(n10)Footnote 10. *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984) .

(n11)Footnote 11. Courts generally have been unwilling to quash SEC subpoenas. *Sprecher v. Graber*, 716 F.2d 968 (2d Cir. 1983) ; *Fleet/Norstar Fin. Group, Inc. v. SEC*, 769 F. Supp. 19 (D. Me. 1991) .

(n12)Footnote 12. Exchange Act § 21(c), **15 U.S.C. § 78u (c)** .

(n13)Footnote 13. The RFPA defines "customer" to include only individuals and partnerships of fewer than six individuals. **12 U.S.C. §§ 3401-3422** . The RFPA defines "financial records" broadly to include both documents and information contained in such documents. **12 U.S.C. § 3401(4)** , (5). "Financial institution" is defined to include banks, and similar institutions and credit card issuers. **12 U.S.C. § 3401(2)** . **12 U.S.C. § 3401(1)** .

(n14)Footnote 14. *Hancock v. Marshall*, 86 F.R.D. 209, 211 (D.D.C. 1980) .

(n15)Footnote 15. **12 U.S.C. § 3417(a)** .

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



148 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.03

§ 10.03 Initial Steps in Responding to SEC Investigation

[1] Alerting Senior Management and Board of Directors

If a company learns of an SEC enforcement inquiry and it appears that either the company or its senior officers may have exposure, the company should consider promptly notifying senior management and the Board of Directors, especially the audit committee of the board.

[2] Forming a Response Team

A company should form a team responsible for responding to the SEC investigation. Potential members of the response team include the company's chief legal officer, the company's disclosure counsel, and the company's senior public relations and investor relations advisers. Often the team should also include the company's chief financial officer and chief accounting officer. The team should work with the company's senior management and Board of Directors.

If the company appears to have potential exposure, the company should consider retaining outside SEC enforcement counsel to advise the response team, senior management and the Board of Directors. SEC defense counsel should quickly gather and evaluate information relating to the SEC investigations and deal with the SEC Staff. Companies may also seek input from outside public relations advisers. If the company retains a public relations adviser, it should be aware that sharing otherwise privileged information with an outside public relations firm may destroy the privilege. n1 Communications with the public relations adviser are most likely to be protected if the adviser is retained by counsel for the purpose of advising counsel and the company with respect to the investigation and anticipated litigation.

[3] Preserving Documents

The company should promptly take steps to maintain documents relevant to the SEC. These steps should address both paper documents and documents that are stored electronically. In many instances, the company should consult extensively with members of its Information Technology Department and/or documents retention/retrieval consultants to ensure that electronic documents are not destroyed inadvertently. Destruction of relevant documents after the commencement of an SEC inquiry can constitute a federal felony and significantly heightens the risk of a criminal enforcement action against the company and its personnel. n2 At a minimum, the destruction of documents will likely color the SEC's view of the case and increase the likelihood of an enforcement action. Moreover, the destruction of documents could pose significant challenges to defending either an SEC enforcement action or related private litigation.

[4] Considering Disclosure Matters

The company should also consider what disclosure, if any, to make regarding the existence of the SEC investigation. In general, a company has no obligation to disclose the existence of an SEC investigation unless the existence of the investigation is material. Even if the existence of the probe is material, disclosure generally is not required unless the company or its insiders are selling securities to people unaware of the probe, the company is filing a periodic report, or disclosure is somehow necessary to correct a prior statement that was inaccurate when made. Of course, a company might disclose an investigation because, as a practical matter, it expects that news of the investigation will leak in any event. In addition, if an SEC investigation prompts a company to discover that its disclosures were materially misleading when made, the company should correct that disclosure. n3 In part because it is historically unusual for companies to disclose SEC inquiries, the unnecessary disclosure of an SEC inquiry can have a number of adverse consequences, including a decline in the company's stock price, the triggering of securities class actions, and anxiety among the customer's suppliers and customers. In addition, there is some concern that the Staff will have a greater reluctance to close an investigation without an enforcement action if the existence of the investigation is public knowledge.

If the company discloses an SEC investigation, there will be great pressure from analysts, the press, and investors to be open and forthcoming. The company should limit its answers to information in which it has great confidence and should recognize that its answers potentially create a duty to update information as the investigation progresses. Before management confers with analysts or the press, it should thoroughly prepare its response. Usually, it is best for the company to identify one spokesperson to respond to media inquiries.

[5] Alerting Employees

The company should consider reminding appropriate personnel of the company policy that company employees refer questions from the investing public, analysts and the press to the appropriate unit(s) within the company, such as investor relations, public relations, and legal. The company should remind company personnel of company policies limiting discussions with the media.

There is a possibility that the SEC will directly contact current and former company employees. Accordingly, counsel may wish to notify company personnel that they might be contacted by the SEC Staff, that (1) they have the right to consult with counsel before submitting to an interview; (2) if they talk to a law enforcement agency, they must tell the truth; and (3) if they talk to a law enforcement agency, they should promptly notify the company's legal department. The company should, however, be careful not to engage in conduct that might be viewed as obstruction of justice or tampering with a witness. n4 For example, the company should not instruct employees not to talk to law enforcement agencies. Accordingly, it is best to educate company personnel regarding their rights before any specific law enforcement is anticipated.

Company counsel should also instruct employees who are aware of the investigation not to discuss the investigation with others beyond the extent necessary to perform their jobs. In testimony, the SEC Staff routinely asks witnesses about conversations they have had regarding the investigation. Thus, at a minimum, discussing the investigation will unnecessarily lengthen the testimony. More seriously, innocent conversations taken out of context can create suspicion that the witnesses were conspiring to orchestrate testimony.

[6] Alerting Insurance Companies

The company should promptly notify insurance carriers of the SEC inquiry. Depending on the circumstances of the request and the terms of the policy, a request for information in an SEC inquiry could be considered either a covered claim under a directors and officers liability policy or a circumstance that triggers a notification obligation. Failure to provide prompt notification to the insurance carrier could jeopardize coverage.

[7] Alerting Auditors and Others

In most circumstances, the company should promptly notify its auditors of any SEC investigation relating to the company's financial statements or related disclosures. Auditors can assist management in assessing the implications, if any, that the SEC investigation might have on the company's financial statements and related disclosures. Failure to notify the auditor can damage the auditor's confidence in the openness and candor of company management. In addition, CEOs and CFOs must certify each quarter that they have notified the auditors (as well as the audit committee) of:

- all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
- any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls. n5

Company management should consider alerting significant regulators and creditors, as well as suppliers and customers who might be contacted directly by the Staff. Failure to provide such notice could jeopardize the company's relationships with these important constituencies. If the company decides to notify suppliers or customers, the company should attempt to make this contact in a manner that does not suggest obstruction of justice or pose a danger that the supplier or customer will sell the company's stock based on the alert.

[8] Setting Priorities

The company's Board and senior management should establish (and continuously reevaluate) a set of priorities. For some companies, the top priority will be expediting a quick resolution of the SEC investigation. For other companies, the top priority will be avoiding a fraud injunction. For others, the top priority will be avoiding criminal prosecution. Counsel should assist the company in making informed decisions in setting priorities and in developing and implementing strategies for achieving these priorities.

[9] Considering Remedial Action

Information gathered in response to an SEC investigation should be evaluated in order to assess whether remedial action is appropriate. This remedial action can include enhancement of internal controls or other disclosure controls and procedures, disciplinary action against employees who acted improperly, and disclosures that either supplement or correct disclosures previously made to the investing public.

[10] Not Retaliating Against Whistleblowers

Companies should refrain from conduct that could be perceived as retaliation against whistleblowers. The Sarbanes-Oxley Act of 2002 sets forth both civil and criminal penalties for retaliating against whistleblowers. n6 In addition, SEC enforcement officials and federal prosecutors are likely to take a dim view of companies that they perceive as engaging in retaliatory conduct against individuals who volunteered information to law enforcement agencies.

FOOTNOTES:

(n1)Footnote 1. See *Calvin Klein Trademark Trust v. Wachner*, 198 F.R.D. 53 (S.D.N.Y. 2000) .

(n2)Footnote 2. **18 U.S.C. § 1503** .

(n3)Footnote 3. *SEC v. Fehn*, 97 F.3d 1276, 1290-94 (9th Cir. 1996) .

(n4)Footnote 4. **18 U.S.C. §§ 1503 , 1512**; Criminal Resource Manual 01720.

(n5)Footnote 5. *17 C.F.R. § 240.13a-14*.

(n6)Footnote 6. Sarbanes-Oxley Act § 806 (codified at **18 U.S.C. § 1514**) (civil liability) and § 1107 (codified at **18 U.S.C. § 1513**) (criminal liability).

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



149 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.04

§ 10.04 Gathering Information and Conducting Internal Investigations

[1] Gathering Information

It is important for defense counsel to gather as much information as practicable regarding the underlying events. The information collected will assist senior management and the Board of Directors in making informed decisions regarding whether the extent, if any, it is appropriate to issue corrective or clarifying disclosures, enhance internal controls, or discipline personnel. n1 The information will also assist the CEO and CFO in assessing whether they can sign the certifications required by Sections 302 and 906 of the Sarbanes Oxley Act of 2002 and assist senior management and the Board in determining the appropriate priorities for the company to set in responding to the SEC investigation.

Unless there is corresponding litigation, counsel cannot use compulsory process to obtain evidence. In addition, company counsel may attend SEC testimony only if such counsel represents the individual witness. Accordingly, defense counsel's investigation usually consists of:

- reviewing company documents (including e-mails) and other documents made available to the company;
- interviewing officers and employees of the company and other cooperative witnesses;
- reviewing public sources of information, such as newspapers, SEC filings, and reports in the business press; and
- talking to counsel for other parties or reviewing the transcripts of testimony given by those persons before the SEC.

The information developed in such an investigation might expedite a favorable resolution of the investigation by enabling the company to persuade the Staff to discontinue, or at least limit, the investigation and by assisting defense counsel in preparing witnesses to testify accurately and effectively. Evidence gathered by counsel may strengthen the defense by enabling counsel to identify evidence that, for example, tends to corroborate the company's position or its disclosures or more effectively refreshes the recollections of the company's employees before they testify.

Defense counsel should carefully search for and review relevant documents. The SEC gives documentary evidence more credence than testimony. Accordingly, the Staff's theory underlying its investigation will be largely derived from documents, and the Staff will extensively use documents in investigative testimony. Counsel's review of the documents is critical in forecasting the direction and outcome of the investigation and in preparing witnesses for testimony.

In addition to searching for documents requested by the Enforcement Staff, the company and its counsel should consider whether to search for other documents relevant to the subject matter of the SEC investigation. These documents may be responsive to a future subpoena or assist the company in demonstrating that its conduct conformed to the law. The persons gathering the documents should keep a record of each file searched, the criteria applied during the search of that file, and the source of each document retrieved during the search.

Defense counsel will also interview company personnel. Unless company counsel also represents the interviewee, before or at the outset of the interview, the witness should be given what are referred to as "Upjohn warnings." In general, Upjohn warnings serve three primary purposes in an internal investigation. First, they lay the predicate for the company being able to assert attorney-client privilege with respect to the interview. Second, they ensure that the interviewee will not be able to successfully assert that the interview is protected by a privilege controlled by the interviewee. Third, they address the counsel's ethical obligation to ensure that the witness understands that the counsel represents the company, not the witness.

Thus, the interviewee should be informed, either orally or in writing, that counsel has been retained to represent the company. In addition, in-house counsel should instruct company witnesses to cooperate with company counsel, to keep confidential any communications with counsel, and to refrain from discussing the investigation with persons other than counsel. Unless company counsel represents the witness as well as the company, company counsel should consider advising the witness that:

- counsel does not represent the witness;
- while the witness should keep the interview confidential, the witness may discuss the interview with his or her separate counsel; and
- the company reserves the right to decide whether information obtained during the interview should be disclosed to any third party, including senior management or the SEC. n2

Consideration should be given to whether the witness should be specifically advised that:

- the witness's personal counsel may attend the interview,
- the company will indemnify the witness for reasonable fees and expenses associated with such counsel; and
- the Government might take the position that if the witness makes false statements to company counsel knowing that company counsel will forward those statements to the Government, the witness may be guilty of obstruction of justice.

Counsel should prepare for each witness interview by identifying significant documents, reviewing the information that other witnesses have provided, and identifying the key points to be covered with the witness. Counsel may want to prepare an interview outline and to compile documents to serve as both a guide and a checklist. Counsel must, however, be alert for additional topics to review with the witness.

In questioning a witness, it is often useful to begin with background questions that will help set the witness at ease and

build a rapport between counsel and the witness. Counsel should ask broad, open-ended questions regarding the events under inquiry. Asking broad, open-ended questions maximizes the likelihood that the witness will provide insights into the witness's perspective on the events and that counsel will elicit unanticipated, but potentially valuable, information.

Counsel should ask follow-up questions to obtain specific information underlying general answers. Counsel should also ask questions based on information learned from other sources. In posing questions based on information provided by other witnesses, counsel should hesitate before revealing the source of the information. Revealing what was said by a prior person can taint the recollection of the witness so that when the witness testifies months or years later, the witness has difficulty distinguishing between what the witness learned in the interview and what the witness knew prior to the interview.

Counsel should ask the witness questions based on documents. Before showing the witness documents, however, it is desirable to learn what the witness recalls without the aid of a document. If a document is shown to a witness at the outset, there is a danger that the witness will tend to adopt the information and characterizations in the document. Careful consideration of a document by the witness in advance of testimony often enables the witness to recall more fully the context in which the document was created and received.

Counsel should ask the witness about documents underlying the relevant events, both existing documents and documents that might no longer be in existence.

Counsel should ask the witness about other individuals who may have information regarding the relevant event. The identification of additional individuals with knowledge is an important goal of every interview.

Counsel should listen carefully to the answers. Counsel should consider what the witness has said and what the witness has not said.

It is often useful to have two attorneys present at the interview. While one attorney takes the lead in asking questions, the other can take notes and help to identify areas for further inquiry. In taking notes, counsel should be careful to note that the appropriate warnings were given to the witness. In taking notes and drafting interview memoranda, counsel should also be aware of the possibility that the company will ultimately waive the privilege and turn the interview memoranda over to the government.

Counsel typically prepares a memorandum of each witness interview. The memorandum of the interview should:

- be prepared by counsel,
- expressly state that it contains the mental impressions and conclusions of counsel,
- expressly state that it is not a substantially verbatim record of the interview, and
- reflect the provision of "Upjohn warnings."

Defense counsel should also review publicly available information. For example, in connection with SEC investigations into securities trades, counsel should obtain trading information from the listing exchange or from the NASDAQ and relevant news stories or analyst reports from computer databases.

Individuals or entities outside the company are also important sources of information. Company counsel should carefully consider contacting these persons (or their counsel) in order to learn the information in their possession and any information or documents that these individuals or entities provided to the SEC Staff. Before making these contacts, however, counsel should consider the impact such a contact might have on the company's business relationship, the

danger that such contacts will trigger rumors regarding the company, and whether the contacts are likely to be protected by a joint defense privilege. n3 Counsel should be mindful in interviewing these persons, however, that the fact and substance of the interview may be disclosed to the SEC and perhaps others. If there is a concern that the government might view the contact with the third person as obstruction of justice or as impeding the government investigation, counsel might consider consulting with the government before making such contact.

Defense counsel should consider whether persons other than the client are likely to have relevant documents. To the extent that the relevant documents are exculpatory or have been obtained by the SEC, counsel should consider attempting to obtain copies of such documents, regardless of whether they have been subpoenaed by the Staff. During the investigation, the SEC will not disclose those documents to company counsel except to the extent the Staff introduces the documents as exhibits in testimony. On the other hand, to the extent that such documents are incriminating and have not been obtained by the SEC, counsel should consider merely inspecting the documents. n4

[2] Internal Investigations

Internal investigations are common where a shareholder has filed (or is expected to file) a derivative action against corporate officers and/or directors. Courts are more likely to defer to not pursue claims against officers and directors if the decision is made by a committee of independent, disinterested directors based on an investigation by independent counsel and after sufficient deliberation by the committee. In addition, the Board of Directors or senior management might authorize an internal investigation in order to obtain information that will assist in the execution of their fiduciary duties to the corporation and its shareholders. The company might institute an internal investigation in response to pressure from auditors or others who have indicated that the financial statements might be misstated. The institution of the internal investigation can assist in the defense of an investigation by demonstrating that far from ratifying the suspected misconduct, senior management and/or the Board of Directors responded affirmatively to red flags. The presentation to the SEC and/or prosecutors of the findings of an internal investigation can sometimes assist in the expeditious resolution of an investigation or earn the company credit for cooperation.

Internal investigations are often especially appropriate where a company learns of a possible securities law violation before the initiation of an SEC investigation. In this circumstance, senior management and the Board of Directors need to learn the facts so that they can make informed decisions and determine whether remedial measures are necessary. For example, if the company determines that its financial statements might have been materially misstated, an internal investigation can assist the company in determining whether the company should restate its financial statements, whether the misstatement was the result of wrongdoing, whether any company personnel should be disciplined, and whether the company should enhance its system of internal accounting controls. In appropriate circumstances, it might be in the company's interest to report the results of the internal investigation to the SEC or other government authorities.

In October 2001, the SEC issued a report of investigation encouraging companies to institute internal investigations upon learning of possible violations of the federal securities laws and to report to the SEC the results of the investigation. n5 This report is commonly referred to as the "Seaboard § 21(a) Report." As reported in the Seaboard § 21(a) Report, the facts are straightforward. A controller at a subsidiary caused Seaboard Corporation's periodic reports to be misstated. On discovering the misconduct, Seaboard Corporation's internal auditors conducted an immediate inquiry and advised management, which notified the audit committee. The audit committee conducted an investigation through outside counsel, the controller and two other employees were fired, and the company issued a prompt public announcement of an anticipated restatement. Seaboard Corporation also cooperated with the Staff by providing "all information relevant to the underlying violations" and setting up meaningful remedial measures. The Commission decided not to bring an enforcement action against Seaboard and issued a report explaining the basis for this decision. In the report, the Commission indicated that among the reasons why it did not bring an enforcement action against Seaboard Corporation were the facts that upon learning of the possible violation Seaboard Corporation had instituted internal reviews performed by outside professionals unfettered by limitations or interference from interested persons, had taken corrective action, and had voluntarily reported the results of that internal review to the Staff. The report

provides only limited comfort to issuers; the Commission and the Staff have emphasized that even if an issuer takes prompt and effective corrective action and cooperates with the Staff, the Commission might bring an enforcement action against the issuer where the conduct was more egregious or the harm to the investing public more substantial.

If the company determines that there has been a violation and it appears that the SEC has not yet launched an inquiry, the company must decide whether to report the violation to the Staff. This is a delicate judgment. There are several reasons why the company should consider reporting the violation to the SEC. If the company's disclosures were materially false or misleading when made, the company may have a duty to correct those disclosures and any restatement of financial statements is likely to trigger any SEC enforcement inquiry. As indicated in the Seaboard § 21(a) Report, the SEC might treat the company more leniently if it voluntarily reports the potential violation to the SEC than if the SEC learns of the potential violation on its own. By voluntarily reporting the potential violation, the company can influence which members of the SEC Staff are involved in the investigation; some members of the SEC Staff have records for being more reasonable and efficient than other members of the SEC Staff.

There are also reasons why a company might refrain from reporting to the Commission that it has conducted an internal investigation and identified possible violations of the federal securities laws. If a company reports itself to the Staff, the company virtually guarantees that the Staff will open an investigation. Although the SEC Staff monitors SEC filings and news wire reports for announcements of restatements, it doesn't investigate everything. In addition, if a company voluntarily reports the results of an internal investigation, the Staff might press the company to provide information protected by attorney-client privilege or the work product privilege. While the Staff will often agree that the provision of privileged information does not waive the privilege, it is not clear whether such an agreement will prevent private litigants and others from arguing that the provision of information did waive the privilege.

Companies sometimes retain for the internal investigation a different law firm than the law firm retained to defend the company in the SEC investigation. It is clear that retaining separate law firms adds to the cost and disruption associated with an SEC investigation. Third parties might view the independence of the law firm conducting the investigation on behalf of the company as impaired if the company also represents members of the company's management. In some circumstances, the simultaneous representation of both the company and members of management might impose limits on the scope of the representations. Moreover, if the company discloses to the Enforcement Staff the results of the internal investigation, because courts are likely to hold that the disclosure waived any privilege that might otherwise protect the internal investigation. Accordingly, there is a risk that the attorneys who conducted the internal investigation might become testifying witnesses and therefore not be able to operate as defense counsel.

Companies sometimes ask the Enforcement Staff to defer seeking documents and taking of testimony for a short time pending completion of the company's investigation. In deciding whether to delay its investigation, the Staff considers the extent to which the internal investigation will be independent, n6 the nature of the suspected violations and whether they are ongoing, the amount of delay involved, whether there is ongoing harm to the investing public, and the extent to which the Staff will be given access to the results of the investigation, perhaps even including a report of the investigation and the underlying workpapers, and the apparent professionalism and depth of the investigation. n7

[3] Minimum Standards for Attorneys

Attorneys who represent issuers in SEC investigations, including law department attorneys supervising such attorneys, should be cognizant of the requirements of the SEC Standards of Professional Conduct for Attorneys. n8 These standards impose requirements on attorneys who "appear and practice before the Commission in the representation of an issuer," including a requirement to report "evidence of a material violation" up the ladder of the issuer's organization. n9 There are a number of exemptions to this requirement. One exemption applies to attorneys:

- (1) retained or directed by the chief legal officer (or the equivalent thereof);

2-10 Federal Securities Act of 1933 § 10.04

(2) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in;

(3) any investigation or judicial or administrative proceeding relating to such evidence of a material violation; and

(4) the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors or a committee of independent directors.

17 C.F.R. § 205.3(b)(6)(ii). An attorney also does not have such a duty if the engagement satisfies an alternative set of four criteria:

(1) the attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof);

(2) to investigate such evidence of a material violation;

(3) the attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

(4) except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors or a committee of independent directors.

17 C.F.R. § 205.3(b)(6)(i).

FOOTNOTES:

(n1)Footnote 1. In many instances, the audit committee will retain independent counsel to conduct an internal investigation. Defense counsel should consider consulting with audit committee counsel to consider the extent to which they can coordinate their efforts in order to reduce the duplication of effort and the burden that simultaneous information gathering processes place on company personnel. Differing missions and the associated privilege issues may, however, limit the amount of coordination.

(n2)Footnote 2. Confidential communications between company defense counsel and a company employee should be protected by the attorney-client privilege even if counsel does not represent the individual employee as long as he or she was interviewed because he or she was believed to possess information as a company employee that was necessary to the effective representation of the company. *See Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981) . A strong argument can be made that such communications with former employees of the company are also protected by the attorney-client privilege.

(n3)Footnote 3. *See, e.g., In re Grand Jury Subpoena Duces Tecum Dated Nov. 13, 1974*, 406 F. Supp. 381, 389-93 (S.D.N.Y. 1975) (describing the requirements of the joint defense privilege).

(n4)Footnote 4. *In re Grand Jury Subpoenas Dated Oct. 22, 1991*, 959 F.2d 1158, 1166 (2d Cir. 1992) .

(n5)Footnote 5. *See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Exch. Act Rel. No. 44969, AAER No. 1470 (Oct. 23, 2001).

(n6)Footnote 6. The Staff's perception regarding the independence with which the fact-gathering investigation was

conducted will turn on such factors as the identity of counsel conducting the investigation and the corporate officials to whom counsel reports. Accordingly, where the conduct of senior management is at issue, it might be appropriate to have counsel report either to the audit committee or a special committee of the Board of Directors.

(n7)Footnote 7. Given the risk that disclosure of the results of the investigation will constitute a waiver of the attorney-client privilege and of work-product protection, any interview notes, memoranda, and evaluative memoranda should be drafted with great care.

(n8)Footnote 8. 17 C.F.R. Part 205.

(n9)Footnote 9. 17 C.F.R. § 205.3.

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



150 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.05

§ 10.05 Issues in Representing Individuals

[1] Meeting with the Client

At the onset of the matter, counsel should meet with the individual client. Counsel should explain to the client how the Staff conducts an investigation and the possible outcomes. Counsel should caution the witness to maintain all documents arguably relevant to the SEC investigation and should caution the witness against discussing the investigation with others, explaining that the Staff is likely to ask the witness regarding all discussions the witness has had regarding the investigation.

Counsel should also begin gathering information from the individual. Counsel should ask about the individual's education and employment background, trading in relevant securities, and any prior involvement in criminal or civil litigation. Counsel should also begin obtaining evidence regarding the events underlying the investigation in order to begin to understand the individual's exposure and to develop a strategy for responding to the investigation. In many instances, company counsel and counsel to other witnesses can be valuable sources of information. Company counsel might provide copies of, or at least access to copies of, documents produced to the Staff and of e-mails and other documents associated with the individual.

Unlike U.S. Department of Justice prosecutors, the SEC Enforcement Staff do not routinely identify persons or entities as "targets" or "subjects" of an investigation. Indeed, the U.S. Supreme Court has held that the Commission is not required to notify the "targets" of nonpublic investigations when the SEC issues a subpoena to a third party. n1 Accordingly, it is often difficult to determine if a particular entity or individual is a target of the SEC investigation.

In 2010, the Enforcement Division revised its enforcement manual to provide a number of tools designed to foster cooperation. The Manual provides that an Assistant Director, with approval of a supervisor at or above the Associate Director level, may orally provide assurance that the Division does not anticipate recommending an enforcement action against the individual or company based upon the evidence currently known to the staff ("oral assurance"). n2 The Manual also provides that the Enforcement Division can agree to recommend to the Commission that the individual or company receive credit for cooperating in its investigation and related enforcement actions and, under certain circumstances, to make specific enforcement recommendations ("cooperation agreement"). n3 Defense counsel should consider whether to seek oral assurances or a cooperation agreement.

