Pace University
DigitalCommons@Pace

Pace Law Faculty Publications School of Law

1967

The Canadian Corporation and Wall Street: Application of United States Securities Laws to Canadian Issuers

Merril Sobie
Elisabeth Haub School of Law at Pace University

Follow this and additional works at: https://digitalcommons.pace.edu/lawfaculty

Part of the Business Organizations Law Commons, Comparative and Foreign Law Commons, and the Securities Law Commons

Recommended Citation

Merril Sobie, The Canadian Corporation and Wall Street: Application of United States Securities Laws to Canadian Issuers, 6 W. Ontario L. Rev. 93 (1967), http://digitalcommons.pace.edu/lawfaculty/367/.

This Article is brought to you for free and open access by the School of Law at DigitalCommons@Pace. It has been accepted for inclusion in Pace Law Faculty Publications by an authorized administrator of DigitalCommons@Pace. For more information, please contact dheller2@law.pace.edu.

THE CANADIAN CORPORATION AND WALL STREET: APPLICATION OF UNITED STATES SECURITIES LAWS TO CANADIAN ISSUERS

*Merril Sobie**

PART I

INTRODUCTION

The purpose of this article is to present the Canadian legal practitioner with a summary of those sections of American securities laws which are applicable to foreign issuers. Discussion, for the most part, will be limited to a brief outline of the more salient aspects of securities regulation; a complete presentation of any one feature would be impossible within the confines of a single article. Wherever possible, relevant authorities will be cited and counsel would be wise to examine their more detailed treatment. Moreover, though federal legislation in this area is not exclusive, discussion will be limited to the national acts. All issuers, however, have the additional, albeit relatively simple, burden of compliance with the "blue sky" laws of each separate state in which an offering is to be made.[1]

Undoubtedly, the most important aspect of securities regulation is registration. Parts II-IV of the article will therefore be directed to this problem. The mechanics of the registration process, however, are often less detailed than some of the exemptive provisions. For this reason discussion of registration will be brief compared to that of the several available exemptions. An issuer who qualifies pursuant to one of these sections need not be concerned with the registration process, though other provisions of the securities acts, most importantly the anti-fraud rules, would have full applicability.

Parts V and VI will deal with the ramifications of the *Securities and Exchange Act* of 1934. That *Act,* though completely separate from the *Securities Act* of 1933, presupposes that an offering has already been made. Continuing responsibilities on the part of the issuing corporation of the type contained in the *Securities and Exchange Act* may have an important bear-

*B.A.; LL.B. (N.Y.U.).

1. Compliance with up to fifty statutory patterns has been greatly simplified by enactment of the *Uniform Securities Act* in many states. In addition, compliance in several jurisdictions may be achieved by the pro forma filing of an informational form and payment of a nominal fee.

HeinOnline -- 6 W. Ontario L. Rev. 93 1967

ing in the decision regarding initial offering of securities in the United States. An explanation of the *Act's* provisions is therefore as important as discussion of registration and exemptions under the earlier *Securities Act.*

PART II

THE REGISTRATION PROCESS

A. Filings

Under Section 5 of *The Securities Act* of 1933 all offerings must be registered with the Securities and Exchange Commission, unless one of several listed exemptions is available.[2] Registration is accomplished by the filing of a statement with the Commission in Washington. Some eighteen different forms are prescribed for this purpose, the most important of which include the S-1, the general form, and the S-2, the form to be used by companies in the development stage, i.e. operating companies which "have not had any substantial gross returns from the sale of products or services, or any substantial net income from any source for any fiscal year ended during the past five years."[3]

All forms, it should be noted, are quite complex and detailed, compelling disclosure, for example, of remuneration to

2. Section 5(a) states that "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
    (1) to make any use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
    (2) to carry or cause to be carried through the mails or in interstate commerce . . . any such security for the purpose of sale or delivery after sale."
3. P.2A, form S-2. The more specialized forms include the S-3, for shares of mining corporations in the development stage, S-4 through S-6, which are used by investment companies regulated by the *Investment Company Act* of 1940, and the S-12, under which American depository receipts issued against securities of foreign issuers are registered (as opposed to registration of the actual foreign security). In addition, form S-8 is widely used by American companies to register securities issued pursuant to stock option plans; however, the foreign issuer, whose officers are generally residents of the country of incorporation, would have little occasion to use S-8.

    Recently, a short-form registration statement, S-7, has been proposed for issuers whose securities are listed on an American securities exchange and have been filing periodic reports with the Commission for at least five years preceding the offering. See S.A. Rel. 4849 (November 16, 1966). Should this form be adopted, it would be available to those foreign issuers whose securities are listed on a United States exchange.

HeinOnline -- 6 W. Ontario L. Rev. 94 1967

officers and directors, option plans, underwriting commitments, and use of proceeds. Complete and certified financial statements covering the five year period preceding registration must be attached and a prospectus, which is incorporated into the form, prepared for dissemination. In all, information is elicited by approximately thirty different items.[4] Finally, the prescribed registration fees must be paid at the time the statement is filed.[5] This completes the process and, after the so-called "waiting period" of at least 20 days has elapsed, the securities may be sold to members of the public.

B. Rules Governing the Registration Process

The actual mechanics of registration are thus relatively simple. However, there are several related requirements which, though not directly involving administrative procedure, proscribe the exact method by which securities may be legally offered within the United States. For purpose of offers, sales and advertisements of securities, registration is divided into three separate chronological intervals: (1) the period prior to filing the statement; (2) the waiting period; and (3) the period subsequent to the "effective date," the day upon which the waiting period ends and sales may commence.

