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COMMITTEE ON POST-ADMISSION LEGAL EDUCATION

JOINT MEETING OF THE SECTION ON ADMINISTRATIVE LAW
AND
SECTION ON BANKING, CORPORATION AND BUSINESS LAW

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MERGERS, CONSOLIDATIONS AND THE SEC WITH PARTICULAR EMPHASIS ON RULE 133 AND SECTION 3(a)(9) OF THE SECURITIES ACT OF 1933

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When this meeting was first mentioned to me, it was suggested that an appropriate subject would be mergers and consolidations, with particular emphasis on Rule 133 1/ under the Securities Act of 1933 and proxy problems under the Securities Exchange Act of 1934. Later, it was suggested that the discussion be limited to problems under Rule 133 and Section 3(a)(9) 2/ of the Securities Act.

It would not be feasible, of course, to compress within the allotted time a summation, let alone an analysis, of the divergent views which have been voiced as to the legal and policy considerations from which have been derived the various opinions of the Commission and its legal officers as to the meaning of Section 3(a)(9), and the present posture of Rule 133.

The discussion of a number of cases in recent months in and out of the Commission, however, suggests the desirability of describing for you some of the problems which have concerned the Commission and the staff with reference to these two subjects.

Before embarking on a project such as this, two observations should be made which I trust will be received in the spirit in which they are offered.

I know that over the years the Commission and its staff have sought to interpret and administer the Securities Acts in a manner which would fairly and objectively apply the statutory standards and requirements to the legal and financial problems arising under them. No one could examine the old files as I have done without being convinced of the sincerity and earnestness of the Commissioners and staff members of prior years in their efforts to give sensible meaning to the statutes and to enforce the law. It would be astonishing, however, if, in almost twenty-five years, differences of opinion and differences in decisions should not appear with reference to statutory and rule provisions not entirely free of ambiguity.

I trust that no comment of mine this evening concerning past actions and opinions in various cases will be construed as criticism of former members of the staff or the Commissioners, their work or their conclusions. They were trying, as we are trying, to administer the law in a manner compatible with its basic theses and objectives. It goes without saying that this assurance is not to be regarded as a species of negative pregnant as to my present superiors and colleagues.

1/ Rule 133 of the General Rules and Regulations under the Securities Act of 1933 adopted in August, 1951.

2/ Section 3(a)(9) of the Securities Act of 1933, as amended July 1, 1934.

You will understand also that while I am delighted to be with you this evening and participate in this program, I am not speaking for the Commission. Neither should you assume that anything I say represents a conclusion or recommendation by the staff to the Commission. In fact, if anyone should refer to my remarks tonight as reflecting my views about anything, I shall be compelled to deny my presence here.

Having thus declared myself in the approved bureaucratic fashion, I will start my subject with the assertion that to my knowledge there has been no instance in which a court has construed Section 3(a)(9) of the Securities Act. 3/ Except for Leland Stanford 4/, I know of no final court decision with reference to Rule 133.

It is presumed that you are familiar with the legislative background of the various sections of the statute pertinent to a consideration of Rule 133 and Section 3(a)(9) 5/, including that intriguing introductory phrase to the definitions of Section 2 of the Act: "When used in this title, unless the context otherwise requires . . . ." These have been discussed in published releases of the Commission and in various law reviews and other articles and there is not time, nor would it be particularly illuminating, to restate or review them here.

What is important is to trace what the Commission has said and done or, perhaps more significantly, to trace what it hasn't said or hasn't done to articulate, with the degree of precision desired by the Bar, a rule or guide to be followed in the day-to-day business of advising clients of their obligations under the law.

It would be impossible to summarize all of the relevant cases which would be of interest to the student of the development of administrative law and administrative policy. In fact, in an agency as small as ours, with the great volume of current business constantly before us, our research facilities are of necessity quite limited and I'm not at all sure that we have the means to identify every case. Some of those I propose to discuss have never before, to my knowledge, been the subject of public discussion by a representative of the Commission. Those which I have chosen for discussion are those which seemed to me to be landmark cases with respect to the problem.

3/ Charles Borland v. Commonwealth Subsidiary Corporation, et al., filed in the United States District Court, Northern District of Illinois, on October 23, 1935. The availability of Section 3(a)(9) was one of the issues but the case was dismissed by agreement of the parties on July 23, 1937.