[2] Fifth Amendment Privilege against Self-Incrimination

Under the *Fifth Amendment of the U.S. Constitution*, an individual witness has the privilege not to make a "testimonial communication" that is "self-incriminating." n4 Corporations, partnerships and other collective entities do not have a privilege against self-incrimination. n5 Companies and other collective entities cannot decline to produce documents on the ground that its individual employees refuse to turn them over. n6

In general, the *Fifth Amendment* does not protect the contents of documents. n7 Under the "act of production" doctrine, an individual can decline to produce documents if the act of producing the documents is testimonial in nature and that testimony is self-incriminating. If the Government already knows the existence and location of the documents, the "act of production" doctrine might not be available. n8

A witness may assert the *Fifth Amendment* privilege against self-incrimination if the witness "reasonably believes that his testimony could be used in a criminal prosecution or could lead to other evidence that might be so used." n9 In general, a witness would likely have grounds for such a belief if the witness is a potential target of an SEC enforcement action.

The decision to assert the *Fifth Amendment* privilege against self-incrimination is a difficult one. In many instances in which a witness could validly assert the *Fifth Amendment* privilege against self-incrimination, it is nevertheless in the interest of the witness to produce documents and testify. A defendant who asserts the *Fifth Amendment* privilege against self-incrimination in litigation will encounter great difficulty defending that litigation. The trier of fact will be entitled to draw an adverse inference from the assertion of the *Fifth Amendment* privilege against self-incrimination during litigation of any civil enforcement action. n10 In addition, the defendant may be precluded from introducing evidence at trial. n11

During an investigation, the Staff is likely to focus its greater investigative energies on any witness who asserts the *Fifth Amendment* privilege against self-incrimination. By declining to testify based on the *Fifth Amendment* privilege against self-incrimination, a witness may forgo a valuable opportunity to present exculpatory information. In addition, the Staff tends to assume that a witness who declines to testify based on the *Fifth Amendment* privilege against self-incrimination will either continue to assert that privilege during litigation of any enforcement action or will give highly incriminating testimony. The Staff will be less forthcoming in the Wells Process if the potential defendant asserted the *Fifth Amendment* privilege against self-incrimination than if the witness testified. If the SEC brings an enforcement action against a defendant who asserted the *Fifth Amendment* privilege against self-incrimination during the investigation, the charging document is likely to plead that the defendant asserted the *Fifth Amendment* privilege against self-incrimination. Moreover, some companies will terminate any employee who asserts the privilege during an investigation.

Nevertheless, invocation of the *Fifth Amendment* privilege is prudent in some circumstances. It may be easier for a witness to defend a criminal prosecution successfully or negotiate a relatively favorable plea bargain, if the witness has declined to testify during the SEC investigation. In all cases, counsel should advise witnesses that false or misleading statements to the SEC may lead to criminal prosecution for perjury or obstruction of justice, even in cases that otherwise would not merit criminal interest. Accordingly, it often will be in the interest of the witness to decline to testify based upon the *Fifth Amendment* privilege against self-incrimination if a criminal prosecution is likely.

Asserting the *Fifth Amendment* privilege may also be in the witness's interest if the SEC is likely to bring an enforcement action against the witness regardless of whether the witness testifies. There are, of course, instances in which the testimony that a witness would provide would be sufficiently incriminating as to render an SEC enforcement action likely.

The Enforcement Staff often requires a witness to appear for testimony even if counsel to the witness notifies the Staff in advance of testimony of the witness's intention to assert the privilege in response to numerous questions. If the Staff does require the witness to appear, defense counsel should carefully prepare the witness to assert the privilege as

appropriate.

In rare circumstances, the SEC Staff seeks a grant of use immunity so that the SEC can compel a witness to testify despite the witness's willingness to assert the *Fifth Amendment* right against self-incrimination. The Organized Crime Control Act of 1970, provides that, where certain criteria are met and upon approval by a DOJ official at the level of an assistant attorney general or higher, the Securities and Exchange Commission may issue an order granting "use immunity" from criminal prosecution to a witness in an investigation and compelling his or her testimony and other information. *18 U.S.C. Sections 6001-6004*. This order federal and state governments from using a witness's compelled testimony, or the fruits of such testimony, against the witness in connection with criminal prosecution of the witness, except in a prosecution for perjury, false statement, or failure to comply with the order. Use immunity conferred to a witness in SEC investigations will not protect that witness from liability in civil proceedings. The SEC can still bring civil or administrative proceedings against the witness based upon the immunized testimony. If the Commission issues an order immunizing the witness and compelling testimony, the witness can no longer continue to refuse to testify either in the investigation or in a related enforcement action.

[3] Multiple Representation

Under the Commission's Rules of Practice, each witness has the right to be accompanied by counsel, but only if counsel represents the individual witness. n12 Thus, counsel for the company usually can attend testimony only if company counsel also represents the witness personally. The Staff will ask counsel to confirm this fact on the record at the beginning of the testimony.

Representing multiple witnesses can result in substantial cost savings. In addition, by representing multiple witnesses can assist counsel in mastering the facts and developing a set of insights into the Staff's approach

If a lawyer represents multiple clients in an investigation, the lawyer should obtain the informed consent of each client to the multiple representation and to lawyer's using that client's confidences and secrets in representing the lawyer's other clients to the investigation. The engagement letter for each client should specify that the client consents to the lawyer's continued use of confidences and secrets even if the lawyer ceases to represent the client because, for example, of a conflict of interest that precludes simultaneous representation.

Conflicts of interest can preclude counsel from representing both the company and an individual witness. A lawyer may not represent a witness in an SEC investigation if that representation will likely be adversely affected by the lawyer's representation of another witness unless the lawyer obtains the informed consent of the client after full disclosure. Unless a lawyer obtains the informed consent of the client after full disclosure, a lawyer also may not represent a witness in an investigation if the lawyer's professional judgment on behalf of the client will be or reasonably may be adversely affected by the lawyer's responsibilities to one or more other clients. In many instances, it is problematic for company counsel to represent a rogue employee.

In 2010, the Enforcement Division instituted measures to encourage individuals to provide extraordinary cooperation to the Enforcement Division. n13 In assessing whether a conflict of interest precludes multiple representation, counsel should consider these measures and the possibility that one prospective client might benefit from providing extraordinary cooperation to the detriment of another prospective client.

If counsel initially determines that it is appropriate to represent multiple clients in an investigation, counsel should reevaluate the situation as the investigation develops. It is particularly appropriate for counsel to re-evaluate the multiple representation if it appears likely that the Staff will make a Wells Call on two or more of counsel's clients or if criminal prosecution becomes likely.

Company counsel may decide that it can represent a witness only if the witness also has the benefit of separate counsel.

Separate counsel might be necessary to ensure that the client's consent to the multiple representation is informed. There might be issues as to which the ability of company counsel to provide impartial advice is impaired, particularly as to advising the witness regarding the *Fifth Amendment* privilege against self-incrimination. This difficulty can be addressed by bringing in separate counsel to advise the individual on the *Fifth Amendment* issue. Separate counsel can also mitigate the potential harm if company counsel later has to withdraw from representing the individual. For example, company counsel will often find it difficult to simultaneously represent multiple witnesses once the Staff has made Wells Calls. At that point, a witness could be prejudiced if separate counsel had not already become familiar with the matter.

[4] Indemnification of Legal Fees

Most corporate charters and by-laws permit or require a company to pay legal fees incurred by a company officer in response to an investigation relating to the company. Under Delaware corporate law, for example, a corporation may indemnify a corporate director, officer or employee for expenses (including reasonable attorneys' fees) incurred by reason of the fact that the person is a director, officer or employee of the corporation provided the person acted in good faith and in a manner the person reasonably believed to be in the corporation's best interest. Corporate charters and by-laws typically provide that indemnification shall be provided to the fullest extent permitted by law. In addition, indemnification often benefits company because it is in the interests of the company that its personnel testify truthfully and effectively.

Companies that advance legal fees typically require the covered employee to undertake to reimburse the company in certain limited circumstances. In *Messing v. FDI, Inc.*,ⁿ¹⁴ for example, the court noted that Delaware law required a resolution of the board of directors and the receipt of an undertaking from the director (whose fees would be paid by the company) regarding his obligation to reimburse the company if no indemnification was available before making any expenditure of corporate funds in connection with the representation of corporate directors.

FOOTNOTES:

(n1)Footnote 1. *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984) .

(n2)Footnote 2. SEC Enforcement Manual § 6.2.1 at 125, available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

(n3)Footnote 3. SEC Enforcement Manual § 6.2.2 at 126, available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

(n4)Footnote 4. *Fisher v. United States*, 425 U.S. 391, 408 (1976) .

(n5)Footnote 5. *Braswell v. United States*, 487 U.S. 99 (1988) .

(n6)Footnote 6. *In re Three Grand Jury Subpoenas*, 847 F.2d 1024, 1029 (2d Cir. 1988) .

(n7)Footnote 7. *In re Grand Jury Subpoena Duces Tecum Dated October 29, 1992*, 1 F.3d 87, 93 (4th Cir. 1993) .

(n8)Footnote 8. *Fisher v. United States*, 425 U.S. 391, 411 (1976) .

(n9)Footnote 9. *Kastigar v. United States*, 406 U.S. 441, 444-45 (1972) .

(n10)Footnote 10. *Baxter v. Palmigiano*, 425 U.S. 308, 318 (1976) .

(n11)Footnote 11. See *SEC v. Grossman*, 121 F.R.D. 207, 210 (S.D.N.Y. 1987) . But see *SEC v. Graystone Nash, Inc.*, [1993-94 Tr Binder] Fed. Sec. Reg. P 98,320 (3d Cir. June 1, 1994).

(n12)Footnote 12. Rule 7(b), SEC Rules Relating to Investigations, 17 C.F.R. § 205.7(c).

(n13)Footnote 13. Robert Khuzami, "Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders," (Jan. 13, 2010), available at <http://www.sec.gov/news/speech/2010/spch011310rsk.htm>. Discussed further *infra* at § 10.13[3][g].

(n14)Footnote 14. *Messing v. FDI, Inc.*, 439 F. Supp. 776 (D.N.J. 1977) .

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



151 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.06

§ 10.06 Production of Documents and Information to the Division of Enforcement Staff

Documents play a central role in SEC investigations. The Staff can request that a person voluntarily produce documents and information or, in formal investigations, issue subpoenas demanding the production of documents. In addition, the Staff can utilize the SEC's examination power to obtain documents and information from regulated entities, such as securities broker-dealers. n1

Once the Commission has issued a Formal Order of Investigation, the Staff can issue a subpoena *duces tecum*, calling for the production of documents. Typically, the subpoena will call for the production of original documents, and the transmittal letter from the Staff will state that the witness may instead produce copies at his or her expense.

[1] Negotiating with the Staff Regarding the Subpoena

SEC subpoenas are typically very broad. In part, the Staff deliberately drafts subpoenas broadly in order to ensure that the recipient preserves all documents likely to be relevant. In part, the breadth results from a lack of familiarity with how the company operates and compiles and maintains information, requests for documents often are ambiguous and burdensome. When a company receives a subpoena, counsel should confer with the company regarding the scope of the subpoena in order to:

- ensure that no documents responsive to the subpoena will be discarded or destroyed,
- determine the extent to which the subpoena is ambiguous or burdensome, and
- begin the process of gathering responsive documents. n2

The Staff will often agree to narrow a subpoena or defer production as to portions of the subpoena if they believe such action will likely accelerate production of more important information. Sometimes, the cost of photocopying the responsive documents is burdensome because of the number of documents or because of the size or condition of such documents. In such circumstances, the Staff sometimes may agree to inspect the documents and designate which are of interest to the Staff, rather than requiring the company to produce all responsive documents. Counsel and the company should consider whether the Staff should be asked to inspect the documents at the company's offices or off-site (e.g., counsel's offices).

The Staff can often be persuaded to alter or defer requests for documents reflecting certain information if counsel explains that locating responsive documents would be burdensome (e.g., require manual searches at numerous locations). The Staff is especially likely to alter or defer a portion of its request (or defer a portion of its request), if the company identifies alternative documents that contain comparable information and can be located with substantially less difficulty or offers to create documents containing the requested information.

The initial discussion with the Staff regarding documents often provides counsel with a vehicle for attempting to explore the Staff's view of the investigation and the Staff's perception of the client. Given that counsel may not have mastered the facts in time for this discussion, counsel should hesitate to provide information to the Staff at this early stage of the investigation. The discussion, nevertheless, may provide an opportunity for counsel to begin attempting to influence the Staff's view of, and approach to, the matter.

The Staff often subpoena documents with a return date two to four weeks in the future, but will usually agree to extend the return date if counsel and the company can explain why such a reasonable extension is appropriate. In many instances, the Staff will agree to a rolling production based on the Staff's priorities or the degree of difficulty involved in the company's retrieving and reviewing the documents.

Companies should never ignore an SEC subpoena. Lack of timely responsiveness to a subpoena will detract from the company's credibility and working relationship with the Staff and significantly increase the burden of responding to the Staff's requests. Moreover, failure to comply with a Commission subpoena "without just cause" is punishable as a misdemeanor. Extensions and other modifications of a subpoena should be confirmed in writing.

[2] Searching for and Reviewing Documents

The search for documents should be thorough. Even if the company conducted a reasonable, good-faith search at the outset, if significant responsive documents surface late in the investigation, the Staff may infer that the documents were deliberately withheld in order to obstruct the probe. Accordingly, a systematic effort should be made to identify all locations reasonably likely to contain documents responsive to the subpoena or document request. Each of these locations should then be searched for responsive documents by persons who understand the request and understand the importance of exercising care in locating and identifying documents. Counsel often supervises and tests the thoroughness of the search. The persons conducting the search should maintain a record of each location searched, when the location was searched, who conducted that search and the search criteria applied.

The search for documents should not necessarily be limited to documents responsive to the subpoena. The search should be extended to cover additional documents that help to explain the relevant events or that might contain exculpatory or inculpatory information. Even if a document is clearly not responsive to the current subpoena, the Staff might issue subsequent, broader subpoenas. In addition, nonresponsive documents can help counsel understand the case, advise the company, and prepare witnesses for testimony.

Many SEC defense counsel interpret SEC subpoenas more broadly than they would a document request or subpoena served in private litigation. In private litigation, defense counsel often are prepared to rely on a narrow reading of a subpoena as long as they believe that they can persuade a relatively impartial court that their interpretation was supported by a good faith reading of the subpoena or document request. In an SEC investigation, defense counsel reason that there will likely be an adverse impact on the credibility of the company and defense counsel if the SEC Staff learns of a significant document that was not produced because it was deemed nonresponsive, unless the Staff can be persuaded that the subpoena that they drafted did not call for such documents. Given the natural tendency of some Staff members to assume that the subpoena that they drafted called for all significant documents, this is a substantial burden.

Many defense counsel rely on search terms when searching electronic documents, such as e-mails. Search terms can

substantially reduce the cost of gathering and reviewing electronic documents. If defense counsel elects to rely on key word searches, defense counsel should consider consulting with the SEC regarding the search terms.

In addition, it often is appropriate to consult with the Staff regarding the format in which electronic documents will be produced.

[3] Producing Documents

The Staff will usually accept the production of copies in lieu of originals. Counsel typically use Bates coding to identify each page of a production. The code should not conceal any text or marking on the document. Documents produced to the Staff should also be labeled with a request for confidential treatment for the purposes of the Freedom of Information Act. n4 The Staff generally does not reimburse for costs incurred in searching for and copying documents, reasoning that the Staff takes the position that reimbursement is not appropriate because it is entitled to the originals and is accepting copies as an accommodation to the recipient of the subpoena. n5 Witnesses typically retain originals and produce a set of numbered copies.

The letter transmitting the documents to the Staff should identify the numerical range of the documents being produced and request that they be accorded confidential treatment for the purposes of FOIA. A copy of the request for confidential treatment should be sent to the SEC's FOIA officer.

When producing documents, counsel should consider addressing with the Staff documents that on first examination might appear to be problematic for the client. It sometimes is useful to defuse these documents at the time of production by putting them into context or otherwise explaining why a more benign interpretation is appropriate. For example, in an investigation into whether a company's publicly disclosed revenue projections were realistic, there might be an internal forecast that deliberately incorporated conservative assumptions to assist the company in determining whether it would still satisfy its loan covenants if the company performed worse than expected. It might benefit the company to provide this explanation to the Staff.

If requested documents contain trade secrets, counsel should consider taking steps to protect the trade secrets. While the law on the subject is unclear, where documents contain trade secrets the Staff may agree to a solution that serve the needs of the Staff while protecting the legitimate interests of the company. For example, counsel might offer to make the documents available for inspection while declining to produce copies.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Exchange Act § 17(b), **15 U.S.C. § 78q(b)** ; Investment Company Act § 31(b), **15 U.S.C. § 80a-30(b)** .

(n2)Footnote 2. When an individual receives a subpoena, counsel and the individual should also consider whether the individual will decline to produce documents on the grounds of the *Fifth Amendment* privilege against self-incrimination.

(n3)Footnote 3. Exchange Act § 21(c), **15 U.S.C. § 78u(c)** .

(n4)Footnote 4. **5 U.S.C. §§ 552 to 559** .

(n5)Footnote 5. In exceptional circumstances, the recipient of a subpoena might be entitled to reimbursement. *See SEC v. Arthur Young*, 584 F.2d 1018 (D.C. Cir. 1978) .

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



152 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.07

§ 10.07 Providing Information Compilations to the Staff

Especially at the outset of a probe, the Staff often asks for information on a voluntary basis. For example, especially in insider trading investigations the Staff might ask for a chronology setting forth events, the identity of persons with knowledge of those events, and the dates on which such persons obtained that knowledge.

Great care should be taken when preparing a compilation of information for the Staff. First, the Staff may rely on the compilation in conducting the investigation and determining whether an enforcement action is appropriate. Second, the company and counsel may lose credibility if the Staff determines that the compilation is incomplete or inaccurate. Third, a chronology of events submitted to the SEC might be admitted as evidence in a judicial proceeding. Fourth, deliberately false statements in the chronology would be subject to criminal prosecution under **18 U.S.C. § 1001**.

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



153 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.08

§ 10.08 Preparing Witnesses for Testimony

The Staff usually obtains information from witnesses through testimony that is provided under oath in the presence of a court reporter. Under certain circumstances, the Staff proceeds through interviews that are not transcribed or recorded. The Staff might proceed with an interview early in the investigation when the Staff is still in the process of trying to decide to proceed. The Staff might proceed with a telephone interview when the witness is sufficiently peripheral to the investigation that the Staff believes that the cost and inconvenience of testimony is unwarranted.

The Staff also sometimes proceeds with in-person interviews that are off-the-record. The Staff might proceed with such an interview when the Staff believes that a criminal proceeding is likely and the prosecutors would prefer that the Staff not create prior written statements of witnesses. The Staff sometimes agrees to an off-the-record interview when an settlement agreement has been tentatively negotiated and the purpose of the interview is to confirm that the settlement terms are appropriate.

It is important to treat interviews seriously even if they are not being recorded or transcribed. An imprecise or inaccurate statement during the interview could have serious ramifications. Great care should be taken to ensure that the witness is prepared to answer questions accurately and effectively. Witnesses have been prosecuted for statements made in interviews. Especially if the interview occurs early in the investigation, the interview can greatly influence the Staff's view of the witness and the matter.

Testimony before the Commission is integral to the effective defense of the corporate client and many of the individual witnesses. In many respects preparation of a witness for testimony is similar to the preparation of a witness for a deposition. Counsel should educate the witness about the Staff's likely focus in the anticipated testimony. It is important for the witness to understand, to the extent possible, the Staff's working theory of the case so that the witness can frame precise answers to the Staff's questions, identify additional information that might assist the Staff in determining that the federal securities laws have not been violated, putting damaging disclosures in an appropriate context, and respond effectively to unanticipated documents or questions.

In preparing for testimony, counsel should review with the witness the key events most likely to be the focus of the Staff's questioning. In large part, this aspect of the preparation should proceed in a manner similar to the interview of a witness. Discussing these events in advance of the testimony often refreshes the recollection of the witness and provides an opportunity for the witness to explore with counsel the implications of the witness's recollections.

Counsel should further prepare the witness for testimony by engaging in question and answer sessions in which the witness practices answering counsel's questions as if the witness were testifying before the SEC. During these sessions, counsel should note how the witness is answering the questions so that counsel can then give the witness constructive feedback on both the positive and the negative aspects of the witness answers.

In addition, counsel should advise the witness of the importance of telling the truth. Counsel should explain that telling the truth is important both because lying during testimony is a crime and because lying undermines the witness's credibility. Counsel should consider cautioning the witness that falsely testifying not to recall a material fact is perjury. n1 According to federal law:

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under [Title 18] or imprisoned not more than five years, or both. n2

Section 1621 further provides:

Whoever ... having taken an oath before a competent tribunal, officer, or person, in any case in which a law of the United States authorizes an oath to be administered, that he will testify, declare, depose, or certify truly, or that any written testimony, declaration, deposition, or certificate by him subscribed, is true, willfully and contrary to such oath states or subscribes any material matter which he does not believe to be true ... is guilty of perjury and shall ... be fined under this title or imprisoned not more than five years, or both. n3

Counsel should explain to the witness that his or her demeanor is important, because the Staff members at the testimony will perform a significant role in forming the decision of the senior Staff and the Commission regarding the nature and extent of any enforcement action that will be authorized by the Commission. The witness should be advised to be respectful, but not obsequious, hostile, or familiar. The witness should be advised to avoid attempts at humor, and that all statements made in the presence of the Staff, even "off the record," might have an impact on the outcome of the investigation.

While witnesses generally should not volunteer information not required by the questions posed by the Staff, because the Staff and the Commission will rely heavily on the transcript of the testimony in assessing whether to bring an enforcement action, counsel should consider advising the witness to volunteer facts important to the defense. Accordingly, an important part of the preparation for testimony may be the process of gathering and identifying those facts and themes that are important to the defense.

Defense counsel should caution the witness not to testify regarding events based on surmise, except to the extent that defense counsel and the witness have specifically agreed otherwise. Because of an eagerness to cooperate with the Staff, many witnesses have a tendency to testify as if they recall certain events when, in fact, they are merely speculating that such events might well have occurred. Unless the witness clearly indicates that the testimony is based on surmise or speculation, the testimony can inadvertently mislead the Staff and (if the testimony conflicts with other evidence) create credibility problems for the witness or for others. Even if clearly identified as speculation or surmise, such testimony can unnecessarily prolong the testimony. In the exceptional circumstance where speculation is appropriate, the witness should make it clear that the testimony is speculation.

Counsel should attempt to familiarize the witness with what is likely to happen during the testimony, including the format of the testimony room, the number of SEC Staff members likely to attend, and the role of the court reporter.

Counsel should review with the witness the speech that the Staff members will give at the beginning of the testimony and the questions that the Staff typically asks at the beginning of testimony. There are certain questions that the Staff routinely asks witnesses. The Staff routinely asks for information regarding the witness's address, telephone numbers, educational background, employment background, criminal convictions, and securities activities. The Staff also routinely asks about the witness' search for documents, whether the witness knows of anyone else who has provided testimony, whether the witness has reviewed any transcripts or summaries of testimony, whether the witness has discussed the witness's testimony or the investigation with any person, whether the witness has been convicted of any crime other than a traffic offense, and whether the witness has testified before.

Counsel should review with the witness topics likely to implicate the attorney-client or work product privilege. In order to protect the privilege, it is prudent to alert the witness to identify for counsel questions that call for him or her to testify regarding any meeting at which counsel to the company or to the witness was present or any document that was addressed to or from counsel for the company or the witness. For example, the Staff might ask from whom the witness learned a certain fact and, unbeknownst to counsel, the witness may have first learned that information through a privileged communication from other company counsel. The witness should be instructed to confer with counsel before testifying regarding any communication between counsel and either the witness or the company.

The Staff often relies heavily on documents when questioning a witness and will frequently endeavor to use documents to refresh a witness's recollection. Counsel should explain to the client the concept of refreshed recollection and admonish the client not to testify to recalling a document merely because it shows the witness as an author or recipient of the document or an event merely because the event is described or referred to in the document.

The SEC Staff often asks questions that incorporate characterizations of the witness's prior testimony. Counsel should prepare the witness to be alert when addressing such questions and on various approaches to addressing mischaracterization by the Staff.

FOOTNOTES:

(n1)Footnote 1. *See, e.g., United States v. Chapin*, 515 F.2d 1274, 1284 (D.C. Cir. 1974) .

(n2)Footnote 2. **18 U.S.C. § 1001** .

(n3)Footnote 3. **18 U.S.C. § 1621** .

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



154 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.09

§ 10.09 Defending SEC Testimony

[1] Authority of the Staff to Take Testimony

Unless the enforcement investigation is defused in the very early stages, the Staff will usually seek to take the testimony of corporate personnel and other individuals under oath. Usually, the Staff prefers to have completed most of its document collection and review before launching this phase of the investigation, although its efforts to obtain relevant documents will likely continue throughout the investigation.

Once a Formal Order has been issued, the Staff has the authority to subpoena witnesses to appear anywhere in the country: "[T]he attendance of witnesses and the production of [books, papers, correspondence, memoranda, and other records] may be required from any place in the United States or any State at any designated place of hearing." n1 Thus, the Staff can subpoena the witness to appear at the Staff's offices even if the witness resides in California and the Staff is located in Washington, D.C. or Miami, Florida. The location of the testimony is, however, often subject to negotiation.

The SEC subpoena will often call for the witness to appear for testimony at the offices in which the Staff is located (e.g., a subpoena issued by Staff of the Northeast Region is likely to call for the witness to appear at the SEC offices in New York). It is sometimes possible to persuade the Staff to take the testimony in a location that is more convenient for the witness. However, the Staff will almost always insist on taking testimony either at an SEC office or other federal government office.