(1) Prior to the filing of the statement both sales and offers to sell are expressly prohibited.[6] Likewise prospectuses or other sales literature may not be disseminated. In short, with the minor exception of preliminary negotiations between the issuer and prospective underwriters[7] the entire securities sales apparatus must remain in limbo until such time as the registration statement is filed.[8]

(2) After filing, but before the effective date has been reached (the waiting period), the issuing company or underwriter may engage in activities to solicit indications of interest from prospective purchasers.[9] Moreover, to aid the issuer in finding potential investors, the Commission has administratively defined certain communications as not constituting a prospectus (a prospectus cannot be disseminated until the effective date has been reached), thus allowing for circulation of specified information regarding an offering which is still in the process of registration.

4. Foreign issuers are additionally required to file a consent to service of process in the United States.
5. P.L. 89-289 (1965). Also Securities Act Rules 455-458.
6. s. 5 (c).
7. See s. 2(3).
8. For a more detailed discussion see Loss, *Securities Regulation,* Volume I at 212-222 (1961).
9. *Ibid.,* 223-226.

HeinOnline -- 6 W. Ontario L. Rev. 95 1967

For example, a "preliminary prospectus"[10] containing information substantially identical to that contained in the final prospectus, may be distributed, provided such literature bears a red legend or "red herring" on its face indicating that the terms of the offering are not final and sales cannot be made until the effective date has been reached. Similarly, limited advertisements, known as "tombstones" may be employed,[11] provided they contain only information prescribed by the Commission. Finally, summary cards, prepared by independent statistical organizations, may be disseminated.[12]

All the methods outlined above may be invoked during the waiting period. Needless to say, however, the issuer must stop short of any binding agreements. Sales cannot be consummated nor, for that matter, can offers to buy be accepted.[13]

(3) Upon reaching the effective date sales are begun and ultimately the securities delivered. A final prospectus must nevertheless be sent to each investor prior to or with the first use of the mails subsequent to the effective date, regardless of whether such investor has already received a preliminary prospectus or other literature. In the normal course of events this will be the time when the issuer or participating broker forwards a copy of the confirmation to the purchaser. And, for a period of at least forty days (ninety if the issuer has not made a previous offering in the United States) following the effective date a prospectus must be furnished for each sale or trade.[14] The forty day provision is a minimal one based on the assumption that the offering will be completed by that time. Should the offering consume additional time, the issuer's obligation to furnish updated prospectuses continues.[15]

C. Administrative Procedure

Before leaving the topic of registration a word should be said concerning the Commission's administrative procedure in processing registration statements. All statements are as-

10. s. 10 (a); also Securities Act Rule 433.
11. s. 2 (10) (b); also see Rule 134, under which more detailed advertisements known as expanded tombstones are permitted.
12. Securities Act Rule 434.
13. For a more detailed discussion see Loss, *supra,* note 8 at 223-245. Another related problem concerns corporate publicity prior to and during the registration period. Generally speaking, any concerted effort to publicize the issuer via press releases or market letters is prohibited, though routine announcements of earnings or new developments may be made. See Securities Act Rel. 3844 and 4697.
14. See s. 4 (3).
15. See Loss, *supra,* note 8 at 245-265. A prospectus is "fresh" for a period of nine months or until there is a major change concerning the issuer's financial condition or the terms of the offering. If necessary, the prospectus may be brought up to date by the filing of post-effective amendments or financial statements.

HeinOnline -- 6 W. Ontario L. Rev. 96 1967

signed to one of some fourteen branches of the Commission's Division of Corporation Finance, each of which is headed by a branch chief who is the Commission's official spokesman with regard to any statements and reports filed by the issuer.[16] Upon filing, a statement is examined and a letter of comment, which outlines possible deficiencies or requests for clarification, sent to the issuer. Following an exchange of correspondence or a conference in Washington, various points are reconciled and amendments acceptable to the Commission are filed. However, filing of amendments automatically initiates a new twenty day statutory waiting period, thus advancing the effective date. If necessary the process is repeated, and a few rounds of correspondence and filings may delay the effective date by several weeks or even months.

In the event major disagreements cannot be reconciled, the Commission is empowered to issue a "stop order"[17] preventing sale of the securities in question. The issuer retains the right to appeal such issuance to a federal court of appeals.[18] Of course, in the vast majority of cases, registration is perfected by the filing of one or more amendments and ultimately an effective date is set and the securities sold to members of the public.

PART III

EXEMPTIONS

A. Exempted Securities

Having outlined the statutory pattern of registration, it is now appropriate to discuss the various exemptions which may be available to a given issuer. Discussion in this section will be directed to exempted *securities,* i.e. those which, because of the nature of the issuer or offering, need not be registered regardless of the type of transaction involved. The next section will outline exempted *transactions,* i.e. transactions or trades in which the underlying security is not necessarily exempt, but in which registration may be avoided because of the type of transaction involved.

All exemptions are available as a matter of right; hence, in the appropriate situation clearance is not necessary, nor is the Commission entitled to notice that an exempted offering is about to occur. However, the *Securities Act* is based on the pre-

16. All inquiries should therefore be directed to the attention of the appropriate branch chief. Assignment is on an alphabetical basis. Hence, it is possible to contact the appropriate branch chief prior to filing the statement.
17. s. 8 (d).
18. s. 9.

HeinOnline -- 6 W. Ontario L. Rev. 97 1967

sumption that all offerings require registration; exemptions are therefore strictly construed against the claimant, who has the burden of proving their availability.[19]

Exempted securities are listed in Section 3 of the *Act*. Several, such as those pertaining to intrastate offerings,[20] securities issued by banks,[21] and securities issued by the United States government or any state or political subdivision thereof,[22] are unavailable on their face to the foreign issuers.

