Fordham Journal of Corporate & Financial Law

Volume 8 | Issue 2 Article 3

2003

An Analysis of the Section 3(a)(10) Exemption Under the Securities Act of 1933 in the Context of the Public Offering Component of Section 3(c)(1) of the Investment Company Act of 1940

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AN ANALYSIS OF THE SECTION 3(a)(10) EXEMPTION UNDER THE SECURITIES ACT OF 1933 IN THE CONTEXT OF THE PUBLIC OFFERING COMPONENT OF SECTION 3(c)(1) OF THE INVESTMENT COMPANY ACT OF 1940

Marc F. Holzapfel[*]

INTRODUCTION

The stock market boom of the 1990s fueled growth not only for mergers and acquisitions, but also for investments by venture capital companies around the world.[1] Cross-border work has now "become the norm, rather than the exception."[2] When different jurisdictions are involved, however, compliance with each country's securities and other disclosure related laws can be challenging.[3] As more U.S. shareholders invest in foreign companies, and as more foreign companies seek to raise capital in the U.S., potential conflicts arise between foreign and domestic securities laws and within the U.S. securities laws themselves. While each of the six principal U.S. securities statutes administered by the U.S.

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1. *International M&A Boom Driven by Ample Finance*, DOW JONES INT'L NEWS, May 30, 2000 [hereinafter *International M&A Boom*]; *see also* Peter Stinton, *Venture-Capital Investing Pot Overflows*, S.F. CHRON., May 6, 2000, at B1 (discussing record investing by venture capital firms in the first quarter of 2000); Matt Marshall, *Venture Capital Juggernaut Begins to Slow in Silicon Valley*, SAN JOSE MERCURY NEWS, Feb. 18, 2001.

2. *Investment Bank Lazard Freres Positioned for Growth in Europe*, DOW JONES BUS. NEWS, Jan. 31, 2000.

3. *See, e.g.*, Peter J. Sutro, *Thinking About a Global Share Plan? Think Smart*, 31 COMPENSATION & BENEFITS REV. 54 (1999) (discussing the growth of global share plans and the regulatory hurdles companies must overcome in creating such share plans).

Securities and Exchange Commission ("SEC") attempts to address a specific area of securities regulation,[4] these statutes can, in certain instances, overlap.[5]

This Article will focus on the relationship between section 3(c)(1) of the Investment Company Act of 1940 (the "1940 Act")[6] and section 3(a)(10) of the Securities Act of 1933, as amended (the "1933 Act").[7] Specifically, this Article examines whether or not shares issued in reliance on the section 3(a)(10) exemption of the 1933 Act ("section 3(a)(10)") can be considered a "public offering" for purposes of section 7(d) and 3(c)(1) of the 1940 Act ("section 3(c)(1)"). The rapid growth of hedge funds and venture capital companies, coupled with the increase in international investment, has made resolution of this uncertainty a necessity. This Article is meant to provide some background and guidance to the practitioner who encounters this issue.

Parts I and II will provide brief descriptions of the relevant provisions of both the 1933 Act and the 1940 Act. Part III will discuss the relationship between the two Acts, and Part IV will analyze this relationship. Part V will conclude with a discussion of the implications of section 3(c)(1) companies being able to—or not being able to—rely on the section 3(a)(10) exemption.

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4. HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 1.1 (2000). These six statutes are: (i) Securities Act of 1933, 15 U.S.C. §§ 77a to z-3 (2002); (ii) Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to ff (2002); (iii) Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa (2002); (iv) Public Utility Holding Act of 1935, 15 U.S.C. §§ 79–79z (2002); (v) Investment Company Act of 1940, 15 U.S.C. §§ 80a to a-64 (2002); (vi) Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to b-18a (2002).

5. Such instances of overlap include periodic reporting requirements, or the regulation of investment companies. *See* WILLIAM M. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS § 1.03 (2000); *see also* BLOOMENTHAL & WOLFF, *supra* note 4, § 1.1; Herman & MacLean v. Huddleston, 459 U.S. 375, 383 (1983) (quoting United States v. Naftalin, 441 U.S. 768, 778 (1979) and SEC v. Nat'l Sec., Inc., 393 U.S. 453, 468 (1969) to demonstrate that securities laws may overlap).

6. 15 U.S.C. § 80a-3(c)(1).

7. *Id.* § 77c(a)(10).

I. 1940 ACT

The focus of the 1940 Act[8] is on "pooled investment vehicles, such as mutual funds, closed-end funds, and unit investment trusts."[9] In the 1920s, the SEC found such investment vehicles especially prone to "manipulation and self-dealing."[10] As a result, Congress enacted the 1940 Act,[11] which provides, in part, that:

> No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under section 8, shall directly or indirectly—(1) offer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security. . . .[12]

Once registered, an investment company is substantially restricted in its activities.[13] Although the term "investment

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8. *Id.* § 80a-1 to a-64.

