



AMERICAN BAR ASSOCIATION

Section of Business Law
750 North Lake Shore Drive
Chicago, Illinois 60611
(312) 988-5588
FAX: (312) 988-6281

August 9, 1991

CHAIR
George Clemons Freeman, Jr.
207 E. Main Street
P.O. Box 1515
Roanoke, VA 24012

CHAIR ELECT
Larry P. Strigens
1100 Charles Center South
16 S. Charles Street
Baltimore, MD 21201

VICE CHAIR
John J. McCann
21 Prudential Plaza
Newark, NJ 07102

SECRETARY
Richard M. Phillips
1800 M Street, NW
Smith Lobby, 9th Floor
Washington, DC 20036

EXECUTIVE DIRECTOR
Thomas F. Baker
One Shell Plaza
Room 4650
Houston, TX 77252

SECTION DELEGATES TO
HOUSE OF DELEGATES
Elliott Goldstein
Atlanta, GA

Linda Wertheimer Hart
Dallas, TX

I. Michael Heyman
Berkeley, CA

Frank R. Morris, Jr.
Columbus, OH

PAST RETIRING CHAIR
Jean Allard
Chicago, IL

COUNCIL
The Officers,
Past Retiring Chair and
William M. Burke
Los Angeles, CA

Meyer Eisenberg
Washington, DC

George S. Trazza
New Brunswick, NJ

Larry J. Haynsworth IV
Caterpillar, IL

William G. Henry
Orlando, FL

Larry P. Kamen
New York, NY

Betty Lane Kirwan
Los Angeles, CA

Le Morales Marks
Washington, DC

Lames P. McLean
Purchase, NY

Stephen B. Mukhlisarski
Hartford, CT

Charles W. Murray, Jr.
Philadelphia, PA

Joseph I. Mulaney
Boston, MA

Maurice B. Pincus
St. Louis, MO

Timothy F. Schauer
Chicago, IL

Abraham M. Stanger
New York, NY

L. Norman Veasey
Wilmington, DE

LAW STUDENT LIAISON
K.C. Vaso
Denver, CO

YOUNG LAWYERS LIAISON
Walker H. White
Milwaukee, WI

BOARD OF GOVERNORS LIAISON
I. Stanley Chauvin, Jr.
Louisville, KY

SECTION DIRECTOR
Gene Tostler
Chicago, IL

Linda C. Quinn, Esq.
Director
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Mary E. T. Beach, Esq.
Associate Director - Small Business
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Revisions to Local Transaction
Exemption

Dear Linda and Mickey:

We are writing as members of the Task Force on Rule 147 of the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association to propose revisions to the local transaction exemption under the Securities Act of 1933 (the "Act") now reflected in Section 3(a)(11) of the Act and Rule 147 thereunder. The revisions we recommend are designed to expand the availability of that exemption in order to foster the capital raising opportunities for business entities. The views expressed in the letter do not represent official positions of the American Bar Association, the Business Law Section or the Federal Regulation of Securities Committee.

As you know, both the private bar and participants in the Securities and Exchange Commission's Small Business Capital Formation Forum have encouraged the SEC to revise existing rules, specifically current Rule 147, to expand the exemption for local transactions. This exemption has not been addressed in a comprehensive way since the adoption of Rule 147 in 1974 as a safe-harbor under Section 3(a)(11) of the Act.

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 2

Since that time Regulation D has been adopted and substantially modified with the active cooperation and involvement of the SEC, the American Bar Association and NASAA. In addition, state securities regulators have taken on an increasing role in the regulation of securities offerings. Also during this period, there has been increased recognition of the need to modify federal and state securities laws to facilitate capital formation activities, particularly for small businesses, where this can be done consistent with the protection of the interests of investors.

We believe that recognition of the importance of eliminating unnecessary impediment to capital raising efforts, the increased role of state securities regulation and the experience gained through the development and operation of Regulation D and similar regulatory initiatives such as ULOE, Rule 701, Form S-18 and Form U-7 make this an appropriate time to revisit and revise the local transaction exemption.