Other exemptions, such as those involving exchanges between an issuer and its existing security holders,[23] are available to all issuers, foreign or domestic. Additionally, the "small issue" exemption is expressly available to the Canadian issuer through unavailable to its counterparts in other countries. However, it is unclear whether the exemptions provided for securities issued by charitable institutions or for short term notes or drafts may be used by persons other than Americans.

1. The Small Issue Exemption:

Perhaps the most popular exemption is that relating to small issues. Congress, in adopting the *Act*, empowered the Commission to exempt any class of securities provided the total offering amounted to less than $300,000.[24] Acting pursuant to this statutory grant, the Commission has indeed exempted all offerings whose aggregate price totals that amount. Originally, exemption was limited to American issuers, but in consideration of on expanded extradition treaty between the two countries,[25] exemption was subsequently made available to Canadian companies.[26]

The small issue exemption, unlike others, is not automatic or self-operative but is conditioned on compliance with a group of rules collectively referred to as Regulation A. Taken together, these rules amount to short-form or pilot registration. In lieu of a statement, "notification" on form 1A, together with complete though uncertified financial statements[27] and a scaled-down

19. See *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119, 126 (1953) and *S.E.C.* v. *Culpepper et al*, 270 F. 2d 241, 246 (2nd Cir. 1959).
20. s. 3 (b) (11).
21. s. 3 (a) (2) The statutory language limits the exemption to the United States national banks or banks organized under the laws of any state or territory thereof.
22. s. 3 (a) (2).
23. s. 3 (a) (9).
24. s. 3 (b).
25. s. 11A, 11B, T.I.A.S. 2454 (1951), Can. Treaty Ser. 1952 No. 12; see Loss, *supra*, note 8 at 1998.
26. Rule 252.
27. Rule 255.

HeinOnline -- 6 W. Ontario L. Rev. 98 1967

prospectus known as an "offering circular"[28] must be filed at the Commission's regional office "nearest the place where the issuer's principal business operations are conducted" at least ten days prior to the commencement of the offering.[29] Canadian issuers are further required to register the offering in the Canadian province in which it conducts or proposes to conduct its principal business operations[30] and to file consent to service of process in the United States.[31] For issues of less than $50,000 requirements are further relaxed.[32] All issuers filing under Regulation A must also file reports indicating the progress of the offering.[33]

Generally, administrative practice closely parallels full registration. However, the regional offices of the Commission assume responsibility for examining filings and issuing letters of comment.[34] It should be added that the exemption is not available to those issuers which have a history of certain deficiencies[35] and, in cases where the securities are being offered in behalf of individual shareholders (as opposed to the corporation itself), the amount offered may not exceed $100,000 per person.

Presumably, a foreign issuer may offer an unlimited amount of securities in other countries in addition to an offering of up to $300,000 in the United States without defeating he exemption. However, it cannot offer more than a total of $300,000 in the United States, either in its own right or in behalf of individual shareholders, in any given twelve month period.

At first glance, Regulation A might appear to be almost as cumbersome as the normal registration process. However, several major advantages accrue to an issuer using the procedure:

(1) a vastly simplified registration form (1A) and prospectus (or offering circular) may be employed;

(2) financial statements need not be certified; and

(3) a regional office convenient to the issuer may be used.

28. Rule 256.
29. Rule 255(c). In the event a United States underwriter is used, notification is filed at the Regional office ". . . for the region in which such underwriter has its principal office." The United States is divided into nine geographical areas, each of which is served by a regional office.
30. Rule 253(b).
31. Rule 262.
32. Rule 257.
33. Form 2A.
34. Copies of Regulation A may be obtained by writing to the Commission or any of its regional offices.
35. Rule 261.

HeinOnline -- 6 W. Ontario L. Rev. 99 1967

2. Voluntary Exchanges:

Under Section 3(a)(9), "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange" is exempt. Typically, an exchange of class A stock for class B, pursuant to a reorganization, or the recall of preferred for common, would be covered by 3(a)(9). Key requirements are: (a) the issuer of both securities must be the same; (b) the offering must be exclusively to existing security holders; (c) it must be exclusively an exchange of one certificate for another (the passage of any other consideration would defeat the exemption); and (d) there may be no paid solicitation.[36]

3. Rule 133:

Somewhat analogous to the Section 3(a)(9) situation is one where an issuer merges with a different company, selling its assets in exchange for stock and then "spinning off" or divesting itself of the resultant stock by a distribution to its own security holders. As a result, the shareholders of the "acquired" corporation (the one which sold its assets) receive stock in the "constituent" corporation (the one which purchased the assets and issued new stock).

The issuance of the new stock, which would normally require registration, may be exempt under Rule 133 of the *Securities Act*, provided the highly technical requirements of that rule are met. Very basically, there must be a reorganization as defined by Section 268(2) of the *Internal Revenue Code* of 1954[37] and an affirmative vote of shareholders, binding on minority holders. The latter requirement has precluded the exemption's availability to closely-held corporations.[38] In the event a Rule 133 type merger is contemplated, it is recommended that several authorities who treat the subject in detail be consulted.[39]

4. The Charitable Exemption:

Section 3(a)(4) exempts securities issued by persons "organized and operated exclusively for religious, educational, benevolent, fraternal, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inure to the benefit of any person, private stockholder, or individual." The text of 3(a)(4) is not expressly limited to American per-

36. For a more complete discussion see Loss, *supra*, note 8 at 573-584.
37. This requirement might be difficult to apply to a foreign issuer, though the Rule itself is technically available.
38. *S.E.C.* v. *Great Sweet Grass Oils, Ltd.* 37 S.E.C. 683 (1957).
39. "Mergers, consolidations, sales of assets — Rule 133", A. A. Sommers, Jr., 16 *West. Res. L. Rev.* 11 (1964); "The Securities Act of 1933 and Stockholders of Acquired Corporations", Wm. F. Voelker, 1965 *Duke L.J.*, Winter 1965, 1.

