# SECURITIES LAW

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I. INTRODUCTION

A. History. The first laws regulating offerings of and trading in securities were passed not by the federal government but by the states. Kansas, a state particularly besieged by promoters of fraudulent enterprises, some of whom were said to be so bold as to attempt to sell building lots in the blue sky in fee simple, enacted the first so-called "blue sky laws" in 1911. Oregon and Washington followed shortly thereafter with blue sky laws of their own.

The first federal securities law was enacted in 1933. The Securities Act of 1933 (1933 Act) regulates the offer and sale of securities sold in interstate commerce. Essentially, the 1933 Act prohibits the offer and sale of any security that is either not registered with the Securities and Exchange Commission (SEC), or exempt from registration pursuant to statutory exemptions. Moreover, the 1933 Act prohibits fraudulent or deceptive practices in any offer or sale of securities.

The Securities Exchange Act of 1934 (1934 Act) extends federal regulation to securities exchanges and over-the-counter markets (OTC), i.e., trading in securities which are already issued and outstanding.

It is with these sources of law which we primarily will be concerned in our exploration of the meaning of the term "security."

B. Applicability of Federal and State Law. Both federal\(^1\) and state law apply to securities transactions. Federal securities laws generally apply only to transactions involving "the use of any means or instruments of transportation or communication in interstate commerce or of the mails" because such laws are based upon Congress's power to regulate interstate commerce. The "use of interstate commerce facilities," however, has been construed broadly by the courts. See, e.g., *Franklin Sav. Bank v. Levy*, 551 F.2d 521 (2d Cir. 1977) (use of the mails to accomplish any part of the transaction, including payment or confirmation after a sale, is sufficient to support federal jurisdiction); *Dupuy v. Dupuy*, 511 F.2d 641 (5th Cir. 1975) (intrastate telephone call involves the use of interstate facilities).

The federal securities laws specifically preserve the jurisdiction of the state securities commissions to regulate securities transactions, provided such state regulation does not conflict with federal law. See, e.g. Securities Act of 1933 § 18. State securities laws, or "blue sky laws," generally provide for registration of broker-dealers, registration of securities to be offered or traded within the state, and sanctions against fraudulent activities.

II. STATUTORY DEFINITION OF A "SECURITY"

The various securities laws define the term "security" statutorily in substantially the same manner. The statutory definitions germane to our examination are, like others, subject to extensive judicial interpretation.

\(^{1}\) Seven statutes, as periodically amended, generally comprise federal securities law. These include: the Securities Act of 1933; the Securities Exchange Act of 1934; the Public Utility Holding Co. Act of 1935; the Trust Indenture Act of 1939; the Investment Company Act of 1940; the Investment Advisers Act of 1940; and the Securities Investor Protection Act of 1970.
A. The Securities Exchange Act of 1933. Under Section 2(1) of the 1933 Act, unless the context otherwise requires,

"[t]he term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fraction of undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

B. The Securities Exchange Act of 1934. The definition of a security provided under Section 3(a)(10) of the 1934 Act is virtually identical to the definition provided under Section 2(1) of the 1933 Act, except that "evidence of indebtedness" is not included among its terms, and the following exclusion is added:

"The term 'security' shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

C. The Oregon Securities Law. The definition of a security under ORS 59.015(17)(a) likewise is substantially similar to the definitions provided under Section 2(1) of the 1933 Act. The Oregon definition, however, adds the following items: (1) "certificate of interest or participation in a pension plan"; and (2) "real estate paper sold by a broker-dealer, mortgage broker" or certain other persons. Moreover, the Oregon definition omits any references to puts, straddles, options or privileges on any security. Finally, the Oregon definition adds an exclusionary section as follows:

"(b) 'Security' does not include:

(A) An insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed or variable sum of money either in a lump sum or periodically for life or some other specified period;

(B) A beneficial interest in a voluntary inter vivos trust unless the trust is created solely for the purpose of voting or is part of an attempt to evade the provisions of ORS 59.005 to 59.370; or
(C) A beneficial interest in a testamentary trust."

D. Washington Law. Again, the definition of a security under RCW 21.20.005(17)(a) substantially mirrors the definition provided under Section 2(1) of the 1933 Act. Like Oregon, Washington's definition omits any reference to puts, calls, straddles, options or privileges on any security. Moreover, the Washington definition adds the following items: (1) "investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture"; (2) "charitable gift annuity." Then in WAC 474-10-020(10) "any sale of an indenture, bond or contract for the conveyance of land or any interest therein where such land is situated outside of the state of Washington and such sale or its offering is not conducted by a real estate broker licensed by the state of Washington." Finally, similar to Oregon, the Washington definition "does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay money either in a lump sum or periodically for life or some other specified period."

E. California Law. The definition of a security under Sec. 25019 is based on Section 2(1) of the 1933 Act but adds "certificate of interest or participation in any profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; viatical settlement contract or a fractionalized or pooled interest therein; life settlement contract or a fractionalized or pooled interest therein; voting trust certificate; certificate of deposit for a security; interest in a limited liability company and any class or series of those interests(including any fractional or other interest in that interest), except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management. The statute goes on to say that the test is not met simply because an operating agreement says all members can vote and participate in the management of the LLC.

III. PROMISSORY NOTES AS SECURITIES

A. Federal Law. All four statutory definitions of a "security" under consideration include "any note" among their terms, excluding notes with maturities not exceeding nine months in the case of the 1934 Act. The statutory definition, consequently, appears to be quite broad. The Supreme Court, however, recently adopted a "literal" or "family resemblance" test for determining whether a note is a security for federal securities law purposes. Reves v. Ernst & Young, 494 U.S. 56, 110 S. Q. 945. 108 L. Ed. 2d 47 (1990). Prior to Reves, the First, Third, Fifth, Seventh, and Tenth Circuits generally applied a "commercial/investment dichotomy test to determine whether a note was a security, while the Sixth and Ninth Circuits usually applied a "risk capital" test.

The "family resemblance" test, first articulated in Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976), presumes that notes are securities, subject to certain listed exceptions. An issuer, therefore, can "rebut the presumption that a note is a security if it can show that the note in question 'bear[s] a strong family resemblance' to an item on the judicially crafted list of exceptions or convince the court to add a new instrument to the list." Reves, 108 L. Ed. 2d at 59.
The list of instruments commonly denominated "notes" that nonetheless fall outside the "security" category includes:

(1) the note delivered in consumer financing;
(2) the note secured by a mortgage on a home;
(3) the short-term note secured by a lien on a small business or some of its assets;
(4) the note evidencing a 'character' loan to a bank customer;
(5) short-term notes secured by an assignment of accounts receivable;
(6) a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of a customer of a broker, it is collateralized); or
(7) notes evidencing loans by commercial banks for current operations."

Id. at 60 (quoting Exchange Nat'l. Bank, 544 F.2d at 1138); Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 939 (2d Cir. 1984).