9. Thomas P. Lemke & Gerald T. Lins, *Private Investment Companies Under Section 3(c)(1) of the Investment Company Act of 1940*, 44 BUS. LAW. 401, 401 (1989).

10. DAVID L. RATNER, SECURITIES REGULATION 214 (1992). The Director of the Division of Investment Management at the SEC stated that the 1940 Act has been "one of the most successful statutes regulating financial institutions," and has been effective in "preventing many of the abusive practices that prompted its adoption." Paul F. Roye, Maintaining the Pillars of Protection in the New Millennium, Address Before the Investment Company Institute (May 21, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch279.htm (last visited Mar. 8, 2003). Specifically, the 1940 Act created protections in order to:

> Give investors confidence that: (i) their investments will be managed in accordance with the fund's investment objectives; (ii) the assets of the fund will be kept safe; (iii) when they redeem, they will get their *pro rata* share of the fund's assets; and (iv) the fund will be managed for the benefit of the fund's shareholders and not the fund's adviser or its affiliates.

Id.

11. *See* RATNER, *supra* note 10, at 214.

12. 15 U.S.C. § 80a-7(a).

13. *See* RATNER, *supra* note 10, at 215. For example, forty percent of the directors—or persons performing similar functions—must be independent; sales by investment companies of additional equity securities at less than net asset value are restricted; and an investment company may not incur debt if, after

company" is broadly defined in the 1940 Act,[14] Congress specifically exempted certain entities from regulation.[15] One common exception is found in section 3(c)(1),[16] which excepts an issuer "whose securities (excluding short-term paper) are beneficially owned by not more than one hundred persons . . . [so long as] it is not making or proposing to make a public offering."[17] Various entities rely on this exception, including trust funds,[18] leveraged buyout funds,[19] venture capital funds,[20] acquisition vehicles, and hedge funds.[21]

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giving effect to the incurrence of such debt, the ratio of (a) assets less liabilities other than such debt, to (b) such debt, would be less than thirty percent. 15 U.S.C. § 80a-1, et seq.; *see also infra* notes 101–03 and accompanying text.

14. Section 3(a)(1) states:

> When used in this title, "investment company" means any issuer which–
> (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
> (B) 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; or
> (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

15 U.S.C. § 80a-3(a)(1).

15. *See* Lemke & Lins, *supra* note 9, at 401.

16. *Id.*; *see also* 15 U.S.C. § 80a-3(c)(1).

17. *See* BLOOMENTHAL & WOLFF, *supra* note 4, § 1.74. Specifically, the statute states that an investment company is not "any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." 15 U.S.C. § 80a-3(c)(1).

18. *See, e.g.*, Torchmark Corp., SEC No-Action Letter, [1986–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,385 (Oct. 24, 1986); Fiduciaries' Index Trust, SEC No-Action Letter, [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,893 (June 25, 1976) (granting favorable treatment to a trust under section 3(c)(1)).

19. *See* Lemke & Lins, *supra* note 9, at 401.

20. Jonathon B. Levine, *Turning Points in the Lives of Companies; What It Takes to Lure the Venture Capitalist*, BUS. WK., Nov. 3, 1986, at 116.

21. TAMARA FRANKEL, 3 THE REG. OF MONEY MANAGERS 318–21 (1980). Although "open to only a limited number of investors, these investing entities

A. Prong 1: Number of Persons

Section 3(c)(1) has essentially two requirements:[22] an issuer cannot have "over 100 beneficial owners"[23] and it cannot be "making or proposing to make a public offering of [its] securities."[24] Although counting the number of beneficial owners to satisfy the first prong seems relatively simple, since the inquiry relates to "beneficial owners" and not just to stockholders, such an approach is complex.[25] While neither "the 1940 Act nor the rules [promulgated] pursuant to it define 'beneficial ownership,'"[26] no-action letters have generally interpreted beneficial ownership broadly[27] in order to "prevent investment company sponsors from forming a public company that itself invests its assets in a private investment vehicle."[28] Thus, if a company holds "[ten] percent or more of the outstanding voting securities of a section 3(c)(1) entity, and in addition, has more than ten percent of its assets invested in section 3(c)(1) entities, *all* of the shareholders of that company will be considered beneficial owners of the entity."[29]

Focusing on the "public offering" prong of section 3(c)(1), if the number of beneficial owners is fewer than 100, then the next step in the section 3(c)(1) inquiry requires an analysis of the "public offering" component.[30]

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often wield great amounts of capital due to the substantial investment each investor makes." Lemke & Lins, *supra* note 9, at 401 n. 14; *see also* J.P. Morgan & Co. Option Fund, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1851 (July 13, 1977).

22. John H. Davis, SEC No-Action Letter, 1984 WL 45309 (Apr. 20, 1984).

23. Although the 1940 Act does not define "beneficial ownership," *see infra* notes 24–25 and accompanying text, in the SEC's view, "anyone possessing any ownership interest in a company's debt or equity securities may be deemed a beneficial owner for purposes of section 3(c)(1)." Lemke & Lins, *supra* note 9, at 406.

