The State Administrative Fairness Hearing and Section 3(a)(10) of the Securities Act—Some Questions

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THE STATE ADMINISTRATIVE FAIRNESS HEARING AND SECTION 3(a)(10) OF THE SECURITIES ACT—SOME QUESTIONS

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Since the passage of the Securities Act of 1933, lawyers have been looking for ways to help their clients issue securities without the time and expense inherent in the registration required by the Act. Some attention has been turned to section 3(a)(10) as a means for accomplishing this goal.¹ The purpose of this article is to consider one type of transaction qualifying under the 3(a)(10) exemption—the state administrative fairness hearing.²

¹ It should be clear from the outset that the antifraud provisions of the 1933 and 1934 federal securities acts are still applicable if the 3(a)(10) exemption is used. See Securities Act of 1933 §§ 3(a), 12(2) & 17(c), 15 U.S.C. §§ 77c(a), 77l(2) & 77q(c) (1964); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1964); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970).

² In a related area, the Securities and Exchange Commission recently alleged that there have been attempts to use chapter 11 bankruptcy proceedings as part of a scheme for issuing new securities without registration. See, e.g., SEC v. Otis Oil and Gas Corp., Civil No. 70-2226 (N.D. Cal., complaint filed Oct. 14, 1970). In skeletal form, the scheme is as follows: Corporation A enters chapter 11 proceedings; Corporation B then attempts to purchase certain assets of A by issuing stock to A's unsecured creditors in return for their claims against A and upon condition that A satisfy the claims by conveying the desired assets to B. Technically, B proposes an arrangement to A in which B issues its stock to A for A's assets; A then distributes the B stock to its unsecured creditors for their claims. Due to the nature of chapter 11, this offer (as subsumed in the arrangement) is made to the creditors even before the court has a chance to consider the arrangement. See Bankruptcy Act § 335, 11 U.S.C. § 735 (1964). Only if the requisite number of creditors accept, is the arrangement submitted to the bankruptcy court for its approval. See Bankruptcy Act §§ 361 & 382, 11 U.S.C. §§ 761 & 762 (1964). Upon the court's approval, B's securities are issued "for" A's assets. Allegedly, on the basis of Bankruptcy Act section 393, no registration is undertaken. See Bankruptcy Act § 393, 11 U.S.C. § 793 (1964). Often, the former A creditors, not B shareholders, immediately sell their new stock. Thus, B's stock is offered to the public without a 1933 Act registration statement being filed and a prospectus being made available.

The legality of this transaction will not be specifically discussed in this article, as it is unlikely to be used often—at least in part because chapter 11 usually involves trade creditors, as opposed to investor creditors, e.g., debenture holders. See SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965). Such creditors are usually most interested in keeping the debtor operational so that they can continue doing business with it; and they generally think it more likely that they will retain this business if the old management, whom they know, is perpetuated. Also, historically, chapter 11 was only used to defer or compromise unsecured creditors' claims. There is some question as to whether it can be used as a means for partially liquidating the debtor. See generally In re May Oil Burner
No attempt will be made to discuss systematically all aspects of the exemption. The following analysis contains a discussion of the relationship required by 3(a)(10) between the state holding the hearing, e.g., California and the corporations involved in the exchange; whether use of that part of the California statute which authorizes a fairness hearing for companies exempt from qualification under the California securities law can provide a 3(a)(10) exemption; and whether 3(a)(10) provides a security or transaction exemption.

BACKGROUND — THE TRANSACTION

The basic transaction under consideration relies upon the exemptive power of the various state commissions "expressly authorized by law" to hold hearings "upon the fairness" of the terms and conditions of an exchange of "any security . . . for one or more bona fide outstanding securities, claims, or property interests, or partly in such exchange and partly for cash," and grant approval "of such terms and conditions." There are at least two typical exchanges. In the first, often called a "stock swap," Corporation X seeks to purchase the shares of Corporation Y, a company with several shareholders, by issuing X stock to Y's shareholders for their Y stock. This type of transaction may qualify as a "B" reorganization if X offers only voting stock and, immediately after the exchange, owns 80 percent

Corp., 38 F. Supp. 516 (D. Md. 1941), which holds that the rights of the debtor's shareholders cannot in any way be tinkered with in chapter 11. Among other things, an arrangement calling for the sale of all the debtor's assets, if the approval of the debtor's shareholders would be required for such sale by the relevant state law, would contain a prohibited "tinkering." Finally, a detailed analysis of the above scheme would require a consideration of section 393 of the Bankruptcy Act, which exempts securities issued pursuant to a chapter 11 arrangement from the registration and prospectus requirements of the 1933 Securities Act. While 3(a)(10) and section 393 have many similarities, they have somewhat different wording and thus might have some differences. Nonetheless, many of the following observations also apply to section 393.

As long as shareholder acceptances cannot be solicited before Commission approval, there is no need for an identity of issuer requirement. See SEC Securities Act Release No. 296 (Feb. 15, 1935); 1 L. Loss, Securities Regulation 587-88 (2d ed. 1961, Supp. 1969) [hereinafter Loss]. Thus, a "stock swap" is permissible. Since 3(a)(10) exempts "any security" issued in a proceeding meeting certain requirements, the wording of the section encourages a "no identity" interpretation, a factor which, when coupled with the legislative history, probably caused Professor Loss to report that it is the law. 1 Loss 585. A "no identity" interpretation, though, would be inappropriate if, as for example in a chapter 11 proceeding, the trade creditor's assent to the plan were required before court approval; the trade creditor being thought adequately protected because, inter alia, of his presumed intimacy with the debtor. See SEC v. American Trailer Rentals Co., 379 U.S. at 613-14. However, section 393 of the Bankruptcy Act has wording similar to 3(a)(10). It exempts "any transaction in any security issued pursuant to an arrangement in exchange for claims against the debtor." Perhaps, this broad language has caused at least one commentator to suggest, without other support, that there is no identity of issuer requirement. See 9 W. Collier, Bankruptcy ¶ 12.03, at 658-59 (14th ed. 1969).
of all the Y stock. In the second situation, Corporation Z seeks to readjust its capital structure by issuing unissued or treasury securities for those shares presently outstanding, e.g., exchanging stock for outstanding debentures. This procedure is often termed a "recap."

In both the "stock swap" and the "recap," state law may require that their judiciary or securities commission approve the exchange before it can be implemented. Even if state approval is not required, the issuer may seek review by a properly authorized state commission in the hope of obtaining a 3(a)(10) exemption from registration under the Federal Securities Act. The section exempts

> any security which is issued 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.

At least three states have attempted to phrase their Blue Sky Laws to conform to the requirements of 3(a)(10)—California, Oregon and Ohio. This article will examine the California proceeding, since it has probably been the state hearing most widely used to gain the exemption.