4/ National Supply Co. v. Leland Stanford Jr. University, 134 F. 2d 689 (C. A. 9, 1943), cert. denied 320 U. S. 773.

5/ See Sections 2(3), 2(11), 3(a)(9), 3(a)(10) and 4(1). See also Section 4(3) of the Act prior to its amendment in 1934.

It may well be that some of you here will recall others which you believe more significant or persuasive in relation to some theory of statutory construction or prior administrative action.

The first public pronouncement with respect to Section 3(a)(9) appeared as Ill. #7 in Release 97 of the Federal Trade Commission on December 28, 1933 6/. The most recent public pronouncement appeared in the opinion of the Commission, published August 12, 1957 7/, in the matter of The Crowell-Collier Publishing Company. The first public pronouncement with respect to Rule 133 appeared as an amendment to the instructions of a registration form in September, 1935 8/. The most recent pronouncements with respect to this rule appeared in the opinion of the Commission, published in April, 1957, in the matter of Great Sweet Grass Oils Limited 9/ and in a subsequent release discussing the application of these views in another case 10/. These, in each instance, were merely the earliest and most recent public manifestations of an administrative effort which has continued through the years in countless cases to reach a rational solution to certain basic questions.

Is Section 3(a)(9) to be relied upon as an exemption for a "security," an exemption for a "transaction," an exemption for a security in a particular type of transaction or may it under certain circumstances be a "security" exemption and under others a "transaction" exemption--and if the latter, when?

Does Rule 133 make it possible to ignore entirely Sections 4 and 5, or are there factors which may make it necessary to determine when and under what conditions, notwithstanding reliance on Rule 133, registration is necessary?

The conclusion reached as to any of these in a particular situation is not one toward which either the practitioner or the Commission is impelled by clear statutory language or the persuasiveness of logical argument and reasoning. Rather, the problems posed, in my judgment, call for what essentially must be policy decisions.

6/ At that time, Section 4(3).

7/ S. A. Rel. 3825.

8/ Rules as to the use of Form E-1, note to Rule 5, S. A. Rel. 493 (September 20, 1935). Form E-1, including the note, was abolished in 1947. See S. A. Rel. 3211, April 14, 1947.

9/ Great Sweet Grass Oils Limited, S. E. A. Rel. 5483 (April 8, 1957).

10/ See S. A. Rel. 3846 (October 10, 1957).

I believe that the Securities Act has worked well in its application to registered distributions of securities for cash by issuers or controlling persons directly to the public in the conventional type of syndication with underwriter or dealer groups. That is not to say that disclosure problems have not on occasion arisen in the registration process or that at times there are not irksome questions as to the delivery of prospectuses by dealers and others, and when or whether prospectuses should be amended or supplemented following the effective date, particularly when a distribution has been unsuccessful or its completion otherwise has been delayed for various reasons. Further, I believe that the disclosure and prospectus procedures have been applied in a generally satisfactory manner to the more involved transactions such as reorganizations, acquisitions or exchanges and various types of two-step or deferred distributions.

The more serious questions, from the long-run point of view of the public interest and effective administration of the Act, arise in the interpretation of the exemptive provisions of the statute and a few of the Commission's own rules. These questions arise in two ways.

The Commission's long-standing policy of offering the services of its staff and, if the circumstances require, to express its own views to assist counsel and others in arriving at a conclusion in advance of a transaction is well known and produces a large number of requests for interpretative guidance and advice. The informal opinions thus expressed over a period of time represent to the Bar a storehouse of precedential material which is relied upon in many ways. It is relied upon in reaching a decision whether to proceed with or without registration independent of any consultation with the Commission. It is often employed to decide whether a particular question should be presented to the Commission for an informal ruling. It is relied upon to cast or recast a deal to avoid a statutory problem.

These decisions, at the time they are made, solve the particular interpretative problem before the issuer and the Commission or its staff. We find, however, that in some instances this precedential material complicates and may make exceedingly difficult the discharge of a second function of the Commission--one not assumed by choice or in a spirit of helpful assistance but compelled by the statute, and one which is the principal reason for the Commission's existence--the enforcement of the law and the prosecution of violators.