Witnesses summoned to appear before the Commission are entitled to the same witness fees and mileage as witnesses in the courts of the United States. n2 The SEC will also pay "reasonable travel expenses" of the witness up to certain caps. After the testimony, the witness can submit a request for witness fees and for reimbursement of travel expenses. The SEC does not reimburse witnesses for either the legal fees or the travel expenses incurred by requiring counsel to travel.

The Staff will often subpoena the witness to appear for testimony two to four weeks after the date on which the subpoena was served. The date of the testimony is often subject to negotiation, especially if either the witness or counsel has a scheduling conflict. If the return date on the subpoena does not provide sufficient time for preparation, counsel should attempt to negotiate a reasonable extension.

The Staff is under pressure to speed investigations along. Accordingly, in circumstances where it appears likely that the witness will eventually be subpoenaed, it is prudent to begin the preparation process before the Staff has served a subpoena.

[2] Right of the Witness to be Represented by Counsel

The Commission's Rules of Practice provide the following description of the role of a witness's counsel during SEC testimony:

The right to be accompanied, represented and advised by counsel should mean the right of a person testifying to have an attorney present with him during any formal investigative proceeding and to have this attorney (1) advise such person before, during and after the conclusion of such examination; (2) question such person briefly at the end of the examination to clarify any of the answers such person has given; and (3) make summary notes during such examination solely for the use of such person. n3

It will sometimes be appropriate for an expert to accompany counsel in order to assist in defending the SEC testimony. For example, in an investigation involving complex accounting issues, an accounting expert sometimes accompanies counsel.

The SEC's Rules of Practice do not expressly state that an expert may accompany counsel at testimony; however, the U.S. District Court for the District of Columbia has held that an expert may accompany counsel for the purpose of providing assistance. n4 In *SEC v. Whitman*, n5 each of two witnesses refused to testify unless the Staff permitted an accountant to accompany and assist each witness and his counsel during the actual taking of testimony. Refusing to enforce the subpoenas unless the SEC permitted the accountant to accompany and assist the witnesses, the court said that, in light of the Administrative Procedure Act, to the extent the Commission's rules impinged "upon counsel's ability to adequately represent his client who has been called upon to testify, they cannot be upheld." n6

Prior to the witness's testifying, counsel should ascertain if the witness suffers from a medical condition rendering him or her particularly susceptible to fatigue, memory lapses, or other conditions that might impair the ability to testify effectively. If the witness has such a condition, counsel should consider notifying the SEC Staff of that condition at or before the outset of testimony.

[3] Representing the Witness During Testimony

The rules of practice governing investigations do not expressly permit counsel to object to the questions posed by the Enforcement Staff, and the Staff frequently notes that the federal rules of procedure and evidence do not govern SEC testimony. It is usually appropriate for counsel to note on the record defects in the Staff's questions (e.g., the question is compound or ambiguous, the question assumes the existence of a fact not in evidence). Counsel should be alert for Staff questions that inadvertently distort a witness's testimony or that contain an inaccurate premise. While it is often preferable for a witness to handle such questions without the intervention of counsel, counsel should intervene as necessary to protect the integrity of the record. If possible, counsel should make his or her points in a manner that demonstrates a desire to enhance, rather than obstruct, the ability of the Staff to obtain accurate and reliable information.

The Staff respects the attorney-client and work-product privileges and other privileges recognized by federal law. Counsel can and should object to questions that call for information protected by the attorney-client privilege and the work-product doctrine. If necessary, counsel should instruct the witness not to answer such questions.

Counsel should monitor the condition of the witness. Testifying before the Staff can be extremely demanding. Accordingly, counsel should request a break whenever the witness appears to be tiring. Although the Staff controls the timing of breaks, it will almost always accommodate such a request.

The SEC often relies heavily on documents during testimony. In general, counsel should ensure that the witness does not respond to questions regarding a document until the witness has completed reading the document. Where the Staff has focused on only a portion of a long document, it sometimes is appropriate to have the witness respond after reading only that portion and the surrounding portions. This should only be done if the record reflects that the witness has not read the entire document.

Occasionally, a witness will inadvertently give an answer that is not completely accurate. For example, the witness might inadvertently neglect to identify one or two persons who were present at a meeting. Counsel should either confer with the witness on such occasions to determine if the witness has testified inaccurately or ask a question designed to supplement or correct the testimony. Prompt supplementation will help preserve the witness's credibility. In addition, while prompt clarification, supplementation, or correction of testimony arguably is not a defense to a charge under §§ 1001 or 1621 of the United States Code for false statements, n7 it is likely to be viewed as strongly negating the element of intent. For example, the court in *Fletcher v. Hook* n8 affirmed the district court's dismissal of a perjury claim where the false statement was corrected later in the person's testimony. n9

There are a number of methods by which the testimony of a witness can be clarified, supplemented, or corrected. Preferably, the witness can work the supplementation into responses to questions posed by the Staff. Alternatively, during the course of the testimony, the Staff will usually permit the witness to make a clarifying statement or permit counsel to ask clarifying questions. In addition, at the conclusion of the testimony, the witness may make clarifying statements and counsel may ask clarifying questions.

Counsel should determine whether it is in the interest of the witness to bring additional or clarifying information to the attention of the Staff through questions posed by counsel. While the rules explicitly provide for clarifying questions only at the conclusion of testimony, the Staff will usually permit counsel to ask brief clarifying questions of the witness during the course of the testimony. The testimony of a witness is often of great importance in influencing the outcome of an investigation. In general, if the Staff's questioning does not permit the witness to present exculpatory evidence, counsel should consider asking questions that will elicit the evidence.

Counsel should request on the record that the transcript and all other records of the testimony be accorded confidential treatment pursuant to 17 C.F.R. § 200.83 and the Freedom of Information Act.

[4] Obtaining a Transcript of the Testimony

A witness who has provided testimony has a qualified right to obtain a copy of the transcript of the testimony upon payment of a fee to the reporter:

A person who has submitted documentary evidence or testimony in a formal investigative proceeding shall be entitled, upon written request, to procure a copy of his documentary evidence or a transcript of his testimony on payment of the appropriate fees; *provided, however*, that in a nonpublic formal investigative proceeding the Commission may for good cause deny such request. In any event, any witness, upon proper identification, shall have the right to inspect the official transcript of the witness's own testimony. n10

In deciding to request a copy of the transcript, counsel should consider not only the expense involved in obtaining the transcript, but also the risk that the witness might be required to produce the transcript in response to a discovery request served in civil litigation. n11 It is rare for the Commission to deny a request for a transcript. If counsel needs to obtain the transcript quickly, he or she should check on the Staff's processing of the request.

The transcript of the testimony provided by the Staff does not include a copy of the exhibits shown to the witness. Accordingly, during the testimony counsel should either keep a careful record of the documents shown to the witness as

exhibits, or ensure that the transcript will contain a sufficiently detailed description of the document to enable counsel to identify the document.

In addition to having a conditional right to purchase the transcripts, the witness and his or her counsel have the right to inspect the transcript. Many Staff members acknowledge that this right includes the right after the testimony to inspect exhibits used during the testimony.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Exchange Act § 21(b), **15 U.S.C. § 78u(b)** .

(n2)Footnote 2. Rule 232(f), SEC Rules of Practice, *17 C.F.R. § 201.232(f)*.

(n3)Footnote 3. Rule 7(c), SEC Rules Relating to Investigations, *17 C.F.R. § 203.7(c)*.

(n4)Footnote 4. *See SEC v. Whitman*, 613 F. Supp. 48 (D.C. Cir. 1985) .

(n5)Footnote 5. *SEC v. Whitman*, 613 F. Supp. 48 (D.C. Cir. 1985) .

(n6)Footnote 6. *Whitman*, 613 F. Supp. at 49 .

(n7)Footnote 7. **18 U.S.C. §§ 1001 , 1621.**

(n8)Footnote 8. *Fletcher v. Hook*, 446 F.2d 14 (3d Cir. 1971) .

(n9)Footnote 9. *Fletcher*, 446 F.2d at 16 .

(n10)Footnote 10. Rule 6, SEC Rules Relating to Investigations, *17 C.F.R. § 203.6*.

(n11)Footnote 11. Even if the witness does not order and obtain the testimony transcript, there is a substantial likelihood that a court would order the witness to request the transcript if the witness was served in civil litigation with a subpoena or document request calling for the production of such transcript. *In re Woolworth Corp. Secs. Class Action Litig.*, 166 F.R.D. 311 (S.D.N.Y. 1996) .

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



155 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.10

§ 10.10 Wells Process

After the SEC Staff has tentatively decided that an enforcement action is appropriate, but before it submits the recommendation memorandum to the Commission, the Staff ordinarily will contact counsel to each prospective defendant and provide notice of its tentative decision. Although the SEC rules provide that the Staff has discretion not to provide such notice, the Staff routinely provides such notice absent unusual circumstances (e.g., the Staff intends to seek a temporary restraining order freezing funds, the Staff fears that the prospective defendant might flee the country).

The Staff can provide the notice by telephone call or letter or a telephone call promptly followed by a letter. The notification is commonly referred to as a "Wells Call." The Staff will typically state that the prospective defendant will be given an opportunity to make a written or videotaped submission setting forth the position and arguments of the individual or entity. n1 This statement is known as a "Wells Submission," after John A. Wells, who chaired the Advisory Committee on Enforcement Policies and Practices (known as the Wells Committee) in 1972.

In response to recommendations made by the Wells Committee, the Commission published Securities Act Release No. 5310, *Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, n2 that vests the Staff with discretion to advise prospective defendants of the indicated violations and to allow them to submit to the Staff a written statement setting forth their "interests and position." As described in the Commission's rules, if the Staff recommends that the Commission authorize an enforcement action, the Staff must forward the submission to the Commission with the Staff's recommendation memorandum:

Persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation. Upon request, the Staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a Staff recommendation to the Commission for the commencement of an administrative or injunction proceeding. Submissions by interested persons should be forwarded to the appropriate Division Director or Regional Director, or District Administrator with a copy to the Staff members conducting the investigation and should be clearly referenced to the investigation to which they relate. In the event a recommendation for the commencement of an enforcement proceeding is presented by the Staff, any submissions by interested persons will be forwarded to the Commission in conjunction with the Staff

memorandum. n3

If, after reviewing the Wells Submission, the Staff decides to recommend an enforcement action, then the Staff's memorandum, along with the prospective defendant's Wells Submission, is distributed to the Commissioners and to senior officers of other offices and divisions of the SEC. If the Staff's proposal is to be addressed in the ordinary course of business, the Commission will meet to act on the recommendation within several weeks of docketing of the matter. The Commission considers the recommendation of the Staff at a closed meeting, without the presence of the prospective defendant or defense counsel.

It is not unusual for the Staff to inform defense counsel that he or she has only 20 days or less from the date of the initial Wells Call to file the Wells Submission. Often the Staff will grant limited extensions if warranted by the circumstances; however, the Staff is under considerable pressure by management to conclude the Wells process without delay. Accordingly, if a Wells Call appears likely, it might be appropriate to begin preparing the Wells Submission in advance of the Wells Call.

[1] Anticipating Impact of Possible Wells Call

Defense counsel should consider asking the Staff to notify counsel if the Staff is considering making a Wells Call. The receipt of a Wells Call can have a substantial adverse impact on an individual or company. For example, the National Association of Securities Dealers (the "NASD") requires a person associated with a NASD member securities firm to update his or her Form U-4 upon, among other things, written notification that he or she is the subject of an SEC investigation that could result in an adverse finding against the person. n4

In addition, a public company might consider it appropriate to disclose the receipt of a Wells Call by a senior officer of the company. In light of the significant adverse ramifications that such a Wells Call can have, Staff members will sometimes agree to notify defense counsel in advance of a Wells Call that the Staff has serious concerns which could ultimately lead to the initiation of the Wells Process. Defense counsel can at this earlier stage attempt to persuade the Staff that an enforcement action is inappropriate.

[2] Obtaining As Much Information As Possible Regarding the Staff's Case

When seeking authority from the Commission to institute an enforcement action, the Staff submits to the Commissioners a memorandum recommending the institution of an enforcement action. The Staff's memorandum usually sets forth the key evidence and legal theories on which the Staff has based their conclusion that the federal securities laws have been or are about to be violated and that an enforcement action should be brought. The preparation of the memorandum can consume weeks or even months as it winds its way through the various layers of supervisory review and is amended to respond to factual or legal arguments set forth in a Wells Submission.

The Wells Submission should respond to the arguments that the Staff makes in its recommendation memorandum. Because the Staff's recommendation memorandum is a confidential document and will not be made available to defense counsel, it is important to elicit from the Staff as much detail as possible regarding the bases for its proposed recommendation.

As indicated above, throughout the information-gathering phase of the investigation, counsel should endeavor to identify the Staff's concerns and potential arguments. Usually, counsel can ascertain many of the Staff's concerns and potential arguments by becoming familiar with the priorities and management realities which drive the SEC's enforcement program, conferring with other defense counsel, and reviewing documents and testimony. n5 Counsel can also learn valuable information by engaging in an ongoing dialogue with the Staff throughout the information-gathering phase of the investigation.

Upon receiving a Wells Call, defense counsel should attempt to supplement this information. In the initial Wells Call letter, the Staff will typically provide a cursory outline of the charge that it tentatively decided to recommend. For example, the letter might do little more than identify the statutory provisions allegedly violated and the nature of the relief tentatively sought by the Staff (e.g., an injunction, civil penalties, a cease-and-desist order, a bar from association with a broker-dealer). If the initial Wells Call is a telephone call, the Staff will often provide more information.

Upon receiving a Wells Call, defense counsel should attempt to engage in a detailed discussion with the Staff. These discussions often involve the investigators who conducted the investigation and the superiors who are familiar with the investigation. When appropriate, counsel can ask for a meeting in order to obtain a more detailed understanding of the basis of the Wells Call. Such a meeting is especially likely to be appropriate if defense counsel is newly hired in response to the Wells Call.

There is a significant range of practices regarding the extent to which the Staff will provide details regarding the theory and evidence underlying its tentative decision. There are several reasons why the SEC Staff should disclose their concerns and potential arguments to defense counsel. Full disclosure improves the ability of the Senior Staff and the Commission to evaluate the Staff's recommendation after having been tested by a well-informed Wells Submission that carefully addresses the Staff's concerns and arguments. It is in no one's interest for the SEC to institute an enforcement action based on a mistaken view of the evidence or the law. In addition, the more information the Staff provides to defense counsel, the more likely it is that the Staff can persuade defense counsel that prompt settlement is in the best interests of counsel's client. For these reasons, among others, the Staff typically is willing to share information in some detail as they set forth their perception of the evidence and the law during the Wells process.

While a limited amount of defense advocacy is sometimes appropriate, defense counsel's primary goal at this phase of the Wells process is usually to obtain as much information as possible regarding the Staff's view of the evidence and the law. The Staff is likely to be more forthcoming with information if defense counsel is open about the defense view of the evidence and the law. The Staff is also more likely to be forthcoming if defense counsel avoids putting the Staff on the defensive. Defense counsel should strive to keep the discussion civil and pleasant; it is rarely productive to debate the facts with the Staff at this stage.

Unless the witness asserted the *Fifth Amendment* privilege against self incrimination during the investigation, the Staff will usually provide to defense counsel sufficient information to prepare an effective Wells Submission. If defense counsel is unable to obtain sufficient information, defense counsel should consider speaking with the more senior members of the Staff who are assigned to the investigation.

Counsel should consider also contacting counsel to other individuals and entities believed to be prospective defendants, individuals believed to have provided testimony to the Staff, and individuals and entities believed to have provided documents to the Staff. In addition, defense counsel should contact other individuals and entities who might be able to provide exculpatory evidence.

[3] Deciding Whether to File a Wells Submission

A Wells Submission serves a number of purposes. Ideally, it might persuade either the Staff or the SEC that an enforcement action is not appropriate. Alternatively, the statement might persuade either of them to narrow the scope or change the form of the proposed enforcement action. In addition, the Wells Process often serves as a vehicle for arriving at a more favorable settlement than might otherwise be the case.

In many cases, it will be clear whether the prospective defendant should file a Wells Submission. In some cases, however, the decision whether to file a Wells Submission will be a judgment call based on a number of factors. These factors include:

- counsel's judgment regarding the likelihood that either the Staff or the Commission can be persuaded not to proceed with an enforcement action. A Wells Submission is especially likely to be effective where (1) the prospective defendant is peripheral to the alleged violation; (2) the Staff appears to be proceeding on a mistaken interpretation of the law; or (3) the Staff appears to be proceeding with an understanding of the facts that are not supported by the record. Even if the SEC Staff members appear to be unmovable, a Wells Submission might persuade either senior members of the SEC Staff or the Commissioners that the proposed action should not be pursued.

- counsel's judgment regarding the likelihood that the Wells Submission might persuade either the Staff or the Commission to agree to a settlement that would be acceptable to the prospective defendant. By highlighting evidence that favors the prospective defendant and by identifying the weaknesses in the Staff's position, the Wells Submission might persuade either the Staff or the Commission to agree to a settlement that would be acceptable to the prospective defendant. For example, where the Staff position expressed in the Wells Call involved a fraud charge and a penalty, the Staff might be persuaded through the Wells Process to recommend a settlement involving a charge of negligence.

- the extent to which the filing of an SEC action would have a devastating impact on the career of the prospective defendant/respondent even if he or she ultimately prevails in the enforcement action. For many individuals who are senior executives of publicly owned companies or who are employed by public accounting firms or regulated entities (e.g., broker-dealer firms, investment companies, investment advisors), the very filing of an SEC enforcement action can have severe adverse consequences. Accordingly, it will often be appropriate to file a Wells Submission on behalf of such individuals, even though, in the judgment of counsel, the Wells Submission is unlikely to avoid an enforcement action and might, for the reasons set forth below, reduce the strategic advantage possessed by the prospective defendant in ensuing litigation.

The filing of a Wells Submission may be unnecessary if the Staff and the prospective defendant or respondent have reached a settlement in principle before the Wells Submission is filed. In addition, there are other factors that sometimes indicate that the filing of a Wells Submission would be inappropriate:

- There is little likelihood that the Wells Submission will dissuade the Staff from recommending the proposed action and the Commission from authorizing the action, and the prospective defendant is not inclined to settle. In these circumstances, the prospective defendant might be better advised to conserve resources for litigation and not reveal defense theories prematurely.

- There is a possibility of a criminal prosecution. The Wells Submission might be admissible in a criminal prosecution and often discloses the defense's arguments.

- There are serious deficiencies in the Staff's case that the Staff could cure with relative ease once they are identified in the Wells Submission. The Staff may respond to a Wells Submission by conducting additional discovery to obtain the evidence that was otherwise missing from the record or by modifying the theory of the case in a manner that will make it harder to defend.

[4] Drafting the Wells Submission

Many Wells Submissions contain a summary, a detailed statement of the facts, and factual, legal and policy arguments. Some Wells Submissions argue that even if the Commission authorizes an enforcement action, the Commission should not seek the sanctions sought by the Staff.

In drafting the Wells Submission, defense counsel should bear in mind that the Submission is likely to be reviewed by a number of Commission personnel including:

- the Staff members who conducted the investigation;
- their supervisors, usually including senior members of the Staff; n6
- the Commissioners or their personal legal assistants;
- the SEC Office of the General Counsel; and
- personnel from other relevant divisions or offices (e.g., the Division of Market Regulation in a case involving broker-dealers, trading practices, or market structure, the Office of the Chief Accountant in a case involving accounting or auditing issues).

The appropriate length of the Wells Submission varies according to the complexity of the case. The SEC Staff routinely informs prospective defendants that a Wells Submission should not exceed 40 pages. In most instances, a serious effort should be made to limit the submission to less than 40 pages. In light of its considerable docket, the Commission may not be prepared to review a lengthy document with care.

In Securities Act Release No. 5310, n7 the SEC advises that Wells Submissions are most useful in connection with questions of policy and law and that disagreements regarding factual matters can rarely be resolved through the Wells process. Defense counsel should largely disregard this advice. If the Staff's recommendation is based on an inaccurate or incomplete factual predicate, counsel should discuss the evidentiary flaws. This evidence can be drawn from the record assembled by the Staff during the investigation or from other sources. For example, in an insider trading investigation, it may be appropriate to submit (1) newspaper articles showing that the allegedly nonpublic information was in the public domain; (2) trading records showing that the trades by an alleged tippee were typical of trades previously made by him or her; and (3) an affidavit from the person (e.g., a stockbroker) who, based on publicly available information, recommended the trade to the alleged tippee. Similarly, in an accounting case, it may be appropriate to submit affidavits from experts explaining why the company's accounting was thought to be in accordance with generally accepted accounting principles.

The Wells Submission should set forth the facts that are central to the defense and should address the evidence on which the Staff places substantial reliance. Facts are often more compelling than legal and policy arguments. Even if defense counsel does not dispute the Staff's facts, defense counsel should bring other, mitigating facts to the attention of the Staff and the Commission.

In advance of arguing for the appropriate sanction, defense counsel should review recent settlements to determine whether the enforcement remedy recommended by the Staff is consistent with recent prior settlements. The SEC and the Staff believe that similarly situated defendants should be treated similarly and may be persuaded by an argument based on fairness and consistency.

The Wells Submission may be discoverable and admissible in litigation. n8 A strong argument can be made that a Wells Submission is settlement material and is inadmissible at trial under Federal Rule of Evidence 408. n9 It therefore is often advisable to include in the Wells Submission a footnote indicating that the Submission is being filed for the purpose of resolving the matter without litigation. Defense counsel should understand the danger that the Commission (or other litigants, such as plaintiff shareholders) will attempt to introduce the Wells Submission into evidence.

[5] Following Up With the Staff After Submitting a Wells Submission

The Wells Process does not end with the filing of the Wells Submission. It is important for defense counsel to ascertain whether the Staff's position has shifted in response to the Wells Submission. The Staff sometimes changes its theory in response to arguments set forth in the Wells Submission. While defense counsel can include in the Wells Submission a request that the Staff notify counsel if it materially changes its position after receipt of the Wells Submission, the Staff does not always notify defense counsel of such changes.

Accordingly, after filing the Wells Submission, defense counsel should discuss with the Staff the issues raised in the Wells Submission. Such a discussion will help counsel assure that the Staff understands the defense theory and its implications and identify and address any changes in the Staff's position and any lingering concerns. Similarly, the Staff might articulate its position in a manner that provides new insights into the Staff's view of the case. If counsel gains new insights into the Staff's view of the case or learns that the Staff has altered its theory, defense counsel should consider filing a supplemental Wells Submission.

While senior members of the Staff review the Wells Submissions, they only have a limited amount of time to devote to most Wells Submissions. In appropriate circumstances, a meeting that includes members of the Staff (e.g., Associate Directors, Associate Regional Administrators, members of relevant specialized units, the Chief Counsel of the Division of Enforcement, the Chief Enforcement Accountant) can provide a valuable opportunity to focus the senior Staff on defense arguments unfiltered by the Staff members who have investigated the case for months, or even years. Similarly, a post-filing meeting can provide an opportunity to ensure that representatives of other interested Divisions (e.g., Division of Market Regulation,

Division of Corporation Finance, Office of the General Counsel, etc.) focus on the defense.

Defense counsel can also attempt to influence who will attend the meeting. If the matter presents technical issues, it is appropriate to ask whether a representative of another relevant division will attend. For example, if the matter involves GAAS and GAAP issues, it might be appropriate to ask whether representatives of the Office of Chief Accountant plan to attend the meeting. If the presentation will focus on the evidentiary weakness of the case, defense counsel can suggest that a member of the trial unit attend the meeting. Prior to attending the meeting, defense counsel should attempt to learn (1) the Staff's reactions to the Wells Submission and (2) the identity of the SEC personnel who are expected to attend the meeting. This information can assist defense counsel in determining the appropriate focus and emphasis for their presentation.

Defense counsel sometimes prepares a detailed presentation of the defense, including visual aids, designed to engage and hold the interest of the attendees. Sometimes, however, defense counsel simply prepares talking points similar to the presentation that an advocate would make in an oral argument. Counsel should take extreme care to ensure that there is adequate evidence to support each factual point and to base the theory of the defense on a factual background as similar as possible to that described by the Staff as the basis for their preliminary determination. By so doing, defense counsel will minimize clashes with the Staff not needed to advance his or her client's interests.

FOOTNOTES:

(n1)Footnote 1. The letter typically states that a written submission should not exceed forty pages and that a videotape submission should not exceed twelve minutes. The Commission does not specify whether the written submission must be double spaced, but prospective defendants often submit written submission that are single spaced.

(n2)Footnote 2. *38 Fed. Reg. 5457 (Mar. 1, 1973)* .

(n3)Footnote 3. Rule 5(c), SEC Rules Relating to Investigations, *17 C.F.R. § 202.5(c)*. The Staff arguably has less discretion with respect to enforcement actions arising from investigations conducted under either the Investment Company Act or the Investment Advisers Act. The provision of the Investment Company Act of 1940 authorizing the SEC to conduct investigations relating to violations of the act requires the Commission to "permit any person to file

with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated." Section 42(a) of the Investment Company Act of 1940, **15 U.S.C. § 80a-41(a)** . Similarly, the provision of the Investment Advisers Act of 1940 authorizing the SEC to investigate violations of the act provides in part whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of the Investment Advisers Act or of any rule or regulation prescribed under the authority thereof, have been or are about to be violated by any person, the Commission may in its discretion require, and in any event shall permit, such person to file with it a statement in writing, under oath or otherwise, as to all the facts and circumstances relevant to such violation, and may otherwise investigate all such facts and circumstances. Section 209(a) of the Investment Advisers Act of 1940, **15 U.S.C. § 80b-9(a)** .

(n4)Footnote 4. See NASD Form U-4, Item 22I & Explanation of Terms.

(n5)Footnote 5. The SEC Staff will typically permit a witness to purchase the transcript of his or her testimony. While the SEC will typically not share with one witness the transcripts of the testimony of other witnesses, counsel often can obtain from the other witnesses or their counsel information regarding the substance of the testimony of those other witnesses.