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6 It also may be construed as a takeover bid and thus be subject to state regulation. See, e.g., OHIO REV. CODE ANN. § 1707.041 (Page 1969); VA. CODE ANN. § 13.1-530 (Cum. Supp. 1968).
7 Section 3(a)(9) of the 1933 Act could provide an exemption for this transaction if its requirements are met. 15 U.S.C. § 77c(a)(9) (1964).
8 Even if a state purports to regulate only those parts of the transaction occurring within its borders—e.g., 25120 of the California Corporations Code refers to "an offer or sale in this state"—the practical effect of such a state rule might be the regulation of the entire "recap" since the trust indenture might require all debenture holders to be treated identically or state law might prohibit "preferment" for any reason. Alternatively, if there are only a few shareholders in the state, the state's rules might be "overlooked." Cf. Loss, The Conflict of Laws and the Blue Sky Laws, 71 HARV. L. REV. 209, 213-14 (1957). Moreover, states sometimes seek to control certain actions of all corporations, whether domestic or foreign, at least if there are sufficient contacts with the state. For an extreme example, see Western Airlines v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (2d Dist. Ct. App. 1961), discussed at note 36 infra.
10 ORE. REV. STAT. ch. 56, § 59.095 (1967).
THE CALIFORNIA BLUE SKY LAW

Under the California Corporations Code, section 25142 specifically authorizes the Corporations Commissioner to approve the fairness of the terms and conditions of qualifying exchanges:

When application is made for a permit to issue securities (whether or not the security or transaction is exempt from qualification) in exchange for one or more bona fide outstanding securities, claims, or property interests, or partly in such exchange and partly for cash, the commissioner is expressly authorized to approve the terms and conditions of such issuance and exchange and the fairness of such terms and conditions, and is expressly authorized to hold 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 have the right to appear.\(^{13}\)

Sections 25110 and 25120 which respectively state the basic qualification requirements for issuer\(^ {14}\) and recapitalization and reorganization transactions,\(^ {15}\) do not distinguish between foreign corporations, \textit{i.e.}, those incorporated outside of California, and those incorporated therein. These provisions emphasize the fact that “[i]t is unlawful for \textit{any issuer} to offer or sell in [California] . . . any security issued by it . . . unless [the sale or security is qualified].”\(^ {16}\) Furthermore, an issuer is defined as “\textit{any person who issues or proposes to issue any security}.”\(^ {17}\) Thus, the California Blue Sky Law applies to all corporations offering or selling securities in California that do not receive a specific exemption.\(^ {18}\)

There are numerous exceptions. In regard to foreign issuers, section 25103(b) and (c) provides exemptions from the qualification requirements of sections 25110 and 25120 for any transaction which contains


\(^{14}\) \textit{i.e.}, the normal offer and sale of securities by an issuer “whether or not by or through underwriters.” Id. § 25110.

\(^{15}\) \textit{i.e.}, a security issued by any issuer “in connection with any change in the rights, preferences, privileges, or restrictions of or on outstanding securities,” or in exchange with existing security holders or in a merger, consolidation or a purchase of corporate assets. Id. § 25120.

\(^{16}\) Section 25110 provides that “[s]uch sale must be qualified under Section 25111 [coordination], 25112 [notification] or 25113 [permit] . . . .” (emphasis added). Section 25120 provides that “the security [must be] qualified for sale under this chapter [permit] . . . .” (emphasis added).

\(^{17}\) Id. § 25010.

\(^{18}\) \textit{E.g.}, id. §§ 25100, 25102. Additionally, the Commissioner of Corporations has the power to exempt from sections 25110 and 25120 any other transaction “as not being comprehended within the purposes of [this] . . . law and the qualification of which he finds is not necessary or appropriate in the public interest or for the protection of investors.” Id. § 25105.
any change in the rights, preference, privileges, or restrictions of
or on outstanding securities, unless the holders of at least 25 per-
cent of the outstanding shares or units of any class of securities
which will be directly or indirectly affected substantially and ad-
versely by such change have addresses of this state according to the
records of the issuer; or [a]ny exchange incident to a merger, con-
solidation, or sale of corporate assets in consideration of the is-
suance of securities of another corporation, unless at least 25 per-
cent of the outstanding shares of any class, the holders of which are
to receive securities of the surviving consolidated or purchasing
corporation, are held by persons who have addresses in this state
according to the records of the corporation of which they are share-
holders.\(^{19}\)

However, as the “outstanding shares” aspect of the 25 percent test
neither includes securities which the issuer knows are in street name
nor “any securities controlled by any one person who controls directly
or indirectly 50 percent or more of the outstanding securities of that
class,”\(^ {20}\) the exemption may be considerably narrowed, especially for
smaller companies.

**THE NEXUS PROBLEM**

Two eminent securities scholars have suggested that “there are
serious doubts whether a corporation may bootstrap itself into a sec-
tion 3(a)(10) exemption by using a statute of a state with which it has
no substantial connection.”\(^ {21}\) What nexus, if any, should be required?
Is a sufficient relationship established if the principle office of the
corporation is in the state?\(^ {22}\) Is choice-of-law doctrine relevant in
establishing the requisite relationship?\(^ {23}\) Should the fact that a state’s
Blue Sky Law requires it to control the exchange between the out-of-
state corporation and its shareholders or debenture holders resident in
the state be a sufficient predicate for permitting that state’s fairness

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\(^{19}\) Id. § 25103(b) & (c).

\(^{20}\) Id. § 25103(d).

\(^{21}\) R. Jennings & H. Marsh, Securities Regulation 474-75 n.12 (2d ed. 1968); see also sec. Problems of Controlling Shareholders and in Underwritings 71 (C. Israels ed. 1962).

\(^{22}\) See H. Marsh & R. Volk 242.

\(^{23}\) It should be remembered that choice-of-law thinking is today in a state of flux. Both editions of the Restatement emphasize predictability, uniformity and simplicity of regulation. See Restatement (Second) of Conflict of Laws § 302, Topic 5 (Proposed Official Draft 1969); Restatement of Conflict of Laws § 192, Topic 5 scope note (1934). These considerations underlie the rule that generally, only the state of incorporation should regulate a corporation's internal affairs — issuance of securities being regarded as an "internal affair." Other theories, based on an "interest analysis" approach, stress a state's "interest" in applying its law to the particular multistate transaction being considered. They would therefore, abandon the "internal affairs" concept. See generally D. Cavars, The Choice of Law Process (1965).
hearing to provide an exemption from the registration requirements of the 1933 Securities Act? Suppose a state's choice-of-law rules would permit it to regulate the exchange, but the corporation has received an exemption from the state's Blue Sky Law; if the corporation seeks and receives the benefit of a state fairness hearing, should the hearing satisfy the requirements of section 3(a)(10)?