As you know, the past few years have produced a volume and activity in the securities markets unprecedented in the twenty-five years of the Securities Act. A by-product of these events has been a demonstrated need for a shift of emphasis in administration. This has been reflected in sharply increased activity on the part of the entire organization in the investigation of apparent or suspected violations. It also has been reflected in an increasing employment of the various administrative sanctions

available to the Commission under Section 8 of the Securities Act and Section 19 of the Exchange Act 11/ and a more frequent resort to court action.

It occurs with disturbing frequency in the course of these pursuits that our staff and the Commission are confronted with indignant assertions and legal arguments that no violations of a statute have occurred because the security in question was "free stock" or the transaction in question was one involving "free stock." Upon inquiry, we discover that the "free stock" was "merger stock"; that it was exempt stock because of an "investment letter" or because "there was a change of circumstances"; that the parties produce an opinion that there was "no public offering" or that a person was not an "underwriter" or that the issue was exempt by Section 3(a)(9); or that a letter from some member of the staff of the Commission in another case or to another person is claimed to provide a basis for an opinion by counsel that the transaction in question is exempt. In many cases it seems clear to us that words and ideas employed in a letter designed to assist someone solve an interpretative question have been torn out of context and employed for a purpose not intended. In other cases, language employed by us to deal with a particular fact situation is used in another case in such a fashion as to make it appear that it had a generality of meaning not intended and not justified by the original problem. Sometimes it appears that a hard decision, from an earlier day and on a specific problem, with the passage of time has gradually acquired a stature and sweep of meaning in the minds of many which blurs the particular facts on which it was based and the doubts which may have attended the original action. And finally, there are cases where one of our own rules is offered in defense of transactions which are suspect.

These impede the investigatory process; they make difficult prosecutions; they cause us to be concerned whether in an effort to help solve problems, interpretative advice may be employed by others in different situations in a manner not contemplated. More serious is the concern we experience that perhaps a rule or an opinion or a policy needs sharper definition or refinement. Finally, questions inevitably arise whether a rule or a policy position should be reappraised in the light of experience and of enforcement problems under present-day conditions.

Thus, in the last few years our attention has been directed to patterns of transactions and the frequent use of forms of legal opinions couched in almost standard language, which raise serious questions as to transactions effected in purported reliance upon statutory exemptions such as Sections 3(a)(9), 3(a)(11), 3(b), the first and second clauses of Section 4(1), rules adopted under these sections and Rules 154 and 133. Since these two rules and all of these statutory exemptions, except 3(b), are self-operating,

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11/ Section 19 of the Securities Exchange Act of 1934, as amended.

transactions under them ordinarily come to our attention only after the fact. It is true that many of them are referred to in reports or proxy statements filed under Sections 13, 14 or 15 of the Exchange Act. It is obvious, however, that an agency of our size cannot, as a matter of enforcement policy, attempt to inquire as to the thousands of transactions which occur.

It is understandable, therefore, that the Commission and the staff should be concerned with the manner in which exemptions appear to have been construed, and to be even more concerned with the possibility that interpretative advice given in the past or hereafter might lead the Bar to assume too much or might be employed under circumstances and in such a manner as to impair or impede the effectiveness of our own enforcement activities. It is also understandable that a Commission such as ours should consider itself duty-bound to make its own assessment of rules and policy decisions, whether of its own creation or inherited from an earlier day, in the light of new and changing patterns of securities transactions and distributions and of the enforcement problems now being encountered. To do so is not incompatible with principles of administrative and judicial continuity and consistency.

As I have indicated, we are frequently faced in our investigations of securities distributions with the assertion that merger stock is "free stock."

Is it reasonable to assume that the Commission has intended that this sweeping conclusion should be reached by promoters, underwriters, dealers, the Bar and the enforcement and prosecuting officials of the Federal Government? But if merger stock is not free stock for all purposes, what standards should govern a determination of the limitations which properly should be applied?

Rule 133 is a rule of the Commission, in full force and effect, I believe, until the Commission itself, the Congress, or the Courts act to modify or repeal it. As a subsisting rule, anyone relying upon it must decide just what protection it affords in relation to the financial and legal factors to which it is being related.