24. *See* Lemke & Lins, *supra* note 9, at 406.

25. *Id.*

26. *Id.*

27. *Id.*

28. *The Investment Company Act of 1940*, CORPORATE PRACTICE SERIES A-11 (1995).

29. *Id.* (emphasis in original).

30. *See* Lemke & Lins, *supra* note 9, at 427.

B. Prong 2: A "Public Offering"

Scant legal precedent guides issuers in determining what constitutes a public offering under section 3(c)(1).[31] The SEC does not "as a matter of policy, issue a no-action or interpretive letter on the question of whether [an] offering is nonpublic. [Rather], it is the issuer's responsibility to determine whether the offering is nonpublic."[32] The SEC has, however, "taken the position that, for purposes of section 3(c)(1) of the 1940 Act, an offering is nonpublic if it complies with section 4(2) of, or Rule 506 under, the Securities Act of 1933."[33]

Accordingly, an analysis of the 1933 Act becomes necessary.

II. THE 1933 ACT

The 1933 Act[34] is "essentially a disclosure statute"[35] aiming to "assure the availability of adequate reliable information about securities that are offered to the public."[36] As with the 1940 Act,[37] the 1933 Act's main feature is its registration requirement.[38] Subject to certain specific exemptions, no security—a term broadly defined in the 1933 Act—can be offered or sold to the public unless first registered with the SEC.[39] However, Congress specifically exempted securities and transactions from registration,[40] where the

31. *See id.*

32. Stars & Stripes GNMA Funding Corp., SEC No-Action Letter, [1986–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,303 (Apr. 17, 1986). But an issuer is able to seek exemptive relief. *See, e.g.*, Hong Kong and Shanghai Banking Corp. and HSBC Holdings, SEC No-Action Letter, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,696 (Jan. 29, 1991).

33. Stars & Stripes GNMA Funding Corp., SEC No-Action Letter, [1986–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,303 (Apr. 17, 1986).

34. 15 U.S.C. § 77a–z-3 (2002).

35. RATNER, *supra* note 10, at 33.

36. *Id.* at 34.

37. 15 U.S.C. § 80a-1 to a-64.

38. *See* PRIFTI, *supra* note 5, § 1.03.

39. 15 U.S.C. § 80a-7(a)(1) (applying to securities sold or offered by way of the mails or any means or instrumentality of interstate commerce).

40. J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES

"intrinsic nature of the issuer or the character of the security [or transaction] itself . . . would make further governmental regulation superfluous."[41] One such exemption is section 3(a)(10),[42] which, unfortunately suffers "from a relative paucity of authoritative interpretation."[43] Consequently, much of what is known about section 3(a)(10)'s requirements and applicability comes from no-action letters.[44]

A. Section 3(a)(10)

Section 3(a)(10) specifically exempts from registration any security which is:

> [I]ssued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, 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.[45]

The SEC has determined that an issuer must satisfy the following criteria to claim a section 3(a)(10) exemption:

> The securities must be issued in exchange for securities, claims or property interests; they cannot be offered for cash;
>
> A court or authorized governmental entity must approve the fairness of the terms and conditions of the exchange;

ACT OF 1933 § 1.01[3][a] (2000).

41. *Id.*
42. *Id.* § 3.01[1].
43. *Id.* § 1.01[5][a].
44. *Id.*
45. 15 U.S.C. § 77c(a)(10) (2002).

> The reviewing court or authorized governmental entity must find, before approving the transaction, that the terms and conditions of the exchange are fair to those to whom securities will be issued; and be notified 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;
>
> The court or authorized governmental entity must hold a hearing before approving the fairness of the terms and condition of the transaction;
>
> A governmental entity must be expressly authorized by law to hold the hearing, although it is not necessary that the law require the hearing;
>
> The fairness hearing must be open to everyone to whom securities would be issued in the proposed exchange;
>
> Adequate notice of the hearing must be given to all those persons; and
>
> There cannot be any improper impediments to the appearance by those persons at the hearing.[46]

Many of these criteria focus on a reviewing court or similar government entity because securities offered pursuant to section 3(a)(10) protect investors not so much through dissemination of a disclosure document,[47] but through the substantive review by an

46. Revised Staff Legal Bulletin No. 3, 1999 SEC No-Act. LEXIS 904 (Oct. 20, 1999); *see also* 15 U.S.C. § 77c(a).

47. *See* Committee on Federal Regulation of Securities, *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595, 600 (1986) [hereinafter *Integration of Securities Offerings*] (noting, however, that as a practical matter, a prospectus-like disclosure is still required); *see also* 15 U.S.C. § 77c(a) (exempting certain securities from the registration requirements of the 1933 Act).

impartial tribunal.[48]