According to the General Counsel of the SEC, the basic theory of section 3(a)(10) is that "the examination and approval by the body in question is a substitute for the protection afforded to the investor by the information which would otherwise be available to him through registration." Such a notion, if extended to its logical extreme, would lead to the conclusion that any time a governmental authority is "expressly authorized by law to grant [the requisite] approval," at least the exchange transaction, i.e., the "stock swap" itself, should be exempted from the registration and prospectus requirements of the 1933 Act. It should not matter whether the approving state's governmental authority had a sufficiently significant relationship or interest under choice-of-law thinking as long as it had the opportunity to make a full investigation and create a complete record before granting approval and actually did so.

Some lawyers have accepted this position and have advised their clients accordingly. California procedure does not prevent such counselling because

[t]he policy of the Department of Corporations [is] . . . to grant a hearing for the purpose of qualifying a transaction for the Section 3(a)(10) exemption . . . if the attorney filing the application is prepared to render an opinion that the circumstances are such that the transaction will be exempted. In other words, the Department will not undertake to determine for counsel for the issuer whether he will in fact obtain an exemption . . . as a result of the hearing.

Nevertheless, most lawyers do not counsel on the basis of the above theory, especially as there is some basis for believing that the SEC will not accept it. The staff of the Commission has indicated at least one situation where the 3(a)(10) exemption would not be applicable even though all of its requirements are met — i.e., "in a situation where there is only one or a 'small number' of shareholders of the corpora-

24 For example, a state following an "interest analysis" approach might normally regulate "stock swaps" involving its residents unless its residents constitute less than a specified percentage of the shareholders receiving the tender offer. Of course, this exemption might imply that there is no strong state interest in regulating this exchange.


tion to be acquired.” Moreover, most lawyers feel that the exchange and court review must be bona fide, and that administrative review by a state without substantial contacts would not be, as it seems “evasive.”

It is not analytical, and therefore not helpful, to criticize the above noted liberal approach by formalistically intoning that “any exemption should be strictly construed.” Such incantation is not sufficiently responsive to the legislative “purpose.” The first task, then, is to reassess the congressional intent behind 3(a)(10).

While the SEC’s General Counsel has implied that the main concern of section 3(a)(10) is to insure the effectuation of an adequate review of the exchange’s fairness, such a review cannot be completed until a sufficient investigation of the issuing corporation has been made. Of course, such an investigation also helps shareholders and creditors gain access to the information they would have received if registration had occurred. In fact, given the general disclosure philosophy of the Securities Act, a precept based on the notion that the federal government is not interested in preventing a fool and his money from being separated, such disclosure incorporated into the...


As a matter of policy, the SEC disclaims responsibility for any private publications by its employees. All of Mr. Corotto’s comments referred to in this article reflect his own views, and are not necessarily those of the Commission.

28 The committee reports discussing section 4(3) of the 1933 Act, the forerunner of 3(a)(10), speak of a “bona fide reorganization of [a] corporation under the supervision of any court.” H.R. REP. No. 152, 73d Cong., 1st Sess. 25 (1933) (emphasis added). In discussing section 3(a)(9) of the Securities Act, the General Counsel of the SEC stated his belief that the section “is applicable only to exchanges which are bona fide, in the sense that they are not effected merely as a step in a plan to evade the registration requirements of the Act.” SEC Securities Act Release No. 646 (Feb. 3, 1936). Illustrating a plan to evade registration, the General Counsel posed a hypothetical of an issuer issuing a large block of stock to X (presumably pursuant to some exemption), then exchanging, pursuant to 3(a)(9), new stock for the previously issued block with the understanding that the new stock is to be offered to the public. See also 1 Loss 585 n.96. However, while both the committee reports and the General Counsel’s opinion clearly indicate the need for a bona fide exchange, neither indicate a need for a nexus requirement. In fact, the committee report might be read to indicate the contrary. Cf. SEC Securities Act Release No. 312 (Mar. 15, 1935). A nexus rule should only be required if it is needed to fulfill the purposes of the Act. See text accompanying notes 43-48 infra.

30 Cf. Jennings, The Role of the States in Corporate Regulation and Investor Protec-
public record would seem to be an essential, rather than incidental, aspect of the exemption. The Supreme Court, by quoting with approval the following statement when discussing disclosure under chapter 11 of the Bankruptcy Act in SEC v. American Trailer Rentals Co.,\(^3\) seems to confirm this analysis:

No authority has been found which would indicate that recipients of stock issued in connection with an arrangement are not entitled to as much information as are those persons acquiring stock under ordinary conditions.\(^2\)

In other words, Congress probably "thought" that in order to facilitate the reorganization many businesses needed during the 1930's, the registration provisions of the Securities Act should be dispensed with if a thorough judicial or administrative hearing were held to elicit all essential information. However, because of the unstructured, rambling and primarily oral nature of the hearing, the difficulty for the shareholder or creditor to comprehend the myriad technical details so presented, the inability of such shareholders and creditors to easily review or obtain copies of the evidence presented,\(^2\) the great expense to each shareholder or creditor of attending or having a representative at the hearing, the lack of a federal proxy system at that time, and the erratic nature of state disclosure requirements, the exchanging creditor or shareholder needed a supplement to fairness hearing disclosures—approval of the fairness of the terms of the exchange by a governmental authority. The question, then, is whether a nexus requirement is necessary to satisfy such legislative intent.

It takes considerable skill, practice and knowledge to adequately investigate and evaluate a corporate "recap," "stock swap," or other exchange. Perhaps, not many states would have many, if any, officials capable of undertaking the task.\(^3\) Insofar as a sufficient supply of

\(^3\) See Note, Protection for Shareholder Interests in Recapitalizations of Publicly Held Corporations, 58 Colum. L. Rev. 1030, 1033, 1034 (1958), and sources cited therein.

\(^3\) Today, this difficulty could be somewhat alleviated due to the Commission's microfiche reproduction system. See THE WHEAT REPORT 63-64, 913-18.

\(^3\) Cf. Note, supra note 33, at 1066. As to whether this investigation should be undertaken by a court or an agency, see id. at 1065-66. See also Comment, Effect of Section 3(a)(10) of the Securities Act as a Source of Exemption for Securities Issued in Re-
capable personnel cannot be found, the disclosure and backstop purposes of 3(a)(10) discussed above could be frustrated. While this problem is unavoidable as long as section 3(a)(10) is in effect, it could be minimized if the exemption were restricted to transactions in which the state had a substantial nexus with the corporation seeking the exemption. Absent budgetary problems, the major corporate and commercial centers, if they chose to satisfy 3(a)(10)'s requirements and bestow the exemption, probably have, or could arrange to have, sufficient personnel with appropriate knowledge and background.