The court also articulated standards for determining when an item should be added to the list. Specifically, the following four factors should be considered:

1. **The motivation of the parties:** Essentially, the commercial/ investment nature of the transaction determines whether the note is a security. If the proceeds from the exchange of the notes are to be used for a purpose normally financed by investment (e.g., for the general use of a business or to finance substantial investments), the note probably is a security. On the other hand, if the proceeds are to be used for a purpose usually financed by commercial loans (e.g., to facilitate the purchase and sale of a minor asset or consumer good or to correct for the seller's cash-flow difficulties), the note probably is not a security.

2. **Plan of distribution:** If the note is an instrument in which there is "common trading for speculation or investment," it probably is a security.

3. **Reasonable expectations of the public:** A transaction involving notes that is characterized as an "investment," "securities," probably indicates that the notes are securities.

4. **Existence of other regulatory schemes:** A transaction involving a note that is subject to another regulatory scheme (e.g., FDIC regulation of certificates of deposit), thereby reducing the risk of the note, is in no need of federal securities law protection and thus probably is not a security.

Reves, 108 L. Ed. 2d at 60-61. The Reves "family resemblance" test, therefore, is rather inclusive, incorporating many types of notes into the definition of a security.

**B. Oregon Law.** By and large, the Oregon courts have skirted the issue of whether a note is a security. Consequently, no test for making such a determination has been developed by
C. **Washington Law.** In the past, Washington courts have applied a "risk capital" test to determine whether, in a particular transaction, a note is a security. Because the U.S. Supreme Court recently opted for the "family resemblance" test, however, one may reasonably suspect that the Washington courts will do likewise, although no rulings on this issue have been made since **Reeves** was handed down.

IV. "**STOCK**" AS A SECURITY

A. **Federal Law.** Generally, a share of "stock" will be deemed to be a security. An instrument that bears the label "stock," however, is not always a security. In **United Housing Foundation, Inc. v. Forman**, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975), for example, the Supreme Court rejected the suggestion that a transaction involving instruments labeled "stock" "must be considered a security transaction because the statutory definition of a security includes the words 'any...stock.'" *Id.* Specifically, instruments labeled "stock" must also possess "some significant characteristics typically associated with" stock in order to be classified as such for purposes of federal security laws. *Id.* at 851. If the instrument both is called "stock" and bears stock's usual characteristics, "a purchaser justifiably [may] assume that the federal securities laws apply." *Id.* at 850. The particular characteristics usually associated with common stock are identified as:

1. The right to receive dividends contingent upon an apportionment of profits;
2. Negotiability:
3. The ability to be pledged or hypothecated.
4. The conferring of voting rights in proportion to the number of shares owned; and
5. The capacity to appreciate in value.

*Id.* at 851. In **Forman**, the court held that shares of stock in a cooperative housing corporation were not "securities" under federal law where "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit." *Id.*

After **Forman**, several lower courts held that the sale of a business, affected by the transfer of all its outstanding stock, is not a sale of "securities" because the transfer of stock is simply the method used to vest ownership and control of the business in the purchasers. In **Landreth Timber Co. v. Landreth**, 471 U.S. 681, 105 S. Ct 2297, 85 L. Ed. 2d 692 (1985),

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however, the Supreme Court rejected this "sale of business" doctrine, ruling that "[i]nstruments that bear both the name and all of the usual characteristics of stock seem ... to be the clearest case for coverage by the plain language of the definition" of a security. \textit{Id.} at 693. In \textit{Landreth}, the court held that the transfer of 100\% of the stock of a company pursuant to the sale of a business involved the sale of a federal "security" since the plain meaning of the statutory definition of "security" mandated that the stock transaction be covered by the federal securities laws.

\section*{B. Oregon Law.} Oregon courts have not ruled on this issue. They may, however, lean toward the sale of business doctrine.\footnote{See \textit{Kneeland v. Shroyer}, 214 Or. 67, 328 P.2d 753 (1958) (the sale of essentially all of the stock of corporation the principal asset of which was trees, was a sale of time rather than securities); \textit{but cf.} \textit{Silvertooth v. Kelly}, 162 Or. 381, 91 P.2d 1112 (1939). \textit{See also} R. MCGAUGHEY, OREGON CORPORATE AND SECURITIES LAW, 181-84 (1988).}


\section*{V. INVESTMENT CONTRACT ANALYSIS}

\subsection*{A. Statutory Interpretation.} Investments in a variety of capital-raising schemes other than "notes," "stocks," or instruments commonly known as "securities" represent perhaps the greatest difficulties in defining a "security." Such investments may fall into the vague categories of "investment contracts" or "certificates of interest or participation in any profit-sharing agreement" These terms have been liberally construed by the courts to apply to a wide range of schemes, particularly where the SEC or state regulators have sought injunctions against activities for which there was no prompt or effective relief available under the laws designed to protect the public. Among the types of interests which have been held in certain circumstances to be "securities" are interests in oil and gas drilling programs, real estate condominiums and cooperatives, farm lands or animals, commodity option contracts, whiskey warehouse receipts, and multilevel distributorship arrangements and merchandise marketing schemes. There are essentially two tests to determine the existence of an investment contract: the so-called \textit{Howey} test, and the "risk capital" test.

\subsubsection*{1. The Howey Test.} The basic definition of an "investment contract" was articulated by the U.S. Supreme Court in \textit{Securities & Exchange Commission v. W. J. Howey Co.}, 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946), and consists of a four-prong test:

\begin{quote}
\end{quote}

\textit{Id.} at 298-99. The definition of a security, however, "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by
those who seek the use of the money of others on the promise of profits"; i.e. substance is to prevail over form. Id. at 299. In Howey, the sale of individual rows of orange trees in conjunction with a service contract under which the seller cultivated, harvested and marketed the orange crop was held to involve a "security" within the meaning of the 1933 Act.

a. Howey's Progeny. Over the years, courts have modified the basic Howey test and have interpreted its four elements differently.

(1) The Investment of Money. While cash investments clearly fall within the Howey test, the status of other types of investment are not so certain. Contributed notes, other securities, or assets or property of almost any nature may constitute an investment of "money" for purpose of the Howey test, International Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 560 n.12, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979), but an investment of labor probably does not. Id.5

(2) In a Common Enterprise. A "common enterprise" obtains where the "fortunes of the investor are interwoven and dependent upon the efforts and success of those seeking those investments or of third parties." SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476,482 n.7 (9th Cir.), cert. denied, 414 U.S. 821 (1973). Courts have split on the interpretation of a "common enterprise." Some jurisdictions ascribe to the "horizontal commonality" test, according to which investors' accounts must be pooled. Under this test, a transaction must involve more than one investor and, although the pooled interests generally are combined with proportional profit sharing among the many investors, it is possible that some investors may profit while others are losing. See Hirk v. Agri-Research, 561 F.2d 96 (7th Cir. 1977). Other jurisdictions, including the Ninth Circuit, ascribe to the "vertical commonality" test, according to which only a common venture between the investor and either the promoter or some other third party must exist. Under this test, more than one investor is not required. For example, discretionary securities or commodities trading accounts have been held to be securities where a single investor may expect profits from his individual trading positions and the broker selling the "security", represented by the discretionary account, likewise expects profits in the form of commissions. See SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974). The Supreme Court has not yet decided which commonality test is to be applied, but the Court has held that "a Unique [profit-sharing] agreement, negotiated one-on-one by the parties, is not a security," thus indicating that the horizontal commonality test may be preferred. Maine Bank v. Weaver, 455 U.S. 551, 560, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982).