According to the SEC, the main justification for exempting section 3(a)(10) securities from registration is because 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."[49] In fact, "[m]any regulators would consider this form [a substantive review by an impartial tribunal as provided in section 3(a)(10)] . . . [to be] a form of protection superior to the [1933] Act's registration process,"[50] notwithstanding the fact that the impartial tribunal can be a court in a foreign country.[51] Indeed, with the SEC's blessing,[52] foreign companies in cross-border acquisitions are able to rely on section 3(a)(10) to exempt from registration those securities that it will issue to U.S. shareholders.[53]

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48. *See Integration of Securities Offerings*, *supra* note 47, at 600. In fact, "[m]any regulators would consider this form of protection superior to the [1933] Act's registration process, as there is always a strong likelihood that many, if not most, offerees would not read a prospectus if it were disseminated to them, assuming they even received it prior to their purchase." *Id.* at 602.

49. Securities Act Release No. 312, [1935–1936 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 2,181, at 2,951 (Mar. 15, 1935).

50. *Integration of Securities Offerings*, *supra* note 47, at 602.

51. *See* Staff Legal Bulletin No. 3, 1997 SEC No-Act. LEXIS 755 (July 25, 1997) (stating that it "is the Division's view that the term 'any court' in section 3(a)(10) may include a foreign court" provided that the requirements are met).

52. *See* HICKS, *supra* note 40, § 3.04[1][a].

53. *See, e.g.*, Mechala Group Jamaica Ltd. and Indus. Commercial Dev. Ltd., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 252 (Feb. 24, 2000) (Jam. Sup. Ct.); ADC Telecommunications, Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 657 (July 30, 1999) (Ir. High Ct.); Lason Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 557 (June 7, 1999) (Eng.); Omnicom Group, Inc. SEC No-Action Letter, 1999 SEC No-Act. LEXIS 294 (Jan. 28, 1999) (Eng. & Wales); ForBio, Inc. SEC No-Action Letter, 1998 SEC No-Act. LEXIS 880 (Sept. 23, 1998) (Austl. & Queensland Sup. Ct.); StaffMark, Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 830 (Sept. 3, 1998) (Eng.); Lytton Minerals Ltd. and New Indigo Resources, Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 379 (Mar. 6, 1998) (Alberta Court of the Queen's Bench); EXEL Ltd., Mid Ocean Ltd. Exel Merger Co., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 691 (July 2, 1998) (Cayman Is. Grand Ct.); China Light & Power Co., SEC No-Action Letter, 1998 SEC No-Act. LEXIS (Jan. 2, 1998) (H.K. High Ct. Special

III. RELATIONSHIP BETWEEN SECTION 3(a)(10) AND SECTION 3(c)(1)

Although exempt from the registration requirements of the 1933 Act, section 3(a)(10) securities are still subject to other U.S. securities laws.[54] For example, section 3(a) of the 1933 Act does not provide an exemption from section 10(b)—the insider trading rules—of the Securities Exchange Act of 1934.[55] The Trust Indenture Act of 1939[56] does not "include an exemption that is the equivalent of section 3(a)(10) of the Securities Act. [Thus, i]f an issuer is relying on section 3(a)(10) to offer and sell debt securities without [1933] Act registration, it should note that the Trust Indenture Act would still apply to that offering."[57]

In this vein, the issue arises of whether or not section 3(a)(10) securities will trigger the public offering component of other securities acts, such as section 3(c)(1) of the 1940 Act.[58] If the answer is yes, then such an issuer can no longer rely on the section 3(c)(1) exception because it would no longer meet the two prong test of section 3(c)(1),[59] and would thus be required to register under the 1940 Act.[60] If the answer is no, then a whole host of hedge funds and foreign investment companies can utilize the section 3(a)(10) exemption to offer their securities as consideration in an acquisition, and still rely on section 3(c)(1) to avoid the

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Admin. Region); Pioneer Natural Resources Co., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1032 (Nov. 25, 1997) (Alberta Queens Bench); Cadillac Fairview, Inc.; The Cadillac Fairview Corporation Limited; Cadillac Fairview Urban Properties Limited, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 520 (May 26, 1995) (Cana. Ct.).

54. *See, e.g.*, Leoni v. Rogers, 719 F. Supp. 555 (E.D. Mich. 1989) (holding that stockholders of a closely held corporation, all of whom were family, lacked standing to bring an action for securities fraud because they did not purchase the stock; there was a redemption of stock and only the corporation had standing).

55. *See* 15 U.S.C. §§ 77c, 78a–ff.

56. *Id.* § 77aaa.

57. Revised Staff Legal Bulletin No. 3, 1999 SEC No-Act. LEXIS 904 (Oct. 20, 1999).

58. 15 U.S.C. § 80a-3(c)(1).

59. *See supra* notes 22, 23 and accompanying text.

