MEMORANDUM

March 30, 1982

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Division of Corporation Finance

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SUBJECT : Revision of Rule 147

Rule 147, adopted in 1974, 1/ provides a safe harbor for offerings effected pursuant to Section 3(a)(11) of the Securities Act of 1933. 2/ Almost immediately following its promulgation numerous legal commentators criticized the provisions of the rule as being overly restrictive and laced with "traps", 3/ thereby further rendering the exemption useless and insignificant. 4/ After discussing the provisions of Rule 147 that commentators uniformly criticize, this memorandum presents two alternatives designed to facilitate use of a Section 3(a)(11)

1/ The Commission published for comment proposed Rule 147 on January 8, 1973, Securities Act Release No. 5349, and adopted the rule one year later. Securities Act Release No. 5450 (January 7, 1974).

2/ 15 U.S.C. 77c (1976) (the "Act").

3/ See, e.g., Cummings, "The Intrastate Exemption and the Shallow Harbor of Rule 147," 69 Nw. U.L. Rev. 167 (1974); Hicks, "Intrastate Offerings Under Rule 147," 72 Mich. L. Rev. 463 (1974).

4/ Before Rule 147 was adopted, commentators had complained that the courts, and the Commission, had so narrowly interpreted the terms of § 3(a)(11) that the "exemption is loaded with dynamite and must be handled with great care." See Gadsby, "The Securities and Exchange Commission and the Financing of Small Business," 14 Bus. Law. 144, 148 (1958).

type exemption, promulgated pursuant to Section 3(a)(11) or Section 3(b). This memorandum also discusses the limitations of each alternative in responding to the criticisms of Rule 147.

I. The Obstacles of Rule 147

Although few provisions of Rule 147 have escaped criticism, certain requirements are criticized more frequently than others. The following outlines and discusses four significant aspects of the rule commonly under fire. 5/

(i) Offerees/Purchasers as residents

Rule 147 requires that all offerees, and purchasers, 6/ be residents of the state in which the offering is conducted. Residence is defined as the principal place of residence, not domicile (established by an intent to reside). If even one non-resident receives an offer to buy the securities, the exemption is lost. 7/ Since the term "offer" is broadly construed,

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5/ The integration provisions of Rule 147, substantially the same as those in Rules 146 and 242, and Regulation D, have been the object of criticism. Since the integration provisions have been the subject of discussion within the Division, and are not the sole province of Rule 147, the memorandum does not include this element in the commentator's criticisms of the rule.

6/ While it seems all purchasers would necessarily be residents if offers were made only to residents, the requirement precludes the sale to a person who was offered securities while a resident but has since moved out of the state.

7/ See Hicks, supra note 3 at 487 ("Since an offeree that does not purchase suffers no harm, it is difficult to see why the SEC continues" this requirement.) Cf. Regulation D, Rule 506(b)(2)(ii) and Rule 146(d)(i).

there is a danger that, while attempting to discover residency of an investor, an offer will be inadvertently made. Even if an issuer makes a good faith effort, including reasonable investigation, a mistake as to the residence of an offeree causes the exemption to be unavailable.

(ii) Resales to non-residents within nine months.

Although investors receive unrestricted, or "free," stock in an offering effected pursuant to Rule 147, the rule imposes a nine month "coming to rest" period commencing upon the last sale of securities pursuant to the offer. 8/ As a precaution, the issuer is required under the rule to employ specified means, such as legending the certificate and issuing stop transfer instructions to the transfer agent, to prevent resales. Despite unlimited efforts by an issuer to preclude resales, any resale to a non-resident within nine months destroys the exemption. Under Rubin v. United States, 9/ conceivably, even the pledge of such securities

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8/ The nine month period creates confusion because investors and issuers may not know when the period ends, in part because when convertible securities or options are issued, the nine month period commences upon conversion or exercise. See Carney, "Exemptions from securities registration for small issuers: shifting from full disclosure - Part II: the intrastate offering exemption and Rule 147". 11 Land and Water L. Rev. 161, 207 (1976).

9/ 449 U.S. 424 (1981) (holding that the pledge of stock to a bank as collateral for a loan is an "offer or sale" of a security within the meaning of §§ 2(3) and 17(a) of the Act).

during the nine months as collateral to a non-resident bank could destroy the exemption.