HeinOnline -- 6 W. Ontario L. Rev. 100 1967

sons or organizations and hence may theoretically be relied upon by foreign issuers. Nevertheless, a Canadian organization would be faced with practical difficulties in asserting the exemption; rulings of the Internal Revenue Service regarding charitable status, which are helpful in determining 3(a)(4)'s applicability, would not be available nor is it certain that a foreign organization would not be considered a private person (as opposed to a charitable organization) for purpose of 3(a)(4). In the absence of an official interpretation or case involving its availability, the foreign issuer should perhaps request a Commission interpretation or "no-action" position before proceeding under the exemption.[40]

5. Short-Term Notes:

Certain notes, drafts, bill of exchange or banker's acceptances which arise "out of a current transaction" and "which have a maturity at the time of issuance of not exceeding nine months" are exempt from registration.[41]

It is doubtful that a Canadian bank or other institution would market short-term securities in the United States. Should one desire to float an issue, the exemption's availability is unclear. Militating against availability is a congressional report referring to the section as an exemption for "short-term paper of the type available for discount at a Federal Reserve Bank."[42] Whether the quoted language precludes foreign issuers or was merely intended to be illustrative has never been decided. Again, in the absence of clear ruling, the best prescription would be to request an interpretation or no-action position.

B. Exempted Transactions

Section 4 of the *Securities Act* contains two important exempted transactions. To recapitulate, when dealing with exempted transactions the underlying security need not necessarily be exempt. Instead, the transaction itself, because of the nature or identity of the offerer, offeree or both, is exempt. It would be helpful to note that under Section 5 the offering (and not the security) is registered. Hence registration is not a permanent attribute but is effective only until the offering is complete and the securities have come to rest with the ultimate investor. If the

40. An interested party may request that the Commission issue a "no action" letter regarding any aspect of securities laws. If issued, the letter states that if the contemplated act or transaction occurs the Commission will recommend that no action be taken. The Commission thus sanctions the event without expressing any view regarding its legality and the party gains assurance that action will not be commenced against him.
41. s. 3 (a) (3).
42. H.R. Rep. No. 85, 73rd Congress 1st Sess. (1933) at 15.

HeinOnline -- 6 W. Ontario L. Rev. 101 1967

investor subsequently re-sells, his transaction must fit one of the exemptions afforded by Section 4.

1. The Private Placement Exemption:

Subsection 2 of the section exempts "transactions by an issuer not involving any public offering," the so-called private placement. The terms of this exemption are thus couched in the negative. If it can be established that a sale is not a "public offering," 4(2) is applicable; ergo the offering need not be registered. Several obvious examples immediately come to mind. A sale to an institutional investor such as a mutual fund or insurance company, sales to closely related persons, or sales to small groups of professional investors are all exempt. Conversely, sales to large random groups such as fraternal or professional groups would not be considered private and must be registered unless another exemption is available. Interpretation becomes difficult, however, when considering sales to small unrelated groups of individuals, usually acquaintances or business associates of the principals or employees of the issuer.

In the landmark case of *S.E.C.* v. *Ralston Purina Co.*[43], the United States Supreme Court, in formulating guidelines for the exemption, held that:

> The applicability of Section 4(1) [now 4(2)] should turn on whether the particular class of persons affected needs the protection of the act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering".[44]

The Court concluded that an offering to a large group of the issuer's employees, including clerical and maintenance staff, constituted a public offering. Had the offer been limited to "key" employees, i.e. managerial or executive personnel, registration would not be required, for such persons would have access to and knowledge of the financial status of the company and therefore would not need the protection of the *Act.*

Ralston Purina has also been applied to classes of unrelated persons.[45] Offerings to small groups of sophisticated investors probably come under the umbrella of 4(2) as would the typical offering of closed corporations to friends and related persons; but offerings to members of an unsophisticated or unrelated group would not normally be considered private.[46]

It has been suggested that offerings to any class of twenty

43. *Supra,* note 19.
44. *Ibid.,* 125.
45. *S.E.C.* v. *Tax Service, Inc.* 357 F. 2d 143 (4th Cir. 1966); *United States* v. *Custer Channel Wing Corp.,* 247 F. Supp. 481 (D.C.Md. 1965); *In the Matter of Dempsey & Company,* 38 S.E.C. 371 (1958).
46. See Securities Act Rel. 4552, dated November 2, 1962.

HeinOnline -- 6 W. Ontario L. Rev. 102 1967

persons or less could not constitute a public offering. Though this test might be helpful as a rough rule of thumb (the Commission has indeed taken a more liberal attitude where sales are limited to smaller groups), every sale should be scrutinized under the *Ralston Purina* doctrine. As a matter of fact, whenever more than a handful of non-institutional investors are involved, counsel would be well advised to contact the commission for the purpose of obtaining an interpretation or no-action position.

The issuer has a continuing responsibility regarding all sales of its securities and, accordingly, when selling pursuant to the private placement exemption, should obtain an "investment" letter from the purchaser.[47] This letter stipulates that the offeree is acquiring the securities for investment purposes only and not with a view to resale.[48] Such representations are often coupled with a legend on the certificate barring transfer without the issuer's consent.