(n6)Footnote 6. A Wells Submission responding to an investigation conducted by a regional office will be reviewed by the Enforcement Staff in the regional office, but also by the Office of the Chief Counsel in the Division of Enforcement in Washington, D.C. The Office of the Chief Counsel typically will review each enforcement recommendation and accompanying Wells Submission for consistency with the policy objectives of the division and treatment of prospective defendants or respondents relative to other cases and soundness on the merits and legal theory.

(n7)Footnote 7. Sec. Act Rel. No. 5310, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,010 (Sept. 27, 1972).

(n8)Footnote 8. In addition, once the investigation has been concluded, members of the press and others might be able to obtain copies of the Wells Submission from the SEC through Freedom of Information Act requests.

(n9)Footnote 9. See *In re Allied Stores Corp.*, Administrative Proceeding File No. 3-6869, 52 SEC Docket (CCH) 451, (decision of administrative law judge excluding Wells Submission on grounds that admitting the statement would impair settlement negotiations).

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



156 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.11

§ 10.11 Settlement Discussions

The vast majority of SEC enforcement actions are resolved through settlements. Often these settlements arise from settlement discussions initiated by defense counsel. Whether and when to initiate settlement discussions is one of the most delicate judgments to be made in an SEC investigation.

Defense counsel should consider initiating settlement discussions if it appears likely that the Commission will ultimately authorize an enforcement action. There are two major advantages to initiating early settlement discussions. First, settlement discussions may assist the Staff in focusing the investigation and thereby facilitate an expeditious resolution, which can substantially benefit a company given the burdens that a pending SEC investigation can impose. Second, the Staff may be more flexible in fashioning settlements early in an investigation rather than later in the investigation when the Staff has invested greater resources to the investigation and the Staff's views have hardened.

On the other hand, the initiation of settlement discussions may embolden the Staff and the Commission, reducing the likelihood that the Staff will be persuaded not to recommend enforcement action or that the Commission will be persuaded not to authorize an enforcement action. n1 In addition, there is no guarantee that the Staff will accept an early settlement offer, especially if the proposed settlement offer covers only a limited number of the potential defendants.

There are a number of factors that encourage settlement irrespective of the strength or weakness of the Commission's case. The legal fees, and other costs incurred in litigating against the SEC, are likely to be substantial. If the enforcement action is filed in federal court, there is likely to be extensive discovery. The adverse publicity generated from the filing of a settled SEC enforcement action arguably is not substantially greater than the adverse publicity initially generated by a litigated enforcement action, and the litigation of the enforcement action can result in continuing adverse publicity. In addition, adverse findings in the enforcement litigation are likely to be binding on the litigating defendants in any private actions brought by shareholders. The Supreme Court has held that where private plaintiffs sue a defendant against whom the SEC has obtained a judgment in a litigated (as opposed to settled) injunctive action, the plaintiffs could use the doctrine of offensive collateral estoppel to preclude the defendant from relitigating in the private litigation the issues necessarily decided in the enforcement action. n2 Moreover, from the perspective of a regulated entity or an issuer, the litigation of the enforcement action can have an adverse impact on relations with other divisions of the SEC.

A number of subjects are typically open for discussion in settlement discussions, including: (1) the type of enforcement

action (e.g., a cease-and-desist action versus an injunctive action); (2) the substantive charges (e.g., violations of the reporting provisions of the Exchange Act versus violations of the antifraud provisions); (3) the language of the charging document (e.g., the defendant might seek to soften inflammatory language or to include mitigating language); (4) the amount of the disgorgement (the amount of disgorgement is often a subject of legitimate debate); (5) the amount of monetary penalties (in negotiating penalties, it is helpful to review recent precedents set by other settlements or litigated matters); and (6) waivers from certain collateral consequences (e.g., in an enforcement action against a broker-dealer, the Staff will often agree to waive the application of Section 9(a) of the Investment Company Act). Companies can also seek to limit the extent to which the SEC brings enforcement actions against company personnel.

In settling an enforcement action, the SEC generally will permit the defendant to settle without admitting or denying any substantive allegations. SEC rules set forth the policy of the Commission "not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceeding." n3 Pursuant to this policy, the Staff requires that a settling defendant agree to the inclusion of the following language in the settling defendant's consent to the settlement:

In compliance with this policy, [settling defendant] agrees not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the Complaint or creating the impression that the Complaint is without factual basis. If [settling defendant] breaches this agreement, the Commission may petition the Court to vacate the Judgment and restore this case to its active docket. Nothing in this provision affects [settling defendant's]: (i) testimonial obligations; or (ii) right to take legal positions in proceedings in which the Commission or the United States is not a party.

The Staff requires similar language in settlements of administrative proceedings.

FOOTNOTES:

(n1)Footnote 1. If the client is an issuer and has not previously disclosed the existence of the SEC investigation, the client should also consider whether disclosure is appropriate in light of the Wells Call.

(n2)Footnote 2. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 331, 99 S. Ct. 645, 58 L. Ed. 2d 552 (1979) .

(n3)Footnote 3. 17 C.F.R. § 202.5(e).

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



157 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.12

§ 10.12 Staff Recommendation Memorandum

The Staff seeks Commission authorization to file or institute an enforcement action by means of an action memorandum that sets forth the Staff's recommendation and the factual and legal basis for that recommendation. The Staff must obtain the authorization of either a Deputy Director or the Enforcement Director before submitting an action memorandum to the Commission. n1 The Commission's consideration of the action memorandum typically takes place in a meeting of the Commissioners at which the Division Staff, but not defense counsel, are present.

FOOTNOTES:

(n1)Footnote 1. SEC Enforcement Manual 29 available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



158 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.13

§ 10.13 Enforcement Remedies

The SEC has access to a wide array of enforcement remedies. The SEC has authority to bring enforcement proceeding in federal court or in the Commission's administrative forum.

[1] Federal Court Enforcement Actions

The SEC can ask a federal court to issue an order imposing monetary penalties, enjoining the defendant from violating the relevant provisions of the federal securities laws, and imposing other equitable relief. In actions against persons who participated in a penny stock offering, the SEC can seek an order prohibiting that person from participating in penny stock offerings. In actions charging violations of the antifraud provisions, the SEC can seek an order barring the defendant from serving as an officer or director of a public company. In certain circumstances, the SEC can also seek a temporary order freezing the assets of a public company that the SEC believes is likely to make extraordinary payments to its directors, officers, partners, controlling persons, agents or employees.

[a] Injunctive Relief

Historically, the SEC relied primarily on civil injunctive actions in matters that did not involve broker-dealers or investment advisers. § Securities Act §§ 20(b) and 22(a) authorizes the SEC to bring an action in federal district court whenever "it shall appear ... that any person is engaged or about to engage in acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof." n1 §

In order to obtain an injunction, the SEC must do more than establish that the defendant violated the federal securities laws. n2 Courts have articulated a variety of standards regarding the additional burden that the SEC must meet, such as stated that an injunction is appropriate only when the SEC has showing that "a reasonable likelihood exists" that a future violation would occur absent an injunction, n3 a "reasonable and substantial" likelihood exists that future violations will occur, or a "substantial likelihood" exists of future violations." n4.

It has been held that the SEC, unlike private plaintiffs, need not prove reliance on alleged misrepresentations in order to enjoin future violations of § 17(a) of the Securities Act.

[b] Disgorgement of Unjust Enrichment

Pursuant to their power to grant equitable relief, courts order defendants to disgorge profits obtained as a result of securities law violations. n5 Disgorgement is a particularly common remedy in proceedings involving insider trading or stock manipulation. n6 More recently the SEC has sought disgorgement from individuals of bonuses, other incentive compensation and stock profits attributable to inflated financial statements. The SEC sometimes also seeks disgorgement of compensation paid to employees, of fees paid to professional or investment banking firms and of proceeds of offerings raised through the use of fraudulent offering materials.

[c] Temporary Freezes

In the Sarbanes-Oxley Act of 2002, Congress gives the Commission authority to seek a temporary order against extraordinary payments by an issuer to any officer, director, agent or employee of any issuer under investigation for the violation of the federal securities laws. n7 In rendering the first appellate opinion addressing the foregoing, the Ninth Circuit, *en banc* panel, approved a broad interpretation of this provision. n8

[d] Other Ancillary Equitable Relief

The Sarbanes-Oxley Act of 2002 amended the Exchange Act to provide expressly that in any action or proceeding instituted by the SEC under any provision of the securities laws, the SEC may seek, and any federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors. n9

[e] Disclosure

In a number of proceedings, the SEC has obtained a court order directing an issuer to make curative disclosures. n10 This remedy can have substantial collateral consequences. For example, the SEC sometimes obtains as part of a settlement a court order directing the issuer to correct previously issued financial statements that the SEC has alleged to be materially misstated. Even though the defendant has consented to entry of the order without admitting or denying any allegations, the act of restating financial statements arguably constitutes an admission that the previously issued financial statements were in error and that the restated financial statements are fairly stated.

Under § 304 of the Sarbanes-Oxley Act of 2002, if an issuer restates its financial statements, the CEO and the CFO might be required to reimburse the issuer for certain incentive-based and equity based compensation and certain stock profits.

[f] Civil Penalties

Prior to 1990, the SEC had only limited authority to seek fines or penalties. The most significant of the statutes conferring fining authority on the courts prior to 1990 was the Insider Trading Sanctions Act ("ITSA"), as amended by the Insider Trading Securities Fraud Enforcement Act ("ITSFEA"), which authorizes the SEC to seek, and the courts to impose, fines up to the greater of \$1,000,000, or three times the profit gained or loss avoided as a result of the violations. n11 These fines are imposed against persons who violate the Exchange Act by purchasing or selling security while in possession of material, nonpublic information, or by communicating such information, or, with respect to controlling persons of issuers, acting with reckless disregard of the risk of insider trading in the issuer's securities.

In 1990, Congress enacted the Securities Enforcement Remedies Act of 1990 (the "Remedies Act") and Penny Stock Reform, n12 which amended the Securities Act, the Exchange Act, the Investment Company Act and the Investment Advisers Act in order, inter alia, to authorize courts to impose penalties for violations of any of the provisions of the federal securities laws upon a proper showing by the SEC. n13 The legislative history indicates that the primary purpose of the monetary penalties was deterrence. n14 The amendments to the Securities Act and the Exchange Act exempt from the civil penalty provisions of the Remedies Act insider trading violations that are subject to penalties pursuant to § 21A of the Exchange Act.

Like the other federal securities laws, the Securities Act authorizes the Commission to seek fines and remedies in a district court. n15 These fines operate in a three-tiered structure that punishes fraud and deceit most severely. n16 Each separate violation of a cease-and-desist order is considered a separate defense and each day violation a cease-and-desist order is also a separate offense. n17

[g] Orders Barring Service as an Officer or Director of a Public Company

Under § 20(e) of the Exchange Act, a court in an SEC enforcement action may bar a defendant from serving as an officer or director of a public company where it finds that the defendant has violated antifraud provisions of the federal securities laws including § 17(a)(1) of the Securities Act, and the defendant's "conduct demonstrates unfitness to serve as an officer or director." n18 In testifying on behalf of the bar authority, then-SEC Chairman Richard Breeden told Congress that the Commission would seek the remedy "only in those cases ... that involve egregious fraudulent conduct." n19

In 2002, SEC enforcement officials publicly complained about the reluctance of courts to bar individuals from serving as officers and directors of public companies. n20 In apparent response to these complaints, the Sarbanes-Oxley Act of 2002 amended the Exchange Act and Securities Act to change the statutory standard from "substantial unfitness" to "unfitness." n21 The SEC is likely to argue that this amendment was intended to lower the threshold for barring individuals from serving as officers and directors of public companies. Indeed, the Commission has sought officer and director bars far more frequently since the Sarbanes-Oxley Act was adopted. n22

[h] Penny Stock Bars

Section 21(d) of the Exchange Act n23 and Section 20(g) of the Securities Act of 1933, n24 as amended by the Sarbanes-Oxley Act of 2002, authorize a court to prohibit any person who engaged in misconduct in the offering of a penny stock from participating in the offering of a penny stock, conditionally or unconditionally for such period of time as the court deems appropriate. n25 This amendment effectively authorized the courts to grant a form of relief that the SEC was already authorized to issue in administrative proceedings.

[2] Administrative Remedies Against Regulated Persons

[a] Bars and Other Limitations

The Securities Act, like other federal securities laws, provides for officer and director bars in connection with scienter-based violations. The Securities Act also authorizes the Commission to impose such bars in connection with cease-and-desist proceedings. n26 The bar may be permanent or for a shorter period and may be conditional or unconditional. n27

[b] Monetary Penalties and Disgorgement

In addition to its power to sanction regulated entities, the SEC is authorized to impose money penalties in administrative proceedings against regulated entities, persons affiliated with those entities, and persons associated with penny stock offerings. n28 The same three-tier structure of penalties applies here as in a civil injunctive action. n29

The SEC also possesses the authority to order an accounting and disgorgement from regulated entities, persons associated with those entities, and persons associated with penny stock offerings. n30 While the presence of illicit gains is a factor to consider in assessing penalties in administrative proceedings, this disgorgement provision gives the Commission direct authority to reclaim illegal profits. Prior to the Remedies Act, this option was available to the SEC only through the courts.

[3] Other Administrative Remedies

[a] Cease-and-Desist Remedies

Under the Remedies Act, the SEC has broad powers to issue an order requiring that a person cease-and-desist from committing the violation or any future violation of the same provision, rule, or regulation. The Commission may enter an administrative cease-and-desist order against any person that is, was, or is about to violate any provision of the federal securities laws and any person "that is, was, or would be a cause of the violation due to an act or omission the person knew or should have known would contribute to the violation." n31

The legislative history of the Remedies Act indicates that Congress provided the cease-and-desist remedy as an alternative remedy that permits flexibility to address violations that do not warrant injunctions or the collateral consequences of an injunction. n32 The House Report noted that it would be appropriate for the SEC to use the cease-and-desist remedy against persons "who commit isolated infractions and present a lesser threat to investors" and to avoid protracted litigation or settlement negotiations resulting from concerns regarding the severe collateral consequences that may arise from an injunction. n33

The Commission and the D.C. Circuit have taken the position that to issue a cease-and-desist order, there must be "some likelihood of future violations." n34 This requires a showing of likelihood considerably less stringent than that required for an injunction to issue. However, because the nature of the cease-and-desist remedy is inherently forward-looking, if there is no possible risk of future harm, then the imposition of a cease-and-desist order is unwarranted.

Furthermore, the Securities Act authorizes the Commission to publish its findings and enter an order to cease-and-desist from any violation of the Securities Act. n35 Using these provisions, the Commission must hold a hearing between thirty and sixty days after the service of the notice. n36 Additionally, the Commission may order a temporary order if there is the likelihood of substantial harm. This temporary order, however, is limited to brokers, dealers, and investment companies.

[b] Accounting and Disgorgement

In any administrative proceeding to obtain a cease-and-desist order, the SEC may also enter an order "requiring accounting and disgorgement." n37

[c] Temporary Cease-and-Desist Authority

The SEC has the authority under § 8A(c) of the Securities Act to issue temporary orders against regulated entities (brokers, dealers, investment advisers, investment companies, municipal securities dealers, government securities brokers, or transfer agents) and persons associated or seeking to become associated with such entities. n38 In 2002, the Sarbanes-Oxley Act § 3(b)(3) amended Exchange Act § 21C(c)(2) to authorize the Commission to issue temporary cease-and-desist orders against "registered public accounting firms" as well. n39 The same findings required for issuance of a permanent order must also be made before issuance of a temporary order. Additionally, the SEC must find that the violation giving rise to the order "is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest" to warrant the temporary order. n40

[d] Administrative Orders Barring Service as an Officer or Director of a Public Company

By the Sarbanes-Oxley Act of 2002, Congress amended the Exchange Act and the Securities Act to authorize the SEC to prohibit a person from serving as an officer or director of a public company if that person violated Exchange Act § 10(b), any rule thereunder, or Securities Act § 17(a)(1) and the conduct of that person demonstrates "unfitness" to serve as an officer or director of the public company. n41

[e] Refusal Orders, Stop Orders, and Examinations

Sections 8(b) and 8(d) of the Securities Act authorize the SEC to issue refusal orders and stop orders, respectively. Both sections provide that if the Commission finds that a registration statement is defective, it may issue an order preventing the statement from becoming effective.

[f] Disciplining Professionals Who Practice Before the Commission

The SEC has long asserted authority over professionals who practice before the Commission. Historically, the SEC based this authority on Rule 2(e) of the SEC Rules of Practice. In 1995, the SEC recodified its Rules of Practice, and Rule 2(e) became Rule 102(e). The Sarbanes-Oxley Act of 2002 amends the Exchange Act to incorporate Rule 102(e)(1) into the Exchange Act. n42

The SEC has interpreted the phrase "practicing before the Commission" broadly. For example, the SEC has found that such practice includes an attorney providing legal advice regarding the securities laws. n43 Accordingly, the SEC has sanctioned an attorney pursuant to Rule 2(e) where the attorney made a misrepresentation in a letter to an escrow settlement that had been established in connection with a registered offering of securities, even though it was not clear that the respondent was even practicing securities law in rendering advice to the escrow agent. n44 As to accountants, the SEC has indicated that the term at issue includes the preparation of financial statements to be filed with the SEC by inside accountants, as well as the audit or review of such financial statements. n45

Section 4C and SEC Rule of Practice 102(e)(1) give the Commission authority to "censure any person, or deny, temporarily or permanently, to any person the privilege of practicing before the Commission" if, after notice and opportunity for a hearing, that person is found:

- not to possess the requisite qualifications to represent others; or
- to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or
- to have willfully violated, or willfully aided and abetted the violation of the securities laws and regulations thereunder.

Both the statute and the rule provide that for licensed accountants "improper professional conduct" includes "intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable professional standards." n46 In addition to intentional or reckless misconduct, the statute also provides that "negligent conduct in the form of ... a single instance of highly unreasonable conduct that results in a violation of applicable professional standards" or "repeated instances of unreasonable conduct ... that indicate a lack of competence to practice before the Commission" are grounds for censure or bar a licensed accountant from practice before the Commission.

Under the Rule of Practice 102(e)(2), any attorney, accountant, or engineer whose license to practice has been revoked in any state, or who has been convicted of a felony or crime involving moral turpitude, is automatically suspended from appearing or practicing before the SEC. n47

In general, the SEC may suspend or bar a person only after notice and hearing. Under Rule of Practice 102(e)(3), the SEC may, however, suspend from appearing or practicing before it any attorney, accountant, engineer, or other professional or expert who has been by name:

- (1) permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder; or

(2) found by any court of competent jurisdiction in any action brought by the Commission to which he or she is a party or found by the Commission in any administrative proceeding to which he or she is a party to have violated (unless the violation was found not to have been willful) or aided and abetted the violation of any provision of the Federal securities laws or of the rules and regulations thereunder. n48

The order of temporary suspension may not be entered by the Commission more than 90 days after the date on which the final judgment or order entered in the judicial or administrative proceeding has become effective, whether upon completion of review or appeal procedures, or because further review or appeal procedures are no longer available. n49

[g] Deferred Prosecution Agreements and Non-Prosecution Agreements

In 2010, the Enforcement Division amended its Manual to set forth two remedies that are analogous to remedies that federal prosecutors had been using extensively for the past decade: deferred prosecution agreements and non-prosecution agreements. The SEC can enter into deferred prosecution agreements and non-prosecution agreements only with the approval of the Commission.

The Enforcement Manual provides that a deferred prosecution agreement is a written agreement between the Commission and a potential cooperating individual or company in which the Commission agrees to forego an enforcement action against the individual or company if the individual or company agrees to, among other things: 1) cooperate truthfully and fully in the Commission's investigation and related enforcement actions; 2) enter into a long-term tolling agreement; 3) comply with express prohibitions and/or undertakings during a period of deferred prosecution; and 4) under certain circumstances, agree either to admit or not to contest underlying facts that the Commission could assert to establish a violation of the federal securities laws. n50 Under the terms of the agreement, if the agreement is violated during the period of deferred prosecution, the Staff may recommend to the Commission--and the Commission may authorize--an enforcement action against the individual or company for the original misconduct as well as any additional misconduct. Furthermore, if the Commission authorizes the enforcement action, the Staff may use any factual admissions made by the cooperating individual or company to file a motion for summary judgment, while retaining the ability to bring an enforcement action for any additional misconduct at a later date. Deferred prosecution agreements must be approved by the Commission.

Like deferred-prosecution agreements, non-prosecution agreements are agreements in which the Commission agrees not to pursue an enforcement action against the company or individual and the company or individual agrees to cooperate fully with the SEC and makes certain other undertakings (e.g., payment of disgorgement or civil penalties) and the Staff retains the ability to recommend--and the Commission retains the authority to authorize--an enforcement action if the company or individual violates the agreement. Unlike deferred prosecution agreements, non-prosecution agreements typically do not include an agreement to admit (or not contest) certain facts and does not include a tolling agreement.

FOOTNOTES:

(n1)Footnote 1. The SEC has similar authority to seek injunctive relief from the courts under the other federal securities laws. For example, the Exchange Act authorizes the SEC to bring an action in federal district court whenever "it shall appear ... that any person is engaged or is about to engage in acts or practices constituting a violation of [the Exchange Act] or the rules or regulations thereunder." Exchange Act § 21(d), 15 U.S.C. 78u(d).

(n2)Footnote 2. See *SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978) ("To obtain injunctive relief the Commission must offer positive proof of the likelihood that the wrongdoing will recur. The Commission needs to go beyond the mere fact of past violations.") (citations omitted); *SEC v. Commonwealth Chem. Secs., Inc.*, 574 F.2d 90, 100 (2d Cir. 1978) (stating that the SEC must "go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence"); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682, 715 (D.D.C. 1978) (stating that absent a showing of a cognizable danger of recurrent violation, injunctive relief is not appropriate).

2-10 Federal Securities Act of 1933 § 10.13

(n3)Footnote 3. See *SEC v. Sargent*, 329 F.3d 34 (1st Cir. 2003) ; *SEC v. Holschuh*, 694 F.2d 130, 144 (7th Cir. 1982) ; *SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992) ; *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977) (denying relief where the SEC could not show the danger of recurrence); *SEC v. Zale Co.*, 650 F.2d 718, 720 (5th Cir. 1981) .

(n4)Footnote 4. *SEC v. Cavanagh*, 155 F.3d 129 (2d Cir. 1998) .

(n5)Footnote 5. *SEC v. Huffman*, 996 F.2d 800, 802 (5th Cir. 1993) (The court describes disgorgement as "an equitable remedy meant to prevent the wrongdoer from enriching himself by his wrongs."); *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989) (Disgorgement is "designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws."); *SEC v. Interlink Data Network*, 1993 U.S. Dist. LEXIS 20163 *52 (C.D. Cal. Nov. 15, 1993) ("Where liability under § 10(b) has been established the Court should fashion relief structured to deprive the defendant of all gains flowing from the illegal conduct.") (quoting *SEC v. Lund*, 570 F. Supp. 1397, 1404 (C.D. Cal. 1983)) .

(n6)Footnote 6. See, e.g., *SEC v. Clark*, 915 F.2d 439, 454 (9th Cir. 1990) (citing *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980)) ; *SEC v. Ferrero*, 1993 U.S. Dist. LEXIS 21379 *48-49 (S.D. Ind. Nov. 15, 1993) (holding that the tipper can be ordered to disgorge the profits of his tippee, even where the tippee has not violated the securities laws).

(n7)Footnote 7. § 21C(c) of the Exchange Act, **15 U.S.C. § 78u-3(c)** , as amended by the Sarbanes-Oxley Act § 110.3.

(n8)Footnote 8. *SEC v. Gemstar-TV Guide Int'l, Inc.*, 401 F.3d 1031 (9th Cir. 2005) .

(n9)Footnote 9. Sarbanes Oxley Act § 305 amending Exchange Act § 21(d) (to be codified at **15 U.S.C. § 15u(d)(5)**) .

(n10)Footnote 10. See, e.g., *In re English*, Administrative Proceeding File No. 3-6401, *34 SEC Docket (CCH) 1230, 1986 SEC LEXIS 2162 (Jan. 8, 1986)* (ordering respondent to provide an accurate disclosure statement meeting the requirements of Investment Advisers Act § 204).

(n11)Footnote 11. Exchange Act § 21A, **15 U.S.C. § 78u-2** .

(n12)Footnote 12. Pub. L. No. 101-429, 104 Stat. 931 (1990).

(n13)Footnote 13. Securities Act § 20(d), **15 U.S.C. § 77t(d)** ; Exchange Act § 21(d)(3), **15 U.S.C. § 78u(d)(3)** ; Investment Company Act § 42(e), **15 U.S.C. § 80a-41(e)** ; Investment Advisers Act § 209(e), **15 U.S.C. § 80b-9(e)** .

(n14)Footnote 14. S. Rep. No. 337, 101st Cong., 2d Sess. at 9 (1990) (the Senate Report) ("The Committee therefore concluded that authority to seek or impose substantial monetary penalties, in addition to the disgorgement of profits, is necessary to the deterrence of securities law violations that otherwise may provide great financial returns to the violator."); H.R. Rep. No. 515, 101st Cong. 2d Sess. 14, at 18-19 (1990)(same).

(n15)Footnote 15. Securities Act § 20(d)(1), **15 U.S.C. § 77t(d)(1)**.

(n16)Footnote 16. Securities Act § 20(d)(2), **15 U.S.C. § 77t(d)(2)**.

(n17)Footnote 17. Securities Act § 20(d)(4), **15 U.S.C. § 77t(d)(4)**.

(n18)Footnote 18. **15 U.S.C. §§ 77t(e) , 78u(d)(2)**. Sec. 305(a) of the Sarbanes-Oxley Act of 2002 makes explicit that the defendant's conduct is subject to an "unfitness" standard.

(n19)Footnote 19. Hearings on Section 647, the Securities Law on Enforcement Remedies of 1989, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 101st Cong., 1st Sess. at 29 (1990) (statement of Richard C. Breeden, Chairman, SEC).