Such a restriction is further recommended by the fact that even if the state has personnel competent to handle the variety of exchanges which can qualify under 3(a)(10), such officials, if in short supply, would probably be quite busy. In brief, they might not have sufficient time to make an adequate investigation and analysis. Besides, if the state has only a minimal stake in the transaction, and especially if the state's only contact with the corporation or corporations involved in the exchange were that a few residents would receive the new securities, a careful review of the proposed exchange would be low on the

organization, 45 Yale L.J. 1050 (1936) (an article characteristic of the era of administrative omniscience).

Another problem involving state regulation is the fact that the different states have Blue Sky regulatory policies of varying stringency. A similar problem is caused by the drafters' failure to specify in the Securities Act as to whether local or federal notions of "fairness" control. California applies its own fairness rules in section 25142 hearings. Interview of Albert Salera, Senior Corporate Counsel, Office of the Commissioner of Corporations of California, by Richard B. Glickman, Jan. 14, 1971 [hereinafter Salera/Glickman Interview]. All of Mr. Salera's opinions noted herein are his alone, and do not necessarily reflect the official views of the Commissioner and his office. See generally CAL. ADMIN. CODE § 260.140 et seq., especially §§ 260.140.60-260.140.62 (1969), 1 BLUE SKY L. REP. ¶ 8616 et seq. (Nov. 2, 1970). See also H. MARSH & R. VOLK 200-95. For example, at one time in California, cumulative voting was required in order for fairness to be established. See Western Airlines v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (2d Dist. Ct. App. 1961). While this requirement is not responsive to the disclosure and antifraud premises of the 1933 Act, it is not unreasonable to impose it on a corporation receiving the benefits flowing from California's approval of its exchange. After all, corporations not exempt from the normal California requirements must satisfy them regardless of the 1933 Act exemption; corporations voluntarily seeking the benefits of California's approval should at least comply with all of its laws. However, since local views of fairness may differ so that the approval of some states may not offer security holders much protection, certain minimum requirements should be federally imposed. Cf. S. REP. No. 47, 73d Cong., 1st Sess. 4 (1933). A federal rule regarding burden of proof might even be sufficient. It should be noted, though, that if there is a federal standard presently in operation, it is probably not too severe. Compare the apparently cursory review required of a court supervising a chapter 11 proceeding. See In re Graco, Inc., 364 F.2d 257 (2d Cir. 1966).

37 Section 25142 can only be invoked by an application "to issue securities . . . in [an] exchange." CAL. CORPS. CODE § 25142 (West 1968). Since no permit is needed if no securities are to be offered or sold to California "residents," cf. id. § 25103(b) & (c), the Commissioner of Corporations might decline jurisdiction, refuse to hold a hearing or refuse to find the exchange fair if no residents were involved. The "regardless of exemp-
list of state priorities. While pride might encourage the state employee making the investigation and review to be careful, thoughtful and thorough, such attitudes would probably be applied in direct relation to the demands on their time and the importance of the task. It is common knowledge that all work is done in terms of a cost-benefit scale—more important work being given greater attention, less important tasks receiving only that care as time permits.

Moreover, because of the problems of sophistication and time pressure, the adversary process becomes quite important. For example, although the California Corporations Commissioner independently reviews all exchanges and, on occasion, has found unfairness even when there were no objections, the pressures noted above probably often foster findings of "fairness" when strong shareholder or debtor dissent is not present. A nexus test requiring a minimum number of shareholders or debtors to reside in the approving state would increase the likelihood that all objections will be voiced. While even one well-informed dissident shareholder or creditor could adequately assist an unsophisticated or harried administrator, there is no guarantee that all objections to a plan of exchange will be brought forth, if, for example, a California hearing were held to consider a tender offer by a Delaware corporation which does no business west of the Mississippi River and has few shareholders residing in California, to a New York corporation similarly situated. It is unreasonable to expect shareholders, especially out-of-state shareholders, to take strong action when

tion" proviso of 25142 would probably not mandate action by the Commissioner as exemptions are only from the qualification to issue in California and there would be no California issuance. However, by analogy, the "regardless of exemption" proviso would probably support the holding of a fairness hearing. See Landis, Statutes and the Sources of Law, 2 HARV. J. LEGIS. 7 (1965). Apparently, the "no resident" hearing problem has not yet been presented. Mr. Salera doubts that the Commissioner would hold such a hearing on the theory that the SEC favors some contacts between the corporation and the approving state, and the Commissioner would probably oblige. Salera/Glickman Interview.


The Commissioner is somewhat aided by the fact that the corporation seeking the permit has the burden of proving fairness. See CAL. CORPS. CODE § 25140(b) (West 1968); see also H. MARSH & R. VOLK 244-45.

Compare the familiar observation that state courts tend to avoid findings of unfairness when there is no strong shareholder or debtor dissent. Note, supra note 33, at 1050. "The courts do not generally inquire into a chapter 11 arrangement if the creditors have accepted the plan and no objections are made." Corotto/Glickman Interview. Nonetheless, commentators have generally praised the California procedure as being protective of shareholders. See Orschel, Administrative Protection for Shareholders in California Recapitalizations, 4 STAN. L. REV. 215 (1952); Note, supra note 33, at 1052.
they receive a complicated plan of exchange and have little knowledge of the companies involved. Furthermore, because few exchanges will grossly harm the shareholder, and the legal notion of “fairness” is generally vague, lawyers often advise their clients not to waste time and money appearing at an out-of-state hearing.\footnote{Of course, an out-of-state shareholder or debtor with a large financial interest would probably undertake an independent investigation and seek adequate California representation to protect his interests at the hearing.}