Generally the Commission has held that a period of two or three years is necessary to fulfill the requisite investment intent,[49] though in cases in which there is an extreme change of circumstance involving the purchaser, such as illness or business reversals, the Commission has taken a more liberal position. In any event, if the purchaser later wishes to resell, corporation counsel should independently determine whether resale would be exempt or demand that the holder furnish a no action letter from the Commission to the effect that it would recommend no action if the sale were consummated.

The private placement exemption is available to all foreign issuers. Of course, sales to Canadian groups or employees cannot be proscribed by American regulations. However, if any United States residents are included, the offering should be examined in its entirety, for there is danger that sales to Americans will be integrated with similar sales to Canadians in determining the exemption's availability. Should the combination surpass the limits of 4 (2), exemption would be defeated.

47. See *Re: The Crowell-Collier Publishing Company*, Securities Act Rel. 3825.
48. The body of such a letter might state: "In connection with the purchase by me of 1,000 shares of your authorized but unissued Common Stock, I hereby represent to you that such shares are being acquired for investment and not with a view to, or resale in connection with, any distribution of such shares. I understand that the shares issued to me have not been registered under the *Securities Act* of 1933 by reason of a specific exemption which depends upon my investment intent." This language may be followed by an agreement to furnish a "no action" letter, if requested, and consent to a "stop transfer" stamp on the certificate.
49. In one case, *In re Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959), a court held that holding for a period of two years by a non-controlled party created a presumption that the shares were acquired solely for investment purposes.

HeinOnline -- 6 W. Ontario L. Rev. 103 1967

2. Section 4(1) and Rule 154:

Section 4(1), perhaps the most important exemption contained in the *Act,* exempts "transactions by any person other than an issuer, underwriter or dealer." Thus John Q. Public, when selling ten shares of General Motors, is protected, albeit unknowingly, by 4(1). Literally hundreds of thousands of these transactions occur daily and the exemption as applied to the average investor needs little further explanation.

When dealing with persons who may be deemed issuers, dealers or particularly "underwriter" under the definition of that term as set forth in Section 2(11), the problem becomes rather complex. 2(11) defines "underwriter" as "any person who has purchased from an issuer with a view toward, or offers or sells for an issuer in connection with, the distribution of any security. . ." And, by postscript, the issuer, in addition to the corporation itself, is deemed to include "any person directly or indirectly controlling or controlled by the issuer." To close the circle, controlled parties presumptively include all officers, directors and owners of ten percent or more of the stock.[50]

In the event an officer, director, or major stockholder desires to sell any security of the issuer, his broker, by combining 4(1) and 2(11) may well be classified as an underwriter selling securities for the issuer in which event the securities must be registered. Moreover, the insider might be deemed an issuer under 4(1) and thus be precluded from selling his stock, unless registered. This has understandably led the securities industry to carefully examine such transactions and obtain opinion of counsel before executing such orders.[51] As a matter of fact, 4(1), by itself, would probably preclude any sales of unregistered securities by insiders, though such persons could resell via the limited method of private placement or under the Regulation A small issue exemption.

To alleviate this problem, the Commission has adopted Rule 154, permitting small "casual" trades by insiders without the necessity of registration. The rule is, strictly speaking, a brokerage exemption which permits the seller's broker to engage in transactions without the danger of being labelled an under-

50. This does not preclude other persons who might, for example, own less than ten percent of the stock, though control would have to be proven rather than presumed.

51. This might be considered a restriction on insider trading and, in fact, certainly constitutes an obstacle to large sales by insiders. However, it differs from the traditional insider restriction in that it is not an absolute bar to trades but an infirmity which may be cured by registration.

HeinOnline -- 6 W. Ontario L. Rev. 104 1967

writer.[52] However, in a release interpreting Rule 154, the Commission stated that:

> If . . ., the selling broker's part of the transaction meets all the requirements of the Rule . . . the controlled person's part of the transaction will likewise be exempt under Section 4(1) of the Act.[53]

Thus, provided all the criteria of the Rule are met, both the controlled party and his broker may engage in selling transactions. Enumerated conditions are: (a) the transaction must be unsolicited; (b) it must be a brokerage transaction, the selling broker acting as agent and not principal; and (c) sales by the controlled party cannot exceed one percent of the total outstanding units of the security in a given six month period.[54] However, repetitive selling of one percent every six months would be considered a distribution requiring registration, as the Rule is designed to encompass only small casual trading. Moreover, the selling party is still subject to all other insider restrictions. Thus, securities originally acquired in reliance on the private placement exemption could not be sold unless the requisite investment intent had been satisfied. Also, restrictions against short-swing profits and manipulation would be applicable, the only obviated requirement being registration.[55]

Exemption under 4(1) is, of course, available to the foreign issuer and persons controlled by such issuer. However, it should be emphasized that, under Rule 154, *all* sales by the controlled party cannot exceed 1% in any six month period. It is probable that sales in Canada or to Canadians would be included and should therefore be calculated in determining the rule's availability.

PART IV

FRAUD UNDER THE SECURITIES ACT OF 1933

The anti-fraud provision of the *Securities Act,* Section 17(a), states that it is unlawful:

> (1) to employ any device, scheme, or artifice to defraud, or

52. A broker, in executing orders, normally comes within the purview of s. 4(4), the so-called "broker's exemption".
53. Securities Act Rel. 4718 at 2.
54. The 1% rule is applicable only to unlisted or over-the counter securities. If the security is admitted to trading on an American exchange, sales cannot exceed "the lesser of either of the outstanding securities of the class, or the largest aggregate reported volume of trading on securities exchanges during any one week (Monday through Friday) within the four weeks preceding receipt of the sell order.)"
55. Insider trading restrictions will be discussed in Part VI.