(n20)Footnote 20. Steven M. Cutler, *Remarks at the GlasserLegalWorks 20th Annual Federal Securities Institute* (February 15, 2002), available at www.sec.gov/news/speech/speech538.htm.

(n21)Footnote 21. The Sarbanes-Oxley Act § 305.

(n22)Footnote 22. Stephen M. Cutler, *Cutler Speech on Penalties at 2*, www.sec.gov/news/speech/soch042904smc.htm.

(n23)Footnote 23. **15 U.S.C. § 78u(d)** .

(n24)Footnote 24. **15 U.S.C. § 77t** .

(n25)Footnote 25. See Exchange Act Rule 3a51-1, SEC Rel. No. 34-30608 (April 20, 1992). Essentially, a penny stock is an issue that trades for less than five dollars per share, is not listed on a national exchange, or is issued by a company beneath a certain market capitalization.

(n26)Footnote 26. Securities Act § 8A(f)

(n27)Footnote 27. Securities Act §§ 8A(f) and 20(e). See § 10.13[1][f], *supra*, for a further discussion of officer and director bars.

(n28)Footnote 28. See, e.g., Exchange Act § 21B(a), **15 U.S.C. § 78u-2(a)** (authorizing the commission to impose civil penalties in administrative proceedings).

(n29)Footnote 29. Kenneth B. Winer & Samuel J. Winer, *Securities Enforcement: Counseling and Defense* § 18.03[2](a)[ii] (LexisNexis Matthew Bender 2005).

(n30)Footnote 30. See, e.g., Securities Act § 8A(e), **15 U.S.C. § 77h-1(e)**; Exchange Act § 21B(e), **15 U.S.C. § 78u-2(e)**.

(n31)Footnote 31. See, e.g., Securities Act § 8A(a), **15 U.S.C. § 77h-1(a)** ; Exchange Act § 21C(3), **15 U.S.C. § 78u-3** .

(n32)Footnote 32. See S. Rep. No. 337, 101st Cong., 2d Sess. 18 (1990); H.R. Rep. No. 616, 101st Cong. 2d Sess. 23 (1990).

(n33)Footnote 33. H.R. Rep. No. 616, at 23-23.

(n34)Footnote 34. *In re KPMG Peat Marwick, 2001 SEC LEXIS 98 *101* (SEC Rel. No. 43862) (Jan. 19, 2001) (opinion of the commission), *aff'd*, 289 F.3d 109 (D.C. Cir. 2002) .

(n35)Footnote 35. Securities Act § 8A, **15 U.S.C. § 77a et seq.**

(n36)Footnote 36. Securities Act § 8A(b).

(n37)Footnote 37. Exchange Act § 21C(e).

(n38)Footnote 38. See, e.g., Exchange Act § 21C(c)(2), **15 U.S.C. § 78u-3(c)(2)** .

(n39)Footnote 39. *Id.* See definition of "registered public accounting firm" at § 2(11) of the Sarbanes-Oxley Act of

2002.

(n40)Footnote 40. *See, e.g.*, Securities Act § 8A(c)(1), **15 U.S.C. § 78u-3(c)(1)** .

(n41)Footnote 41. Sarbanes-Oxley Act § 1105(a), amending Securities Act § 8A and Exchange Act § 21C.

(n42)Footnote 42. Sarbanes-Oxley Act § 602, amending Exchange Act § 4B, **15 U.S.C. § 78dC** .

(n43)Footnote 43. *In re Hecht*, Admin. Proc. File No. 3-6224, *28 SEC Docket (CCH) 1174, 1983 SEC LEXIS 692 (Sept. 27, 1983)* ; *In re Hodgin*, Exch. Act Rel. No. 16,225, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,594 (Sept. 27, 1979). *See also* SEC v. Erzine, No. 72-3161 (S.D.N.Y. Aug. 2, 1972) (summarized in [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,594 (Aug. 2, 1972)).

(n44)Footnote 44. *In re Coven*, Exch. Act Rel. No. 16,448, *19 SEC Docket (CCH) 12 (Dec. 21, 1979)* (Karmel, Commissioner, dissenting).

(n45)Footnote 45. *In re Zarcone*, Exch. Act Rel. No. 32,290, *54 SEC Docket (CCH) 125 (May 11, 1993)*. *See also In re Briggs*, Exch. Act Rel. No. 30,665, *50 SEC Docket (CCH) 984 (May 6, 1992)* (audit of financial statements filed with commission); *In re Lipoff*, Exch. Act Rel. No. 34,714, *57 SEC Docket (CCH) 1700 (Sept. 23, 1994)* (preparation by chief financial officer of financial statements filed with the SEC); *In re Murphy*, Exch. Act Rel. No. 33,014, *55 SEC Docket (CCH) 338 (Oct. 5, 1993)* (CFO of subsidiary that reported inflating income figures to parent company, which reported inflated income figures to the commission). An Administrative Law Judge found the phrase "practice before the Commission" to be so broad and vague as to be subject to a "void-for-vagueness challenge." *In re Carroll A. Wallace*, Initial Decision Rel. No. 178, *73 SEC Docket 3969, 2000 SEC LEXIS 2798 (December 18, 2000)* .

(n46)Footnote 46. **15 U.S.C. § 78d-3(b)(1)**

(n47)Footnote 47. Rule 102(e)(2).

(n48)Footnote 48. Rule 102(e)(3)(i).

(n49)Footnote 49. Rule 102(e)(3)(i).

(n50)Footnote 50. SEC Enforcement Manual § 6.2.3 at 129.

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



159 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.14

§ 10.14 Closing an Investigation

The Staff sometimes closes an investigation without any enforcement action. In deciding whether to close an investigation without an enforcement action, the Staff is to consider such factors as: the seriousness of the potential violations; the Staff resources available to pursue the investigation; the sufficiency of the evidence; and the age of the conduct underlying the potential violations. n1 The SEC manual provides that once a decision has been made to close an investigation, the Staff should (1) prepare a short closing memorandum summarizing what the Staff did in the investigation and (2) prepare and send appropriate termination notices. In addition, the Staff is to send a termination notice to an individual or entity when the Staff has decided not to recommend an enforcement action against that individual or entity, even if the investigation has not been closed. n2

FOOTNOTES:

(n1)Footnote 1. SEC Enforcement Manual at 33 available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>

(n2)Footnote 2. SEC Enforcement Manual at 34 available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



160 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 10 SEC Enforcement Practice *

2-10 Federal Securities Act of 1933 § 10.15

§ 10.15 Conclusion

The enormous increase in the stakes associated with SEC enforcement has highlighted the importance of responding carefully to SEC investigations. From the initial indication of potential wrongdoing or the initial contact from the Staff through the production of documents and the provision of testimony to the Wells process and, perhaps, the settlement discussions, each step of the response is filled with opportunity and fraught with peril. Armed with knowledge of the SEC process, experience with potential challenges, and insights into the Staff's perspectives, counsel may be able to help clients maximize the opportunities and minimize the risks.

* Kenneth B. Winer and Samuel J. Winer. Kenneth B. Winer and Samuel J. Winer are partners in the Washington, D.C. office of Foley & Lardner LLP.



161 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 10A: Agreement to be Interviewed and/or Deposed

2-10A Federal Securities Act of 1933 APPENDIX 10A:.syn

§ 10A.syn Synopsis to Appendix 10A: Agreement to be Interviewed and/or Deposed

Agreement to be Interviewed and/or Deposed



162 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

APPENDIX 10A: Agreement to be Interviewed and/or Deposed

2-10A Federal Securities Act of 1933

Agreement to be Interviewed and/or Deposed

Agreement to be Interviewed and/or Deposed

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Regional Office

You have expressed an interest in providing an oral statement to the _____ Regional Office [Regional Office] on behalf of your client, _____. The statement will relate information which _____ possesses and which you and he believe relevant to the above-referenced litigation. You are willing to provide this statement recognizing that the Securities and Exchange Commission ("Commission") is not empowered or authorized to consider or grant any kind of immunity from criminal prosecution based on your statement or bind any other local, state or federal regulatory agency or department. The [Regional Office] has agreed to hear this statement with the following understandings:

Any statements you make to the [Regional Office] will not be used in any actions or proceedings which may be brought against _____ by the Commission. The Commission can, however, use these statements directly or indirectly for obtaining leads to other evidence, which evidence may be used against _____ and/or others.

Based upon your statement, the [Regional Office] will consider whether it can at this time determine what, if any, enforcement action it would recommend to the Commission against your client. If the [Regional Office] believes that either an administrative proceeding or civil injunctive action, or both should be sought against your client, it will then consider what sanctions or relief it would recommend and consult with the Commission. You and _____ understand that the Commission is not bound to accept the [Regional Office] recommendation concerning (1) whether an action should be instituted; (2) if instituted what sanction or relief is appropriate; or (3) whether it is appropriate to make such a decision at this time. In order for the Commission now to consider any [Regional Office] enforcement recommendation concerning possible administrative proceedings and sanctions against _____, just agree to waive any provisions of the Commission's Rules of Practice as may be construed to prevent any staff member from advising the Commission as to the disposition of a potential administrative proceeding, as well as the ex parte communications provision at 17 CFR § 200.62, and his subscription to this letter will

2-10A Federal Securities Act of 1933

constitute such a waiver.

If, after conferring with the Commission, the [Regional Office] advises you that it would not recommend any enforcement action against _____, _____ himself will cooperate fully with the staff, shortly following our advice. If the [Regional Office] advises you that an enforcement action is appropriate and the sanctions or relief the Commission would accept, you and _____ will decide if any further information will be forthcoming. If, in either case, _____ chooses to provide information to the [Regional Office] and such information is knowingly untruthful or incomplete, or _____ ceases his full cooperation by refusing to testify in any commission actions or proceedings, or by refusing to be interviewed or deposed, the Commission may use _____ statements against him in any actions or proceedings brought by the Commission and the Commission is not bound to its decision concerning enforcement action, sanctions or relief. Further, the Commission may take whatever other steps it thinks appropriate.

The above reflects the entire understanding of the parties and can only be modified in writing signed by the Regional Administrator of the [Regional Office]. No promises (other than set forth above) or threats of any kind have been made to you or your client to induce your coming forward with the aforementioned statement.

Please sign and have _____ sign this letter if it comports with your understanding of our agreement. A signed copy of this letter is enclosed for your files. Please call _____ of my office at the above listed telephone number to arrange a date for your statement.

Very Truly yours,

Regional Administrator



163 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933 11.syn

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

§ 11.syn Synopsis to Chapter 11: Criminal Enforcement of the Federal Securities Act

Scope

§ 11.01 Criminal Referrals from the SEC to the Department of Justice

§ 11.02 Elements of a Criminal Offense Under Section 24 of the Securities Act

[1] "Willfulness"

[a] Specific Versus General Intent.

[b] The "Knew or Should Have Known" Standard.

[c] The Professional Advice Defense.

[2] Violations of Section 17(a)

[3] Violations of Section 5(a)

[4] Violations of Section 24

§ 11.03 Other Criminal Statutes Frequently Charged in Conjunction with Violations of the Securities Act

[1] Mail Fraud and Wire Fraud

[2] Conspiracy

[3] Aiding and Abetting

[4] False Statements

[5] Perjury

[6] RICO

§ 11.04 Statute of Limitations for Criminal Prosecutions Under the Securities Act

§ 11.05 Jurisdiction and Venue Over Criminal Prosecutions Under the Securities Act

[1] Subject Matter Jurisdiction

[2] Transnational Offenses

[3] Venue

§ 11.06 The Sarbanes-Oxley Act of 2002

Thomas A. Ferrigno
and Matthew H. Kirtland n*

FOOTNOTES:

(n1)Footnote *. This chapter was prepared by Thomas A. Ferrigno and Matthew H. Kirtland. Mr. Ferrigno and Mr. Kirtland are partners in the Washington, D.C. office of Fulbright & Jaworski, L.L.P. Mr. Ferrigno practices in the area of securities enforcement. Mr. Kirtland focuses his practice on white collar civil and criminal defense, international arbitration and complex civil litigation. Assistance was provided in the preparation of this chapter by summer associate Devon Edwards.



164 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

Summary of This Chapter

Persons or companies under investigation by the Securities and Exchange Commission (the "SEC" or "Commission") may be potential criminal defendants because the SEC regularly refers evidence of violations of the Securities Act of 1933 (the "Securities Act") to the Department of Justice (the "DOJ") for criminal prosecution. In the absence of highly unusual circumstances, there is no prohibition against such referrals. Likewise, in the absence of substantial prejudice to a defendant, the government may bring simultaneous civil and criminal actions to enforce the Securities Act. *See § 11.01 infra.*

Section 24 of the Securities Act provides criminal penalties for willful violations of it or of the rules and regulations promulgated thereunder. It also prohibits a person from willfully making any untrue statement of material fact in a registration statement or from omitting to state any material fact required to make a registration statement not misleading. Most prosecutions under Section 24 concern willful violations of Section 5(a) (sale of unregistered securities) and Section 17(a) (fraud in connection with the offer and sale of securities). *See § 11.02 infra.*

Criminal prosecutions under the Securities Act frequently include charges under other criminal statutes. The most commonly joined offenses are for mail fraud, wire fraud, and conspiracy. Other relevant statutes concern aiding and abetting, false statements, perjury, and racketeering. *See § 11.03 infra.*

A five-year statute of limitations applies to prosecutions under the Securities Act. As a general rule, the limitations period begins to run when the crime is complete. There is an exception, however, for ongoing criminal schemes. *See § 11.04 infra.*

The United States district courts have exclusive jurisdiction over prosecutions under the Securities Act. This jurisdiction covers cases even where some of the allegedly criminal conduct occurred outside of the United States. Finally, the venue provisions applicable to Securities Act prosecutions frequently give the government a choice among several district courts for seeking an indictment. *See § 11.05 infra.*

In 2002, Congress passed the Sarbanes-Oxley Act which, among other things, creates new criminal securities fraud offenses as well as modifies existing laws that traditionally have been used to prosecute securities fraud. *See § 11.06 infra.*

This chapter will begin with an examination of the manner in which the SEC refers cases to the DOJ for criminal prosecution. It will then discuss the elements of criminal offenses under the Securities Act. Particular attention will be given to the "willfulness" requirement. A brief analysis of other criminal statutes that frequently are implicated in Securities Act prosecutions will follow. The chapter will then discuss the statute of limitations for criminal prosecutions under the Securities Act and conclude with a review of jurisdictional and venue provisions applicable to criminal prosecutions.



165 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933 § 11.01

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

§ 11.01 Criminal Referrals from the SEC to the Department of Justice

Any investigation commenced by the SEC could result in a potential criminal prosecution. Section 20(b) of the Securities Act n1 empowers the Commission to "transmit such evidence as may be available concerning ... acts or practices [that may violate the Act] to the Attorney General who may, in his [or her] discretion, institute the necessary criminal proceedings under this title." n2 The Commission's formal process for making criminal referrals to the DOJ involves a recommendation from the Division of Enforcement to the Commission and review by the SEC General Counsel. n3 In addition to the formal criminal referral process, SEC staff members are permitted to discuss nonpublic investigations with prosecutors if authorized to do so by an official at the level of Assistant Director or higher in one of the SEC Divisions, or by an official in a regional office at the level of Assistant Regional Director or District Administrator or higher. n4 SEC staff may also share information in its investigatory files with prosecutors. n5 A number of cases have acknowledged the propriety of simultaneous SEC and DOJ investigations. n6 Accordingly, it is not unusual for SEC staff members to make informal referrals during the course of a preliminary investigation, and there is no statutory or regulatory impediment to such action. n7

There may, however, be situations where a criminal referral infringes a defendant's constitutional rights. For example, in *United States v. Rodman*, n8 the SEC not only made a criminal referral in violation of a promise that it would "strongly recommend" against prosecution, but it also obtained and forwarded to federal prosecutors incriminating evidence given by the defendant in reliance on that promise. Affirming the district court's dismissal of the defendant's indictment, the appellate court held that "[i]n light of the failure of the SEC to comply with what the district court found to be its agreement, the district court's view that the unfairness to the appellee warranted dismissal of the indictment was not an abuse of the court's supervisory function." n9 In *United States v. Fields*, however, the court called *Rodman* "the rare case" n10 and held that, in the absence of prejudice to the defendant or of widespread or continuous official misconduct, conduct of SEC employees in concealing their criminal referral while negotiating a civil consent decree, albeit improper, did not justify dismissal of the subsequent indictment. n11

As a general rule, "[i]n the absence of substantial prejudice to the rights of the parties involved, simultaneous or successive prosecution of civil and criminal actions [also] is unobjectionable." n12 In other words, the criminal defendant has "the burden of showing that the civil investigation was conducted in 'bad faith' and solely for the purpose of obtaining criminal evidence." n13 Moreover, it has been held that civil investigators act in good faith if there is a

non-criminal purpose to their investigation, even if the information gleaned is later used for criminal enforcement purposes. n14 Despite this substantial burden on the defendant and presumption of good faith, one recent case, *United States v. Scrushy* n15 held that the SEC and the DOJ were working together improperly because discovery mechanisms in the civil investigation were being used to gather evidence for the criminal investigation. In *Scrushy*, the defendants were unaware of a prospective criminal proceeding when they agreed to provide testimony to the SEC. The court characterized the merger of the proceedings as a departure "from the proper administration of criminal justice." Although this case could be viewed as evidence of district courts' willingness to entertain challenges to improper parallel proceedings, a more recent case that discusses *Scrushy* has viewed it as distinguishable because of the egregious government misconduct involved, including the government's actively concealing the existence of the criminal investigations from the defendants in order to continue obtaining discovery through the civil investigations. n16 Even if a court finds no objection to simultaneous criminal and civil proceedings, it may order the SEC not to furnish non-public information to the DOJ. n17

For various reasons, referrals may result in successful criminal prosecution notwithstanding the SEC's inability to obtain relief that it seeks in the parallel civil actions. For example, a defendant's avoidance of an SEC injunction does not guarantee victory in a criminal proceeding concerning the same transactions; a court may decline to enter an injunction because the SEC failed to establish a reasonable likelihood of future violations even though it did establish a violation. Similarly, in *United States v. Mumford*, n18 the Fourth Circuit affirmed the denial of a motion to dismiss the indictment, which the defendant made on the grounds that a prior court decision denying the SEC's petition for injunctive relief was *res judicata*. The court explained:

The SEC complaint was for prospective injunctive relief, an equitable action which is in many respects *sui generis*. This trial is a criminal action. Since the two proceedings do not present the same cause of action, *res judicata* does not bar the criminal prosecution ... n19

Likewise, the court held that the SEC's civil defeat did not collaterally estop the government from litigating the issue of the defendant's past criminal violations:

The only issue actually litigated in the SEC action was the likelihood that [the defendant] would engage in future SEC violations. Since the two proceedings addressed different issues, collateral estoppel does not apply. n20

Accordingly, the SEC and the DOJ, in many ways, have independent bites at the apple. However, in *United States v. Rogers*, it was held that criminal proceedings were estopped by a prior civil enforcement action. n21 Nonetheless, it should be noted that while *Rogers* distinguishes *Mumford*, there is no case precedent that dictates that a victory in a civil action will assure dismissal of a criminal indictment.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77t(b) (2000); see also 15 U.S.C. § 78u(d)(1) (2000) (providing that "[t]he Commission may transmit ... evidence as may be available concerning ... acts or practices as may constitute a violation of any provision of this title or the rules or regulations thereunder to the Attorney General, who may, in his [or her] discretion, institute the necessary criminal proceedings under this title.").

(n2)Footnote 2. Similar provisions for criminal referrals are contained in Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d) (2000); Section 18(f) of the Public Utility Holding Company Act; 15 U.S.C. § 79(e) (2000) (repealed 2005); Section 321(a) of the Trust Indenture Act of 1939, 15 U.S.C. § 77uuu(a) (2000); Section 42(d) of the Investment Company Act of 1940, 15 U.S.C. § 80a-41(d) (2000); and Section 209(e) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-9(d) (2000).

(n3)Footnote 3. See 17 C.F.R. §§ 202.5(b), 200.21(a), 200.19(b) (2003).

(n4)Footnote 4. 17 C.F.R. § 203.2 (2003).

(n5)Footnote 5. See 17 C.F.R. §§ 200.30-4(a)(7), 240.24c-1 (2003).

(n6)Footnote 6. See *In re Grand Jury Subpoena Duces Tecum* (Jan. 17, 1980), Fed. Sec. L. Rep. P 97,562, 1980 U.S. Dist. LEXIS 12508 (D. Conn. 1980) ; *SEC v. First Jersey Sec., Inc.*, 1987 U.S. Dist. LEXIS 10157, at *6 (S.D.N.Y. 1987) (statement of Magistrate Judge Roberts of the Southern District of New York) (observing that "it is well established that the federal government may pursue related civil and criminal actions arising out of the same set of operative facts either simultaneously or successively"); *SEC v. Incendy*, 936 F. Supp. 952, 956 (S.D. Fla. 1996) (citing *SEC v. Dresser Indus. Inc.*, 628 F.2d 1368, 1377 (D.C. Cir. 1980) (en banc) ("effective enforcement of the securities laws may require prompt civil and criminal enforcement, and that neither proceeding can always await the completion of the other without jeopardizing the public interest in protection of the efficient working of the securities markets and of investors from the dissemination of false or misleading information."); *SEC v. Zubkis*, 1998 U.S. Dist. LEXIS 10871 (S.D.N.Y. 1998) .

(n7)Footnote 7. See *United States v. Fields*, 592 F.2d 638, 645-46 (2d Cir. 1978) (refusing to dismiss indictment resulting from informal criminal referral).

(n8)Footnote 8. 519 F.2d 1058 (1st Cir. 1975) .

(n9)Footnote 9. See 519 F.2d at 1059-60 . But see *United States v. Stokes*, 124 F.3d 39, 46 (1st Cir. 1997) (citing *Rodman* in the course of reversing an indictment for a weapons offense, stating that *Rodman* was an illustration of "the sort of egregious circumstances which are essential before a court appropriately may unleash its supervisory powers to interfere with the exercise of prosecutorial discretion.").

(n10)Footnote 10. 592 F.2d at 648 . Recent precedent continues to distinguish *Rodman* as an unusual case. See *United States v. Aaronoff*, No. 91 CR. 221 (CSH), 1992 U.S. Dist. LEXIS 1307, at *31-34 (S.D.N.Y. 1992) (citing *Rodman* as distinguishable because there was no non-prosecution agreement as a matter of contract law), *aff'd*, 990 F.2d 622 (2d Cir. 1993) ; see also *United States v. Flemmi*, 225 F.3d 78, 90-91 (1st Cir. 2000) (distinguishing *Rodman* by holding that the government's promise of non-prosecution was non-binding because the investigator who issued the promise lacked authority to make it).

(n11)Footnote 11. See *Fields*, 592 F.2d at 647-48 . The *Fields* court concluded that there had been no prejudice to the defendants because, by the time of the improper conduct, the SEC already had obtained enough evidence to proceed either civilly or criminally against the defendants. *Id.*

(n12)Footnote 12. See *SEC v. Horowitz Ullman, P.C.*, 1982 U.S. Dist. LEXIS 11548 (N.D. Ga. Mar. 4, 1982) ; accord *SEC v. First Financial Group of Texas, Inc.* 659 F.2d 660, 667 (5th Cir. 1981) ; *SEC v. Dresser Indus. Inc.*, 628 F.2d 1368, 1374 (D.C. Cir. 1980) (en banc).

(n13)Footnote 13. *United States v. Handler*, 1978 U.S. Dist. LEXIS 16182 at *25 (C.D. Cal. Aug. 3, 1978) ; see also *United States v. Bloom*, 450 F. Supp. 323, 330 (E.D. Pa. 1978) .

(n14)Footnote 14. See *Dresser Indus. Inc.*, 628 F.2d at 1387 .

(n15)Footnote 15. *United States v. Scrushy*, 366 F. Supp. 2d 1134 (N.D. Ala. 2005) .

(n16)Footnote 16. *United States v. Mahaffy*, 446 F. Supp. 2d 115 (E.D.N.Y. 2006) , *aff'd*, *United States v. Mahaffy*, 283 Fed. Appx. 852, 2008 U.S. App. LEXIS 17473 (holding that the defendants' rights were not violated because the defendants were aware of the criminal investigation before they were questioned in the civil proceeding. Therefore, the statements made to the SEC were admissible in the criminal proceeding).

(n17)Footnote 17. See *SEC v. Gilbert*, 79 F.R.D. 683, 687 (S.D.N.Y. 1978) ; cf. *Perry v. McGuire*, 36 F.R.D. 272, 274 (S.D.N.Y. 1964) (staying discovery in private civil action pending termination of criminal proceedings regarding same events).

(n18)Footnote 18. 630 F.2d 1023 (4th Cir. 1980) .

(n19)Footnote 19. 630 F.2d at 1027 (footnotes omitted).

(n20)Footnote 20. 630 F.2d at 1027-28 ; cf. *United States v. Jensen*, 608 F.2d 1349, 1355 (10th Cir. 1979) (in criminal prosecution for violations of Section 17(a), government was not collaterally estopped from relitigating issues decided in liquidation proceedings initiated by the SEC under the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa (2000); SEC merely initiated those proceedings and was not a real party in interest).