(3) Expectation of Profits. The "expectation of profits" is not

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necessarily required to be in the form of a normal investment return. For example, the expected profit may be in the form of the use of recreational facilities that the investor finances, see Silver Hills v. Sobieski, 55 Cal. 2d 811. 13 Cal. Rptr. 186, 361 P.2d 906 (1961), or in the form of capital appreciation when an asset, rather than an interest in an ongoing business, is sold. See Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980). On the other hand, the Supreme Court has held that, where the inducement to purchase stock in a cooperative housing corporation is solely to acquire low-cost housing, and not to invest for profit, such stock is not a "security."421 U.S. at 851. Likewise, the expectation of employer contributions to an employee's pension fund also does not constitute an expectation of profit. International Brotherhood of Teamsters v. Daniel, 439 U.S. at 560.

(4) Solely From the Efforts of Others. The requirement that profits derive "solely" from the efforts of others has been modified to a large extent by cases involving fraudulent pyramid sales schemes. In such schemes, the investor is expected to expend some "efforts" in soliciting other individuals to participate in the scheme. The critical inquiry in cases involving such schemes is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d at 482; see also SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Aqua-Sonic Products Corp., 687 F.2d 577 (2d Cir. 1982).


The Howey Test. The Oregon Supreme Court explicitly adopted a modified Howey test, however the Oregon Supreme Court has added the phrase "or money's worth" to the first prong of the test. Pratt, 276 Or. at 497; see also Jost v. Locke, 65 Or. App. 704, 713, 673 P.2d 545 (1983) (gold coins alone not a security) (citations omitted).

Oregon courts have taken an expansive view of the third prong of the Howey test, too. Rather than requiring the investor to have been seeking a "money profit", the Oregon courts have found the expectation of a "mere benefit" to be sufficient to fall within the modified Howey test. Pratt, 276 Or. at 490. For example, in Black v. Corporation Div., 54 Or. App. 432, 634 P.2d 1383 (1981), the Oregon Court of Appeals ruled that a tax savings alone could constitute "profit."

Finally, Oregon also has dropped the "solely" requirement from the fourth prong of the Howey test. Instead, Oregon courts will determine "whether the efforts made by those other than the investor are the managerial efforts which affect the failure or success of the enterprise." Jost, 65 Or. App. at 714 (quoting SEC v. Glenn W. Turner Enterprises, Inc. See R. McGaughey, OREGON CORPORATE AND SECURITIES LAW, 169-72 (1988).


Unlike Oregon, Washington courts have not added the phrase "or money's worth" to the first prong of the test. Presumably, Washington would follow the federal line of cases on this point. See V.A.l.a.i., *supra*.

The Washington Supreme Court also has adopted the "vertical commonality" view. "[A] common enterprise need not be a common fund. The term denotes rather an interdependence of fortunes, a dependence by one party for his profit on the success of some other party in performing his part of the venture." *McClellan*, 89 Wash. 2d at 532. A common pool of investors, consequently, is not required for the second prong of the Washington version of the Howey test to be met. When a distinct item such as a secured promissory note or even real property is sold, moreover, "[t]he crucial question is whether extra services are offered to purchasers that would tend to make them dependent on the seller or another for their profits, rather than the value of the item purchased." *Philips*, 108 Wash. 2d at 633.

To a certain extent, Washington has loosened the "expectation of profits" requirement of the Howey test, too. For example, the expectation of fixed interest payments and the return of principal within three years has been held to constitute an "expectation of profits", *Sauve v. K.C., Inc.*, 91 Wash. 2d 698, 591 P.2d 1207 (1979), and an investor was held to have had such an expectation even though he was investing on behalf of his sons. *Christgard, Inc. v. Christensen*, 29 Wash. App. 18, 627 P.2d 136 (1981).

Finally, the Washington Supreme Court clearly has dropped the "solely" requirement from the last prong of the test. Following Glenn Turner, 474 F.2d at 482, the court recently ruled that,

"[i]n order to promote the remedial purpose of the Securities Act of Washington, we do not require that the profits come 'solely' from the efforts of others, as the United States Supreme Court opinion in SEC v. WJ. Howey Co. appears to indicate. Rather, the test is whether the efforts of [others] were the undeniably significant ones that affected the success or failure of the enterprise."

*Philips*, 108 Wash. 2d at 635.

B. Various Kinds of Investment Contracts.

1. Franchises, Pyramid Sales Programs, License Agreements, Multi-Level Distributorships, and Chain Distribution Schemes. Where an investor in a franchise or other arrangement is actively involved in operating and managing his own independent business, the courts rarely have found a security to exist. This is true even though the franchisor/promoter offers significant support, services or products to, or exercises a large amount of control over the business of, the franchisee/investor.
On the other hand, when the franchisee/investor does not actively participate in the business, but instead is merely financing the chain operations of the franchisor/promoter, a security generally will be found to exist. A common example of this type of arrangement involves a promoter who offers a service package to operate the business for the franchisee/investor, who is expected to be a passive investor rather than an active operator. Where the service package is optional, but appears to be the only economically acceptable alternative for the franchisee/investor, the courts also are likely to find a security.

As may be apparent, the outcome of cases involving franchises or other similar arrangements frequently turns upon the "solely from the efforts of others" prong of the Howey test. See V.A.I.a.iv., supra. Because this prong of the test has been attenuated substantially by the Howey progeny, some participation by the franchisee/investor in the business is not fatal to the finding of a security. At the margins, courts are willing to find the existence of a security where the investment merits of the arrangement appear questionable, such as in pyramid sales or chain distribution schemes where the principal activity of the investor is locating other investors.6

2. Discretionary Securities or Commodities Trading Accounts. Generally, courts have held that discretionary securities or commodities trading accounts are not securities. Horizontal commonality is rarely present in these cases, since discretionary accounts normally do not involve pooling of multiple customer accounts. Vertical commonality, which requires a direct relationship between the success or failure of the promoter and the investor to satisfy the "common enterprise" prong of the Howey test, likewise is not usually found since the broker may earn commissions from the account at the same time the investor is losing money from the trading. The Oregon Court of Appeals, however, has found that pooled commonality trading accounts offered by a promoter as a tax shelter straddle were securities.7

3. Pension and Employee Benefit Plans. Using investment contract analysis, the U.S. Supreme Court has ruled that an interest or participation in an involuntary non-contributory pension plan pursuant to a collective bargaining agreement is not a security. Daniel, 6 See e.g., SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973) (pyramid sales program found to be a security); SEC v. Koscot Interplanetary Inc., 497 F.2d 473 (5th Cir. 1974) (pyramid selling scheme found to be a security); SEC v. Aqua-Sonic Products Corp., 687 F.2d 577 (2d Cir.), cert. denied sub nom., Hecht v. SEC, 459 U.S. 1086, 103 S. Ct. 568, 74 L. Ed. 2d 931 (1982) (license agreements to distribute dental devices were securities); SEC v. Quality Care, 14 Sec. Reg. & L. Rep. 1024 (D.C.D. 1982) (investor-owned franchises to operate health care facilities were securities). See also Rosenthal, Can a Software Royalty Agreement Be a Security Under Oregon Law?, 8 OR. BUS. L. DIGEST 5 (Winter 1990-91); Johnson & CampbeU, Securities Law & the Franchise Agreement, 1 UTAH. L. REV. 311 (1980).