60. 15 U.S.C. § 80a-1 to a-64.

onerous requirements imposed by 1940 Act registration.[61] This interplay between section 3(a)(10) securities and section 3(c)(1) is particularly relevant to the many foreign investment companies that wish to exploit section 3(a)(10) by issuing securities—once highly valued—as consideration in acquisitions to U.S. shareholders.[62]

As outlined in Part I, an offering is "not public" for purposes of section 3(c)(1) if it complies with section 4(2) of, or Rule 506 under, the 1933 Act.[63] Section 4(2) of the 1933 Act exempts from registration transactions "by an issuer not involving any public offering."[64] The determination of what constitutes a public offering is "essentially a question of fact."[65] An important interpretation of the requirements of public offerings is the 1953 U.S. Supreme Court decision[66] in *Ralston Purina Co.*[67] The Court attempted to clarify section 4(2) by stating that:[68]

> The design of the ... [1933 Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory

61. *See id.* § 80a-18d; *see also* RATNER, *supra* note 10; *infra* notes 102, 103 and accompanying text.

62. Recent merger and acquisition activity has "been driven by rising stock prices, giving companies an acquisition currency with which to buy other companies." *See International M&A Boom, supra* note 1. Although not investment companies, many of the recent acquisitions, such as AOL/Time Warner, Vodafone Air Touch/Mannesmann, British Petroleum/Amoco have been purchased with stock. *See EU Takeover Rules*, THE ECONOMIST, Dec. 9, 2000.

63. John H. Davis, SEC No-Action Letter, 1984 WL 45309 (Apr. 20, 1984); *see also supra* note 30 and accompanying text.

64. 15 U.S.C. § 77a4(2).

65. Securities Act Release No. 5,121, 1970 SEC LEXIS 1463 (Dec. 30, 1970).

66. *See* PRIFTI, *supra* note 5, § 1.05.

67. SEC v. Ralston Purina Co., 346 U.S. 119 (1953). In this case, the SEC sought to enjoin a corporation from offering its stock to its employees without complying with the registration requirements of the 1933 Act. *Id.* The Court held that the availability of any exemption is to be considered in light of the intent of the statute and the need to protect investors by providing full and fair disclosure. *Id.*

68. *See* PRIFTI, *supra* note 5, § 1.05.

> purpose. Since exempt transactions are those as to which "there is no practical need for [the bill's] application," [sic] the applicability of § 4(1) should turn on whether the particular class of persons affected needs the protection of the Act.[69]

The Court further stated that "the exemption question turns on the knowledge of the offerees . . .[and, therefore,] the focus of inquiry should be on the need of the offerees for the protection afforded by [a] registration [statement]."[70] Thus, the crux of the analysis focuses on the offerees themselves. The SEC has issued a number of releases describing certain offeree characteristics to be evaluated when determining whether an offering is public or private.[71] Such factors include: (a) the number and identity of offerees; (b) the size of the offering; and (c) the manner of the offering.[72]

A. Number of Offerees

Although nothing prevents the SEC from using a strict numerical test in deciding what rises to the level of a public offering, the U.S. Supreme Court has held that the number of offerees is not conclusive as to the availability of the nonpublic exemption.[73] It is not even a question of the number "of actual purchasers, but [rather] the number of persons to whom the security in question is offered for sale."[74] Negotiations with a large, unrelated group of prospective purchasers with little association or knowledge of the issuer are typical in public offerings,[75] even if few offerees ultimately purchase shares.[76] It is the identity of the initial offerees—and not just the actual purchasers—that is significant.[77]

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69. *Ralston Purina*, 346 U.S. at 124–25.
70. *Id.* at 126–27.
71. *See, e.g.*, Securities Act Release No. 285, 11 Fed. Reg. 10,952 (Jan. 1935); *Id.* No. 4,552, 27 Fed. Reg. 11316 (Nov. 1962); *supra* note 65.
72. Securities Act Release No. 4,552, 27 Fed. Reg. 11316, ¶ 2770 (Nov. 1962).
73. *Ralston Purina*, 346 U.S. at 125.
74. Securities Act Release No. 285, 11 Fed. Reg. 10,952, ¶ 2741 (Jan. 1935).
75. *Id.* ¶ 2771.
76. Securities Act Release No. 4,552, 27 Fed. Reg. 11316, ¶ 2772 (Nov. 1962).
77. *Id.*

Thus, an offering to persons who are able to "fend for themselves would most likely indicate a transaction not involving any public offering."[78]

B. Size of Offering

The larger the size of the offering, the more likely it will be considered public.[79] A multi-million dollar offering to non-institutional and non-affiliated investors would thus tend to indicate a public offering.[80] Similarly, an offering in connection with a "settlement of a class action or a business combination where the corporation to be acquired is not closely held would more likely be a transaction involving a public offering."[81] Since a class action or a non-closely held corporation would have a large, diverse, and unsophisticated number of shareholders, such offerees may need the protections typically afforded investors in public offerings.