(n21)Footnote 21. 960 F.2d 1501, 1508-09 (10th Cir. 1992) (distinguishing *Mumford* on the grounds that "the only issue litigated in the first SEC action was the likelihood of future SEC violations," whereas the prior proceedings in *Rogers* had dealt with the merits of the case); cf. *SEC v. Zandford*, 238 F.3d 559, 562 (4th Cir. 2001) , *rev'd on other grounds*, 535 U.S. 813 (2002) . The issue in *Zandford* was whether a prior criminal conviction for wire fraud estopped the defendant from litigating an SEC civil suit under § 17(a) of the Securities Act. *Id.* The *Zandford* court held that estoppel did not apply because the two offenses had distinct elements: securities fraud requires a securities transaction, whereas wire fraud does not. *Id.*



166 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933 § 11.02

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

§ 11.02 Elements of a Criminal Offense Under Section 24 of the Securities Act

Offenses under the Securities Act are made criminal by Section 24, which provides:

Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than \$10,000 or imprisoned not more than five years, or both. n1

Section 24 creates two broad categories of criminal transgressions. n2 The first is for "willful" violations of any other provisions of the Securities Act or of the rules and regulations promulgated thereunder by the SEC. For purposes of reference, those activities, the willful commission of which may subject persons to criminal prosecution under the Securities Act, are listed in the footnotes. n3

The statutory provisions most frequently cited in criminal prosecutions under Section 24 are Section 5(a) (sale of unregistered securities) and Section 17(a) (fraud in connection with the offer and sale of securities). The second category of offenses provided under Section 24 is for "willful" misrepresentations in a registration statement filed with the SEC under the Securities Act. Accordingly, any discussion of Section 24 must begin with an analysis of the requirement of "willfulness."

[1] "Willfulness"

[a] Specific Versus General Intent. No one can be convicted under Section 24 of the Securities Act unless the government can prove that he or she acted "willfully." Unfortunately, it is easier to state what is not required to prove willfulness than to state what is required. n4 For example, it has long been established "that in proving that a defendant acted knowingly and wilfully [sic] it [is] not necessary for the defendant to know that he [is] breaking 'any particular law or any particular rule'." n5 It also has been held that a defendant can be convicted for willfully violating Section 17(a)(1) of the Securities Act even if he or she does not know that he or she is dealing with a "security," as that term is defined in Section 2(1) of the Securities Act. Likewise, a defendant may be found to have acted willfully even if he or

she did not know that his or her illegal act would make use of the mails as long as "the use of the mails ... should have been foreseen and contemplated." n6 Two Supreme Court decisions suggest that willful violations require some appreciation of illegality. In *Ratzlaf v. United States*, the Supreme Court reversed a conviction for willful violation of an anti-structuring provision because it was not clear that the defendant *knew* his conduct was illegal. n7 The Court extended this logic four years later when it held in *Bryan v. United States* that a street-corner gun dealer could be convicted of willfully violating a licensing requirement because "[t]he evidence was unquestionably adequate to prove ... that he *knew* that his conduct was unlawful," even if he was unaware of the specific licensing statute. n8 The *Ratzlaf* and *Bryan* decisions suggest that Section 24 requires knowledge of unlawfulness. However, the Supreme Court has also observed that willful is a " 'word of many meanings' and 'its construction is often influenced by its context.' " n9 The Court has yet to define the precise meaning of the word in the securities context and some lower courts have resisted applying the *Ratzlaf* and *Bryan* construction of willfulness in cases considering violations of the Securities Act and the Securities Exchange Act of 1934 (the "Exchange Act").

In a case decided after *Ratzlaf* and before *Bryan*, the Ninth Circuit considered the definition of willfulness under Sections 17(a) and 24 of the Securities Act, and held that, unlike the *Ratzlaf* definition, willfulness in this context does not require proving that the defendant knew his conduct was illegal. n10 A similar result was reached by the Ninth Circuit in *United States v. Tarallo* n11 with respect to the definition of willfulness in Section 32(a) of the Exchange Act, the provision which criminalizes violations under that Act. There the court stated: "[u]nder our jurisprudence, then, 'willfully' as it is used in [Section 32(a)] means intentionally undertaking an act that one knows to be wrongful; 'willfully' in this context does not require that the actor know specifically that the conduct was unlawful." n12

Although willfulness is not equivalent to a specific intent to violate the law, the term does require some level of guilty knowledge. This requires a jury to ascertain the condition of the defendant's mind at the time of the alleged violation. n13 "Since the condition of the mind is rarely susceptible of direct proof, recourse must be had to all pertinent circumstances." n14

An easy case is provided by *United States v. Custer Channel Wing Corp.* n15 In this case, the defendants were convicted of criminal contempt n16 for disobeying a previously issued injunction that prohibited them from selling unregistered securities in violation of Section 5 of the Securities Act. Under these circumstances, the court of appeals had no trouble finding sufficient evidence of willfulness to support the convictions:

The appellants had already breached the law and had been enjoined not to do so again; yet they knowingly repeated the selfsame forbidden acts. It is not consonant with reason, in these circumstances, to demand a more explicit demonstration of an evil mind in order to sustain the conviction for criminal contempt. n17

In *United States v. Dinneen*, n18 the Tenth Circuit also concluded that the defendant's violation of an injunction against the sale of unregistered stock automatically satisfied the willfulness requirement of Section 24, at least where "personal service was made on [the defendant] of the preliminary injunction prior to the [questioned] transaction [and the] wording of the injunction plainly indicated the lack of registration." The Eighth Circuit reached a similar conclusion in *United States v. Prugh*:

In view of Prugh's prior experience in the securities field it seems reasonable to presume that he would know whether the securities he purchased [and resold] were properly registered or not. If uncertain, he knew how to check on the registration. In view of the injunction which was entered against him it was incumbent on him to determine if his transactions were in violation of the terms of that injunction. n19

In other words, his failure to do so showed a reckless disregard for the legality or illegality of his actions. n20 Thus, "[t]he Government was not required to show that Prugh knew that he was violating the terms of the injunction ... but

only to prove that he intentionally conducted the proscribed stock transactions." n21

As these cases demonstrate, a criminal defendant who is under prior injunctive restraint "cannot possibly be fitted into the pattern of an innocent stumbling into an unintended transgression." n22 The injunctions "pointedly brought to the defendants' attention their past infraction[s] ... and laid down a specific admonitory prescription to guide their future course... thus warned, they should have been more than normally careful in their behavior not to repeat the offense[s]." n23

Another issue is the possibility that scienter standards developed in the SEC civil context may be imported into a criminal proceeding to analyze willfulness. For example, Section 17(a)(1), under which most criminal prosecutions are brought, prohibits the employment of "any device, scheme or artifice to defraud" in relation to an offer or sale of securities. n24 In *Aaron v. Securities and Exchange Commission*, n25 the Supreme Court held that proof of scienter -- "a mental state embracing intent to deceive, manipulate, or defraud"-- is required to prove a violation of Section 17(a)(1) in an SEC injunctive action, but not to prove violations of Sections 17(a)(2) or 17(a)(3). n26 In a 1982 decision, *United States v. Boyer*, n27 the Third Circuit suggested that the mental element of the offense in civil and criminal cases under the Securities Act should be the same. Accordingly, in a criminal prosecution under Section 17(a)(1), evidence of scienter could be required to establish willfulness. n28

Specific intent under Section 17(a)(1) can be established by evidence that a defendant sold securities with a recommendation that they were a "good investment" in spite of his or her knowledge of the issuer's precarious financial condition. n29 Specific intent under Section 17(a) also can be established by evidence that the defendant acted with reckless disregard for the truth or falsity of his or her statements. n30

A different standard of willfulness is used in prosecutions under Section 5 of the Securities Act. "Fraud is not a necessary constituent of" this offense. n31 Accordingly, willfulness can be established simply by proving that the defendant knew "the facts which constitute [the] statutory violation." n32 In *United States v. Hill*, this was shown by evidence that (1) the defendant caused the unregistered securities to be sold and (2) he knew that registration was required. n33 In another case, it was held that evidence that the defendant did not register the securities in order to conceal a fraudulent scheme would also establish "willfulness" under Sections 5 and 24. n34

[b] The "Knew or Should Have Known" Standard. Since at least 1964, a "knew or should have known" standard has been used to prove "willfulness" in criminal prosecutions under the Securities Act. In *United States v. Benjamin*, n35 the Second Circuit considered the claims of an accountant, an attorney, and a promoter who had grossly misrepresented the activities and financial condition of the issuer. Claiming that their misrepresentations had been made in ignorance of the true facts, the defendants disputed the finding of willfulness by the trial court. The court of appeals, however, found that the government had amply proved willfulness, stating "that in the context of § 24 of the Securities Act as applied to § 17(a), the Government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see or recklessly stated as facts things of which he was ignorant." n36 The court opined that Congress did not intend for professionals to "be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen" n37

[c] The Professional Advice Defense. One of the most common defenses to a prosecution under Section 24 is the claim that the violation was caused by good faith reliance upon professional advice from an attorney or accountant. The rationale behind this defense is that a belief that one's actions are legal negates any finding of willfulness in violation of the law. Courts have uniformly held that advice of counsel under these circumstances does not provide a complete or automatic defense, but that it may, on a case-by-case basis, exculpate the person relying on the advice. n38 It has been held, however, that while reliance on advice of counsel may provide a valid defense if "the crime requires specific intent, it does not if only knowledge of the facts is required." n39

For example, in *United States v. Crosby*, n40 three brokers were found guilty of willfully selling unregistered securities

in violation of Section 5(a). These brokers, however, repeatedly had received legal advice that "the stock was exempt from registration and free for trading." n41 The Second Circuit overturned their convictions, finding that the defendants' procurement and reliance on this advice was in good faith and precluded a finding of willfulness. The court rejected the government's insistence that there had been no real reliance on the legal advice or that the advice had not actually blinded the brokers to the illegality of their acts. Although there had been a large number of stock sales, a stock dividend declared after the acquisition of a company, and frequent meetings between the brokers and corporate officials, the court dismissed each of these as normal business conduct. n42

The *Crosby* case, then, sets up a framework for the advice of counsel defense: if the advice is credible, complete, and accepted in good faith, it can negate any "willfulness" in a technical violation of the law. n43 Legal advice will not exculpate where there is evidence to infer that the defendant truly understood the illegality of the activity, regardless of the advice. n44 In short, the legal advice must be a reasonable and actual cause of a misperception in legal duties.

In *United States v. Dardi*, the Second Circuit found extrinsic evidence sufficient to support the jury's conclusion that the defendant had not relied in good faith on legal advice. n45 While acknowledging that the jury could consider the advice of counsel defense, the court sought to explain the reasonable inferences the jury might have made in concluding that legal advice had not negated the willfulness of the defendant's offense:

[R]eliance on the opinion of counsel is but one consideration which may be persuasive in the jury's determination of the defendant's state of mind. Among other factors which the jury could consider as going to [defendant's] good faith reliance on legal advice was the fact that the letters expressing the opinion that the stock could be sold without registration specifically made the assumption that the sales were not being made for "control" persons. And, as pointed out, the jury could have inferred that when these opinions were rendered [defendant] knew that he was dealing with control persons. n46

Using much the same approach, the Ninth Circuit in *United States v. Manning* summarily affirmed convictions of defendants who tried to use the advice of counsel defense where their lawyer was an alleged co-conspirator. n47 The Court's opinion conveys the impression that the obvious illegality of the acts made any claim on reliance of counsel incredible:

The assertion that the appellants' actions were immunized by reliance on the legal advice of their alleged co-conspirator Eisenberg misreads the law in this respect. Their actions in utilizing fictitious stockholders and nominees negate any claim that they thought they were acting lawfully. Moreover, it appears from the evidence that they did not treat Eisenberg as an independent, unbiased legal advisor. n48

Manning represents a logical factual application of the *Crosby/Dardi* doctrine: an attorney's advice is not a defense unless it is neutral and independent.

Advice of counsel can displace willfulness, but it will only be a strong defense if it meets rigorous conditions. The client must seek legal advice in good faith, from an unaffiliated, unbiased professional to whom all the pertinent facts must be given. n49 The client must rely on the advice in good faith--a condition perhaps best shown by the credibility of the legal opinion coupled with the client's lack of countervailing knowledge. On the other hand, evidence that a client ignored his lawyer's advice that his actions were illegal is evidence of willfulness. n50

[2] Violations of Section 17(a)

The majority of prosecutions under Section 24 are for willful violations of Section 17(a):

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as

defined in Section 206B of the Gramm-Leach-Bliley Act) 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. n51

The threshold element of a Section 17 violation is "the use of any means or instruments of transportation or communication in interstate commerce or ... use of the mails." The purpose of this requirement "is solely to create a basis for federal jurisdiction." n52 Telephone conversations satisfy this "jurisdictional means" test. n53 So do telegrams n54 and sales initiated from the floor of a national stock exchange, even though no use of the mails or of telephones occurs in connection therewith. n55

Use of the mails also triggers Section 17(a). However, it is not necessary to prove that the defrauded investor relied on any of the mailings. n56 "Rather, what must be shown is that the scheme had an impact on the investor and that the mails were used in employing the scheme." n57 Thus, the use of the mails need only be a small part of the fraudulent scheme. n58 In fact, it is immaterial whether the mailing was done by the defendant or by someone else as long as the use of the mails was foreseeable. n59

Section 17(a) prohibits fraudulent sales not only to investors, but also to brokers and dealers. n60 Also, it is not essential that the Section 17(a) defendants be the actual offerors or sellers of securities: "it is enough to show that [they] knowingly and actively participated in a fraudulent scheme which resulted in the offer or sale." n61 Section 17(a) thus applies to a wide variety of situations, for the "[c]ourts have recognized that section 17(a) must be given broad scope and flexible interpretation in order to encompass all the ingenious variations of securities fraud that arise." n62

[3] Violations of Section 5(a)

Criminal actions are also brought under Section 5(a) of the Securities Act. n63 While less frequently filed than Section 17(a) prosecutions, several major criminal prosecutions have included Section 5(a) violations. n64 Section 5(a) provides:

- (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly --
 - (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
 - (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

The elements of a Section 5(a)(1) violation are:

- the mails or facilities of interstate commerce are used;

- to sell a security for which no registration statement is in effect;
- through the use of or medium of any prospectus or otherwise.

The essential elements of a Section 5(a)(2) violation are:

- a security is carried through the mails or in interstate commerce;
- for the purpose of a sale or delivery after a sale; and
- no registration statement is in effect as to such security at the time thereof. n65

There is no requirement that the use of means or instruments of transportation, communication in interstate commerce, or the use of the mails actually caused the sale of unregistered securities. n66

This subsection is violated when, in connection with the sale of such stock, the mails are used to transmit an offer or other sales literature, to transport the securities after sale, to remit the proceeds to the seller, to send confirmation slips to the buyer, and perhaps even when used in more tangential ways. n67

If the defendant did not personally perform the mailing, he may nevertheless violate Section 5 if the mailing was a reasonably foreseeable result of the transaction. n68 Likewise, registration under the "Exchange Act" does not excuse a failure to register under Section 5 of the Securities Act. n69

[4] Violations of Section 24

In addition to providing for criminal prosecution of violations of other sections of the Securities Act, Section 24 prohibits the willful filing of a false or misleading registration statement. Criminal prosecutions under this clause of Section 24 are not as common as prosecutions for violations of Section 17(a) or 5(a). n70 In fact, the filing of false or misleading registration statements is sometimes prosecuted as fraud under Section 17(a). n71

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. § 77x (2000)*.

(n2)Footnote 2. An additional criminal provision is found in Section 22(b) of the Securities Act, *15 U.S.C. § 77v(b) (2000)*. It makes failure to obey a court order requiring compliance with an SEC administrative subpoena punishable as criminal contempt.

(n3)Footnote 3.

(1) Activities violative of Section 17(a), *15 U.S.C. § 77q(a)* the fraud section of the Act, discussed in § 11.02[2] *infra*.

(2) Use of the mails or facilities of interstate commerce to circulate any notice, advertisement or other written material, which, though it does not purport to offer a security for sale, describes that security for a consideration to be received from an issuer, underwriter, or dealer without disclosing that fact. *15 U.S.C. § 77q(b) (2000)*.

(3) Use of the mails or facilities of interstate commerce to sell a security through the use or medium of any prospectus or otherwise, unless a registration statement is in effect. *15 U.S.C. § 77e(a)(1) (2000)*, discussed in § 11.02[3] *infra*.

2-11 Federal Securities Act of 1933 § 11.02

(4) Use of the mails or facilities of interstate commerce to carry or cause to be carried an unregistered security for the purpose of sale or delivery after sale. 15 U.S.C. § 77e(a)(2) (2000), discussed in § 11.02[3] *infra*.

(5) Use of the mails or facilities of interstate commerce to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed, unless the prospectus meets the requirement of Section 10. 15 U.S.C. § 77e(b)(1) (2000). In this connection, it should be noted that there is an additional requirement that when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to its use. 15 U.S.C. § 77j(a)(3) (2000).

(6) Use of the mails or facilities of interstate commerce to carry or cause to be carried any registered security for the purpose of sale or for delivery after sale unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of Section 10. 15 U.S.C. § 77e(b)(2) (2000).

(7) The affixing of a signature to a registration statement without the authority of the purported signer. 15 U.S.C. § 77f(a) (2000).

(8) The making of a representation to any prospective purchaser that the Commission has found a registration statement to be true and accurate or that it does not contain an untrue statement of fact or omit to state a material fact, or that the Commission has in any way passed upon the merits of, or given approval to, the security. 15 U.S.C. § 77w (2000).

(9) Activities violating any rule and regulation of the Commission. 15 U.S.C. § 77x (2000).

(n4)Footnote 4. See *United States v. English*, 92 F.3d 909, 915 n.8 (9th Cir. 1996) (observing that "courts that have construed § 77x [Section 24 of the Securities Act] have not given 'willfulness' a consistent meaning"); see also Robert F. Koets, Annotation, *What Constitutes "Willfulness" for Purposes of Criminal Provisions of Federal Securities Laws*, 136 A.L.R. Fed. 457, § 2(a) (1997).

(n5)Footnote 5. See *United States v. Dardi*, 330 F.2d 316, 330-31 (2d Cir. 1964) (approving jury charge to that effect). In *Dardi*, however it was not necessary for the court to assess the district court's statement that "[a]n act, is wilful [sic] if it is done knowingly, deliberately and with an evil motive or purpose," *Id.* at 331, or determine whether some lesser standard would suffice: "[s]ince the charge was adequate on either view, we need not consider whether it gave the defendants an advantage to which they were not entitled." *Id.* at 331 n.6.

(n6)Footnote 6. See *McDaniel v. United States*, 343 F.2d 785, 787 (5th Cir. 1965); cf. *United States v. Sampson* 371 U.S. 75 (1962) (holding that a conviction for mail fraud under 18 U.S.C. § 1341 does not require proof that defendant actually knew of the use of the mails).

(n7)Footnote 7. 510 U.S. 135, 144-46 (1994) (emphasis added) (Congress has since amended the statute at issue in *Ratzlaf*, 31 U.S.C. §§ 5322(a), (b) 5324(c), and removed the requirement for a specific mental state). But see *English*, 92 F.3d at 915 (holding that a Section 24 conviction does "not require proof of knowledge of illegality"); *Wonsover v. SEC*, 205 F.3d 408, 413 (D.C. Cir. 2000) (holding that *Ratzlaf* and its progeny applied "to statutory schemes different from the 1933 Act and the Exchange Act [of 1934]").

(n8)Footnote 8. 524 U.S. 184, 189 (1998) (emphasis added). "[K]nowledge that the conduct is unlawful is all that is required." *Id.* at 196.

(n9)Footnote 9. See *Ratzlaf*, 510 U.S. at 141 (quoting *Spies v. United States*, 317 U.S. 492, 497 (1943) .

(n10)Footnote 10. *United States v. English*, 92 F.3d 909 (9th Cir. 1996) .

(n11)Footnote 11. 380 F.3d 1174 (9th Cir. 2004) .

(n12)Footnote 12. *Tarallo*, 380 F.3d. at 1187-88; see also *United States v. Wenger*, 427 F.3d 840 (10th Cir. 2005)

(n13)Footnote 13. See *United States v. Smallwood*, 443 F.2d 535, 541 (8th Cir. 1971) .

(n14)Footnote 14. 443 F.2d 535, 541 ; see also *United States v. Porter*, 441 F.2d 1204, 1210 (8th Cir. 1971) . It should be remembered, however, that, although the defendant's state of mind may be inferred from the circumstances, the government must prove the defendant's guilt, including his or her "willfulness," beyond a reasonable doubt.

(n15)Footnote 15. 376 F.2d 675 (4th Cir. 1967) .

(n16)Footnote 16. The evidence needed to prove a criminal contempt for violation of an injunction under the Securities Act is the same as that needed to prove a direct criminal violation of Section 24. *United States v. Prugh*, 479 F.2d 611, 612-13 (8th Cir. 1973) .

(n17)Footnote 17. *Custer Channel*, 376 F.2d at 682 .

(n18)Footnote 18. 463 F.2d 1036, 1041 (10th Cir. 1972) .

(n19)Footnote 19. *Prugh*, 479 F.2d at 612 .

(n20)Footnote 20. *Prugh*, 479 F.2d at 612 .

(n21)Footnote 21. *Prugh*, 479 F.2d at 613 .

(n22)Footnote 22. *Custer Channel*, 376 F.2d at 682 .

(n23)Footnote 23. *Custer Channel*, 376 F.2d at 682 .

(n24)Footnote 24. 15 U.S.C. § 77q(a)(1) (2000).

(n25)Footnote 25. 446 U.S. 680, 697, 100 S. Ct. 1945, 1956, 64 L. Ed. 2d 611, 627 (1980) .

(n26)Footnote 26. 446 U.S. at 686 n.5 , (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, n.12 (1976)) 695-97 , see also *Meadows v. SEC*, 119 F.3d 1219, 1226 (5th Cir. 1997) (articulating that recklessness must be severe and "present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it" in order to satisfy the scienter requirement); see also *SEC v. Carriba Air, Inc.* 681 F.2d 1318, 1324 (11th Cir. 1982) ("Scienter may be established by a showing of knowing misconduct or severe recklessness.").

(n27)Footnote 27. 694 F.2d 58, 60 (3d Cir. 1982) .

(n28)Footnote 28. Cf. *United States v. Brown*, 578 F.2d 1280, 1284 (9th Cir. 1978) ("We think that the government is required to prove specific intent only as it relates to the action constituting the fraudulent, misleading or deceitful conduct, but not as to the knowledge that the instrument used is a security under the Securities Act.").

(n29)Footnote 29. See *United States v. Farris*, 614 F.2d 634, 639 (9th Cir. 1979) ; cf. *United States v. Vasilios*, 598 F.2d 387, 392 (5th Cir. 1979) (holding that an underwriter made false statements to accountant preparing issuer's

financial statement).

(n30)Footnote 30. *Farris*, 614 F.2d at 638 .

(n31)Footnote 31. *Price v. United States*, 200 F.2d 652, 654 (5th Cir. 1953) .

(n32)Footnote 32. *United States v. Hill*, 298 F. Supp. 1221, 1234 (D. Conn. 1969) .

(n33)Footnote 33. *Hill*, 298 F. Supp. at 1234 .

(n34)Footnote 34. *United States v. Abrams*, 357 F.2d 539, 546 (2d Cir. 1966) .

(n35)Footnote 35. 328 F.2d 854 (2d Cir. 1964) .

(n36)Footnote 36. *Benjamin*, 328 F.2d at 862 (citations omitted).

(n37)Footnote 37. *Benjamin*, 328 F.2d at 863 .

(n38)Footnote 38. *Tarvestad v. United States*, 418 F.2d 1043, 1047 (8th Cir. 1969) ; see also *United States v. United Med. & Surgical Supply Corp.*, 989 F.2d 1390, 1403 (4th Cir. 1993) ("Good faith reliance on the advice of counsel is not a complete defense to an allegation of willful misconduct, but is merely one factor a jury may consider when determining [the defendant's] state of mind.").

(n39)Footnote 39. *United States v. Hill*, 298 F. Supp. 1221, 1235 (D. Conn. 1969) ; see *United States v. Bristol*, 473 F.2d 439, 443 (5th Cir. 1973) .

(n40)Footnote 40. 294 F.2d 928 (2d Cir. 1961) .

(n41)Footnote 41. *Crosby*, 294 F.2d at 939 .

(n42)Footnote 42. As to the large number of stock sales, the court said that "[t]he course of conduct of the three brokers in selling so many shares proves little -- it merely presents, in multiple instances, the same question: ... Were the brokers justified in selling unregistered stock on the representation of counsel ...?" 294 F.2d at 941 . On the dividend, the court said, "Appellee argues that the brokers 'knew' Texas-Adams legitimately could not have declared such a large stock dividend to controlling American Montana The fallacies in this reasoning are clear. There are numerous transaction which might have been the base for legitimate issuance of this stock to the parent corporation... ." *Id.* Finally, "[s]ince the broker appellants were a principal outlet for over the counter sales of Texas-Adams stock, there is nothing strange about 'hotel meetings' with the top officers of the corporation. " *Id.*

(n43)Footnote 43. See also *SEC v. Goldfield Deep Mines Co.*, 758 F.2d 459, 467 (9th Cir. 1985) (summarizing the prerequisites for an advice of counsel defense).

(n44)Footnote 44. See *SEC v. Bonastia*, 614 F.2d 908, 914 (3d Cir. 1980) (rejecting in a civil suit, a defense of good faith reliance because of the defendant's "high-ranking" position with the various companies engaged in the illegal activity and the "specific finding of scienter made by the district court").

(n45)Footnote 45. 330 F.2d 316, 326 (2d Cir. 1964) (discussed in n. 5 supra).

(n46)Footnote 46. *Dardi*, 330 F.2d at 326 .

(n47)Footnote 47. 509 F.2d 1230, 1234 (9th Cir. 1974) .

(n48)Footnote 48. *Manning*, 509 F.2d at 1234 (citations omitted).

(n49)Footnote 49. See *United States v. Hill*, 298 F. Supp. 1221, 1235 (D. Conn. 1969) .

(n50)Footnote 50. *United States v. Robinson*, 543 F.2d 951, 959 (2d Cir. 1976) .

(n51)Footnote 51. 15 U.S.C. § 77q(a) (2000); see also *United Med. & Supply Corp.*, 989 F.2d 1390, 1402 (4th Cir. 1993) (stating elements of a Section 24 charge based on a Section 17(a) violation).