439 U.S. at 560. The SEC, however, has indicated that an interest in a voluntary contributory plan may be a security.\(^8\)

Under Oregon securities law, on the other hand, a participation in a pension plan is included expressly under the definition of a security. ORS 59.015(17)(a).

4. Animal Breeding and Feeding Programs. Programs involving the breeding, management or sale of animals may involve securities.\(^9\)

5. Investment Programs in Personal Property. An investment program in personal property may constitute a security. The courts consider the following factors (none of which is essential or singularly determinative) indicative of the existence of a security when examining such programs:

(a) Selection of the items to be purchased, e.g., fine art, collectibles, gems, etc., requires the exercise of skill by the seller/promoter.

(b) Production of income requires the management of the particular asset by the seller/promoter.

(c) Determination by the purchaser of how or when the assets should be sold for capital appreciation requires the assistance of the seller/promoter.

(d) Purchase of the asset from the original purchaser is either arranged or undertaken by the seller/promoter.

(e) The assets are pooled, with each investor owning an undivided interest in the pool of assets.\(^10\)


\(^9\) See Smith v. Gross, 604 F.2d 639 (9th Cir. 1979) (program involving breeding and sale of earthworms found to be a security); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1979) (chinchillas); Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), cert. denied, 391 U.S. 905 (1968) (beavers). See also Exch. Act Rel. No. 15345 (1978) (earthworms). But cf. Hector v. Wiens, 14 SEC. & L. Rep. 257 (9th Cir. 1982) (cattle feeding program found not to be a security); Gin & Pepper Horse Syndication, SEC No-Action, 14 SEC. Reg. & L. Rep. 1261 (available June 25, 1982) (partnership interest in racehorse breeding syndicate found not to be a security).

\(^10\) See Glen Arden Commodities, Inc. v. Constantino, 493 F.2d 1027 (2d Cir. 1974) (whiskey warehouse receipts found to be securities); Sec. Act Rel. No. 5018 (1969) (interests in whiskey warehouse receipts may be securities); Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961) (notes secured by second trust deeds on real estate found to be securities); SEC v. Brigadoon Scotch Distributors, Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975) (sale of rare coin portfolios, with market information, storage, insurance, assistance in resale and in handling administrative details, found to be sale of security). Cf. Jost v. Locke, 650 Or. App. 704, 673 P.2d 545, review denied, 296 Or. 712, 678 P.2d 740 (1983) (sale of gold coins as investment not a security; profits were not derived from seller's efforts); Noa v. Key Futures, Inc., [1980 Transfer Binder] Fed.
The SEC no longer will give no-action letters regarding "esoteric commodity offerings," including those involving gems, gold, silver and master recordings. Sec. Act Rel. No. 6253 (1980).

6. Memberships in Recreational Facilities. If memberships in a recreational facility are freely transferable, or if the funds of the members represent the initial capital used to construct the facility, such memberships may be found to be a security. On the other hand, the offer and sale of club memberships by a nonprofit corporation to finance the purchase and operation of a private country club was ruled not to involve a security.

C. Partnerships, Joint Ventures and Limited Liability Companies.

1. General Partnerships and Joint Ventures. Whether a general partnership or joint venture interest is a security generally will be determined by the fourth prong of the Howey test, since the first three prongs normally are met. Absent a finding that profits are expected "from the entrepreneurial or managerial efforts of others," general partnership and joint venture interests usually are not found to be securities.

The leading case on analyzing general partnership and joint venture interests is Williamson v. Tucker, 645 F.2d 404 (5th Cir.), cert. denied, 454 U.S. 897 (1981). Although no security was found, the court cited three alternative tests which could establish the fourth prong of the Howey test:

(1) Where the "agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership;"

(2) Where "the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers;" or

(3) Where "the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers."

Id. at 424. To meet one of these alternative tests, the general partner or venturer must lack the power to participate in partnership or venture affairs, not merely the practical ability to do so. Odom v. Slavik, 703 F.2d 212 (6th Cir. 1983).


The Ninth Circuit, however, recently has muddied the waters. In *Reeves v. Teuscher*, 881 F.2d 1495 (9th Cir. 1989), the court rejected the second and third *Williamson* tests, but agreed with the first test. The court required that the agreement itself be examined, rather than the actual operation of the partnership after execution of the agreement. *Id*. On the other hand, the Ninth Circuit also cited approvingly all three *Williamson* tests in another case decided in the same term. *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir. 1989), *cert. denied*, 494 U.S. 1078, 110 S. Ct. 1805, 108 L. Ed. 2d 936 (sufficient evidence that management arrangement involving condominium rental policy agreement constituted a security). Indeed, the court specifically relied upon the second and third *Williamson* tests in reversing the trial court. *Id*.

2. **Limited Partnerships.** Unlike general partnerships, limited partnerships usually meet the fourth prong of the *Howey* test, and consequently are generally classified as securities. See, e.g., *In re Longhorn Securities Litigation*, 573 F. Supp. 255 (W. D. Okla. 1983), and cases cited therein. A limited partnership interest also is considered to be a security under Oregon securities law. *Pratt*, 276 Or. at 494.13

3. **Limited Liability Companies.** California makes it explicit that interests in an LLC are securities unless all members actively manage the business. Sec. 250119.

Oregon and Washington do not address the issues statutorily; presumably investment contract analysis applies.

**D. Real Estate.**

1. **Condominiums, Co-ops, Units in Subdivisions and Real Estate Development.** Condominiums or units in a real estate development that involve rental pools or are sold through marketing arrangements that emphasize investment potential, income production, or cost-free property use may be found to be securities.14 Moreover, allegations by land purchasers that developers promised site improvements and assistance in the resale of the property raise factual issues as to whether an investment contract was created, particularly when such promises were made through promotional materials, oral representations, or other merchandising techniques.15

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14 *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187 (5th Cir. 1979), *mod. on other grounds*, 611 F.2d 105 (5th Cir. 1980) (condominium campsite development units were securities); *Aldrich v. McCullough Properties, Inc.*, 627 F.2d 1036 (10th Cir. 1980) (subdivided lots in real estate development may be securities). See generally Sec. Act Rel. No. 5347 (1973).