C. Manner of the Offering

A determination of whether an offering is public or private "also include[s] a consideration of the question of whether it should be regarded as part of a larger offering."[82] Indeed, it is not enough to focus narrowly on a specific offering.[83] Section 4(2) of the 1933 Act[84] does not "exempt every transaction, which is not itself a public offering."[85] Rather, the statute exempts "transactions not 'involving' any public offering."[86] Thus, a person may not separate small parts of a series of related transactions—each of

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78. *See* PRIFTI, *supra* note 5, § 1.05.
79. Securities Act Release No. 285, 11 Fed. Reg. 10,952, ¶ 2743 (Jan. 1935).
80. *Id.* No. 4,552, 27 Fed. Reg. 11316, ¶ 2775 (Nov. 1962).
81. *See* HICKS, *supra* note 40, § 3.06[2].
82. Securities Act Release No. 4,552, 27 Fed. Reg. 11316, ¶ 2782 (Nov. 1962).
83. *Integration of Securities Offerings*, *supra* note 47, at 610.
84. 15 U.S.C. § 77d(4)(2) (2002).
85. Securities Act Release No. 2,029, 1939 SEC LEXIS 322, *6 (Aug. 8, 1939).
86. *Id.*

which alone would have been a private transaction, but the sum total of which is really one offering—and claim that a particular part is a non-public transaction merely to avoid registration.[87] The SEC uses additional factors to determine whether or not a series of transactions should be integrated: whether (1) the different offerings are part of a single plan of financing; (2) the offerings involve issuance of the same class of security; (3) the offerings are made at or about the same time; (4) the same type of consideration is to be received; or (5) the offerings are made for the same general purpose.[88]

IV. ANALYSIS

The determination of whether or not a section 3(a)(10) offering will be deemed non-public under section 4(2) of the 1933 Act[89]—and fall within the parameters of section 3(c)(1)[90]—is thus made on a case by case, characteristic by characteristic basis. Each of the "public offering" factors, such as, the number of offerees, the size of the offering, and the manner of the offering[91]—and whether the offerees need the protections of the 1933 Act[92]—will

87. *Integration of Securities Offerings*, *supra* note 47, at 610.

88. *Id.*

89. 15 U.S.C. § 77d(4)(2).

90. *Id.* § 80a-3(c)(1).

91. Securities Act Release No. 4,552, 27 Fed. Reg. 11316, ¶¶ 2771–82 (Nov. 1962). Other factors include whether or not the shares were offered to employees, sold to promoters, acquired for investment, retained for long periods of time, or sold to institutional investors. *Id.*

92. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). The Court wrote:

> The design of the statute [the 1933 Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which "there is no practical need for . . . (the bill's) [sic] application," the applicability of section 4(1) [now 4(2)] should turn on whether the particular class of persons affected need the protection of the Act. Any offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."

Id. at 124–25. The preamble of the 1933 Act itself also illustrates this point, as it states that the 1993 Act is "[a]n Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the be scrutinized.

The foregoing criteria are helpful in providing some guidance to those wishing to rely on both section 3(a)(10) and section 3(c)(1). The SEC, however, has never expressly ruled on this issue, although it has been presented with the question.[93] An issuer hoping to rely on section 3(a)(10) to issue shares as consideration in an acquisition and avoid the registration requirements of the 1940 Act argued in a no-action letter that its section 3(a)(10) offering should not be considered "public." The issuer relied on the position that U.S. shareholders receiving the section 3(a)(10) shares were, in its transaction, merely changing their shares as an investment in one company to one in a similar company.[94] The letter specifically argued that

> [I]n the context of a corporate reorganization exempt from registration under section 3(a)(10) of the 1933 Act and involving no new investment decisions and no fundamental change in the underlying investment, and where the underlying securities entered the U.S. markets through secondary market trading, it would be inappropriate to treat the transaction as involving a 'public offering' for purposes of section 7(d) of the 1940 Act.[95]

The SEC, however, responded on an unrelated issue and did not address the validity of this argument. In fact, the SEC stated that the petitioner should not have requested a no-action letter because its situation "is the type of transaction [that] should generally be approved through the exemptive process."[96] Was the SEC indicating that exemptive relief would be granted in such a situation? Could a section 3(c)(1) company thus seek specific relief from the SEC and rely on section 3(a)(10) to issue shares?

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mails, and to prevent frauds in the sale thereof, and for other purposes." 15 U.S.C. § 77a.

93. *See* Hong Kong and Shanghai Banking Corp. and HSBC Holdings, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,696 (Jan. 29, 1991).

94. *Id.*

95. *Id.*

96. *Id.*

Because the SEC has never resolved this issue, and because of the uncertainty in the language of the 1933 Act and the 1940 Act, the answer, unfortunately, remains unclear.