HeinOnline -- 6 W. Ontario L. Rev. 105 1967

(2) to obtain money or property by means of any untrue statement of a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

An article of this nature is not the place to detail the elements of Section 17. Every issuer should nonetheless be aware of its presence and possible, if uncontemplated, application. The following brief observations are offered with that purpose in mind:

(1) the statute goes beyond traditional common law fraud, encompassing, at the very least, omissions of material facts as well as direct falsifications or half-truths;

(2) Section 17 may form the basis for either civil or criminal action;

(3) any seller of securities, private or corporate, may be held liable;

(4) the section is expressly applicable to all securities, including those exempted under Section 3[56]; and

(5) suits for recovery under Section 17 must be commenced within three years following the date the offering began, a rather short statute of limitations. However, the elements of a Section 17 violation may give rise to liability under Section 10 of the *Securities and Exchange Act* of 1934, that section's statute of limitations being geared to the generally longer statutes for fraud in the state in which the act was perpetrated.

PART V

THE SECURITIES AND EXCHANGE ACT OF 1934: PERIODIC REPORTS & PROXIES

The *Securities Act* of 1933, with concomitant provisions regulating sales, advertising and underwriting, is almost exclusively limited to offerings. When sales have been completed application ceases, though subsequent transactions may confront the person initiating sales and, tangentially, the issuer with registration problems. The 1934 *Act*, on the other hand, calling for periodic reports, proxy regulation and controls on insider trad-

56. s. 17(c) provides that "the exemptions provided in section 3 shall not apply to the provisions of this section."

HeinOnline -- 6 W. Ontario L. Rev. 106 1967

ing, creates a continuing responsibility on the part of issuers.[57] In one sense then, the 1934 *Act* commences where the 1933 *Act* ends. Moreover, its provisions are not applied equally to all issuers. Some classes of corporations are required to file periodic reports, others are exempt. Although the anti-fraud and anti-manipulation rules are applied against all issuers, the prohibition against short-swing insider profits is applicable only to listed corporations and the larger over-the-counter companies.

Application against foreign issuers is further clouded by recently enacted or proposed amendments. Proposed rules regarding the filing of periodic reports are particularly controversial and have resulted in a virtual stalemate between the Commission and foreign corporations. Although existing regulations will be discussed at relevant points in this section, counsel would be well advised to adopt a "wait and see" attitude pending future clarification by the Commission.

Under Section 13 of the *Securities and Exchange Act*, certain classes of issuers are required to file annual, semi-annual and current reports designed to keep their financial records updated. Filing is based on two related sections, 15(d) and 12. The former, which is relatively simple, provides that each issuer who files a registration statement pursuant to the 1933 *Act* shall file "such supplementary and periodic information, documents, and reports as may be required pursuant to Section 13 of this title", except that "if, at the beginning of [any] financial year, the securities of each class to which the registration statement related are held of record by less than three hundred persons" obligation to file is suspended. In short, any issuer who has filed under the 1933 *Act* and has more than 300 shareholders comes within the purview of Section 15(d).

Under 15(d) filings are limited to periodic financial reports; hence, proxy information or reports regarding insider trading need not be submitted. Reports include an annual statement[58], semi-annual statements[59] and reports concerning major corporate events which might affect the issuer's financial position.[60]

57. The *Act* additionally regulates American broker-dealers or foreign brokers doing business in the United States: however, since this aspect of the *Act* does not directly affect issuers, it will not be discussed.
58. Rule 13a-1 and Form 10K.
59. Rule 13a-13 and Form 9K.
60. Rule 13a-11 and Form 8K. Investment companies and certain real estate companies are also required to file quarterly reports; see rules 13a-12 and 13a-15. Section 15 additionally contains a set of rules (15d-1 through 15d-21) duplicating those found under s. 13. One of these, Rule 15d-14, exempts Canadian banks subject to the *Bank Act* of Canada from the requirement of filing annual reports. However, in view of an absence of similar provision in the s. 13 rules, Rule 15d-14's applicability is in doubt.

HeinOnline -- 6 W. Ontario L. Rev. 107 1967

The annual report, filed on Form 10K, is quite detailed, requiring information regarding remuneration, option plans and re-evaluation of assets, as well as balance sheets and income statements. However, all other forms have been simplified, compliance often entailing only a brief report of a few pages. Furthermore, with the exception of the annual statement, reports need not be certified.

Section 12 is more complex, necessitating separate registration under the 1934 *Act* (as opposed to 1933 *Act* registration of offerings) and compliance with several additional *Exchange Act* provisions. As originally enacted only those issuers listed on national stock exchanges were required to file pursuant to subsection 12(b). Application of the *Act* in such cases is clear and, as few foreign issuers elect to list on an American exchange, no further discussion is warranted.[61]

However, in 1964, in the course of the first major revision of the securities acts in thirty years, a new subsection, 12(g), was added, requiring registration of those companies which are not listed, but have assets exceeding $1,000,000 and a class of equity security "held of record by five hundred or more" persons. American companies have already begun compliance with the new regulations. However, foreign issuers, though not afforded statutory exemption, have been administratively exempted by a series of one-year "temporary" rules. In the interim, various proposals have been submitted by the Commission for public discussion, but have been deferred following severe opposition by foreign governments and companies.