In its original form, the note to Form E-1, the predecessor of Rule 133, by its generality seemed to have the effect of making Sections 12 and 17 of the Securities Act, as well as Section 5, inapplicable to a merger 12/ transaction. While this proposition was repudiated by the Commission in its brief in the Leland Stanford case, it was not until 1951 that Rule 133 was adopted in essentially its present form to state specifically that "For purposes only of Section 5 of the Act, no 'sale,' 'offer to sell,' or 'offer for sale' shall be deemed to be involved so far as the stockholders of a corporation are concerned where," etc. . . . . . It was stated in the

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12/ The term "merger" is employed as a means of easy reference to each of the four types of transactions now referred to in Rule 133.

published release 13/ announcing the adoption of Rule 133 that one of its purposes was to make it clear that it was intended only to make the registration provisions of the Act inapplicable to the transaction and not to remove such transaction from the scope of Sections 12 and 17 or of any other part of the statute. It seems clear that, whatever the scope of the theory underlying the original version of the rule, the purpose of Rule 133 was to limit its operation to the mechanics of soliciting and securing the action of security holders and the issuance of the security in the Rule 133 transaction itself for purposes of Section 5 of the Act. 14/ It does not purport to deal with subsequent transactions or other actions by stockholders, nor to provide that there cannot also be activities, negotiations and conduct on the part of an issuer and other persons in connection with a merger negotiation (including stockholders who may have voted for or against the merger or not have voted at all) which might raise a question as to the need for registration with respect to a public distribution of a security by persons receiving such security pursuant to the terms of the merger.

If under certain circumstances consideration must be given to the registration provisions of the Act with reference to transactions in a security following or in connection with a Rule 133 transaction, then it would seem that a question is presented which is not unlike that posed by some of the provisions of Section 3(a) and particularly Section 3(a)(9) of the Act.

In other words, even though Rule 133 is couched in terms of a definition or interpretation of the term "sale," it may be considered for purposes of this discussion as being in the nature of an exemption from registration. So construed, the question then arises whether this so-called exemption should be regarded as in the nature of a "security" exemption or a "transaction" exemption. If the former, it would seem that the principles applicable to Sections 3(a)(2) through Section 3(a)(8) should be equally applicable to a security issued in a Rule 133 transaction. If the rule is deemed to provide what is tantamount to a "transaction" exemption, then it would seem that the principles applicable to Sections 3(a)(9), 3(a)(10) and 3(a)(11) should be considered, since the Commission has held for many years that for certain purposes these must be considered as "transaction" rather than "security" exemptions.

13/ S. A. Release 3420, August 2, 1951. Rule 133 was amended in October, 1954. See S. A. Release 3522 (October 26, 1954).

14/ In 1952, the Commission ruled that Rule 133 would not operate to relieve an issuer of the necessity of qualifying an indenture under the Trust Indenture Act of 1939. In this connection, consideration was given to the interrelations of the two statutes and the express purpose of the 1951 restatement to the rule.

If this analysis and analogy have any validity, it would seem to follow that, if securities issued in a Rule 133 transaction should be regarded as "exempted" securities, Sections 4 and 5 may be ignored entirely. Under these circumstances, the witness in an investigation of possible violation of Section 5 might with considerable confidence assert that his stock, being merger stock, was "free" stock.

If, however, the rule merely provides a means of escaping registration for the transaction of merger and should therefore be viewed as tantamount to a "transaction" exemption, it would seem to follow that consideration must be given to Section 4(1) and Section 5 with respect to any contemplated public distribution following the merger.

Both the Great Sweet Grass and the Schering 15/ cases seem to indicate that the Commission is construing Rule 133 in the latter manner and, in effect, is saying that the principles of Release 646 16/ must be applied. Release 646 in effect said that notwithstanding the language of Section 3(a)(9), it may not be employed by an issuer as a means of evasion of the registration provisions of the Act, and securities received by controlling persons in a Section 3(a)(9) transaction may not be sold in reliance upon this section if registration would otherwise be required 17/.

The suggestion is made that, assuming arguendo the validity of these propositions, the problems thus created become impossible of solution. Questions are raised as to all sorts of complex fact situations and effort is made to demonstrate that the burden would be unreasonable; that no one can know when to register and when it is safe not to register, that the issuer can't be "compelled" to register; that people should not have the responsibilities of an underwriter; that counsel do not know how to advise because of the absence of some precise formula to be applied as a rule of thumb.

The basic difficulties with these contentions are that, under the first and second clauses of Section 4(1), this type of problem has been with us since 1933 in all sorts of transactions and that counsel, recognizing these problems, has proceeded to deal with them effectively. It is the assumption that, if Rule 133 is in any way involved, one need be concerned with nothing else which produces the difficulty. If the assumption be eliminated, the problem is reduced to the conventional though perhaps not always easy Securities Act problem. Of course, there are cases where

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15/ S. A. Release 3846, October 10, 1957.