V. IMPLICATIONS

If a section 3(c)(1) company is unable to rely on the section 3(a)(10) exemption in a certain instance, it is limited to basically two options: it can either (1) not proceed with the transaction, or (2) register itself as an investment company.[97] Option one obviously ends the discussion. Option two would free a company from having to rely on both the 100 beneficial owner and "public offering" confines of section 3(c)(1). However, registration pursuant to the 1940 Act carries with it numerous other requirements that are more burdensome[98] than either attempting to structure a certain transaction as "private",[99] or seeking some sort of exemptive relief from the SEC. In fact, registration is not a very realistic solution.

Some of the 1940 Act's more onerous provisions are its severe limitations on a registered investment company's capital structure. An investment company cannot: (i) have more than one class of preferred stock;[100] (ii) have more than one class of non-bank debt;[101] or (iii) issue warrants or options for a period of more than 120 days, even to employees.[102] In addition, companies that wish to utilize section 3(a)(10) are foreign companies also relying on the section 3(c)(1) exemption, and who wish to avoid the expense and complications of full 1933 Act registration.

However, a "corporation that is not organized under U.S. law cannot as a practical matter register under the [19]40 Act."[103] section 7(d) of the 1940 Act prohibits a company organized outside the United States "from registering as an investment company and

97. 15 U.S.C. § 80a-7(a).

98. *See supra* note 13; *infra* notes 101–03 and accompanying text.

99. 15 U.S.C. § 77d(4)(2); *see also supra* notes 71–87 and accompanying text.

100. 15 U.S.C. § 80a-18(a).

101. *Id.*

102. *Id.* § 80a-18(d).

103. *The Investment Company Act of 1940*, *supra* note 28, at A-9.

making a public offering in the United States, unless the SEC issues an order permitting it to register."[104] The SEC, however, is only authorized to issue such an order if it finds that: "[(1)] it is both legally and practically feasible to effectively enforce the provisions of [the 1940 Act] . . . against . . . [the funds;] and [(2)] that the issuance of such order is otherwise consistent with the public interest and the protection of investors."[105] This standard, "which is referred to commonly as the 'enforceability' standard, historically has proven difficult for foreign companies to meet." In fact,

> The SEC has only permitted 19 foreign funds, mostly from Canada, to register under the [19]40 Act; it last granted such permission in 1973. Even though § 7(d) [of the 1940 Act] refers only to "public offerings," the commission, reading the section in connection with § 3(c)(1) of the [1940 A]ct, . . . has interpreted § 7(d) to prohibit a foreign fund from making a private offering to more than 100 U.S. resident investors without obtaining SEC approval. An unregistered foreign fund may, however, make a *private offering* of its securities to U.S. residents, provided the fund does not have more than 100 U.S. investors.[106]

Indeed, the SEC has stated that "[b]y its terms, section 7(d) does not preclude a foreign investment company from offering its shares privately in the United States"[107] because "Congress could not have intended unregistered foreign funds to be able to conduct private placements in the United States larger than those permitted to be conducted by unregistered private investment companies organized under U.S. law."[108] In this vein, the inquiry as to whether a section 3(a)(10) offering will be deemed public or private becomes even more crucial.

Another potential pitfall would be the consequences of a loss of the section 3(c)(1) safe harbor. If the consummation of a section

104. *Id.*

105. 15 U.S.C. § 80a-7(d).

106. *The Investment Company Act of 1940*, *supra* note 28, at A-9.

107. Investment Funds Institute of Canada, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 334 (Mar. 4, 1996).

108. *Id.*

3(a)(10) transaction stripped a company of the ability to use the section 3(c)(1) exception, that U.S. company might be deemed an investment company. Section 47 of the 1940 Act[109] "generally renders any contract made by an unregistered investment company unenforceable."[110] Furthermore, the SEC has, in the past, brought a number of enforcement actions against entities whose business activities brought them within the definition of an investment company, thus exposing that entity to penalties for creating an unregistered investment company.[111]

Accordingly, the stakes are high for a section 3(c)(1) company that wishes to rely on section 3(a)(10) to make its securities offerings. If its offering is not structured correctly, the issuer not only jeopardizes its ability to complete the section 3(a)(10) offering, but also risks exposing itself to penalties for conducting an offering without first registering under the 1940 Act. If the issuer attempts to wade through the current uncertainty and hedge against unforeseen risk, it will most likely incur considerable legal expenses and other costs. In light of the foregoing, it is understandable if the issuer chooses not to proceed with any section 3(a)(10) offering that might endanger its section 3(c)(1) status.

Historically, when issuers have been hampered by uncertainty or unintended legal exposure, the SEC has offered clarity by promulgating explanatory rules, protection by creating safe harbors, or both.[112] For example, in an attempt to provide issuers

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109. 15 U.S.C. § 80a-46.

110. *The Investment Company Act of 1940*, *supra* note 28, at A-9. The language of this section goes on to state that a contract will not be rendered unenforceable if "a court finds that under the circumstances enforcement would produce a more equitable result than nonenforcement and would not be inconsistent with the purposes of [the Act]." 15 U.S.C. § 80a-46(b)(1).