Although the above factors suggest the propriety of a nexus test, there is much to suggest that such a requirement is unnecessary. For example, a few states have a statute authorizing an approval procedure that would qualify under 3(a)(10),\footnote{See R. Jennings & H. Marsh, supra note 21, at 475 n.12; notes 10-11 supra.} and, given the scarcity of properly trained and experienced officials and the lack of local pressure, it is unlikely that many other states will soon implement such a provision. Moreover, as the previous discussion of legislative purpose indicated, administrative review is only necessary to implement disclosure and provide a support for the investor who cannot clearly focus on the information he received rather disjointedly in the hearing. Thus, if information were well presented, in a form similar to the prospectus required under the Securities Act, there is no policy reason for a hearing. Consequently, to the extent that the federal proxy rules,\footnote{Securities Exchange Act of 1934 §§ 13(d) & (e), 14(d), (e) & (f), 15 U.S.C. §§ 78m(d) & (e), 78n (d), (e) & (f) (Supp. V, 1970); Regulation 14D, 17 C.F.R. § 240.14d-1 et seq.; Regulation 14D, 17 C.F.R. § 240.14d-1 et seq. (1970). See generally Note, Cash Tender Offers, 83 Harv. L. Rev. 377 (1969); Note, Closing the Disclosure Gap in Corporate Take-Overs: The Williams Amendments and the Wheat Report, 44 St. John’s L. Rev. 484 (1970).} the Williams Bill rules,\footnote{E.g., the California Commissioner of Corporations generally requires users of section 25142 who do not comply with federal proxy rules to send out a statement containing most of the needed information demanded by those rules. Cal. Corps. Code § 25148 (West 1965). See also H. Marsh & R. Volk 239-40, 291-92. The statement is usually filed with the Commissioner before it is distributed. Cal. Admin. Code § 280.140.60 (1969), 1 Blue Sky L. Rep. ¶ 8622 (Dec. 20, 1968). One commentator has stated that the California disclosure procedure, because of its flexibility in molding disclosure to the particular case, is superior to the federal rules. See Orsche, supra note 41, at 224.} or similar state requirements\footnote{In essence, this is an argument for coordination of the various federal securities statutes inter se and with appropriate state disclosure rules. At the federal level, the argument has been made numerous times. See, e.g., The Wheat Report; Cohen, “Truth in Securities” Revisited, 79 Harv. L. Rev. 1340 (1966).} are followed, disclosure will normally be adequate,\footnote{Cf. SEC v. Ralston Purina Co., 346 U.S. 119, 125-27 (1953); Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir.), cert. denied, 361 U.S. 896 (1959); The Wheat Report 280-81.} and a substantial relationship test should be unnecessary.\footnote{Securities Exchange Act of 1934 §§ 13(d) & (e), 14(d), (e) & (f), 15 U.S.C. §§ 78m (d), (e), 78n (d), (e) & (f) Supp. V, 1970); Regulation 13D, 17 C.F.R. § 240.13d-1 et seq.; Regulation 14D, 17 C.F.R. § 240.14d-1 et seq. (1970).}
From a legalistic perspective, the statute offers little help. Although the language of 3(a)(10) does not specify a nexus requirement, it would not be wreaking too much havoc with its wording to construe it as impliedly containing a reservation that substantial contacts between the corporation instigating the fairness hearing and the state conducting it must exist.

Probably the best solution is an alternative test, i.e., satisfactory disclosure required by either federal or state law or a nexus test. If a nexus test is used, in order to maximize the possibility of an adequate adversary system the corporation-state relationship should be defined in terms of a percentage of security holders. For example, it could be phrased as: 25 percent of the record shareholders (a head count), owning at least 25 percent of the outstanding stock, must live in the state holding the hearing.

The Voluntary User Problem

Section 25142, which specifically authorizes a fairness hearing, expressly permits an application to be filed and the necessary hearing to be held even in a case where the security or the transaction is exempted from the qualification requirement [of section 25120], e.g., in connection with an issuance of securities listed on the New York Stock Exchange [which is exempted from the qualification requirement by section 25100(o)].

The effect, under California law, of the Commissioner's refusal to approve is unclear. Nothing in the Corporations Code requires a corporation seeking the Commissioner's 25142 blessing to waive its exemption, and nothing in the Code gives the Commissioner power to prevent the issuance of exempt securities. Thus, it has been suggested that a finding by the Commissioner that the terms and conditions of an exchange are unfair would not affect the issuer's ability to use his prior exemption. Assuming that this interpretation is correct, can a corporation offering to issue in an exchange securities exempt in California receive a 3(a)(10) exemption from registration under the Securities Act if the terms of the exchange were approved in a 25142 hearing?

Section 3(a)(10) distinguishes between courts, officials or agencies of the United States, and "State or Territorial . . . governmental authority." The former need only actually pass upon the fairness of the terms of the exchange in order for 3(a)(10) to be applicable; the latter

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49 Draftsmen's Commentary to the 1968 California Corporations Code, in H. Marsh & R. Volk 580-81. See also id. at 241-42.
50 Salera/Glickman Interview.
must also be "expressly authorized by law" to approve the terms of the exchange after a fairness hearing for the exemption to be effective. The General Counsel of the SEC, apparently reading the "express authorization" proviso as an expression of Congress' desire to insure that the state authorities had power to consider shareholder interests, "as well as [those of] the issuer and the consumer, and to disapprove terms and conditions because unfair either to those who are to receive the securities or to other security holders of the issuer, or to the public," would seem to permit a voluntary user to receive the exemption. In response to the question whether the exemption could be obtained if state law expressly authorized, but did not require, a fairness hearing, and a hearing approving the fairness of the terms and conditions of the exchange was held, he said that "if state law expressly authorized the approving authority to hold a hearing on the fairness of the terms and conditions of the issuance and exchange of securities, and such a hearing is in fact held, [the express authorization] requirement is satisfied."

From a "disclosure policy" perspective, the General Counsel's conclusion is also acceptable. Because 3(a)(10) offers considerable savings of time and money vis-à-vis registration, the vigor of any opponents of an exchange would not be affected by the continued exemption from the California Blue Sky Law regardless of a finding that the exchange was unfair.

**THE SECURITY VERSUS TRANSACTION EXEMPTION PROBLEM AND ITS CONSEQUENCES**

The final question to be considered is whether the 3(a)(10) exemption should be limited to the initial transaction, i.e., the exchange, or whether it should apply to any future offer or sale of a security issued in the exchange. Clearly, 3(a)(10) would be more widely used if it were construed as a security as opposed to a transaction exemption. If held to be the latter, unless all the securities issued pursuant to the

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52 Id.
53 Assuming, of course, that the disclosure-nexus test is satisfied.
54 Nonetheless, an argument based upon lack of good faith could be made if 25142 is voluntarily utilized since there would be no independent business purpose in such use. It is not clear that the General Counsel addressed himself to this issue in his opinion. The disclosure-nexus test, however, should adequately protect the public interest, thus obviating the need for a bona fide test. It should be noted that the lack of a business purpose argument cannot be made if a permit were required under the California Blue Sky Law. The state may require qualification even when few contacts are present. See Cal. Corps. Code § 25103(d)(2) (West 1968).
fairness hearing have come to rest or 3(a)(10) is properly coupled with another transaction exemption before resale, the issuer and all participants in the exchange transaction who took the newly issued stock "with a view to distribution," i.e., with the intent of possibly reselling immediately, may be held liable in damages. It is unlikely that many would want to assume this risk.

The generally accepted view, both within and without the Commission, is that 3(a)(10) is a transaction exemption. The crux of the legal argument is based upon legislative history and administrative construction. The forerunner of 3(a)(10) was section 4(3); stated differently, it was originally in the section which deals with transaction exemptions. The "express purpose" behind its shift to section 3, which governs security exemptions

was merely to codify the Federal Trade Commission's previous interpretation [SEC Securities Act Release No. 97 (Dec. 28, 1933)] that, when the issuer was excused from registration under § 4(3) . . . , dealers could trade immediately notwithstanding the non-applicability of the dealer's exemption in § 4(1) to transactions within "one year [now forty days] after the first date upon which the security was bona fide offered to the public.