16/ S. A. Release 646(c), February 3, 1936.

17/ See also In the Matter of Thompson Ross Securities Co., 6 SEC 1111, 1118 (1940).

parties do not know and are unable to determine whether a public distribution, with which an issuer may have a connection, will occur or when it may occur. More often the parties know very well what is proposed and the deal is usually set up in such a way as to accomplish its purpose.

A few cases might be mentioned for purposes of indicating an approach to the problem. These cases merely represent an evolutionary process toward a solution--toward the development of a policy.

In one type of case the Commission expressed the opinion that if the issuer participated in the arrangements for a public offering through investment bankers of securities coming out of a Rule 133 transaction, the securities should be registered. In other cases the Commission has considered that the size of the holdings of the insider group was such that, for all practical purposes, the merger transaction should be regarded as a negotiated sale as to them and that, while no objection would be raised to reliance on Rule 133 as to stockholders, the distribution of securities to the public by the persons in the insider group, following the merger transaction, should be registered. In another type of case where it was contemplated by the parties that a public offering would be made by the security holders of the company selling assets in a Rule 133 transaction, and the deal was arranged with this as one of the objectives, it was felt that the securities so to be offered should be registered.

Now we can leave Rule 133 for a moment and consider the same underlying problem in relation to Section 3(a)(9) and the two-step distribution of securities where a transaction under this section precedes a distribution to the public. Three situations commonly arise. In the early days of the Securities Act, when companies all over the country were effecting readjustments of their debt and equity capital, inquiries were received as to the requirements of the statute in situations where creditors or other security holders wished to exchange their existing holdings for other securities of the issuer and to distribute the new securities. Questions were put to the Federal Trade Commission and the S.E.C. whether former Section 4(3) or the present Section 3(a)(9) offered an exemption for these transactions of exchange and subsequent sale.

A little later, when markets revived somewhat, questions arose whether an issuer selling convertible securities in a public offering might rely on Section 3(a)(9) for the issuance of the underlying security on conversion and whether the holders were free to sell that security.

At about the same time, the Commission was confronted with the question whether the purchasers of a convertible security in a non-public transaction under Section 4(1) might later convert and sell to the public the security received on conversion. A book could be filled with illustrations of the many fact situations presented and the arguments advanced as to the purpose and effect of Section 4(1) and Section 3(a)(9) in relation to them.

Thus, where an issuer relies on Section 3(a)(9) for a transaction of exchange or a conversion (and I am treating both as exchanges), does it follow that the parties may ignore the first two clauses of Section 4(1) and Section 5 with reference to all subsequent transactions?

So far as I have been able to determine, the Commission has consistently maintained the positions described in Release 646(c) 18/; i.e., that the controlling person may not avoid registration after either the straight exchange or in the case of the convertible security, in reliance on Section 3(a)(9); and that an exchange may not be effected in reliance on Section 3(a)(9) if it is merely a step in a plan to evade the registration provisions of the Act. It is interesting to note that just as the Federal Trade Commission had said in 1933 (Rel. 97, Ill. 7) that for certain purposes the "transaction" exemption of Section 4(3) must be regarded as a "security" exemption, so in Release 646(c) the Securities and Exchange Commission concluded that for some purposes the security exemption of Section 3(a)(9) must be regarded as a "transaction" exemption.

The facts of the two cases to which Release 646 refers are interesting. In the first illustration, two commercial banks and an individual were creditors of the company on short-term notes. The notes were exchanged for temporary debentures in a transaction designed to convert the short-term debt into long-term obligations. Before issuing debentures in definitive form, the company inquired whether there was any problem under the Securities Act. The company claimed it had no knowledge as to the intent of the creditors as to sales of the definitive debentures. The Commission's General Counsel responded in a letter, the substance of which appeared as Ill. #1 in Release 646(c), and pointed out that formal compliance with Section 3(a)(9) would not necessarily afford an exemption.

The second letter referred to in the release referred to a proposal by a company to exchange new bonds for outstanding bonds in the hands of a person owning 87 per cent of the issuer's common stock. Counsel for the company argued that the exchange would be exempt by virtue of Section 3(a)(9) and therefore the securities issued in the exchange transaction would be exempt throughout their life. The General Counsel's letter, as set forth in the release, discussed the legislative history and purpose of the section at some length and concluded that the controlling person could not sell without giving full regard to the provisions of the second clause of Section 4(1) and the definition of "underwriter" in Section 2(11).