Initially, exemption was granted until November 30, 1965[62] but was later continued until November 30, 1966.[63] As a temporary compromise, foreign issuers which met the requirements of 12(g) and whose securities were held by 300 or more residents of the United States were requested to voluntarily submit copies of all reports filed with the appropriate regulatory agency of the domicilary nation.[64] As of August, 1966, thirty-three Canadian corporations had filed under that program.[65] An additional fourteen were listed as having failed to comply.[66] Not unexpectedly, most of the forty-seven companies listed as either complying or failing to "volunteer" are engaged in mining oper-

61. Foreign issuers, with the exception of those domiciled in a North American country, are exempt from the proxy and insider trading rules (See Securities Exchange Act Forms 18-21). However, United States controlled corporations may lose exemption; See Rule 13-12-3, as adopted on 4/4/66 and Securities Exchange Act Rel. 7865.
62. Rule 12g3-1.
63. Rule 12g3-1.
64. Securities Exchange Act Rel. 7867, dated April 21, 1965.
65. Securities Exchange Act Rel. 7934, dated August 10, 1966.
66. *Ibid.*

HeinOnline -- 6 W. Ontario L. Rev. 108 1967

ations. It should be added that, because of the almost complete absence of reports filed prior to enactment of Section 12(g), it is impossible to estimate the number of Canadian concerns which might become subject to its provisions.

The last exemption afforded foreign issuers lapsed on November 30, 1966 and, to the date of writing, has not been extended. Although this necessitates registration by appropriate issuers, all companies are granted 120 days in which to submit a statement.[67] In effect, this four month "grace" period provides the Commission with additional time to prepare new rules. In the absence of any statement on the part of the agency it can only be assumed that further exemption will be permitted or, in the alternative, regulations will be drafted specifically for use by foreign issuers.

One aspect of *Exchange Act* compliance which has been the cause of great difficulty to Canadian issuers is the Commission's policy of treating North American issuers on the same basis as United States ones. Other foreign companies are generally granted complete exemption from proxy regulation and insider trading prohibitions and partial exemption under the Section 13 reporting requirements.[68] Reluctance to grant Canadian issuers the same privileges is probably attributable to the large volume of sales of Canadian securities in the United States, some of questionable quality, and the fact that identity of language and similarity of accounting methods tend to facilitate filings. However, should Section 12(g) be applied in full force, great hardship might result, the entire spectrum of *Exchange Act* regulations having application.

Finally Section 12(g) is not specifically related to the offering of securities through American sources. Large Canadian corporations could conceivably accumulate 300 American holders without intentionally tapping the United States market. United States residents might purchase the securities while in Canada or through Canadian brokers, especially if the issuer were "touted" by American brokers. However, such wide-spread sales are unlikely, nor is it by any means certain that the Commission would pursue recalcitrant issuers.[69]

Proxy regulations, to the extent such rules may become applicable through Section 12, are very detailed as well as time consuming. Firstly, a proxy statement must be filed every year

67. s.12(g)(1)(B).

68. Rules 13a-11(b) and 13a-13; also forms 18-21. These issuers are exempt from filing all reports except the annual statement.

69. For that matter it is questionable whether the Commission would have jurisdiction. For an excellent discussion of jurisdictional and extraditional problems see Williamson, *Securities Regulation in Canada* (1960) at 336-393.

HeinOnline -- 6 W. Ontario L. Rev. 109 1967

regardless of whether management elects to solicit proxies.[70] In addition, there are provisions covering the manner of solicitation and inclusion of proposals made by minority or dissident security holders.[71] Suffice it to say that compliance might result in major revision of the manner in which the issuer conducts its internal affairs.

Registration under Section 12 by a North American issuer would also necessitate the filing of insider trading reports by controlled parties.[72] Insiders would additionally become subject to the strictures of Section 16 (b) prohibiting short-swing profits.

PART VI

THE SECURITIES AND EXCHANGE ACT: INSIDER TRADING AND FRAUD

Insider trading restrictions are covered by Sections 9, 10 and 16 of the *Act.* Of these, only Section 16, which is applicable to those issuers registered pursuant to Section 12, is, technically speaking, an insider regulation, its provisions having application exclusively to controlled parties. Sections 9 and 10, on the other hand, are applicable to all persons, controlled or otherwise. However, prosecutions and civil suits for violations have been brought mainly against insiders. For this reason, management officials have been severely critical of their application, especially in view of recent judicial interpretation broadening applicability.

Section 9 augmented by Sections 10 and 15 (c)[73], prohibits several highly specialized manipulative devises such as simultaneous purchases and sales (wash-outs) "for the purpose of creating a false or misleading appearance of actual trading"[74] or transactions to raise or depress the price of a security for the purpose of inducing purchases or sales by others.[75] Although these prohibitions are obviously tailored for professional manipulative techniques, any intentional attempt to raise or lower prices,

70. s. 14.
71. See Securities Exchange Act Rules 14a-1 through 14a-11 and Schedule 14A therein.
72. Officers, directors and holders of 10% or more of any class of equity security are deemed controlled parties under s. 16 and must file on Exchange Act Forms 3 and 4.
73. Section 9 is applicable only to securities traded on national securities exchanges. However, Section 15 (c) (1) extends full coverage to the over-the-counter market; see *Barrett & Co.*, 9 S.E.C. 319 (1941).
74. s. 9 (a) (1).
75. s. 9 (a) (2).