Moreover, as early as 1936, the General Counsel of the Commission issued an opinion limiting 3(a)(10) to a transaction exemption. Finally, the legislative history of section 264 of the Bankruptcy Act, exempting securities issued pursuant to chapter 10 plans from the registration and prospectus requirements of the 1933 Act, specifically approves the policy behind the General Counsel's opinion and makes clear that section 264 is only a transaction exemption:

Under Section 264 no registration in compliance with the Securities Act of 1933 is required for the issuance of securities to the security holders or creditors of the debtor in whole or part exchange for their old securities or claims. However, new issues sold by the

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56 Cf. SEC Securities Act Release No. 4434 (Dec. 6, 1961). See also the enormous volume of literature surrounding the investment intent requirement of the private placement exemption.

57 The issuer might at least be liable to any purchaser from a participant in the exchange transaction; the sellers, to their purchasers. See Securities Act of 1933, §§ 2(11), 12(1), 15 U.S.C. §§ 77b(11), 77l(1) (1964); SEC Securities Act Release No. 3846 (Oct. 8, 1957); see also United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968); SEC PROBLEMS OF CONTROLLING SHAREHOLDERS AND IN UNDERWRITINGS, supra note 21, at 74; discussion of the 1 percent rule, at 661 infra.

58 See R. JENNINGS & H. MARSH, supra note 21, at 450.

59 1 Loss 709.


reorganized company for cash are required to be registered under the Securities Act just as any other new issues of securities, in order that prospective investors may have all material information before buying. Furthermore, the exemption for the issuance of securities to security holders and creditors under the plan does not extend to any subsequent redistribution of such securities by the issuer or an underwriter; for any such redistribution is subject to the same need for public disclosure of relevant data as in the case of a new issue. This need for registration upon redistribution has been recognized by the Securities and Exchange Commission in its interpretation of section 77B(h), but the revision embodied in section 264 is designed to remove all doubt as to the correctness of that interpretation. 61

If 264, with its many safeguards in addition to a fairness review — including formulation of a plan of reorganization by an impartial trustee, 62 SEC review of the plan if the debtor is larger than a certain size, 63 and a "feasibility" study by the court, 64 protections which improve the quality of any security issued pursuant to the plan and thus help subsequent purchasers — is only a transaction exemption, it is reasonable to assume that Congress also intended 3(a)(10) to be so limited. 65 As one commentator observed, "[t]he subsequent sale may be on different terms, and the security may have changed in the interim." 66

However, the legislative report on section 264 does admit that there is "doubt as to the correctness of [the General Counsel's] interpretation [of 3(a)(10)]." 67 Section 3(a)(10) is within section 3, which

61 S. Rep. No. 1916, 75th Cong., 3d Sess. 39 (1938). This policy is probably expressed in section 264(2)(a), through the phrase "in connection with a distribution otherwise than pursuant to the plan."


63 A trustee may be appointed in the court's discretion if the debtor is smaller. Id. § 156, 11 U.S.C. § 556 (1964). See also id. §§ 168, 170, 11 U.S.C. §§ 568, 570 (1964) (concerning impartiality in the filing of a plan when a trustee is not appointed).

64 The court may request SEC review if the debtor is smaller. Moreover, the Commission may intervene with court approval. Id. § 208, 11 U.S.C. § 608 (1964).


deals with security exemptions. Furthermore, at least one appellate court seems to indicate that 3(a)(10) might be a security exemption. In *Shaw v. United States*, the court said that if the jury inferred that the shares which the defendant, indicted for selling unregistered securities, had acquired were received in an exchange approved by the California Corporations Commissioner after a 3(a)(10) hearing, the “provisions of the [Securities] Act requiring registration and penalizing issuing and dealing in unregistered shares ‘shall not apply’ to [those] shares,” unless the original recipient “transferred them back to the corporation for reissue.”69 Finally, there is little reason to distinguish 3(a)(10) securities from those issued pursuant to 3(a)(7), i.e., “[c]ertificate issued by a receiver or by a trustee in bankruptcy, with the approval of the court,”70 and the SEC has indicated that the latter receives a security exemption.71

The Commission has further justified its interpretation of 3(a)(10) as a transaction exemption on policy grounds. Phrasing the issue in terms of whether there is anything “in the intrinsic nature of securities issued in a transaction falling within section [3(a)(10)] which justifies consideration of such securities as permanently exempt from registration without regard to other facts,”72 the Commission has argued that securities issued pursuant to 3(a)(10) are only exempt “because of the circumstances surrounding their issuance.”73 The SEC, then, is apparently worried that the terms of a subsequent sale may be different, or that the value of the securities may have changed between the time of the 3(a)(10) exchange and the later sale. The public would then no longer be adequately protected by the fairness review.

Insofar as the resale follows soon after the 3(a)(10) exchange,
subsequent purchasers are reasonably well protected if the section were construed to be a security exemption. The information received by the participants through federal proxy, Williams Bill or similar state disclosures would still be available and pertinent. Moreover, the information received at the fairness hearing could be made a matter of public record, placed on microfiche, filed in Washington, and easily sent to inquiring investors. However, if the subsequent sale is delayed several months, the seller is someone in control of the issuer, and S(a)(10) were held to be a security exemption, no registration would be needed and the public would be receiving an “ordinary” stock, i.e., one without any inherent safeguards, without the protection which Congress has normally deemed necessary on sales by a controlling person. Nothing in S(a)(10) demands this protection of the control seller.

Assuming S(a)(10) is a transaction exemption, when can the participants in the exchange resell their newly acquired securities? At least the San Francisco regional office of the SEC has advised participants receiving more than a minimal number of shares to obtain a no-action letter before reselling; otherwise they may be held to be underwriters. Similarly, counsel for the Corporation Finance Division of the Commission, possibly on the theory that

[i]those receiving an ininsubstantial amount of securities in [a S(a)(10) transaction] should not be deemed underwriters or engaged in a

74 The subsequent purchasers would often receive more information than they normally receive in a 1933 Act prospectus. For example, projections are allowed at a California fairness hearing (Salera/Glickman Interview), whereas they may not be included in a 1933 Act prospectus. Of course, the public may overemphasize both the projections and the Commission’s approval. Cf. THE WHEAT REPORT 95-96. Moreover, the information received by microfiche would not be organized in the same manner as would the prospectus. The SEC has been quite strict regarding the presentation of information in the prospectus, see, e.g., SEC Securities Act Release No. 4936 (Dec. 9, 1968), and has recently expressed concern over the incomprehensibility of many prospectuses. SEC Securities Act Release No. 5119 (Dec. 16, 1970). Finally, the microfiche would probably not receive the same breadth of distribution as would a legally required prospectus. However, since much information in a prospectus is received by investors primarily via a “trickledown” from their brokers, THE WHEAT REPORT 52-53, many of these problems are not substantial.