A third case was considered by the Commission at the same time but was not made the subject of a public release. At the instance of a corporation owning a large block of preferred stock of another company, the issuer of the

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18/ Release 646(c) was published in February, 1936.

preferred stock made an exchange offer to all preferred stockholders, offering a new preferred with a convertible feature and a lower redemption price. The large holder of the preferred--not a controlling person--proposed to sell the new preferred to an investment banker for resale to the public. Counsel for the issuer inquired whether the sale and resale of the new preferred would be exempt under Section 3(a)(9). The Commission's General Counsel in reply observed that the question of the application of Section 3(a)(9) where holders of large amounts of securities take other securities in exchange, with a view to distribution, is a difficult one. He concluded, however, that he would not recommend action by the Commission if the transaction proceeded without registration.

So you see the control case is considered clear. Likewise the "evasion" case is clear--if it can be so identified, but the difficulty is in determining what constitutes evasion, so it doesn't really solve anything.

Our files support the conclusion that the ordinary exchange of securities with public security holders in a Section 3(a)(9) transaction, particularly where there is no large concentration of ownership of one or more classes, presents no real problem. Obviously, it was never contemplated that the language of Section 2(11)---purchase from an issuer with a view to distribution---should be so strictly construed as to produce the absurdity that the security holder for whose protection the statute was enacted should become transformed into an underwriter with the attendant responsibilities and liabilities.

The in-between type of case, where control is not a factor, is the one I wish to discuss. Assume first a straight exchange of one security for another where the original security had been sold in a private placement in reliance on Section 4(1). Assume a second situation where a convertible security has also been sold in a private placement. Then assume a third case where an outstanding convertible security, which may have been registered on original issuance or which may have been sold prior to the effective date of the Act, has become concentrated in the hands of a number of large holders. In each case the holders wish to receive a new security in exchange for the original and sell the new to the public. In all three types of cases we encounter the proposition that the stock received on exchange or conversion is "free" stock and that Section 5 can be ignored as to resales.

The theory offered in support of the proposition is sometimes referred to as the "package" theory. In general, the argument runs that if the original security itself can be sold without registration, then the security received on conversion or exchange likewise can be sold without registration, since the security received in the exchange transaction must be regarded as having been "sold" when the original was sold.

As applied to the convertible security in the hands of one who acquired it in a Section 4(1) (private) transaction, the argument is that if the convertible security has been held under such circumstances as to satisfy

the condition of "taking for investment" then the holder, since in effect he bought the subject security in the original transaction, is free to sell that security when received upon conversion at any time.

This argument has a certain plausibility and appeal, particularly when presented by, and considered in terms of the business problem of, the owner and the dealer. Precisely this reasoning was proposed to and specifically rejected by the Commission as early as February, 1936, in its consideration of an inquiry as to the proper construction of Section 3(a)(11). A Michigan corporation proposed to sell debentures, immediately convertible into common stock, to residents of Michigan. Counsel, recognizing that, eventually, debentures might be presented for conversion by nonresidents of Michigan, was concerned whether the issuance of common stock upon conversion would destroy the 3(a)(11) exemption. In support of his position that the exemption would not be destroyed, his argument ran as follows: the sale of the debentures and of the right to convert being sold only to residents of Michigan would be exempt by 3(a)(11); it would seem, therefore, that the security subject to the right must also be exempt; otherwise, no convertible security could be issued under the exemption. Furthermore, he argued, Section 2(3) implies that, if the conversion right is exercisable immediately, there is a present sale of stock and, if there is a present sale of the stock, that sale likewise must be exempt under Section 3(a)(11).

The Commission's reply, which assumed the bona fides of the intrastate character of the debenture transaction, expressed the view that registration of neither the debentures nor the stock would be required. This conclusion was not based on concurrence with the argument of counsel. Our records show that the staff and the Commission considered that the issuer could properly rely on Section 3(a)(11) as to the debentures and on Section 3(a)(9) as to the common stock on conversion.