The objective of the revision should be to create a workable exemption from federal registration requirements consistent with the policy underlying Section 3(a)(11) of the Act for offerings of a local nature that can best be left to regulation by the states. A workable exemption of this sort will assist smaller corporations and partnerships with clear local nexus, which more often than not raise funds locally, in meeting capital raising regulatory requirements. This is consistent with the approach taken under Rule 504, but the capital needed by local business and investment entities often exceeds the Rule 504 limit.

We believe that a workable local transaction exemption should be developed using the Section 3(b) exemption for offerings within the \$7.5 million limit of Section 3(b) in order to avoid statutory requirements of Section 3(a)(11) which may be unduly restrictive. Thus, certain Section 3(a)(11) statutory requirements would then be applicable only in the case of offerings exceeding the Section 3(b) limit. On some provisions, the full 3(b) limit (as it may from time to time be changed) would be appropriate; on others, a lower limit might be used. The combination of Sections 3(b) and 3(a)(11) in this way would introduce flexibility that would permit shaping a truly workable local transaction exemption. Regulation D provides a useful model for the combination of two statutory exemptions to provide an integrated exemption scheme applying progressively more stringent requirements as the offering size increases.

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 3

We phrase our suggestions below in terms of revisions to Rule 147. We recognize, however, that our approach might best be implemented by a series of related rules, comparable to Regulation D.

Summary

Our recommendations for modification of the local transaction exemption discussed below include:

- Inclusion in Rule 147 of a number of the concepts developed under Regulation D, such as reasonable belief tests, substantial compliance relief and focus on purchasers rather than offerees.
- Redefinition of permissible residence for purposes of the local transaction exemption to recognize that purchasers can have more than one residence and that residence is determined at a defined time, and inclusion of safe harbors for determining residence.
- Elimination of the state of incorporation test for issuers to the extent statutorily permissible and redefinition of the doing substantial business tests.
- Development of a local transaction exemption which could cross state lines using Section 3(b).

Conformance with Regulation D

Rule 147 should be updated to conform with several of the approaches taken in Regulation D. These include the following:

- A substantial compliance provision similar to Rule 508 that would make clear, for example, that an inadvertent sale to a single non-qualified purchaser would create liability only to that purchaser but not to others, should be added to Rule 147.
- A reasonable belief test should be added so that requirements such as the residence of the purchaser could be satisfied by either the existence of the fact or a reasonable belief as to the fact.
- The Rule 147(d) limitations should apply, to the extent statutorily permissible, to purchasers and not

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 4

offerees, for the same reasons that Regulation D focuses solely on purchasers. In this connection, the limitations under Rule 147(d) could be made applicable solely to purchasers for offerings within the Section 3(b) limit. In addition, the rule could recognize the effectiveness of legends limiting the offering to residents so that the appearance of information on the offering outside the local area would not result in disqualifying offers. At the same time, such legends would alert the investment community to the limitations on the offering. These steps would allow businesses to proceed with efforts to raise capital under a local offering exemption without tripping up on offers to persons who turn out not to be residents. In addition, they would facilitate the use of local media such as newspapers which are targeted primarily to a local market but which might have limited circulation beyond the local area.

• Rule 147(f) should be conformed to the philosophy of Rule 502(d) by requiring reasonable steps to prevent disqualifying resales and disclosure of resale restrictions but it should not impose specific actions as conditions to the exemption.

Changes to Rule 147 to Expand its Availability

Purchaser Residence. We recommend that a more expansive definition of residence be adopted for purposes of the local transaction exemption. Use of the local transaction exemption would be simplified and the pool of potential investors expanded consistent with the purpose of the exemption (i) if Rule 147 made clear that a person can have more than one residence and still come within the residence requirements of the Rule and (ii) if a safe harbor for determining residence was established. To the extent this suggestion may present a statutory problem under Section 3(a)(11), the relaxed requirement might be applicable only for offerings within the Section 3(b) limit.