111. *See, e.g.*, SEC v. Dart Group Corp., SEC Lit. Rel. No. 12392 (D.D.C. Feb. 28, 1990) (holding that Dart Group violated the 1940 Act by acting as an investment company as defined in section 3(c)(1) without first registering with the SEC pursuant to section 8(a) thereof).

112. Regulation D, Rules 501–509, issued under the 1933 Act, provide exemption from the 1933 Act registration requirements for sales to "accredited investors." 17 C.F.R. §§ 230.501–.508 (2002); *see also* Regulation S, Rules 901–905 under the 1933 Act, which provide a safe harbor for offshore sales. 17 C.F.R.

with guidance on securities offerings made outside the United States, the SEC promulgated Regulation S.[113] Rules 903 and 904[114] afford issuers with certain "safe harbors, compliance with which serves to establish that registration under the 1933 Act is not required."[115] Similarly, in 1982, the SEC "took a major step in simplifying and coordinating the exemptions for limited [securities] offerings"[116] by adopting Regulation D.[117] Rules 501 through 508 were designed to "simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions in order to facilitate capital formation consistent with the protection of investors."[118] Thus, since companies were unsure of the requirements to register securities issued outside the U.S., and issuers needed clarification of their obligations when making discrete offerings to accredited investors, the SEC responded by issuing Regulation S and Regulation D.

Today, section 3(c)(1) issuers find themselves similarly perplexed and vulnerable to legal exposure and enforcement actions. Without relief, these issuers will be limited to making section 3(a)(10) offerings that are encumbered by an excess of the public offering requirements of the 1933 Act. Yet, even with such an approach, issuers have no assurance that they will not have violated the 1940 Act, the 1933 Act, or both. Consequently, now is an appropriate, indeed necessary time for the SEC to provide guidance to section 3(c)(1) companies that wish to avail themselves of the U.S. capital markets.

One approach the SEC might take is to promulgate a rule that would set forth what section 3(c)(1) companies need to do to

§§ 230.901–.903 (2002).

113. Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Exchange Act Release No. 6,863 (Mar. 8, 1982), 17 C.F.R. §§ 230.901–.903.

114. *Id.* §§ 230.903–.904.

115. *Regulation S: the Safe Harbor for Offshore Securities Transactions*, CORPORATE PRACTICE SERIES A-5 (1997).

116. *See* RATNER, *supra* note 10, at 58.

117. *Id.*

118. Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Exchange Act Release No. 6,863 (Mar. 8, 1982).

ensure that they are conducting a valid section 3(a)(10) offering. The rule could outline which private offering characteristics should be part of a section 3(a)(10) offering; in other words, it would codify which section 4(2) criteria must be present so that the section 3(a)(10) offering is not deemed "public."

For example, the following language might provide the section 3(c)(1) issuer with the necessary guidance and protection:

> Notwithstanding the provisions of section 7(d) of the 1940 Act, an issuer relying on, and satisfying the requirements of, section 3(c)(1) of the 1940 Act shall be able to utilize the mails and interstate commerce to offer securities; provided that all of the following conditions are satisfied: (i) the securities are offered in reliance on, and satisfy the requirements of, section 3(a)(10) of the 1933 Act; (ii) the offering is made solely to accredited investors, or to accredited investors and no more than 50 non-accredited investors; (iii) the value of the offering is not in excess of $50 million; (iv) the offering is narrowly tailored to the intended offerees; and (v) a reasonable person would determine that the offerees are protected to the extent they would have been had the security been first registered pursuant to the 1933 Act.

So long as a transaction satisfied the foregoing requirements, issuers would no longer jeopardize their section 3(c)(1) status when making section 3(a)(10) offerings, and would thus be more likely to conduct section 3(a)(10) offerings. Such an increase in equity offerings would enable section 3(c)(1) issuers to expand their shareholder base and to raise additional capital. Additionally, U.S. investors would benefit because they would then have more opportunities to acquire section 3(a)(10) securities as investment opportunities.

Until the SEC rules directly on this issue or creates a safe harbor, the best available protection for a section 3(c)(1) issuer—the party who has the burden of proving that section 4(2) of the 1933 Act would apply[119]—is to structure its section 3(a)(10) offering with as many "private" offering criteria as possible so as not to

119. *See* HICKS, *supra* note 40, § 3.01[1]. As is true with any exemption, claiming a section 3(a)(10) protection carries with it the burden of proving compliance with all of the requirements. *Id.*

trigger the "public offering" component of the 1940 Act. Yet, unfortunately, even if the section 3(c)(1) issuer manages to fashion its transaction with numerous "private" offering factors, it has no assurance that the SEC will not bring an enforcement action against it for making a public offering, if the issuer first did not register under the 1940 Act.

Notes & Observations