In later cases--construing Section 3(a)(9) under various circumstances--the Commission has ruled informally, and the staff has written letters in rather general terms expressing the view, that registration did not appear necessary, from which counsel, if they were thinking in terms of the "package" argument, might have concluded that the staff or the Commission agreed with it. For example, a letter issued by the staff in 1941 has been referred to as authority for a particular conclusion as to the applicability of Section 3(a)(9) to a conversion problem. The question with which the letter in question dealt was whether a note taken in a bona fide Section 4(1) transaction as a single instrument to avoid taxes might later be exchanged for debentures of equivalent terms in the event the purchaser at some future date might wish to sell some or all of its investment. This letter, which actually was concerned with the matter of breaking an obligation evidenced by a single instrument of large denomination into the same obligation evidenced by a large number of instruments of small denomination (which probably isn't a sale at all), apparently was considered as authority for the application of Section 3(a)(9) to other and quite different types of transactions.

It seems to me that the "package" doctrine as a guide for administering and enforcing the Securities Act overlooks too much of the purpose and meaning of Section 2(11) and particularly the language of the second clause of Section 4(1); i.e., transactions by an issuer not involving any public offering.

A convertible debenture or other convertible security consists of two securities--the convertible security and a right to acquire another security. The other security may or may not be issued by the issuer of the debentures, and it may or may not require some consideration other than the convertible security upon exercise. The offer of the debenture contains within it a continuing offer of the other security. A purchaser of the debenture acquires the debenture and a right and no more. If he sells the debenture, he sells also the right; the offer by the issuer of the other security made to the original holder by virtue of his ownership of the debenture becomes a continuing offer to the next purchaser and successive transferees. The offer terminates upon exercise or expiration of the right. The owner can at any time own only one security or the other; he can never own both. He remains a creditor until he chooses to become an owner of the equity security; the two interests never merge. The transaction of conversion is an exchange for value and, therefore, a sale under the Securities Act and under accepted commercial practice and understanding. The courts have held that the acquisition of the common on conversion is a purchase. 19/

Obviously, no issuer would consider that it had "sold" common stock to a purchaser of a convertible bond who remained a creditor throughout the life of the instrument. Economically, the purchaser of a convertible bond may consider that his capital is committed to a venture rather than to a security, but legally and in the commercial sense he has never changed his position until he exercises the right. 20/ I take it that proponents of the "package" theory would not carry it so far as to agree that a purchase of a security convertible immediately into common stock should be matched against a sale of common stock within six months for purposes of Section 16(b) of the Exchange Act even though that statute defines as an "equity security" a debt security which is convertible into stock.

The package theory, it seems to me, can offer no satisfactory universal solution to the questions which arise under Section 5 with respect to the resale to the public of securities issued in a transaction of conversion or exchange.

19/ Park & Tilford, Inc. v. Schulte, 160 F. 2d 984 (C.A.2, 1947); Kogan v. Schulte, 61 F. Supp. 604 (1945).

20/ Pratt v. American Bell Tel., 5 N.E.307 (1886); City of Philadelphia v. Philadelphia Transportation Co., 126 A. 2d 132 (1956); Chaffee v. Middlesex R.R.Co., 16 N.E.34 (1888); Lisman v. Milwaukee L.S. & W. Ry. Co., 161 F. 472 (1908); Parkinson v. West End St. Ry. Co., 53 N.E.891 (1899); P. W. Brooks & Co. v. North Carolina Public Service Co., 32 F. 2d 800 (1929); Cheatham v. Wheeling and Lake Erie R.R. Co., 37 F. 2d 593 (1930).

The books are full of hard cases and understandably the staff and the Commission have tended to decide a particular case on the facts of that case rather than to attempt to formulate a proposition of general application. If, however, the package doctrine is not acceptable as a theory of exemption, then if the distribution must be registered, it must be because some other principle must apply.

As I have reviewed the cases and the Commission's rulings, it seems to me that patterns can be perceived which perhaps can be stated as a broad proposition. I would phrase it this way.

The capital of a business is evidenced by debt and equity interests. If that debt or equity interest is a public interest, if it has been contributed by the public investor, if those interests are freely traded by public investors and transferred to other public investors, then, if Section 3(a)(9) is to have any meaning, transactions of exchange and conversion and subsequent sale should be freely conducted without there being any interruption of the normal trading processes of the market place by dealers and others. This should be so even though it may occur on occasion that a particular portion of the capital interest may come to be held in a large block or a few large blocks by non-controlling persons. It is implicit in the concept of trading that there be a constant change of identity of ownership and a constant flow of public capital in and out of securities. With that process we are not here concerned.