Many investors typically spend substantial parts of the year in more than one state. Amending Rule 147 to allow a person to maintain a dual residence and still be in compliance with the exemption requirements would permit individuals who spend significant portions of the year in different states to be a local resident in each state for purposes of utilizing the local transaction exemption. For example, many investors have

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 5

permanent connections with a northern state, but for estate tax or other reasons maintain a residence and regularly spend a substantial portion of the year in a warm state. Such individuals should be treated as "local" investors at both homes for purposes of the exemption. In addition, a person who lives in one state and works in another should be considered "local" in both states.

Residence is usually identified by certain objective indicia. We believe it would be advantageous to create a safe harbor in Rule 147 to permit a residence to be established for purposes of the exemption by any of the following: (1) the jurisdiction in which a person owns or leases, under a lease for an initial term of at least one year, a place of residence which is maintained for the person's personal residence; (2) the jurisdiction in which a person maintains certain other indicia of residence (such as driver's license, voting registration, tax situs, etc.); or (3) the jurisdiction in which a person's principal occupation is based.

Rule 147 should also provide for the time when residence is to be determined. For example, residence should be fixed only at the time of sale when there is deferred or installment payments rather than at each payment date. Cf. Protective Real Estate Trust (July 17, 1972). Also, the residence of employees receiving compensatory options should be fixed at the time of grant. Cf. Synbiotics Corp. (August 22, 1985).

Issuer Residence. Use of the local transaction exemption by corporations and partnerships would be facilitated if the issuer's residence under Rule 147(c)(1)(i) is considered to be the place where the issuer's principal operations or executive offices are located rather than the place where it is incorporated or organized. These are concepts that have been well developed in other areas of the law and could easily be incorporated into the rule.¹ Section 3(a)(11) penalizes issuers that use the laws of states such as Delaware to take advantage of well established bodies of corporate or partnership law. In view of the practice of corporations, partnerships and other entities

¹ See, for example, 28 U.S.C.A. §1332(c) (dealing with diversity of citizenship of corporations) and §9-103(3)(d) of the Uniform Commercial Code and Official Comment 5(d) (identifying the "chief executive office" of a business as the place to perfect a security interest in certain collateral).

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 6

to incorporate and organize in jurisdictions outside their home state, it is unnecessarily restrictive to deny them the ability to use a local transaction exemption to raise capital in their home state. Given the statutory problem under Section 3(a)(11), the application of this change to corporations could be limited to offerings within the full Section 3(b) amount.

Rule 147(c) provides that a qualifying issuer must have 80% of its gross revenues and assets within the relevant state, as well as use at least 80% of the proceeds within that jurisdiction. In addition to clarifying the meaning of the percentage tests, case law suggests that Section 3(a)(11) requires a lower standard than 80% since the purpose of the tests is to verify the local nature of the offering.² Consideration should be given to lowering, eliminating or modifying these tests. In addition, it may be appropriate to change or eliminate the use of proceeds test to permit issuers to apply proceeds out-of-state so long as the issuer will continue to meet the local issuer test after giving effect to the use of proceeds. This would increase the ability of local issuers to use the exemption. Also, Rule 147 should codify the staff's view that the gross revenues test does not prevent start-up companies from using the exemption.

Integration.

The staff position taken consistently since 1983 that concurrent local offerings and offers to non-United States residents do not preclude a local transaction exemption should be codified.³ Also, the concept embodied in Rule 152 that a

² See, Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969) (requiring issuer to conduct a "predominant" amount of its business within its state of residence); SEC v. Asset Management Corp., CCH Fed. Sec. L. Rep. ¶97,278 (S.D. Ind. 1979); SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957); SEC v. McDonald Inv. Co., 343 F. Supp. 343 (D. Minn. 1972). See also, Busch v. Carpenter, 827 F.2d 653 (10th Cir. 1987). Compare, SEC Release 33-4434 (equating doing business with "substantial operational activities"). Terms such as "predominant" and "substantial" imply something less than the 80% standard of Rule 147.