An interest in a normal apartment cooperative generally is not considered to be security, even if the interest takes the form of a share of stock. Forman, 421 U.S. at 851. See also Grenader v. Spitz, 537 F.2d 612 (2d Cir.). cert. denied, 429 U.S. 1009 (1976).

The Oregon Court of Appeals has found fractional undivided interests in real estate, advertised to distant investors and coupled with an agreement giving the seller/promoter certain management powers, to be securities. Oregon v. Jacobs, 55 Or. App. 406, 637 P.2d 1377 (1981).

2. **Leases of Real Estate.** Generally, leases of real estate are not considered to be securities, regardless of the fact that the lessor may be dependent to some degree on the success of the lessee's business. See Klein v. Arlen Realty & Dev. Corp., 419 F. Supp. 1261 (E. D. Pa. 1976) (lease of real estate where rental varied with level of lessee's sales found not to be a security).

In Oregon, a lease of real estate where the lessee was dependent upon the lessor's management of a shopping center was found not to be a security. Cordas v. Specialty Restaurants, Inc., 470 F. Supp. 780 (D. Or. 1979) (lessor retained many controls in a large, multi-store shopping center). See also Northern Terminals, Inc. v. Leno, 475 Sec. Reg. & L. Rep. (BNA) A-21 (Wash. Sup. Ct. 1978).

3. **Mortgages and Real Estate Paper.** Under Oregon securities law, ORS 59.015(17)(a) provides that "real estate paper sold by a broker-dealer, mortgage broker" or certain other persons is a security. "Real estate paper" is defined as "any obligation secured or purportedly secured by an interest in real property . . . [including] mortgage-backed securities, collateralized mortgage obligations, and real estate mortgage investment conduits." ORS 59.015(13). Subject to certain exceptions provided in ORS 59.015(10)(b), a "mortgage broker" designates a

"person who engages all or part of the time, for the account of others, or for the person's own account in the business of: (A) Selling real estate paper whether as issuer, agent or principal to persons other than persons enumerated in ORS 59.035(4); or (B) Accepting funds from one or more persons other than persons enumerated in ORS 59035(4) for investment in real estate paper."

ORS 59.015(10)(a). These provisions of the Oregon securities law have not yet been interpreted by a court.

Furthermore, those who effect transactions in real estate papers are required to be licensed as mortgage brokers.

Under Washington securities law, the definition of a "security" includes "any sale of an indenture, bond or contract for the conveyance of land or any interest therein where such land is situated outside the State of Washington and such sale or its offering is not conducted by a real estate broker licensed by the State of Washington." RCW 21.20.005(12). This provision of the Washington securities law also has not yet been interpreted by a court.

**E. Evidences of Indebtedness and Loan Participations.** Although "evidences of indebtedness" are included in the definition of a security, this term has not been carefully
analyzed, unlike the term "investment contract." One court has ruled that "[t]he term 'evidence of indebtedness' is not limited to a promissory note or other simple acknowledgment of a debt owing and is held to include all contractual obligations to pay in the future for consideration presently received." United States v. Austin, 462 F.2d 724 (10th Cir.), cert. denied, 409 U.S. 1048 (1972); cf. Cocklereece v. Moran, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) H98,482 (N. D. Ga. 1982) (Austin criticized as elevating "form over substance").

Oregon courts also have not attempted to define "evidence of indebtedness" with any particularity, but the Oregon Supreme Court has ruled that statutory terms such as "evidence of indebtedness"

"As used in the act refer only to such of these types as are commonly known as 'securities'; they contemplate the presence of the investment process, that is 'the investment of funds with a view of receiving a profit through the efforts of other than the investor.'"

Sperry and Hutchinson Co. v. Hudson, 190 Or. 458, 226 P.2d 501 (1951) (citations omitted).

Participations in a commercial note or certificate of deposit may be found to be securities issued by the lead lender, even though the underlying note is not a security. See Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969); Commercial Discount Corp. v. Lincoln First Commercial Corp., 445 F. Supp. 1263 (S.D.N.Y. 1978). On the other hand, a loan participation agreement usually is not considered to be a security unless it possessed a preponderance of the following characteristics:

1. An unfixed interest rate on the loan or an equity kicker built into the return on the loan;
2. An unsecured or minimally secured loan;
3. A borrower without accessible or preservable cash flow or net worth with which to repay the loan;
4. A lead bank which has:
   a. sole or primary and virtually exclusive access to borrower information, and
   b. primary or exclusive control of loan administration and enforcement upon default;
5. A lead lender which has greater sophistication in lending than the participant; and
6. A purpose involving a new, unique or speculative venture rather than a relatively risk-free venture.¹⁶

F. Certificates of Interest or Participation in Any Profit Sharing Agreement. A unique profit-sharing agreement, negotiated face-to-face in a private two-party transaction, is insufficient alone to make the agreement a security. *Marine Bank v. Weaver*, 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) (unique arrangement whereby plaintiffs acquired rights to 50% interest in slaughterhouse profits and use of barn and pasture found not to be a security). The securities laws were not intended to apply to unusual, non-commercial instruments that do not involve a number of potential investors. Unique agreements of this sort usually require the participation of the investor and do not fall within the ordinary concept of a security. 17

G. Fractional Interests. Under traditional investment contract analysis, fractional interests generally will be found to be a security. The Oregon Supreme Court has analyzed fractional interest as follows:

"One type of transaction commonly found to be a security under the blue sky laws, often as a type of investment contract, is a transaction in which real or personal property purportedly is sold, but where the 'seller' in fact retains possession and control of such property and the 'buyer' obtains the right to receive profits resulting from the management of it. ... In such arrangement, the 'buyer,' or investor, depends entirely upon the efforts of the 'seller' for a return upon his investment and the arrangement is a security." *Marshall v. Harris*, 276 Or. 447, 454-55, 555 P.2d 756, review denied, 276 Or. 823, 556 P.2d 1358 (1976) (fractional interest in racehorse is a security under Oregon law).

Under Washington law, a percentage royalty interest of five percent or less in a windshield wiper patent was found to be a security. *State v. Williams*, 17 Wash. App. 368, 563 P.2d 1270 (1977).

H. Leaseholds and Other Interest in Minerals. Ordinary leaseholds or other interests in minerals may not be securities, but a fractional interest in such leaseholds or other interests usually are securities. 18 See V.G., *supra* for fractional interest analysis.