76 Corotto/Glickman Interview.

77 Cf. SEC Securities Act Release No. 3846 (Oct. 8, 1957). An underwriter cannot use a 4(1) exemption. As to the other transaction exemptions, none would normally be available for the resale. By its terms, 3(a)(9), which exempts an exchange between issuer and existing shareholders with no compensation involved, is inapplicable. It would be a fortuity if the 3(a)(11) intrastate exemption is available. The private placement exemption would only be available if the initial offering satisfied 4(2), in which case the SEC staff has suggested that 4(2), rather than 3(a)(10), controls. H. MASH & R. VOLK 248.
distribution, even if they purchase with the intent to resell [, for]
... to hold otherwise would virtually read 3(a)(10) out of the act
since no issuer could ever be certain of the investment intent of all
such purchasers,\(^7\)\(^8\)

seems to have suggested concerning a somewhat similar situation\(^7\)\(^9\) that

\[\text{whether a particular purchaser is an underwriter may be a} \]
\[\text{question of degree. If you have someone who has a substantial} \]
\[\text{block of stock with whom the buying corporation must negotiate} \]
\[\text{a deal even before the registration statement is effected ... [he} \]
\[\text{would probably be] an underwriter.}\(^8\)\(^0\)

This position may have recently been liberalized and somewhat
clarified.

\[\text{[T]he staff of the Securities and Exchange Commission takes the} \]
\[\text{position that they will apply the limitations of Clauses (c) and (d)} \]
\[\text{of Rule 133 to subsequent resales of the securities received by the} \]
\[\text{former controlling persons of the acquired corporation in a Section} \]
\[3(a)(10) \text{transaction.} \]

These limitations basically require that such controlling
persons of the acquired corporation either take the securities re-
ceived for investment, or limit any such subsequent resales to the
amounts specified in Clause (d) of Rule 133 in so-called "brokerage
transactions."\(^8\)\(^1\)

This new position is reasonable; it equates a "stock swap" with
a rule 133 transaction,\(^8\)\(^2\) thereby establishing a similarity of treatment
between like transactions. The Corporation Finance Division's Counsel
apparently was unwilling to make this equation. He seems to have
regarded large, and possibly key block, shareholders, as well as con-
trol shareholders, as underwriters if they took with a view to distribu-
tion.

Professor Loss, discussing "recaps" and other one corporation ex-
changes,\(^8\)\(^3\) seems to report, though, that the "1 percent" test is applied

\(^7\) Flanagin, \textit{supra} note 66, at 1156 n.91; \textit{see also} 1 Loss 642-43.

\(^8\) An exchange offer where the exchanging shareholders received registered stock.

\(^9\) SEC Problems of Controlling Shareholders and in Underwritings, \textit{supra} note 21,
at 74-75.

\(^1\) H. MARSH \& R. VOLK 242-43.

\(^2\) 17 C.F.R. \S 230.133 (1970), which covers mergers, consolidations, reclassification of
securities or a sale of assets.

\(^3\) The point is phrased in terms of "non-controlling creditors," and the discussion,
which centers on trade creditors, implies a chapter 11 orientation. 4 Loss 2599-2600. \textit{Cf. id.}
at 2521-22. However, there is little logic behind such a limitation of Commission policy.
Professor Loss does not indicate that the trade creditors he refers to have only short-term
paper and that the SEC is thus striking a balance between fairness to short-term
creditors and the needs of the investing public. \textit{Cf. Securities Act of 1933, \S 3(a)(3), 15
U.S.C. \S 77j(a)(3) (1964).}
to "noncontrolling" participants in the 3(a)(10) exchange. A possible implication is that a controlling shareholder who receives securities in the exchange cannot resell, even under rule 154.84 until the stock comes to rest. To the extent this speculation is correct, since the controlling person will be in a less favorable position after using 3(a)(10) than after registration, 3(a)(10) will be rarely used. On the other hand, if all persons — whether controlling or noncontrolling — are restricted to the "1 percent" rule for immediate sales, Loss' understanding indicates that the Commission follows an even more restrictive view than the one proffered by the Counsel for the Corporation Finance Division, but one which will permit the continued utilization of 3(a)(10) for its speed and economy.86

From a normative perspective, there is little need to prevent a control person participating in a 3(a)(10) transaction from immediately utilizing the "1 percent" rule. Given the abundance of information then available,87 there is even a good case for permitting the control person, and a fortiori all others, to immediately resell all securities received in the exchange.88 If this approach were adopted, the lack of limits on resales by someone in control would, of course, have to be restricted to a period defined in relation to when the available information became dated.

86 It should be noted that the Loss and Marsh-Volk reports on Commission policy can be harmonized since the Loss view refers to a one corporation exchange, e.g., a "recap"; the Marsh-Volk study considers a two corporation transaction, e.g., a "stock swap." However, aside from the greater likelihood that companies reporting under the 1934 Securities Exchange Act will be involved in a two corporation exchange, there is little reason to treat the two situations differently.
87 Cf. e.g., THE WHEAT REPORT, ch. 6 distinctions between reporting and nonreporting companies.
88 On the basis of this argument, 3(a)(10) participants who had formerly held restricted stock would be immediately free to sell it. Cf. THE WHEAT REPORT, ch. 6 & app. VI. Under present law, a holder of restricted securities who exchanges them for other securities in a 3(a)(10) exchange probably cannot sell freely. For example, assuming a restricted security holder is not in control, and that noncontrolling shareholders are permitted to sell after a 3(a)(10) exchange if they can establish their own exemption, it is unlikely that the restricted holder could find an applicable exemption since he would still be an underwriter. The Commission's staff apparently believes that the "taint" of the restricted securities pass to the new holdings so that a "public" sale may not be made until there is a "change of circumstances," and a bona fide, unanticipated 3(a)(10) exchange probably does not constitute such a change. Cf. THE WHEAT REPORT 166-67; Schneider, supra note 85, at 833. But cf. Wander, The No-Sale Rule — II, 3 REV. OF SEC. REG. 832, 833-34 (1970). While the example in the Wheat Report refers to a merger, presumably involving no judicial or administrative review, given the disclosure orientation of the 1933 Act, the normal use of proxies in a merger, and the variety of state attitudes toward fairness, it is unlikely that the hearing held pursuant to 3(a)(10) would cause a different result.
Even in the absence of a "total freedom on resale" period immediately following a 3(a)(10) exchange, given the sufficiency of disclosure it is hard to understand why there should be a 1 percent limit on noncontrol participants, thus placing some of them in a worse position than they were in before the exchange. The information available to the public, and the obvious ability of the courts and the Commission to treat it as a different situation, sufficiently protects the public from a scheme by the issuer to distribute a large amount of new stock through an exchange, for example, in which the security holders tender both their former securities and money. While, ideally, subsequent sales by noncontrolling security holders should also be accompanied by a disclosure statement, the same impracticality that prevents such a rule when noncontrolling security holders buy in a registered issuance and later sell exists here.