(iii) "Doing business" requirements

Under Rule 147, an issuer must (a) have 80% of its assets located within the state where the offering is being conducted; (b) have 80% of its gross revenues derived from within such state; and (c) expend 80% of the proceeds from the offering within such state. 10/ While all three elements have been criticized as being too restrictive, the gross revenues requirement particularly attracts complaints because it precludes companies who sell their products interstate from using the exemption. In addition, although the adopting release gave examples to illustrate the gross revenues test, its meaning, when applied to a particular factual situation, is unclear. With respect to the proceeds requirements, critics complain that it precludes a local company from expanding outside the state, even if 80% of its assets will remain in that state. 11/

10/ In addition, the rule provides a de minimus exception to these requirements for issuers whose gross revenues in its most recent twelve month fiscal year do not exceed $5,000.

11/ See Carney, supra note 8 at 201.

(iv) Residence of an issuer.

To qualify for the safe harbor provided by Rule 147, an issuer must be a "person resident and doing business" within the state in which the offering is conducted. Corporations are deemed to be residents if incorporated in the state. Since the "doing business" tests under the rule are stringent, 12/ commentators argue that requiring the corporation to be incorporated in the state provides little additional protection to investors, while denying the corporation the advantages of incorporating in another state. 13/

II. Revisions based upon Section 3(a)(11)

Rule 147 was promulgated pursuant to Section 3(a)(11). The statute thus limits the Commission's authority to expand the scope of the exemption, as well as its ability to respond to criticisms of Rule 147.

Section 3(a)(11) provides an exemption as follows:

> 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.

12/ See text accompanying note 10 supra. Generally, the rule requires that 80% of gross income, assets and use of proceeds be within the state.

13/ For example, many corporations prefer, for planning purposes, to incorporate in Delaware because of the extensive development of corporate law.

With respect to the criticisms discussed above, at least two elements seem to be specifically mandated by the statute: (1) the issuer must be a resident of the state; 14/ and (2) the issue must be offered and sold only to persons resident in one state. Although the Commission, in adopting Regulation D, eliminated any requirements with respect to offerees in non-public offerings under Section 4(2), Section 3(a)(11) seems expressly written to preclude any offers or sales to nonresidents.

The Commission could, it seems, alleviate two concerns of Rule 147 without compromising the statute. First, although the statute requires that issuers be "doing business" in the state, that term is not defined in the statute and the Commission could amend the 80% tests of Rule 147. 15/ For example, the following provision might replace all the "doing business" tests:

14/ See, McCauley, "Intrastate Securities Transactions Under the Federal Securities Act," 107 U. Pa. L. Rev. 937, 948-49 (the language of the statute seems to require that the corporation be incorporated in the state).

15/ See text accompanying note 10 supra. Interpretations of § 3(a)(11) before the adoption of Rule 147 had not identified any required percentage, but had simply indicated that 97% was sufficient and that 7% was insufficient. See Stratford Employees' Cattle Program, Ltd. [Transfer Binder 1973-74 Decision] CCH Fed. Sec. L. Rep. ¶79,761 (Div. Corp. Fin., April 8, 1974); SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957).

> The issuer shall be deemed to be doing business within the state if, both before the offering, and after the proceeds of the offering are expended, the issuer had at least 60% of its assets and those of its subsidiaries on a consolidated basis located within such state or territory.

Such a definition would assure that the company is primarily a local company, and would eliminate the discrimination against local companies that do an interstate business. In addition, the exemption would permit expansion (through use of the proceeds) in another state if the 60% assets test were met after the proceeds from the offering were expended, thus assuring that the company remains primarily in one state.

Second, the nine month "coming to rest" period is not required by the statute. The Commission would seem to have the authority to modify this time period, including its commencement date. Although some time period is likely necessary, the existing nine month period may be unnecessarily restrictive to achieve the desired effect. To the extent that the time period is shortened, it also alleviates the total prohibition on sales to nonresidents.

III. Relief under Section 3(b).

Although Rule 147 is promulgated pursuant to Section 3(a)(11), the Commission has authority to adopt an analogous rule under Section 3(b) of the Act, which provides an exemption for securities as the Commission may prescribe provided that

the aggregate amount of the offering does not exceed $5,000,000. 16/ Although offerings effected pursuant to such a rule would be limited in amount, the Commission would have total flexibility in structuring such a rule and, could, as discussed below, incorporate the "local distribution" concept, as embraced by the proposed federal securities code, and endorsed by the Commission.

The ALI Federal Securities Code ("Code") establishes a "local distribution" that is exempt from the registration requirements. 17/ As endorsed by the Commission, 95% of the

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16/ 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 subscription where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.