(n52)Footnote 52. *United States v. Cashin*, 281 F.2d 669, 673 (2d Cir. 1960) .

(n53)Footnote 53. See *Coplin v. United States*, 88 F.2d 652, 656 (9th Cir. 1937) .

(n54)Footnote 54. See *Harper v. United States*, 143 F.2d 795, 801 (8th Cir. 1944) .

(n55)Footnote 55. *United States v. Re*, 336 F.2d 306, 315 (2d Cir. 1964) .

(n56)Footnote 56. See *United States v. Ashdown*, 509 F.2d 793, 799 (5th Cir. 1975) ; see also *United States v. Rodgers*, 624 F.2d 1303, 1309-10 (5th Cir. 1980) (citing *Ashdown* and noting that "[t]here is no requirement of a 'but for' relationship between the use of the mails and execution of the scheme to defraud in order for a mailing to be 'in furtherance' of the scheme").

(n57)Footnote 57. *Ashdown*, 509 F.2d at 799 .

(n58)Footnote 58. *Cashin*, 281 F.2d at 673 .

(n59)Footnote 59. See *United States v. Farris*, 614 F.2d 634, 639 (9th Cir. 1979) ("The acts of all active parties to a conspiracy are imputed to each other so long as those acts are reasonably foreseeable steps toward the agreed upon goal.")

(n60)Footnote 60. *United States v. Naftalin*, 441 U.S. 768 (1979) . However, to prosecute fraud in connection with the purchase of securities, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder must be used. But see, *United States v. Haddy*, 134 F.3d 542, 550 (3d Cir. 1998) (extending *Naftalin* to cover the Exchange Act as well as the Securities Act). "We read *Naftalin* as teaching that if fraud 'in' a securities transaction, as prohibited by the 1933 Act, does not require fraud on an investor, then deception 'in connection with' a securities transaction per the 1934 Act does not have such a requirement."

(n61)Footnote 61. *United States v. Mayo*, 646 F.2d 369, 371 (9th Cir. 1981) ; accord *United States v. Carroll*, 582 F.2d 942, 947 (5th Cir. 1978) .

(n62)Footnote 62. *United States v. Jensen*, 608 F.2d 1349, 1354 (10th Cir. 1979) (misrepresentation of a guaranteed investment package violates Section 17(a) even though sale of securities was only a minor part of overall scheme to defraud).

(n63)Footnote 63. 15 U.S.C. § 77e(a) (2000).

(n64)Footnote 64. See, e.g., *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968) ; *United States v. Abrams*, 357 F.2d 539 (2d Cir. 1966) ; *United States v. Re*, 336 F.2d 306 (2d Cir. 1964) .

(n65)Footnote 65. *United States v. Attaway*, 211 F. Supp. 682, 684 (W.D. La. 1962) ; see also *SEC v. Softpoint*, 958 F. Supp. 846, 859 (S.D.N.Y. 1997) , *aff'd*, 159 F.3d 1348 (2d Cir. 1998) ("Sections 5(a) and (c) of the Securities Act ... prohibit 'any person' from directly or indirectly using the mails or the means of interstate commerce to offer or sell a security unless it is registered with the SEC or is exempt from registration.").

(n66)Footnote 66. *United States v. Kane*, 243 F. Supp. 746, 750 (S.D.N.Y. 1965) .

(n67)Footnote 67. *Kane*, 243 F. Supp. at 750 ; see also *Wolfson*, 405 F.2d at 783-84 (2d Cir. 1968) (convicting defendant of Section 5 violations for sending confirmation slips regarding the sale of unregistered securities though the mails).

(n68)Footnote 68. *Price v. United States*, 200 F.2d 652, 655 (5th Cir. 1953) (convicting defendant of causing unregistered securities to be carried through federal mails for the purpose of sale and delivery after sale, although actual mailing was done by his attorneys).

(n69)Footnote 69. *SEC v. Allison*, 1982 U.S. Dist. LEXIS 14326 (N.D. Cal. Aug. 11, 1982) .

(n70)Footnote 70. *But see, e.g., United States v. Wentland*, 234 F. Supp. 936 (D.D.C. 1964) (explaining that defendant falsely overstated the inventory of the corporation by \$200,000, which materially distorted the financial statement required to be filed with the registration papers); *United States v. Pope*, 189 F. Supp. 12 (S.D.N.Y. 1960) (noting that registration statements contained misstatements and omissions of material facts about the company's dealings with other corporations it owned).

(n71)Footnote 71. *See, e.g., Danser v. United States*, 281 F.2d 492 (1st Cir. 1960) .



167 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933 § 11.03

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

§ 11.03 Other Criminal Statutes Frequently Charged in Conjunction with Violations of the Securities Act

In many criminal prosecutions under the Securities Act, the indictments will include charges of mail fraud, n1 wire fraud, n2 conspiracy, n3 aiding and abetting, n4 false statements, n5 perjury, n6 and racketeering. n7 Charges under the Exchange Act may also be joined. The elements of these offenses, other than those under the Exchange Act, are discussed below. n8

[1] Mail Fraud and Wire Fraud

Due to their broad language and scant legislative history, the mail and wire fraud statutes are commonly charged in prosecutions of various fraudulent schemes. The mail fraud statute provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service ... or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than \$1,000,000 or imprisoned not more than 30 years, or both. n9

The wire fraud statute has similar provisions. n10 While the two statutes are very similar, the wire fraud statute requires communications in interstate or foreign commerce while the mail fraud statute only requires use of the mails. However, courts have held that these statutes are to be given the same construction. Even after the enactment of the more specific Securities Act and Exchange Act, mail and wire fraud prosecutions continue, for it has long been held that the securities laws did not repeal any part of the mail or wire fraud statutes. n11

The essential elements of mail or wire fraud are (1) a scheme to defraud, and (2) use of the mails or of communications in interstate or foreign commerce, (3) in execution or furtherance of this scheme. n12 "A scheme to defraud is conduct intended to or reasonably calculated to deceive ordinary people." n13 Proof of this scheme does not require a showing that the investor relied on these mailings to his or her detriment. n14 Nor is the scheme's lack of success relevant. n15 However, the misrepresentations must be material. n16 A mail or wire fraud scheme may be designed to deprive the owner of all kinds of "property," including such intangible property as confidential business information. n17

A scheme to defraud also requires proof of the defendant's specific intent to defraud, n18 or, at the very least, proof of a reckless disregard for the truth or falsity of one's representations. n19 The requirement of specific intent or reckless indifference, however, is not satisfied by the possibility that the defendant *could* have discovered the fraud. n20

The second essential element of mail or wire fraud is use of or causing the use of the mails or of communications in interstate or foreign commerce. n21 A person "causes the mails to be used" if use of the mails or wires would reasonably follow the actions he has taken. n22 Therefore, it is not necessary for the government to prove that the defendant himself mailed or wired anything; it must only be proved that defendant was a knowing participant in a scheme to defraud at the time the mails or wires were used. n23 Of course, if the defendant had no reason to believe that the mails or communications in interstate or foreign commerce would be used in executing the scheme and if someone else actually did the mailing, then the defendant has a valid defense against a mail fraud charge. n24

The third essential element of mail or wire fraud is proof that the mailings or communications were executed to further the fraudulent scheme. In securities-related cases, this element may be satisfied even if the fraudulent sale occurs before anything is mailed or communicated by wire. n25 For example, information sent to defrauded investors after they have paid for worthless stock may prolong the illusion of the sale's legitimacy. This is referred to as "lulling" by most courts, and the Supreme Court has held that "lulling" letters are to be considered as mailings in "furtherance of the scheme" for the purpose of mail fraud prosecutions. n26 However, the mail fraud statute is not violated if mails are not sufficiently related to the defendant's fraudulent scheme. n27

[2] Conspiracy

The federal conspiracy statute prohibits two or more persons from joining together to commit any offense against the United States or to defraud the United States or its agencies. It reads in part:

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both. n28

This conspiracy statute is commonly charged in securities fraud prosecutions because the grand schemes involved usually require the participation of many people. n29

In a conspiracy prosecution, it is not necessary for the government to show that each co-conspirator knew all parts of the illegal plan. n30 It is necessary to show only that the defendants "knew of the conspiracy and that they associated themselves with it" in some way. n31 Thus, in one prosecution for conspiracy to violate Sections 5 and 24 of the Securities Act through the sale of unregistered securities, it was held that the "government was required to prove either that [the defendants] knew, or that they deliberately closed their eyes to the necessity for registering the ... stock before selling it." n32

Such proof included evidence that the defendants acted in a furtive and roundabout manner; were warned by their lawyers regarding the illegality of their actions; "laundered" their securities through a shell corporation; were familiar with the registration requirements of the Securities Act and its implementing regulations; and used nominees to conceal

their stock ownership. n33

[3] Aiding and Abetting

Aiding and abetting charges may be brought under *18 U.S.C. § 2 (2000)* against those who assisted in a proven securities law violation:

Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal. Whoever willfully causes an action to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

It should be emphasized that a violation of *18 U.S.C. § 2* does not create a separately indictable offense. n34 Such a violation merely allows aiders and abettors to be punished as principals under some other criminal statute. n35

In civil enforcement actions brought by the SEC, the elements necessary to establish an aiding and abetting charge for violation of the Securities Act are set forth in Section 20(e) of the Securities Act:

For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this title [*15 U.S.C. §§ 78a et seq.*], or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided. n36

This provision was part of the Private Litigation Securities Reform Act of 1995 (PLSRA). The PLSRA was a response to the Supreme Court's decision in *Central Bank v. First Interstate Bank*, n37 which eliminated aiding and abetting liability under section 10(b) in private actions n38 and could also have been interpreted as eliminating aiding and abetting liability in SEC federal court actions. n39 The provision restored the SEC's ability to pursue aiders and abettors and intentionally reflects the elements necessary to establish an aiding and abetting charge under the previous case law. n40

Under the previous case law, the scienter requirement was that an aider and abettor act with "actual knowledge." n41 To the extent that pre-*Central Bank* jurisprudence diverged on whether "recklessness" might also satisfy this scienter requirement, this divergence of views gives way to the plain language of the PLSRA, which uses the word 'knowingly.' " n42

It is unclear whether criminal aiding and abetting charges may be brought under Section 20(e) of the Securities Act or whether these charges can only be brought under *18 U.S.C. § 2*. Section 20(e) restricts itself to "any action brought by the Commission," not the DOJ. In *Glaser v. Enzo Biochem Inc.*, however, the 4th Circuit Court of Appeals stated that "the post-*Central Bank* enactment of *15 U.S.C. § 78t(e)* ... authorizes *criminal* prosecutions of persons who aid and abet securities laws violations." n43 These results may be reconcilable since the Commission can make a criminal referral to the DOJ under paragraph (1) of section 78u(d), specifically incorporated into the aider-abettor provision of the Securities Act, Section 20(e).

Regardless, the standard for aider and abettor liability in criminal cases brought by the DOJ appears to be the same as the standard for aider and abettor liability under Section 20(e). For example, in *United States v. Erb*, aider and abettor liability was imposed under Section 24 on an underwriter who "knowingly assisted in the preparation and filing of a false registration statement." n44 This defendant had purchased a substantial block of stock at a reduced price prior to its public offering. n45 He gave instructions, however, that the stock should be issued in the name of a third person in order to avoid SEC and NASD rules on the pre-offering purchase of stock by underwriters. n46 He knew, therefore, that

any registration statement filed with the SEC would falsely represent his interest in the issuer corporation and that the filing of a registration statement was a prerequisite to making a profit by selling his stock. n47 Under these circumstances, a case for aider and abettor liability was established.

[4] False Statements

Criminal prosecution under Section 24 of the Securities Act for the filing of a false or misleading registration statement can also involve the false statement section of the Criminal Code:

[W]hoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States knowingly and willfully (1) falsifies, conceals or covers up by any trick, scheme, or device a material fact; (2) makes any materially false, fictitious or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious or fraudulent statement or entry; shall be fined under this title or imprisoned not more than 5 years ... or both. n48

The essential elements of a false statement prosecution are "that (1) the defendant made a statement; (2) the statement was false, fictitious or fraudulent ... ; (3) the statement was made knowingly and willfully; (4) the statement was within the jurisdiction of the federal agency n49 In addition, some circuits require that the statement was material." n50

Although interpreted broadly, *18 U.S.C. § 1001 (2000)* only applies to those who knowingly and willfully lie to the Government. n51 This burden does not require the Government to prove that the defendants acted with evil intent "but rather that they had certified a statement knowing it to be false." n52

In addition to written statements, *18 U.S.C. § 1001 (2000)* also covers oral statements. n53 Unlike the perjury statute, however, the false statements statute does not limit prosecution to statements made under oath. In fact, the Supreme Court has interpreted the false statement statute broadly to include any false statements made to any administrative agency. n54 Accordingly, *§ 18 U.S.C. 1001 (2000)* would cover false statements made to officers of the SEC in the course of a formal or informal investigation, n55 as well as the filing of false and misleading documents, *e.g.*, registration statements with the Commission. Yet, it is not frequently used in conjunction with Section 24.

[5] Perjury

Perjury in testimony before the SEC could also be charged in an indictment along with violations of Section 24. The operative statute is *18 U.S.C. § 1621 (2000)*, which provides in pertinent part:

Whoever ... having taken an oath before a competent tribunal, officer, or person, in any case in which a law of the United States authorizes an oath to be administered, that he will testify, declare, depose, or certify truly ... willfully and contrary to such oath states ... any material matter which he does not believe to be true ... is guilty of perjury and shall, except as otherwise provided by law, be fined under this title or imprisoned not more than five years, or both. n56

An SEC staff attorney who by order of the Commission is designated as an officer of the Commission and empowered to administer oaths and take evidence for the purpose of an investigation is competent to do so within the meaning of the perjury statute. Thus, in *Boehm v. United States*, n57 a corporate director was convicted of perjury after he testified falsely under oath before an SEC officer that he did not pay his expense account, falsify his travel vouchers, or accept kickbacks or rebates. Likewise, in *Woolley v. United States*, n58 the defendant was convicted of perjury after he testified under oath in an SEC investigation that he had no connection with the investigated corporation, when, in fact, he was a director and officer.

[6] RICO

The Racketeer Influenced and Corrupt Organizations Act ("RICO") n59 contains sweeping prohibitions against a wide variety of activities conducted in interstate commerce "through a pattern of racketeering activity." n60 Violations of these prohibitions are punishable by a fine or imprisonment up to life or both. n61 The statute also contains broad criminal forfeiture provisions. n62

A "pattern of racketeering activity" requires, at a minimum, the commission of two predicate offenses within a period of ten years. n63 Such predicate offenses include mail fraud, wire fraud, and "fraud in the sale of securities." n64 Accordingly, a RICO charge may be joined in an indictment charging violations of Sections 24 and 17(a) of the Securities Act n65 and greatly increases the potential penalties for securities fraud.

FOOTNOTES:

(n1)Footnote 1. *18 U.S.C. § 1341 (2000)*.

(n2)Footnote 2. *18 U.S.C. § 1343 (2000)*.

(n3)Footnote 3. *18 U.S.C. § 371 (2000)*.

(n4)Footnote 4. *18 U.S.C. § 2 (2000)*.

(n5)Footnote 5. *18 U.S.C. § 1001 (2000)*.

(n6)Footnote 6. *18 U.S.C. §§ 1621, 1623 (2000)*.

(n7)Footnote 7. *18 U.S.C. §§ 1961 - 1968 (2000)*.

(n8)Footnote 8. *See also, e.g., United States v. Yeaman*, 194 F.3d 442 (3d Cir. 1999) (securities fraud and conspiracy); *United States v. Haddy*, 134 F.3d 542 (3d Cir. 1998) (fraud under the Securities Act and Exchange Act); *United States v. English*, 92 F.3d 909 (9th Cir. 1996) (securities fraud, mail fraud, criminal contempt, and money laundering); *United States v. United Med. & Surgical Supply Corp.*, 989 F.2d 1390 (4th Cir. 1993) (securities fraud, mail fraud, and conspiracy); *United States v. Rogers*, 960 F.2d 1501 (10th Cir. 1992) (securities fraud, mail fraud, RICO, and tax violations); *United States v. Boone*, 951 F.2d 1526 (9th Cir. 1991) (securities fraud, mail fraud, transportation of stolen property, conspiracy, perjury, and false statements).

(n9)Footnote 9. *18 U.S.C. § 1343 (2000)*.

(n10)Footnote 10. "Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than \$1,000,000 or imprisoned more than 30 years, or both." *18 U.S.C. § 1343 (2000)*. *See, e.g., United States v. Giovengo*, 637 F.2d 941, 944 (3d Cir. 1980) ; *United States v. Von Barta*, 635 F.2d 999, 1005, n.11 (2d Cir. 1980) ; *United States v. Goldberg*, 401 F.2d 644 (2d Cir. 1968) (holding that telephoning prospective investors to sell worthless stock established violation of the wire fraud statute); *see also 18 U.S.C. § 2314* (making it a crime to transport in interstate or foreign commerce securities worth more than \$5,000 and known to have been stolen, converted, or taken by fraud).

(n11)Footnote 11. *See United States v. Alluan*, 13 F. Supp. 289, 291 (N.D. Tex. 1936) ("[T]he joinder in the same bill of a charge of fraudulent use of the mail..., and of conspiring to defraud by offering the sale of stock which is useless, and of an alleged transgression against the Securities Act, which relates to actual sales of securities, or stocks ... is permitted.").

(n12)Footnote 12. *United States v. Sawyer*, 85 F.3d 713, 723 (1st Cir. 1996) ("To prove mail and wire fraud, the government must prove, beyond a reasonable doubt: (1) the defendant's knowing and willing participation in a scheme or artifice to defraud with the specific intent to defraud, and (2) the use of the mails or interstate wire communications in furtherance of the scheme."); *see also United States v. Mackay*, 491 F.2d 616, 619 (10th Cir. 1973) ; *United States v. White*, 673 F.2d 299, 302 (10th Cir. 1982) .

(n13)Footnote 13. *Gusow v. United States*, 347 F.2d 755, 756 (10th Cir. 1965) ; *see also United States v. Trammell*, 133 F.3d 1343, 1352 (10th Cir. 1998) ("A scheme to defraud is conduct intended to or reasonably calculated to deceive ordinary people.") (citation omitted); *see also White*, 673 F.2d at 302 .

(n14)Footnote 14. *See Neder v. United States*, 527 U.S. 1, 24-25 (1999) , *cert. denied*, 2008 U.S. LEXIS 8984, 77 U.S.L.W. 3345 ("The common-law requirements of 'justifiable reliance' and 'damages,' for example, plainly have no place in the federal fraud statutes."); *see also United States v. Ashdown*, 509 F.2d 793, 799 (5th Cir. 1975) (assets were misrepresented by defendants in a press release and in an annual report distributed to investors chiefly through the mails).

(n15)Footnote 15. *See United States v. D'Amato*, 39 F.3d 1249, 1257 (2d Cir. 1994) ("The scheme to defraud need not have been successful or complete."); *Pelletier v. Zweifel*, 921 F.2d 1465, 1499 (11th Cir. 1991) ("As we note above, when the government prosecutes a defendant under the mail and wire fraud statutes, it is not required to show that the intended victim was actually deceived and suffered injury."); *see also Henderson v. United States*, 202 F.2d 400, 405 (6th Cir. 1953) .

(n16)Footnote 16. *See Neder*, 527 U.S. at 23 ("We must presume that Congress intended to incorporate materiality 'unless the statute otherwise dictates.' ") (*quoting Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322 (1992)) ; *see also White*, 673 F.2d at 302 . A material fact is one which has a "natural tendency to influence or is ... capable of influencing another's decisions." *United States v. Halbert*, 712 F.2d 388, 390 (9th Cir. 1983) .

(n17)Footnote 17. *Carpenter v. United States*, 484 U.S. 19, 25 (1987) . *But cf. Cleveland v. United States*, 531 U.S. 12, 15 (2000) ("It does not suffice, we clarify, that the object of the fraud may become property in the recipient's hands; for purposes of the mail fraud statute, the thing obtained must be property in the hands of the victim.")

(n18)Footnote 18. *See United States v. Peters*, 962 F.2d 1410, 1414 (9th Cir. 1992) ("In order to prove a violation of 18 U.S.C. § 1341, there must be a showing of a specific intent to defraud.") (citation omitted); *United States v. Williams*, 728 F.2d 1402, 1404 (11th Cir. 1984) (*citations omitted*) .

(n19)Footnote 19. *See United States v. Gay*, 967 F.2d 322, 326 (9th Cir. 1992) ("We have repeatedly held that reckless indifference alone will support a mail fraud conviction."); *see also United States v. Boyer*, 694 F.2d 58, 59 (3d Cir. 1982) (defendant showed disregard for the truth or falsity of statements he presented to prospective investors as facts); *United States v. Farris*, 614 F.2d 634, 639 (9th Cir. 1979) (defendant was guilty of mail fraud because he was aware that the guarantor of notes was in dire financial straits, yet continued to sell notes to investors without revealing this information).

(n20)Footnote 20. *See United States v. McDonald*, 576 F.2d 1350, 1359 (9th Cir. 1978) (defendant's mere mention that he once thought fraud might be the cause of his salesperson's problems was insufficient evidence to prove mail fraud).

(n21)Footnote 21. Each mailing or communication may be charged as a separate crime even though it relates to the same fraudulent scheme. *Badders v. United States*, 240 U.S. 391, 394 (1916) . For an explanation of why mail fraud is not viewed as one continuing offense, *see Mitchell v. United States*, 142 F.2d 480, 481 (10th Cir. 1944) :

It is of course true that an offense of a continuing duration cannot be arbitrarily divided into separate and distinct offenses by the disposition of the prosecutor and the grand jury to divide it into separate

elements of time But we have quite a different situation. The crimes charged in each count constitute one continuous scheme to defraud; the same scheme is alleged in each count of the indictment, and the offense charged in each count has its genesis in the continuing scheme to defraud. But the gist and crux of the offense is the use of the mails in the execution of the scheme; it is the use of the mails for the purpose of executing the scheme which gives the federal courts jurisdiction over the offense The plain distinction lies in the difference between one continuing offense which may be consummated by a single or plural acts over a period of time ... and an indictment which alleges a continuing scheme and artifice to defraud, which is made criminal under the law each and every time the mail is used in execution thereof, and only when and if the mails are used.

(n22)Footnote 22. See *Pereira v. United States*, 347 U.S. 1, 8 (1954) .

(n23)Footnote 23. See *United States v. Sampson*, 371 U.S. 75, 81 (1962) (finding defendant corporate officers guilty of mail fraud because their fraudulent loan scheme required their salesmen to use the mails).

(n24)Footnote 24. See *United States v. Walters*, 997 F.2d 1219, 1223-24 (7th Cir. 1993) ; see also *Price v. United States*, 200 F.2d 652, 655 (5th Cir. 1953) .

(n25)Footnote 25. *United States v. Ashdown*, 509 F.2d 793, 799 (5th Cir. 1975) .

(n26)Footnote 26. *Sampson*, 371 U.S. at 80 -81 (applications and form letters sent to fraud victims after the collection of the fee designed to convince these investors that meaningful services were being performed on their behalves violated the mail fraud statute).

(n27)Footnote 27. See, e.g., *United States v. Maze*, 414 U.S. 395, 403 (1974) (in a credit card fraud prosecution, the Court held that the stores' mailings of the defendant's forged receipts to the banks for payment were not for the purpose of executing the defendant's scheme, but rather for the purposes of adjusting accounts between the retailers, card owner, and banks; therefore, no mail fraud occurred).

(n28)Footnote 28. 18 U.S.C. § 371 (2000).

(n29)Footnote 29. An indictment charging violations of the general antifraud provisions of the securities laws may be brought simultaneously with charges under the mail fraud statute, and the conspiracy statute. *United States v. Tallant*, 547 F.2d 1291, 1299 (5th Cir. 1977) ; see also *Edwards v. United States*, 312 U.S. 473, 484 (1941) .

(n30)Footnote 30. *United States v. Downing*, 297 F.3d 52, 57 (2d Cir. 2002) ("[T]he government was not required to establish ... knowledge of the details of [the] scheme; it sufficed that the evidence showed that he understood its essential nature.") (citations omitted); *United States v. Alvarez*, 625 F.2d 1196, 1198 (5th Cir. 1980) (en banc) ("The government was not required to prove that Alvarez had knowledge of all the details of the conspiracy or each of its members, provided that prosecution established his knowledge of the essential[s] of the conspiracy.") (citations omitted); *United States v. Benjamin*, 328 F.2d 854, 864 (2d Cir. 1964) (convicting an accountant of conspiracy to defraud investors, although his role consisted solely of preparing false investment statements).

(n31)Footnote 31. *United States v. Dardi*, 330 F.2d 316, 327 (2d Cir. 1964) (brokers' sale of stock, which they knew was unregistered, was sufficient evidence for a conspiracy charge, although brokers claimed they were not involved in the creation and distribution of the shares to the co-conspirators); see also *United States v. Valdez*, 861 F.2d 427, 431 (5th Cir. 1988) ("In a conspiracy case such as this the government must prove beyond a reasonable doubt that the (1) conspiracy existed; (2) defendant knew about it; and (3) defendant voluntarily joined it with that knowledge.")

(n32)Footnote 32. *United States v. Robinson*, 543 F.2d 951, 959 (2d Cir. 1976) (citations omitted).

(n33)Footnote 33. *Rubinson*, 543 F.2d at 959 .

(n34)Footnote 34. *United States v. Erb*, 543 F.2d 438, 446 (2d Cir. 1976) .

(n35)Footnote 35. *Id.*

(n36)Footnote 36. 15 U.S.C. § 78t(e).

(n37)Footnote 37. 511 U.S. 164 (1994) .

(n38)Footnote 38. *Id.* at 177 .

(n39)Footnote 39. See *id.* at 200 (Stevens, J., dissenting) (stating that the majority leaves little doubt that the SEC is not permitted to pursue aiders and abettors).