If, however, the capital of a business evidenced by a debt or equity interest is to be transferred for the first time to public ownership and thus public capital is to be substituted for non-public capital, in a transaction with which an issuer has a connection, then that process of substitution of capital is one as to which the registration process should apply.

Certainly, an issuer has a direct, intimate, and continuing connection with any offer it is making of a security whether by virtue of a right, conversion privilege or otherwise, so long as that offer continues. As cases are observed in which conversion prices are established close to market prices, as we witness forced conversions by issuers through calls for redemption with underwriting syndicates formed to distribute the underlying security for the protection of the issuer's cash position, as we observe the character of the membership of syndicates formed to acquire a private placement and the frequency with which transactions in securities coming out of an exchange or conversion or Rule 133 transaction find their way to the public investor at the time capital gains provisions begin to operate, it is hard to escape the conclusion that in many instances a public distribution was the hope if not the object of the parties in the first place. In these two-step operations, which in the case of the convertible require the linking of two exemptive provisions in order to avoid registration, the provisions of the first and second clauses of Section 4(1) should not be loosely construed to bolster a doubtful reliance on Section 3(a)(9). These are transactions involving a

public offering in which the connection of the issuer is not remote nor accidental. The stage for the subsequent transaction is always erected by the issuer itself in the first instance.

This approach may involve a reorientation of thinking as applied to the construction of the first and second clauses of Section 4(1) in certain transactions. Perhaps, to avoid hardship or unreasonable effort and expense in some situations, some additional rules or definitions should be considered.

Such an approach would mean that these matters be viewed primarily from the point of view of the issuer and its duty to the ultimate sources of its capital and secondarily with respect to the problem of whether some other interest might unhappily become a statutory underwriter.

Objections would be voiced that this undoubtedly would make impossible the sale of convertible securities in private placements. Without agreeing with this proposition, I would add to it the suggestion that it might make less likely the substitution of public capital for private capital by the issuer in a two-step process without registration.

There is nothing new in all of this.

The Commission in June, 1935, in the Brooklyn Manhattan Transit Corporation decision 21/, referred to the comment contained in the House Committee Report on the Act 22/ concerning the dealer exemption in Section 4(1):

"Paragraph (1) broadly draws the line between distribution of securities and trading in securities, indicating that the act is, in the main concerned with the problem of distribution as distinguished from trading. * * * * * * it exempts transactions by an issuer unless made by or through an underwriter so as to permit an issuer to make a specific or an isolated sale of its securities to a specific person, but insisting that if a sale of the issuer's securities should be made generally to the public that that transaction should come within the purview of the Act." The opinion goes on to observe that "Obviously an act designed to afford regulatory protection for investors in connection with the distribution of new security issues demands that its various parts should be construed in harmony with its general purposes."

This discussion should not be concluded without returning for a moment to Rule 133. Pages could be filled with nice, legal arguments for and against the theory underlying the rule and these arguments may be pursued in some other forum. What I have said this evening has had to do with transactions

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21/ 1 S.E.C. 147

22/ H. R. Rep. No. 85, 73d Cong. 1st Sess., pp. 15-16; Securities Act of 1933, House Committee on Interstate and Foreign Commerce.

following a merger or other transaction effected in reliance on an existing rule with which we work and which continues to be employed in accordance with its terms. What, if anything, should be done about the rule itself, I think, is more a matter of policy than it is one of law.

I don't know how the Commission views the matter--I can't imagine that any change would be made with respect to it without proposing at the same time some rules or forms which would attempt to recognize new problems which might thereby be created. In any event, any action by the Commission in this area must of necessity be the subject of full publicity and, I am sure, very full debate. Neither am I in a position to advise you how the Commission may rule on some of the other matters I have discussed, since some are involved in pending proceedings or pending litigation. In no event, however, can you err if you consider in your practice that "free" stock may not perhaps be so "free" if that freedom purports to spring from Section 3(a)(9) and Rule 133.

I will conclude my remarks with just one observation. I am sure you did not expect me to answer all the questions which have remained unanswered with reference to our subject this evening. There are many and there always will be. The important thing is that to the maximum extent possible, your answers and ours be right answers. Neither you nor we can afford serious error in a business so intimately connected with the savings and investments of the public.