CONCLUSION

The preceding discussion raises the question of whether 3(a)(10) should be retained. This article has suggested that 3(a)(10) is primarily based upon the fact that adequate disclosure is available through sources other than the registration statement and prospectus required by the Securities Act. As such, it is not inconsistent with the basic


90 Two other issues should be briefly considered. The first is whether the exemption is effective before the time for an appeal from a state administrative hearing expires. Cf. 1 Loss 589-90. Professor Loss seems to say that the exemption is effective after the administrative hearing if neither the agency order nor the enabling statute contemplates court review. From a normative sense, it could be argued that the standard of review should control. For example, if the standard were the "substantial evidence" test, the administrative decision would generally be final and thus should mark when the exemption becomes final. While such an approach would theoretically minimize a security holder's protection in that the reviewing court might reverse the fairness finding, on balance, any other approach would afford a dissident too much power. Besides, the federal proxy, Williams Bill or state disclosure rules will generally be applicable and provide the security holders a sufficient shield.

The second issue involves the scope of the exemption. Section 3(a)(10) exempts any security issued in an exchange "where the terms and conditions of such issuance are approved." Conceivably, since all shares will not be issued in the approving state, and the state commission might not be authorized to approve securities issued in other states as part of the complete exchange transaction (see, e.g., Cal. Corps. Code § 25142 (West 1968)), the securities issued in states other than the approving state would not be exempt. Cf. Securities Act of 1933, §§ 2 & 6, 15 U.S.C. §§ 77b & f (1964); Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967). However, this interpretation, which reads the phrase "such issuance and exchange" as referring to the issuance and exchange in the reviewing state (see SEC Securities Act Release No. 312 (Mar. 15, 1935)), would require redundant hearings in the several states and would thereby, as a practical matter, read the exemption out of existence. Moreover, assuming adequate disclosure and review at the first fairness hearing, it offers security holders little additional protection. Cf. text accompanying notes 43-48 supra. Perhaps safety from this sort of attack may be garnered if all shares to be issued are registered in the first reviewing state.
philosophy of the Act and does not substitute "permission" for "disclosure." Therefore, there is no reason why a procedure similar to that proposed by the Wheat Report to replace rule 13391 should not also supersede 3(a)(10). Such an approach would be inexpensive and quick.

This is not to say that continued state review of the various types of reorganizations and recapitalizations is unnecessary. Given the complexity of such transactions, a state may well consider that a legitimate state interest is involved in protecting its residents from unfair proposals. However, there is no state concern involved in the present 3(a)(10) exemption. Perhaps this is why so few states authorize the necessary hearing procedure.

The change proposed can only be undertaken by Congress. Its philosophy, though, can be incorporated immediately when the SEC and the courts interpret the Act.

Postscript

Since this article was put into page proof, the SEC Division of Corporate Finance published a denial of a request for a "no-action" letter regarding Institutional Corporation of America which might be read as indicating that the staff would not agree with the "disclosure" test suggested in the "nexus" section of this article. It is more likely, though, that the staff did not consider the disclosure test and that their denial indicated either that state law did not give the North Dakota Commissioner of Insurance the requisite express authorization to approve the fairness of the Exchange's terms and conditions from the standpoint of the investor or that what is meant by "fairness" in Section 3(a)(10) is a question of federal law and that North Dakota Century Code section 26-30-09 did not meet the federal standard. The one clear conclusion that can be drawn from the denial is that the Commission's staff reads the "express authorization" proviso of 3(a)(10) as applying to state banking and insurance commissions, and not just to "other governmental authorities."

92 Salera/Glickman Interview. Of course, a state could use the exemption to increase its revenue, but such use, while relevant to revenue sharing, is not responsive to the purposes of the Securities Act. Interestingly, California makes no profit from its 25142 hearings. The fee for such a hearing is limited to "the actual expense of noticing and holding it." CAL. CORPS. CODE § 25608(r) (West 1968).
93 CCH FED. SEC. L. REP. ¶ 78,133 (April 22, 1971).
94 See paragraph 16 of counsel's letter to the SEC requesting the "no-action" letter.
95 See 1 Loss 586 for an indication that the syntax of section 3(a)(10) could possibly lead to the opposite result.
Add to last complete paragraph at page 661 Volume 45, No. 4 footnote 82a.

82a See R. Jennings and H. Marsh, supra note 21, at page 474, for the suggestion that the Corporate Finance Division Counsel’s position is legally more proper because it is logically impossible under the terms of the statute to distinguish “between non-controllers who used to be controllers of a no-longer-existing corporation, and non-controllers who did not formerly have that status”, assuming neither purchased from the issuer.

However, even the Corporate Finance Division’s Counsel’s position is subject to attack by analogy to the Commission’s position on Section 3(a)(9). The SEC construes that section to permit large shareholders participating in bona fide exchanges to immediately sell the securities they received in the exchange as long as Rule 155 is not applicable or the security exchanged was not purchased in a private placement. See SEC Securities Act Release 4248 (July 14, 1960); Woodside, Speech, quoted in 1 Loss 682; 4 Loss 2659-60. Since those shares may well be taken with a view to distribution (see SEC Securities Act Release 4162, Para. VI (December 2, 1959) for two other possible bases for treating such large purchasers as underwriters, and see 1 Loss 681 for a criticism of them), the SEC apparently treats 3(a)(9) as transforming the exchange into one not involving a “purchase” within the meaning of Section 2(11). If this approach is proper, it is hard to understand why 3(a)(10), whose hearing procedure better protects both the participating shareholders and the public, does not have the same transforming effect.

In fact, though, the use of the transformation doctrine in a 3(a)(9) transaction is itself legally questionable. Nothing in the wording of the Act condones it, see 1 Loss 682 (although Congressional intent might arguably be frustrated if the transformation doctrine were not used since, as a practical matter, 3(a)(9) would rarely be employed if large shareholders were not free to immediately sell the securities they received in a 3(a)(9) exchange, the exemption would still be important for exchanges involving only small shareholders, see 1 Loss 642-43, a limited use not inconsistent with the exemption’s uncertain parentage, see 1 Loss 573); the disclosure policy of the Act is somewhat undermined by its application (especially as no distinction is drawn between reporting and non-reporting companies). Cf. 1 Loss 573, 683, the Wheat Report; but see Woodside, supra, and 4 Loss 2659-60, for a discussion of a countervailing policy of somewhat limited applicability—non-interference with the existing public trading market (if any) for the security given-up in the exchange.

See pp. 662-3, infra, for a discussion of who should be permitted to sell after a 3(a)(10) exchange if 3(a)(10) is to be a viable exemption, be interpreted consistently with the rest of the 1933 Act and yet provide reasonable protection to the public.