(n40)Footnote 40. *SEC v. Johnson*, 530 F. Supp. 2d 325, 332 (D.D.C. 2008) . Cf. *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974) (Laying out the required elements for an aider-abettor charge pre-*Central Bank*: "a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted in the violation."); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 96 (5th Cir. 1975) (requiring a party have "actual awareness of the party's role in the fraudulent scheme."). The provision was intended to "preserve the definition of aiding and abetting as it existed pre-*Central Bank*." *SEC v. Fehn*, 97 F.3d 1276, 1287-88 (9th Cir. 1996) ; *Johnson*, 530 F. Supp. 2d at 333-34 . However, the PLSRA did not go so far as to restore private rights of action for aiding and abetting. *Stoneridge Investment Partners v. Scientific Atlanta*, 128 S. Ct. 761, 771, 773 (2008) (holding that the PLSRA did not create a private action against aiders and abettors for violations of the Securities Acts but noting that the SEC had ample enforcement powers against aiders and abettors under 15 U.S.C. § 78t(e)).

(n41)Footnote 41. *Woodward*, 522 F.2d at 96 .

(n42)Footnote 42. *Johnson*, 530 F. Supp. 2d at 333-34 (citing *Fehn*, 97 F.3d 1276 at n. 11); see also *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 382-83 (S.D.N.Y. 2006) (holding that the PLSRA does not encompass recklessness).

(n43)Footnote 43. 126 Fed. Appx. 593, 599 (4th Cir. 2008) .

(n44)Footnote 44. 543 F.2d 438, at 445-46 (2d Cir. 1976) .

(n45)Footnote 45. *Id.* at 446 .

(n46)Footnote 46. *Id.*

(n47)Footnote 47. *Id.*

(n48)Footnote 48. 18 U.S.C. § 1001(a) (2000).

(n49)Footnote 49. *United States v. Wiener* 96 F.3d 35, 37 (2d Cir. 1996) .

(n50)Footnote 50. See *United States v. Laughlin*, 26 F.3d 1523, 1526 n.6 (10th Cir. 1994) (quoting *United States v. Irwin*, 654 F.2d 671, 675-76 (10th Cir. 1981)) ; accord *United States v. Ranum*, 96 F. 3d 1020, 1028 (7th Cir. 1996) (quoting *United States v. Petullo*, 709 F. 2d 1178, 1180 (7th Cir. 1983)) . But see *United States v. Mahler*, 363 F.2d 673, 678 (2d Cir. 1966) (materiality is not an element of offenses under the second and third clauses of § 1001 in the second circuit).

(n51)Footnote 51. *United States v. Rodgers*, 466 U.S. 475, 483 (1984) .

(n52)Footnote 52. *United States v. Simon*, 425 F.2d 796, 809 (2d. Cir. 1969) ; see also *United States v. Hildebrandt*, 961 F.2d 116, 118-19 (8th Cir. 1992) ("the term 'willful' simply means that the defendant did the forbidden act deliberately and with knowledge. It is not necessary that the defendant act with the intent to deceive the United States or have the actual knowledge that the statement was made in a matter within a federal agency's jurisdiction.") (citations omitted)

(n53)Footnote 53. *Mahler*, 363 F.2d at 678 .

(n54)Footnote 54. *Rodgers*, 466 U.S. at 483 (false statement made to FBI and Secret Service during criminal investigation).

(n55)Footnote 55. See *United States v. Wiles*, 102 F.3d 1043, 1067 (10th Cir. 1996) ("Without any express indication that Congress intended otherwise, we join the Second Circuit and conclude that both Section 78ff and Section 1001 proscribe the making of false statements to the SEC, and the government may prosecute such conduct under either statute."), *reh'g granted*, 106 F.3d 1516 (10th Cir. 1997) , *vacated sub nom*, *United States v. Schleibaum*, 522 U.S. 945 (1997) ; see also *Mahler*, 363 F.2d at 675 .

(n56)Footnote 56. See also 18 U.S.C. § 1623(a) (2000). ("Whoever under oath ... in any proceeding before or ancillary to any court or grand jury of the United States knowingly makes any false material declaration ... shall be fined under this title or imprisoned not more than five years, or both.")

(n57)Footnote 57. 123 F.2d 791 (8th Cir. 1941) .

(n58)Footnote 58. 97 F.2d 258 (9th Cir. 1938) .

(n59)Footnote 59. 18 U.S.C. §§ 1961-1968 (2000).

(n60)Footnote 60. 18 U.S.C. § 1962(b) (2000). For discussion of private RICO litigation, see Frederick Robinson & Matthew H. Kirtland, *Private RICO Litigation*, in *The Federal Securities Exchange Act of 1934* (A.A. Sommer, Jr., ed. 2006). While this section pertains solely to criminal RICO, it should be noted that the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (the "Reform Act"), amended the civil RICO provisions at 18 U.S.C. § 1964(c) by excluding "conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962." See Reform Act § 107.

(n61)Footnote 61. 18 U.S.C. § 1963(a) (2000).

(n62)Footnote 62. 18 U.S.C. § 1963 (2000).

(n63)Footnote 63. 18 U.S.C. § 1961(5) (2000). In order to demonstrate a pattern under § 1962, it must be shown that the predicate offenses (1) are related; and (2) "constitute a threat of ... *continuing* racketeering activity." *H.J. Inc. v. N.W. Bell Tel. Co.*, 492 U.S. 229, 240 (1989) (emphasis in original).

(n64)Footnote 64. 18 U.S.C. §§ 1961(1)(B),(D) (2000).

(n65)Footnote 65. *United States v. Rogers*, 636 F. Supp. 237, 241 (D. Colo. 1986) (holding that where RICO, mail, tax and securities fraud charges allegedly were part of the same common scheme and were inextricably connected, joinder under Fed. R. Crim. P. 8(a) was proper); *United States v. DePalma*, 461 F. Supp. 778, 787-88 (S.D.N.Y. 1978) (finding that joinder of RICO, securities fraud, and bankruptcy fraud charges is proper where frauds are part of a common scheme). But see *United States v. Bledsoe*, 674 F.2d 647, 656-57 (8th Cir. 1982) (finding that joinder of defendants was improper under Fed. R. Crim. P. 8(b) where one defendant was charged with securities fraud under § 17(a) and other defendants were charged with securities fraud and RICO violations in connection with the sale of

unrelated securities).



168 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933 § 11.04

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

§ 11.04 Statute of Limitations for Criminal Prosecutions Under the Securities Act

The Securities Act does not contain a statute of limitations for criminal offenses. Hence, *18 U.S.C. § 3282* n1 which sets a five-year period of limitation for all non-capital criminal offenses, must be applied in criminal prosecutions under Section 24.

To determine whether *18 U.S.C. § 3282* bars prosecution of an offense, it must be determined when the offense occurred. As a general rule, the limitations period begins when the crime is completed. n2 For example, in a prosecution under Section 24 for the filing of false or misleading registration statements, the statute of limitations begins to run "when the statements are 'received' by the SEC." n3 Moreover, each such filing constitutes a separate and distinct offense. n4

In criminal cases under Section 17(a), however, it should be noted that the statute of limitations does not act as an "evidentiary bar," and evidence of a scheme outside of the five year limitations period is admissible. n5 For example, in *United States v. McDonald*, n6 lulling payments mailed to investors concealed a land fraud scheme, caused some investors to invest more money, and maintained the defrauding company's reputation as a reliable source of investments. Accordingly, the statute of limitations did not begin to run until after those payments were made. n7

McDonald dealt with an initial fraudulent act that was followed by other acts that furthered the initial crime and, hence, was properly characterized as a continuing offense. However, an initial act that violates the law is not a continuing offense simply because it is not corrected. n8

[T]he statute begins to run the moment the crime is sufficiently complete to enable the government to initiate prosecution. There are only two exceptions to this general rule: (a) when a defendant (or, in the case of conspiracy, one of his co-conspirators) thereafter engages in some "affirmative" action in furtherance of the crime; or (b) where time is extended by a statute which *specifically* refers to limitations of time. n9

Therefore, there being no provision in the Securities Act extending the limitations period, in the absence of additional affirmative action by a defendant in furtherance of his crime, the statute of limitations for securities fraud under Section

24 will have begun to run whenever "the government could have commenced prosecution." n10

FOOTNOTES:

(n1)Footnote 1. 18 U.S.C. § 3282(a) (2000) provides that: "Except as otherwise expressly provided by law, no person shall be prosecuted, tried, or punished for any offense, not capital, unless the indictment is found or the information is instituted within five years next after such offense shall have been committed."

(n2)Footnote 2. See *United States v. Rastelli*, 870 F.2d 822, 839 (2d Cir. 1989) (holding, in a RICO prosecution governed by Section 3282, that the "period of limitations began to run against [the defendant] only when each crime or racketeering act he aided and abetted was complete"); *United States v. Erb*, 543 F.2d 438, 446 (2d Cir. 1976) .

(n3)Footnote 3. *United States v. Handler*, 1978 U.S. Dist. LEXIS 16182 (C.D. Cal. Aug. 3, 1978) ; see also *Erb*, 543 F.2d at 446 (noting that although acts of aiding and abetting occurred more than five years before indictment, false registration statement was filed within the limitations period; therefore, crime was completed within five years of indictment and statute of limitations did not bar prosecution of aider and abettor).

(n4)Footnote 4. *Handler*, 1978 U.S. Dist. LEXIS 16182 .

(n5)Footnote 5. *United States v. Jensen*, 608 F.2d 1349, 1355-56 (10th Cir. 1979) (five year statute of limitations was no bar to prosecution for fraud in the sale of securities as long as fraudulent stock purchase for investor's account continued into the five-year period); see also *In re Simpson and Pattee, Sec. Act Rel. No. ID-148*, 1999 SEC LEXIS 1908 (Sept. 21, 1999) (citing *Jensen*, 608 F.3d at 1355-56 , and explaining that the statute of limitations does not act as an evidentiary bar for evidence outside of the applicable limitations period).

(n6)Footnote 6. 576 F.2d 1350, 1357 (9th Cir. 1978) .

(n7)Footnote 7. *McDonald*, 576 F.2d at 1357 .

(n8)Footnote 8. *United States v. Sloan*, 389 F. Supp. 526, 529 (S.D.N.Y. 1975) (although the Exchange Act forbids inaccurate maintenance of records and the regulations thereunder require certain books and records to be maintained for either three or six years depending on the type of record, the statute of limitations for the offense of falsely making and maintaining certain records begins to run at the time a false entry is made, not later when the required preservation period for records has elapsed).

(n9)Footnote 9. *Sloan*, 389 F. Supp. at 529 . (citing *Toussie v. United States*, 397 U.S. 112, 120 S. Ct. 585, 863 (1970) (although defendant never registered for the draft, violation occurred on defendant's eighteenth birthday and had to be prosecuted within five years therefrom), *superseded by statute*, Military Selective Service Act, Pub. L. No. 92-129, 85 St. 348, as recognized in *United States v. Martinez*, 890 F.2d 1088 (10th Cir. 1989) ; *United States v. Kerley*, 838 F.2d 932 (7th Cir. 1988) ; *United States v. Eklund*, 733 F.2d 1287 (8th Cir. 1984) .

(n10)Footnote 10. *Sloan*, 389 F. Supp. at 529 ; see *Carroll v. United States*, 326 F.2d 72, 85-86 (9th Cir. 1963) (mailing of stock certificates is only incidental to sale of stock and will not extend limitations period for prosecution under § 17(a)).



169 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933 § 11.05

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

§ 11.05 Jurisdiction and Venue Over Criminal Prosecutions Under the Securities Act

[1] Subject Matter Jurisdiction

Section 22(a) of the Securities Act vests the federal district courts with "jurisdiction of offenses and violations under this title and under the rules and regulations promulgated by the Commission in respect thereto" n1 Similarly, 18 U.S.C. § 3231 grants the district courts "original jurisdiction, exclusive of the courts of the States, of all offenses against the laws of the United States." Accordingly, there is no dispute regarding a federal district court's subject-matter jurisdiction over criminal prosecutions under the Securities Act.

[2] Transnational Offenses

Disputes do arise, however, regarding the application of the Securities Act to transactions occurring outside of the United States. As discussed *supra*, many of the prohibitions contained in the Securities Act have "jurisdictional means" tests. In other words, the defendant must have used the mails or some instrumentality of interstate commerce to achieve the unlawful end. Because Section 2(7) of the Securities Act defines "interstate commerce" to include transportation or communication "between any foreign country and any State," n2 the courts have extended the Securities Act's prohibitions to fraudulent securities transactions involving foreign countries. n3

For example, in *United States v. Clark*, n4 the defendant moved to dismiss one count of his indictment alleging fraud in the sale of securities to European investors. The securities at issue were "debentures of Four Seasons Overseas, N.V., a Netherlands Antilles corporation, with attached warrants for the purchase of the common stock of Four Seasons Nursing Centers," a U.S. company. n5 Relying on *Leasco Data Processing Equipment Corp. v. Maxwell*, n6 a case dealing with Section 10(b) of the Exchange Act, the court held Section 17(a) applicable to misconduct occurring in a foreign country as long as "there was *both* conduct in the United States and impact on an American investor." n7 The court then found that the indictment contained sufficient allegations of fraudulent conduct in the United States and of detrimental impact on American investors because the European offering was part of a scheme to inflate the earnings and market price of Four Seasons stock traded in the United States. n8

In *Clark*, the court employed "conduct" and "effect" tests. n9 The "conduct" test analyzes whether the fraudulent conduct that forms the alleged violation occurred in the United States, whereas the "effects" test analyzes whether

conduct outside the United States has had a substantial damaging effect on U.S. investors or securities markets. n10 In *United States v. Cook*, n11 to the court used only the "conduct" test to affirm the district court's assertion of jurisdiction over a defendant who had defrauded European investors through a Ponzi scheme n12 related to the sale of fractional undivided working interests in oil and gas wells located in the United States.

The scheme operated out of Dallas, Texas; the securities sold were American securities; the money from the scheme was brought back to the United States; and some investors were defrauded, in part, in this country. n13 The Court had no trouble concluding that this fraud thus violated Sections 17(a) and 24 of the Securities Act:

It is an absurd notion that Congress intended activity in the United States involving American securities to be exempt from the fraud provisions of the securities acts simply because the victims are not American citizens That Congress would allow America to be a haven for swindlers and confidence men when the victims are European while expecting the highest level of business practice when the investors are American is "simply unimaginable." n14

[3] Venue

Even if a court has subject-matter jurisdiction over an offense, venue must also be proper. A crime committed in a single judicial district must be prosecuted there. n15 However, a criminal offense may span more than one district. Accordingly, Section 20(b) of the Securities Act provides that a criminal proceeding "may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such prospectus or security is received." n16 It is clear, however, that not every criminal violation of the Securities Act involves the transmittal or receipt of a prospectus or security. Accordingly, it has been held that the general criminal venue provisions of *18 U.S.C. § 3237 (2000)* apply to all prosecutions under the Securities Act, and that Section 20(b) "merely provides for an auxiliary venue under certain circumstances." n17

Therefore, any offense under the Securities Act that is "begun in one district and completed in another, or committed in more than one district, may be inquired of and prosecuted in any district in which such offense was begun, continued, or completed." n18 Alternatively, "[a]ny [Securities Act] offense involving the use of the mails, transportation in interstate or foreign commerce, or the importation of an object or person into the United States ... may be inquired of and prosecuted in any district from, through, or into which such commerce, mail matter, or imported object or person moves." n19

A change of venue may be granted upon motion under Rule 21(b) of the Federal Rules of Criminal Procedure, which provides that "[u]pon the defendant's motion, the court may transfer the proceeding, or one or more counts, against that defendant to another district for the convenience of the parties and witnesses and in the interest of justice." n20

This provision is addressed to the trial judge's discretion. n21 To invoke its benefits, a defendant need not necessarily show that venue is proper in the proposed transferee district. n22 The defendant, however, must show that the interests of justice favor transfer. For example, in *United States v. Cashin*, the Second Circuit denied the government's petition for mandamus after the lower court granted the defendants' request for a transfer of their trial from the Southern District of New York, where the jurisdictional mailings took place, to the Southern District of Alabama, where all the defendants resided and where they allegedly created their fraudulent scheme. n23 In this case, "the only alleged use of the mails was to confirm purchases already induced by the defendants' deceit." n24 Accordingly, the appellate court saw no abuse of discretion in the district court's application "of the liberal transfer provision of Rule 21(b)." n25

On the other hand, in *United States v. Wolfson*, the United States District Court for the Southern District of New York denied the defendants' transfer motion even though all the defendants lived in Jacksonville, Florida, all their records were there, the witnesses they intended to call at trial lived there, and personal reasons of health and convenience favored a transfer to the Northern District of Florida. n26 According to the court, "none of the[se] factors, whether

considered singly or collectively, would justify transfer of the trial." n27 To the contrary, the substantial number of transactions undertaken by the defendants in New York, the defendants' financial ability to travel thereto, and the court's ability to manage the case so as to minimize the inconvenience to the defendants militated against transfer. n28

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77v(a) (2000).

(n2)Footnote 2. 15 U.S.C. § 77b(a)(7) (2000).

(n3)Footnote 3. See, e.g., *United States v. Clark*, 359 F. Supp. 131, 132 (S.D.N.Y. 1973) (Securities Act allows prosecution of defendants for fraudulent conduct in the United States resulting in sales of securities abroad where purpose of scheme was to inflate earnings of a U.S. company that traded stock domestically); see generally Note, *American Adjudication of Transnational Securities Fraud*, 89 Harv. L. Rev. 553 (1976).

(n4)Footnote 4. 359 F. Supp. at 131 .

(n5)Footnote 5. *Clark*, 359 F. Supp. at 132 .

(n6)Footnote 6. 468 F.2d 1326 (2d Cir. 1972) .

(n7)Footnote 7. *Clark*, 359 F. Supp. at 133-34 (original emphasis).

(n8)Footnote 8. *Clark*, 359 F. Supp. at 134 .

(n9)Footnote 9. *Clark*, 359 F. Supp. at 134; see also Restatement (third) Of Foreign Relations Law Of The United States § 416 (1987).

(n10)Footnote 10. See *Robinson v. TCI/US W. Communications, Inc.*, 117 F.3d 900, 905 (5th Cir. 1997) ; see also *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1333-34 (2d Cir. 1972) ; *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208 (2d Cir. 1968) , rev'd on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc). The Courts of Appeal are divided regarding the scope of the conduct test. Compare *Robinson*, 117 F.3d at 905 (domestic conduct must have been of "material importance" or "directly caused" the fraud complained of to satisfy the jurisdictional test); with *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir. 1977) (proper test is whether at least some activity in furtherance of the fraudulent scheme occurred in the United States); and *Cont'l Grain (Aust.) Pty. Ltd. v. Pac. Oilseeds, Inc.*, 592 F.2d 409, 420 (8th Cir. 1979) (test is whether defendant's domestic conduct is "significant" with respect to the alleged violation and whether it furthered the fraudulent scheme).

(n11)Footnote 11. 573 F.2d 281, 283 n.4 (5th Cir. 1978) .

(n12)Footnote 12. "In a Ponzi scheme, a swindler promises a large return for investment made with him. The swindler actually pays the promised return on the initial investments in order to attract additional investors. The payments are not financed through the success of the underlying venture but are taken from the corpus of the newly attracted investments. The swindler then takes an appropriate time to abscond with the outstanding investments." 573 F.2d at 282 n.3 .

(n13)Footnote 13. *Cook*, 573 F.2d at 283 .

(n14)Footnote 14. *Cook*, 573 F.2d at 283-84 , (quoting *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1016 (2d Cir. 1975)) .

(n15)Footnote 15. See U.S. Const., art. 3, § 2, (trial of Crimes "shall be held in the States where the said Crimes shall have been committed"); see *id.*, amend. VI (criminal trial shall be held before "an impartial jury of the State and district wherein the crime shall have been committed"); Fed R. Crim. P. 18 ("[T]he government must prosecute an offense in a district where the offense was committed.")

(n16)Footnote 16. 15 U.S.C. § 77t(b) (2000).

(n17)Footnote 17. *United States v. Monjar*, 47 F. Supp. 421, 428 (D. Del. 1942) , *aff'd*, 147 F.2d 916 (3d Cir. 1944) (citations omitted); *accord United States v. Olen*, 183 F. Supp. 212, 217 (S.D.N.Y. 1960) .

(n18)Footnote 18. 18 U.S.C. § 3237(a) (2000); *see, e.g.*, *United States v. Handler*, 1978 U.S. Dist. LEXIS 16182 (C.D. Cal. Aug. 3, 1978) (Section 24 prosecution for filing of false or misleading registration statement may be brought in district where registration statement was prepared or in district where it was filed, Washington, D.C.).

(n19)Footnote 19. 18 U.S.C. § 3237(a) (2000). Venue may be fixed under either prong of § 3237(a) where the offense involves the use of the mails. *United States v. Cashin*, 281 F.2d 669, 674-75 (2d Cir. 1960) (in prosecution under §§ 24 and 17(a), venue was proper in district where fraudulent scheme to sell securities was created, even if mailings in furtherance thereof occurred elsewhere).

(n20)Footnote 20. Fed. R. Crim. P. 21(b).

(n21)Footnote 21. *See United States v. Garber*, 413 F.2d 284, 286 (2d Cir. 1969) .

(n22)Footnote 22. *See In re Application to Take Testimony in Criminal Case Outside District*, 102 F.R.D. 521, 523 (E.D.N.Y. 1984) (noting that Federal Rule of Criminal Procedure 21 places no limits on which district a court may transfer a case to and Rule 21(b) was amended for the purpose of eliminating the requirement that transfer could only be to a district where an offense was committed); Fed. R. Crim. P. 21, Advisory Committee's Note (1966 Amendment, Subdivision b). However, a court may consider the lack of venue in the proposed transferee district as one factor in determining whether the interests of justice require transfer. *See Platt v. Minn. Mining & Mfg. Co.*, 376 U.S. 240, 243-44 (1964) (finding that in determining Rule 21(b) motion, court must consider, *inter alia*, the "location of the events likely to be in issue").

(n23)Footnote 23. 281 F.2d 669, 676 (2d Cir. 1960) .

(n24)Footnote 24. *Cashin*, 281 F.2d at 674 .

(n25)Footnote 25. *Cashin*, 281 F.2d at 675 .

(n26)Footnote 26. 269 F. Supp. 621, 623-24 (S.D.N.Y. 1967) , *aff'd*, 405 F.2d 779 (2d Cir. 1968)

(n27)Footnote 27. *Wolfson*, 269 F. Supp. at 624 .

(n28)Footnote 28. *Wolfson*, 269 F.Supp. at 624 .



170 of 170 DOCUMENTS

Federal Securities Act of 1933

Copyright 2010, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

CHAPTER 11 Criminal Enforcement of the Federal Securities Act

2-11 Federal Securities Act of 1933 § 11.06

AUTHOR: Thomas A. Ferrigno and Matthew H. Kirtland

§ 11.06 The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") was passed by Congress, in part, to strengthen the prohibitions against securities fraud. One component of Sarbanes-Oxley is the creation of new federal criminal securities fraud offenses as well as modification of the existing statutes traditionally used to prosecute securities fraud. Other components include the creation of a Public Company Accounting Oversight Board, mandatory enhanced financial disclosures from public companies, and implementation of provisions aimed at increasing corporate responsibility.

Sarbanes-Oxley, however, does not amend the Securities Act and therefore is not directly relevant to this chapter. The effect Sarbanes-Oxley will have is its addition of new statutes and strengthening of existing statutes that can be charged in conjunction with violations of the Securities Act. These add powerful new tools to a prosecutor's arsenal and should not be underestimated by any regulated entity. For example, Section 903 of Sarbanes-Oxley increases the maximum prison terms under the federal mail and wire fraud statutes from five years to twenty years. In addition, Section 1107 amends the federal whistle-blower protection statute to prohibit retaliation against any informant who provides law enforcement officers with truthful information relating to the commission or possible commission of any federal offense, including criminal violations of the Securities Act or the Exchange Act. n1 The penalty for such offense is a criminal fine and/or imprisonment for up to ten years. n2 Because criminal violations of the Securities Act often are triggered by disclosures from corporate insiders, who sometimes are retaliated against, this new provision could have a broad impact.

Sarbanes-Oxley also creates entirely new securities fraud offenses. For example, Section 807 of Sarbanes-Oxley adds a new felony to the criminal code at *18 U.S.C. § 1348 (2000)*, penalizing with fines and/or up to 25 years imprisonment any person who knowingly executes or attempts to execute a "scheme or artifice" to defraud any person in connection with securities of a public company or to obtain, through false or fraudulent pretenses, any person's money or property in connection with securities of a public company. This provision applies equally to corporations and corporate officers and eliminates the previously existing hodge-podge of federal statutes, including mail and wire fraud, that prosecutors often resorted to prosecute securities fraud.

Section 906 of Sarbanes-Oxley makes it a crime for any chief executive officer or chief financial officer to falsely certify that the periodic financial reports required by Section 13(a) or 15(d) of the Exchange Act comply with the

requirements of such statutes. If such a false certification violation is committed "willfully," the penalty can be up to \$5 million and 20 years in prison. For a violation that is not committed "willfully," the penalty can be up to \$1 million and ten years in prison. While not directly relevant to prosecutions under the Securities Act, this new provision has the potential to dramatically increase the overall number of criminal securities prosecutions.

Section 1102 of Sarbanes-Oxley expands the existing federal obstruction of justice offense, adding Sections 1519 and 1520 to Title 18 of the United States Code, to cover destruction of evidence before a proceeding is pending and to cover persons acting alone, as opposed to in concert with others, when destroying evidence. This closes existing loopholes in the law and it is likely that these offenses will be charged more frequently in conjunction with prosecutions under the Securities Act.

FOOTNOTES:

(n1)Footnote 1. *18 U.S.C. § 1513(e) (2000)*.

(n2)Footnote 2. *18 U.S.C. § 1513(e) (2000)*.