17/ Section 514 of the Code provides:

> [Local distributions.] (a) [Definition.] A "local distribution" is one that (1) results in sales substantially restricted to persons who are residents of or have their primary employment in a single State, or an area in contiguous States (or a State and a contiguous foreign country) as that area is defined by rule or order on consideration of its population and economic characteristics, and (2) involves securities of an issuer that does business or proposes to do business primarily in that State or area, regardless of where it is organized. Section 514(a)(1) is not satisfied unless at least 95 percent of all the buyers holding of record at least 95 percent of the

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purchasers (who must purchase 95% of the securities distributed) must be residents or have their primary employment in a single state or an area in contiguous states, as defined by the Commission. The issuer must be doing, or propose to do, business in the state or area, but the Code does not define "doing business."

17/ (continued from previous page)

securities distributed are persons there described.

(b) [Secondary distributors.] Section 514(a) extends to a local distribution by a secondary distributor, whether or not he is a resident of the State or area in question; but, if he acquired any securities of the same class in a limited offering (not otherwise exempted) during the one-year or three-year period (as the case may be) specified in section 242(b), section 514(a) applies only to securities of the class in excess of those he so acquired.

(c) [Exemption.] Section 502 to 504 inclusive do not apply with respect to a local distribution except when the security is issued by an investment company.

(d) [Resales.] (1) Section 242(b)(4) to (6) inclusive applies for purposes of section 514, but as if section 242(b)(4)(A) referred to resellers within whatever period up to one year is specified by rule. (2) An original seller or a reseller who in good faith accepts from his buyer a written undertaking that is reasonably designed to avoid an illegal distribution and complies with any rule adopted under this section is not considered to be a participant in any such distribution. (3) When an owner of securities that were the subject of a local distribution within whatever period is specified by rule under section 514 owned other securities of the same class at the time that he acquired those securities, or later acquired other securities of the same class that were not the subject of a local distribution within the specified period, and he sells securities of the class, it is considered for purposes of this Code, regardless of which certificates or papers he delivers, that he is selling the other securities if he retains for the specified period at least as many of his securities of the class as were the subject of the local distribution.

Unlike Rule 147, however, the issuer need not be incorporated in the state, nor is the eligibility of offerees considered. In addition, the Code permits the Commission to restrict the resale of the securities, even between residents, for up to one year. Two other significant departures from Rule 147 are that a secondary distribution may rely on the exemption, and that distributors who in good faith comply with any rules adopted under the section are not responsible for illegal resales of the securities distributed. Thus, the Code addresses and remedies three of the four criticisms outlined above. The remaining element, the "doing business" definition, is left to the Commission to define.

An additional modification not incorporated by the Code or Rule 147 might be a disclosure requirement of certain information. Commentators at the Commission's Hearings on Small Business and Form S-18 were evenly split over the need for enacting a disclosure requirement if Rule 147 were liberalized. Those opposing the disclosure requirement asserted that the state of the issuer's residence should be responsible and that the anti-fraud provisions of the federal securities laws were adequate protection. Commentators supporting the disclosure requirement expressed concern because the intrastate offering will almost certainly be made to unsophisticated investors and suggested that the information specified in Rule 146(e) be required. 18/

18/ See Summary of Comments, Small Business Hearings and Proposed Form S-18 (File No. S7-734), 109.

CONCLUSION

OSBP recommends proposing for comment a rule under Section 3(b) analogous to the "local distribution" concept as proposed by the Code. 19/ As discussed above, that approach resolves the primary criticisms of Rule 147. Although the Code concept would permit a "regional" offering, the Commission could propose for comment the "local distribution" approach without the "regional" characteristics by restricting its availability to one state. 20/

The use of the Section 3(b) approach seems especially appropriate in view of the fact that the Commission staff, in its review of the Code, negotiated modifications with Professor Loss in the original draft of Section 514, which defines a local distribution. 21/ Although the staff expressed some concern with the 95% figures and the provision permitting

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19/ Although adopting the local distribution approach under Section 3(b) would limit the amount that could be raised through an offering to $5 million, such a limit may be desirable while the Commission gains experience with the exemption.

20/ If restricted to one state, the Code would still permit 5% of the purchasers to be nonresidents and to purchase up to 5% of the securities offered.

21/ As originally drafted, the 5% nonresident purchasers could purchase up to 20% of the offering. The staff succeeded in reducing that amount to 5%.

place of employment to create eligibility for the offering, 22/ the Commission endorsed the proposal in September 1980 23/ and reaffirmed its support in January 1982. 24/

OSBP recognizes that the proposal raises a policy question as to whether the Commission should further facilitate offerings under Section 3(a)(11). We would like to meet to discuss this matter and the other issues raised in this memorandum at your earliest convenience.

22/ See, Memorandum to the Commission dated July 27, 1979 from the Office of General Counsel re: ALI Federal Securities Code.

23/ Securities Act Release No. 6242 (September 18, 1980)

24/ Securities Act Release No. 6377 (January 21, 1982).