I. Certificates of Deposit. Certificates of deposit issued by domestic commercial banks or savings banks are subject to alternate regulatory schemes, including FDIC or FSUC insurance, and thus effectively are guaranteed by the government. Consequently, the investor is protected against the risk of the debtor's insolvency. On this basis, such certificates of deposit

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On the other hand, certificates of deposit issued by foreign banks are securities because they are not subject to an alternate regulatory scheme which protects the domestic investor. Wolf v. Banco Nacional de Mexico, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) 1)98,992 (N. D. Cal. 1982). Moreover, a certificate of deposit issued by a foreign bank, but sold through the domestic offices of its affiliated state chartered bank, may be a security. Bank of Miami v. Meason, 652 F.2d 542 (5th Cir. 1981), cert. denied, 455 U.S. 939, 102 S. Ct. 1428, 71 L. Ed. 2d 649 (1982).

J. Other Securities Instruments.

1. Repurchase and Standby Agreements. Repurchase agreements ("repos") and standby agreements (a form of repo arrangement) involve the sale of a security (usually a United States government security) by a seller (usually a bank) to a purchaser, with a concomitant obligation of the seller to repurchase the security from the purchaser at a future date (usually only a few days) at the original purchase price plus a return to the buyer equivalent to interest. "For purposes of the federal securities laws, [repos] are deemed to involve the purchase and sale of the United States government securities to which they relate." Sec. Act Rel. No. 6351 (Sept. 25, 1981).19

2. Guarantees. The guarantee of a security is itself a separate security under federal, Oregon, Washington and California securities laws. Of course, a guarantee may involve two issuers and two securities: the issuer of the underlying security that is guaranteed, and the issuer of the guarantee. Even though the underlying security may be exempt from securities registration, the guarantee of that underlying security may not fall within the same exemption or any other exemption.20


VI. EXCLUSIONS

19 See SEC v. G. Weeks Securities, 678 F.2d 649 (6th Cir. 1982) (Gene Mac "standby with pair-off" transactions involved securities); First National Bank of Las Vegas, New Mexico v. Estate of Russell, 657 F.2d 668 (5th Cir. 1981) (repo transaction can involve purchase and sale of underlying security and not collateralized loan). See also Waters, Sale of Retail Repurchase Agreements by Banks and Savings and Loan Associations - Issues for Legal Counsel and Bank Management, 43 ALA. L. REV. 283 (1982).

A. Federal Securities Laws. Section 2(1) of the 1933 Act, Section 3(a)(10) of the 1934 Act, and case law interpreting these two provisions "define" the term "security" for purposes of federal securities law. Any instrument that falls outside this definition, therefore, is excluded from the remaining provisions of the 1933 and 1934 Acts. An "exclusion" is quite different from an "exemption," for which both Acts also provide. See Securities Act of 1933 § 3(a); Securities Exchange Act of 1934 § 3(a)(12). An "exempted security" generally is not subject to the registration and disclosure requirements of the particular Act, but may be subject to the general antifraud and civil liability provisions of both Acts.

The 1934 Act, for example, specifically excludes

"currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof of the maturity of which is likewise limited."

Securities Exchange Act of 1934 § 3(a)(10). These types of instruments, therefore, are excluded from the particular provisions of the 1934 Act. On the other hand, the definition of a security under the 1933 Act contains no such exclusionary language, so any of the specifically mentioned instruments presumably may be subject to the other provisions of the 1933 Act if a court determines that it falls within § 2(1) of the 1933 Act.

B. Oregon Securities Law. ORS 59.015(17)(b) specifically excludes from the definition of "security" the following instruments:

1. certain insurance contracts;
2. a beneficial interest in certain voluntary inter vivos trusts; and
3. a beneficial interest in a testamentary trust.

The registration requirements and antifraud provisions of the Oregon blue sky law, consequently, do not apply to these types of instruments. On the other hand, federal securities law continues to apply to insurance contracts, which are not excluded from its definition of a "security."

C. Washington Securities Law. RCW 21.20.005(12) specifically excludes "any insurance or endowment policy or annuity contract under which an insurance company promises to pay money either in a lump sum or periodically for life or some other specified period." Again, federal securities law continues to apply to these types of instruments. Unlike Oregon, Washington securities law does not expressly exclude beneficial interests in testamentary trusts and certain voluntary inter vivos trusts from its operation.

D. California Corporate Securities Law of 1968. Sec. 25019(1) excludes, (a) interests in voluntary inter vivos trust which isn’t a voting trust and doesn’t carry on a business; (b) interests in testamentary trusts; (c) insurance policies; or (d) franchises subject to registration in California.

VII. EXEMPTIONS FROM REGISTRATION FOR "PRIVATE OFFERINGS" UNDER THE SECURITIES ACT OF 1933
If an offering is not to be registered, appropriate exemptions from the registration requirements of federal and state law must be sought. Although there are parallels between the Oregon Securities law and the 1933 Act, the availability of a federal exemption does not guarantee the availability of a state exemption.

Registration exemptions (both state and federal) tend to fall into two categories: Statutory and regulatory safe harbor exemptions. Federal and state statutory exemptions may exempt either particular classes of transactions or the securities themselves. Securities offered in corporate financings will typically not be exempt, and therefore this outline will primarily describe transaction exemptions. The parameters of statutory exemptions are largely set by case law. Regulatory safe harbors are more specific than statutory exemptions, making it easier for the attorney and the client to verify compliance. Regulatory safe harbors are not exclusive elections. A person who attempts to comply with the provisions of a regulatory safe harbor and fails can still claim the availability of any other exemption.

The burden of proof in identifying the exemption provision relied upon falls to the issuer. If claims are made that securities were sold without a valid exemption, the practitioner and his or her client should be prepared to prove that all of the elements of the federal and state exemptions have been satisfied. See SEC v. Ralston Purina Co., 346 U.S. 119, 97 L. Ed. 2d 1494, 73 S. CL 981 (1953); Hill York Corp. v. American Int'l. Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

The descriptions of the federal and state exemptions that follow are necessarily general and abbreviated. A practitioner and his or her client should closely review the applicable statutes and rules to confirm the requirements of the exemption and to make appropriate plans for the creation of adequate disclosure and documents to confirm the qualifications of the investors.

A. Federal Exemptions

1. Statutory Exemptions. A limited number of securities and transaction exemptions are available for corporate financings. The better practice is to rely on regulatory safe harbors when available or on registration if practical. The statutory exemptions do provide a critical backstop if a regulatory exemption has been "blown" or if the practitioner must do damage control in the case of a client who has offered securities in apparent violation of the law.

a. Intrastate Offering Exemption. Section 3(a)(ll) exempts securities offered and sold in a single state or territory if the issuer is resident (or incorporated, if a corporation) in, and doing business within, the state or territory. Rule 147 is the regulatory safe harbor promulgated under § 3(a)(ll). While the Intrastate Offering Exemption is technically an exemption for the security, the transaction must be analyzed to insure compliance with the exemption. The Act § 3(a)(ll)/Rule 147 exemption is not available if (i) the offer is made or otherwise transmitted across the jurisdictional boundary or (ii) more than 20% of the proceeds are not used in the same state. Statements accompanying the offer that state that the offer is made to only residents of a particular state or territory may help preserve a § 3(a)(ll)/Rule 147 exemption. However, such limiting language will not assist the issuer if the method chosen to convey the offer cannot be expected to adequately limit the offer's dissemination, as would clearly be the case of offers made through newspapers, radio or television.
Even where § 3(a)(11)/Rule 147 is available, the issuer will likely find that the regulatory scheme of the state or territory is the limiting factor. A significant restriction on the use of Rule 147 is that the issuer must derive at least 80% of its gross revenue from its state of residence.

b. **Private Offerings.** Section 4(2) exempts transactions by an issuer not involving a public offering. There are few real guides for determining whether a particular offering will be considered a public offering.