³ See, Scientific Manufacturing, Inc. (May 12, 1983); Wagner, Rummonds, Murphy and Vaughn (February 12, 1987); First National Bank & Trust Co. (November 18, 1985).

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 7

subsequent public offering will not defeat an otherwise valid private offering should be extended to local offerings.

Similar to Regulation D, local offerings should not be integrated with offerings under Rule 701 so that local businesses may provide equity to directors, officers and employees without regard to their residences while raising capital locally.

Local Transaction Exemption Crossing State Lines.

We believe that the scope of Rule 147 should be expanded, using the statutory authority of Section 3(b), to permit certain prescribed offerings that cross state lines but are essentially local in nature. This provision could apply to offerings that do not exceed \$7.5 million or some lower amount. It would reflect the policy considerations in Section 514 of the proposed Federal Securities Code. It would also recognize the cooperative efforts undertaken by state securities regulators and further encourage such efforts by continued federal delegation to the states to regulate local offerings. For example, an offering could have multi-state aspects and still be considered "local" if the transaction is confined (1) to one standard metropolitan statistical area, (2) to purchasers having residences that may be beyond the state boundary but within a prescribed distance from the issuer's principal place of business, or (3) to states that have identified themselves as a single region for these purposes. Currently, the local transaction exemption is available only for a transaction in which the issuer and purchasers are all resident in one state but not for a transaction in which one purchaser claims residence just over the border in a neighboring state. The change we suggest would alleviate this unnecessarily restrictive result in transactions which are both clearly local and within the Section 3(b) limit. State boundaries are not the only appropriate measure of what constitutes an economically local transaction.

A local transaction exemption under Section §3(b) would also provide broader latitude to relax certain other requirements of Section 3(a)(11). For example, it would be possible to require only 90% of the purchasers to be local residents.

Secondary Distributions

As applied, Rule 3(a)(11) is available for both primary and secondary distributions. Consideration could be given to making Rule 147 available for secondary distributions. The policy of leaving regulation of local transactions to the states is equally

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 8

applicable to secondary distributions. Liquidity for investors would be improved, which in turn would enhance the ability of companies to raise capital. In addition, since investors are restricted in the ability to resell securities purchased in a local offering outside the jurisdiction, they should have a clear local transaction exemption available to them.

State Regulation

The approach taken by Rule 504 of leaving certain smaller offerings to the states to regulate has proven to be sound. This is demonstrated by the increase in the permitted size of Rule 504 offerings and the development of Form U-7 for state registration of small corporate offerings. We believe that a similar approach is justified for local offerings and the suggestions we have made are designed to accomplish this.

Upon creation of a workable federal local transaction exemption under the Act, the states will be in a position to focus on the appropriate regulation of these offerings. For example, development of a limited offering exemption along the lines of the Regulation D - Uniform Limited Offering Exemption may be appropriate for essentially private local offerings. It also might make sense to expand the availability of Form U-7 to allow its use for certain local public offerings. In addition, the states might choose to deal regionally with local offerings that cross state lines. Federal initiative in this area along the lines we suggest would continue the process of coordinating federal-state regulation of capital raising activities.

* * *

We hope you will agree that these proposed changes to Rule 147 are desirable to conform to the philosophy underlying the changes to Regulation D and the other recent initiatives designed to facilitate the capital formation process and that they are necessary to increase the practical availability of the local transaction exemption. By increasing the ability of issuers to use this exemption, the changes we propose would significantly aid financing for smaller regional business entities.

Our task force would be pleased to discuss the foregoing concepts more fully with you, with a view toward developing a specific rule or rules. Please let us know whether you believe this effort merits further joint consideration.

Linda C. Quinn, Esq.
Mary E. T. Beach, Esq.
August 9, 1991
Page 9

Thank you for considering the views expressed in this letter. Your attention to this is greatly appreciated.

Very truly yours,

Marc H. Morgenstern

Marc H. Morgenstern, Co-Chairman

Carl W. Schneider

Carl W. Schneider, Co-Chairman

Stanley Keller

Stanley Keller