HeinOnline -- 6 W. Ontario L. Rev. 110 1967

"corner" the market or create an artificial volume of trading may give rise to a cause of action.[76]

Section 10 and Rule 10b-5, promulgated pursuant to this section, are the most potent weapons in the securities acts' anti-fraud arsenal. The rule, in its entirety, states that:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates, or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

These prohibitions could well be classed as a shotgun approach aimed at all possible fraudulent transactions and coverage is indeed broad. The rule applies across-the-board to listed as well as over-the-counter securities, insiders, non-insiders and the issuer itself.[77] In addition, purchases as well as sales are included. However, at least some of the common law fraud elements must be proven. There must be a misstatement or silence as to a material fact and reasonable reliance on such fact.[78] Other common law requirements, most notably privity, have been obviated.[79]

The anti-fraud rules have had great effect on insider trading. Indeed, because of the insider's intimate knowledge of

76. Most administrative or court actions under s. 9 have been directed against the investment community. Often a broker "corners" the market of a sluggish over-the-counter issue in which there is little professional interest via a series of high-volume purchases. Following the inevitable rise in the prices resulting from his volume of purchases, the broker sells his holdings to members of the public, thereby reaping a high profit. However, occasionally the issuer creates an inflated price by means of high volume purchases in contemplation of merger (the price paid per share in mergers is commonly based on current market price) or, perhaps, to "feed" its pension or option plans. See *S.E.C.* v. *Georgia-Pacific Corp.*, C.C.H. Fed. Sec. Reg. Paragraph 91,692, decided May 24, 1966.

77. See *Ruckle* v. *Roto American Corporation*, 339 F. 2d 24 (2nd Cir. 1964).

78. See *List* v. *Fashion Park, Inc.* 340 F. 2d 457 (2nd Cir. 1965). Materiality has been defined as that "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities", *Kohler* v. *Kohler Co.*, 319 F. 2d 634, 642 (7th Cir. 1963); also *List* v. *Fashion Park, Inc.*

79. *Miller* v. *Bargain City, U.S.A.*, 229 F. Supp. 33 (E.D.Pa. 1964); also *Cochran* v. *Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962).

HeinOnline -- 6 W. Ontario L. Rev. 111 1967

his corporation's affairs, a strict definition of materiality would taint any trade to which he were a party.[80] Though enforcement of the Rule is a complex matter, insiders would be well advised to consider its possible application before initiating trades in which they might have knowledge of significant facts the opposite party lacks.[81]

Finally, Section 16(b) provides that any profit realized by an insider from the purchase and sale or sale and purchase of an equity security of a Section 12 issuer within a period of less than six months (i.e. short-swing profits) shall be recoverable by the issuer directly, or indirectly by means of derivative action.[82] The section creates an absolute liability. Hence, wrongful intent or use of insider information need not be shown; for that matter, profits may be recovered even though the insider purchased in order to prevent a "panic" decline, thereby protecting the equity of minority shareholders.[83] On the other hand, if the security has been held for longer than six months, action under 16(b) is impossible, though profit accrued through the use of insider information.[84]

Without detailed analysis of Section 16(b), the following observations are offered concerning its enforcement:

1. The statute is applicable only for purchases and sales of equity securities. Hence, an insider is free to engage in short-swing transactions involving debt securities.
2. All equity securities of an issuer subject to Section 12 are covered. Thus, the security in question need not be registered under the 1933 and 1934 *Acts*.[85]
3. The purchase and sale or sale and purchase need not be of the identical certificate. Any transaction involving the same class of equity security could give rise to a cause of action.
4. Action may be commenced within two years following the date profit was realized. Also, an individual shareholder must request that the issuer bring suit before commencing derivative action.

80. The Commission has taken the position that during a merger period or other significant corporate event the insider must disclose all relevant information or forebear trading; *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).
81. See *S.E.C.* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966).
82. The only exemption afforded is for securities "acquired in good faith in connection with a debt previously contracted."
83. See *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (2nd Cir. 1943), cert. denied, 320 U.S. 751.
84. *Adler* v. *Klawans*, 267 F. 2d 840 (2nd Cir. 1959).
85. The only exception pertains to securities issued by an American governmental unit. See s. 16(b) and s. 3(a)(12).

HeinOnline -- 6 W. Ontario L. Rev. 112 1967

All of the fraud, manipulation and short-swing profit prohibitions are at least theoretically applicable against foreign issuers and their officers, directors and major shareholders. However, despite the large volume of case law, apparently no action has been directed against an issuer or person who is not a resident of the United States. This is not surprising, considering the formidable issues which might be raised. For example, would a Canadian insider who purchased in Canada and sold in the United States within six months have violated Section 16(b)? Or would a person who engaged in "washout" transactions (i.e. simultaneous purchases and sales) between America and Canadian markets have violated Section 9? To begin to answer these questions would require detailed and probably unfruitful analysis of jurisdictional, extraditional and conflict of laws questions. To date, apparently no one has been willing to open Pandora's box.

PART VII

CONCLUSION

Every Canadian issuer who contemplates an offering to United States residents would be well advised to study the registration process under the *Securities Act* of 1933 as well as possible application of several *Securities Exchange Act* of 1934 provisions. Although the mechanics of filing a registration statement are relatively simple, several attendant regulations strictly control the manner in which securities may be legally offered. However, the issuer may avoid the registration process provided the offering fits one of the *Act's* several exemptive provisions, the most important of which pertain to small issues and private placements.

Exchange Act requirements may also have an important bearing on decisions regarding the initial offering of securities. Although enforcement actions under that *Act* have not been directed against foreign companies, Canadian issuers should not glibly ignore *Exchange Act* strictures. Reporting aspects can easily be enforced under the Commission's formidable suspension of trading powers[86] and there is always the possibility, however distant, that shocking violations could result in successful test cases. These factors should be seriously considered by every issuer contemplating an offering within the United States.

86. s. 19(a)(4) and s. 15(c)(5).

HeinOnline -- 6 W. Ontario L. Rev. 113 1967