The SEC has declined to provide bright line tests to determine what type of offering will qualify for a § 4(2) exemption.

## 2. Regulation D

Regulation D was adopted in 1982 to simplify and liberalize federal regulation of private offerings. Regulation D provides to issuers a regulatory safe harbor from the registration requirements of the 1933 Act.

Regulation D contains six provisions. Rule 501 contains key definitions of common Regulation D terms such as "affiliate" and "accredited investor" and describes how to calculate the number of purchasers to determine whether the limitations elsewhere in Regulation D have been met or exceeded. Rule 502 sets forth the general requirements for "integration" with other offerings, the information to be provided by the issuer, and the limitations on the manner of offering and on resale. Rule 503 describes the issuer's obligation to file sales notices on Form D. Rules 504, 505, and 506 set out the particular requirements for the three separate exemptions, which vary according to the aggregate dollar amount to be raised in the offering and the types of purchasers in the offering.

In 1989, Rule 508 was added to Regulation D to protect issuers from claims that a Regulation D exemption was unavailable because of an insignificant deviation from the rules:

> Failure to comply with a term, condition and requirement of Regulation D does not cause a loss of the exemption for any offer or sale to a particular individual or entity if the person relying on the exemption were to demonstrate that (1) the term, condition or requirement violated was not directly intended to protect the complaining party, (2) the failure to comply was insignificant to the offering as a whole, and (3) a good faith and reasonable attempt was made to comply with all of the regulation's terms, conditions and requirements.

The conditions relating to dollar ceilings, numerical purchaser limits, and general solicitations are always deemed significant and therefore beyond the protection of Rule 508. Securities Act Release No. 6825 (March 14, 1989).

Failure to comply is still actionable by the SEC. Rule 508 is a back-up in a defensive situation and should not be used in the planning process.

a. **Rule 504.**

(1) **Dollar Limitation.** Rule 504 offerings may not exceed $1 million less the aggregate offering price of all securities sold during the 12 months prior to and during the offering in reliance on any exemption under § 3(b) of the Act (i.e., other Rule 504 or 505 sales or Regulation A) or in violation of the registration requirements of § 5(a) of the 1933 Act.
Therefore, Rule 504 may not be available to issuers that have engaged in recent financings or that have been "dribbling out" securities on an ongoing basis to the extent the amounts raised are required to be included for purposes of calculating in the $1 million limitation. See also the discussion of "Integration" below.

(2) **Information Delivery Requirements.** Rule 504 does not prescribe a form of disclosure document to be delivered in connection with the offer or sale of the securities. See Rule 502(b). However, the practitioner should bear in mind that under the antifraud provisions of the 1934 Act and the state securities statute, all material information about the offering and the issuer should be delivered to the investor prior to the sale.

(3) **Manner of Offering and Limitations on Resale.** The limitations on the manner of offering contained in Rule 502(c) and the requirement that the issuer take affirmative steps to prevent resale of the securities contained in Rule 502(d) do not apply to offers and sales under Rule 504. Therefore, securities sold under Rule 504 are generally freely tradeable without registration under the 1933 Act. See discussion of the Washington Uniform Limited Offering Registration below.

(4) **Number of Purchasers.** Rule 504 contains no limitations on the number of purchasers.

(5) **Other Restrictions.** Rule 504 is not available to companies subject to the reporting requirements of the 1934 Act.

b. **Rule 505 (Limited Offering Exemption).**

(1) **Dollar Limitation.** Rule 505 is available for offerings of up to $5 million. As with Rule 504, sales of securities in the 12 months prior to or during the offering made in reliance upon § 3(b) or in violation of § 5 of the Act are aggregated for purpose of the dollar limitation.

(2) **Information Delivery Requirements.** The information delivery requirements under Rule 502(b) are applicable (see below).

(3) **Manner of Offering and Limitations on Resale.** The manner of sale restrictions under Rule 502(c) and the resale restrictions under Rule 502(d) apply.

(4) **Limitation on Number of Purchasers.** The offering may be sold to an unlimited number of accredited investors and not more than 35 nonaccredited investors. (See Rule 501(e)), as nonaccredited investors do not have to meet a sophistication requirement.

(5) **Disqualification.** The disqualifications set forth in Regulation A apply to this exemption. (See Regulation A, Rule 262, describing orders and judgments against issuer, officers, directors and 10% owners.)

c. **Rule 506.**

(1) **Dollar Limitations.** There are no limitations on the aggregate dollar amount that can be raised in any offering under Rule 506.
(2) **Information Delivery Requirements.** The information delivery requirements under Rule 502(b) are applicable (see below).

(3) **Manner of Offering and Limitations on Resale.** The manner of offering restrictions under Rule 502(c) and resale restrictions under Rule 502(d) apply.

(4) **Limitation on Number of Purchasers.** The offering may be sold to an unlimited number of accredited investors and not more than 35 nonaccredited investors. See Rule 501(e).

(5) **Nature of Purchasers.** (Sophistication requirement). The issuer has the obligation to make such investigation as may be necessary to form a reasonable belief that each nonaccredited purchaser, either alone or with the purchaser's representative, has the knowledge and experience in financial and business matters to be able to evaluate the relative risks and merits of the investment.

d. **Important Definitions — Regulation D.**

(1) **Accredited Investor.** The definition of "accredited investor," found in Rule 501(a), generally speaking, is intended to pick up persons (including entities) that have the sophistication to evaluate an investment in the offering or the ability to withstand a loss of the investment, or both. "Accredited Investors" include ERISA plans administered by savings and loans and self-directed plans for which the investment decisions are made solely by accredited investors; corporations, partnerships, and Massachusetts Trusts not formed for the specific purpose of acquiring the securities offered and having a net worth in excess of $5,000,000; regular trusts meeting the same requirements and whose purchases are directed by a person meeting the sophistication requirements of Rule 506; natural persons whose individual incomes exceeded $200,000, or a natural person whose joint income with the person's spouse has exceeded $300,000, in each of the prior two years and such income is expected to continue in the present year; natural persons whose aggregate net worth exceeds $1,000,000; any director, executive officer or general partner of an issuer or any director, executive officer or general partner of a general partner; and entities in which all of the equity owners are accredited investors.

(2) **Calculation of Number of Purchasers.** The provisions for calculating the number of purchasers in an offering are in the definitions section of Regulation D. These provisions work by allowing the issuer to exclude from the number of purchasers certain persons, thereby allowing the actual number of purchasers under Rules 505 and 506 to exceed 35. Accredited investors are excluded from the calculation of the number of purchasers. Also excluded are (i) certain persons related to a purchaser whose principal residence is the same as the purchaser, (ii) certain trusts in which the purchaser has a beneficial interest, (iii) certain entities owned by the purchaser and (iv) certain of his or her relatives.

e. **General Conditions Under Rule 502 and 503.** Regulation D prescribes certain general conditions that must be met unless Rules 504, 505 or 506 expressly state otherwise. Listed below is a brief overview of these requirements.

(1) **Integration.** Certain sales of securities by an issuer made within six months prior to the start or six months after the completion of an offering may be considered to be a part of (i.e., integrated with) the offering. Sales outside of either six-month window may also be integrated if
offers were made within the window period. The significance of integration is that all of the sales integrated must meet the same criteria as the offering with which they are integrated. For instance, an isolated sale made to a nonaccredited investor without the benefit of an offering document, if integrated with an otherwise valid Rule 505 offering, would invalidate the entire Rule 505 offering. Integration can be distinguished from aggregation under Rules 504 and 505, which require that the proceeds of certain offerings be added for purposes of determining whether the aggregate dollar limits have been exceeded.

(2) Information. If the securities are to be sold under Rule 504 or only to accredited investors, there are no requirements for the form or content of the disclosure document. However, the practitioner should keep in mind that the issuer is still subject to the antifraud provisions discussed above. If a disclosure document is necessary, all offerings require the same kind of nonfinancial statement information required on Part n of Form 1-A if the issuer is eligible to use Regulation A. Otherwise, requirements are the same kind of nonfinancial statement information as required in Part I of a registration statement filed under the 1933 Act on the form that the issuer would be eligible to use.

Financial statement information is required as follows:

(a) **Offerings to $2 million** require the same kind of statement information as required under Item 310 of Regulation S-B (except that only the balance sheet must be audited);

(b) **Offerings to $7.5 million** require the same financial statement information required in Form SB-2 (except that only an audited balance sheet is required if the issuer cannot obtain audited financial statements without unreasonable effort or expense) or such other form as the issuer may be entitled to use for registration under the 1933 Act;

(c) **Offerings Over $7.5 million** require the same financial statement information required by Part I of any registration form available to the issuer.

(3) Limitation on Manner of Offering. Except for offerings under Rule 504, general solicitations are prohibited. General solicitation is defined to include advertising in the media or by meetings whose attendees have been invited through general solicitation.

(4) Limitations on Resale. The issuer is to take reasonable steps to make sure the purchasers are acquiring the securities for their own accounts and not with the intent of reselling such securities. The issuer must place a legend on the securities stating they have not been registered. (Not applicable to Rule 504.)

(5) Notice Filing. A notice on Form D is required to be filed within 15 days of the first sale; however, the notice is not a condition to a Regulation D exemption. Note that this filing requirement differs as to timing from those of many states that have adopted counterparts to Regulation D, including Washington. If an issuer has been enjoined for a violation of the filing requirements, Regulation D is unavailable as an exemption. See Rule 507.

VIII OREGON & CALIFORNIA REGISTRATION EXEMPTIONS

A. Self-Executing Exemptions.
Oregon. ORS 59.035(12)(a) is a particularly useful transactional exemption. Its rules provide an exemption from registration for sales of up to 10 persons within any consecutive 12-month period provided no advertising or general solicitation is made in connection with the sale of securities, and that no commission or remuneration of any kind is paid in connection with such sales. Similar language regarding commissions or other remuneration is found in exemptions in the securities laws of other states and have been interpreted by courts to include real estate commissions, finders fees, and referral fees as examples of "other remuneration", which thereby vitiated the use of the exemption. It is important to recognize that this exemption contains no purchaser sophistication requirements.

1. **Accredited Investor Exemption.** ORS 59.035(5) exempts sales to accredited investors. See A.L(4)(a) supra.

2. **Existing Shareholder Exemption.** ORS 59.035(3). This exemption is available to an issuer selling its securities on a pro rata offering to its existing security holders if no commissions or other remunerations are paid, and if the issuer has not had an effective registration statement under the Oregon securities law within one year from the use of the exemption. The requirement that securities be offered pro rata somewhat restricts the use of this exemption for all purposes except a rights offering. It is useful to note that the securities laws of many other states have an existing shareholder exemption available to issuers selling securities to their own shareholders without a pro rata offering requirement.

3. **Isolated Transaction.** OAR 441-35-055 permits an issuer to sell to up to three persons within a consecutive 24-month period. The rule is silent on commissions. The advantage to issuers of this exemption over the 10-or-under exemption in ORS 59.035(12)(a) is that the isolated transaction exemption does not prohibit commissions. Therefore, transactions involving fees to business brokers may qualify under this exemption.

B. **Short-Form Registrations**

1. **Oregon "Regulation D".** The Securities Section has adopted a state analogue to Regulation D. Generally, the Oregon provisions parallel the federal provisions; however, there are a number of significant differences:

   a. **Registration not Exemption.** Oregon's OAR 441 Division 65 is a registration of securities and is not an exemption from the Oregon Securities Law registration requirements. Therefore, no offers or sales of securities may occur until the application for registration has been declared effective by the Securities Section.

C. **Suitability Standards.** Whereas federal Rule 504 contains no investor suitability standard, the Oregon analogue in OAR 441-65-220 imposes suitability standards and restricts sales to accredited investors, sophisticated purchasers, suitable purchasers (those persons who purchase securities through an NASD licensed broker-dealer, for whom such broker-dealer believes such acquisition is suitable) and permitted Oregon purchasers.

A "permitted Oregon purchaser" means a person who fits into one of the following categories:
(1) A natural person who purchases at least $10,000 worth of the securities being offered, where the purchaser's total purchase does not exceed 10% of their net worth at the time of purchase; or

(2) A natural person who has an individual income in excess of $70,000 in each of the two most recent years and reasonably expects an income in excess of $70,000 in the current year, provided the amount purchased does not exceed 10% of the person's individual income for the most recent year. The income of a spouse may be included for the purposes of both these tests; or

(3) Any partnership, trust, corporation, or other entity in which all the equity owners satisfy the requirements of (1) and (2) above.

D. Disqualification Provisions. Whereas disqualification provisions contained in SEC Rule 262, which disqualify persons who fit such definitions from the use of federal Rule 505, disqualifies such persons or issuers from the use of all three of the Oregon analogue exemptions to Regulation D.

California. Sec. 25102(f) has an extra territorial application restricting an offering to 35 purchasers. All purchasers must (a) have a pre-existing personal or business relationship with the issuer, or its officers, directors, etc. or (b) be reasonably assumed to have business or financial experience sufficient to protect their own interest (Ralston Purina standard). No ads or general solicitation permitted; investment intent required.