

**REPORT OF THE
STATE CORPORATION COMMISSION ON**

**The Exemption of Certain
Securities from the
Registration Requirements
of the Virginia
Securities Act**

**TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA**



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**COMMONWEALTH OF VIRGINIA
RICHMOND
1989**

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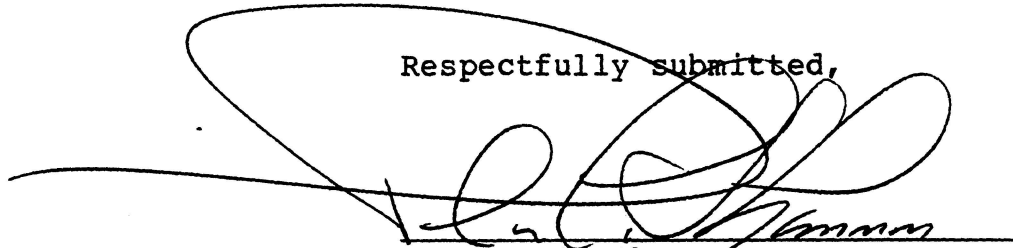
December 21, 1988

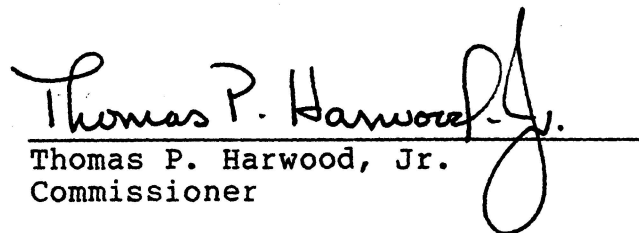
TO: The Honorable Gerald L. Baliles
Governor of Virginia
and
The General Assembly of Virginia

We are pleased to transmit this Report of the State Corporation Commission on Exemption of Certain Securities from the Registration Requirements of the Virginia Securities Act.

The study was initiated and the report prepared pursuant to House Joint Resolution 179 of the 1988 Session of the General Assembly of Virginia.

Respectfully submitted,


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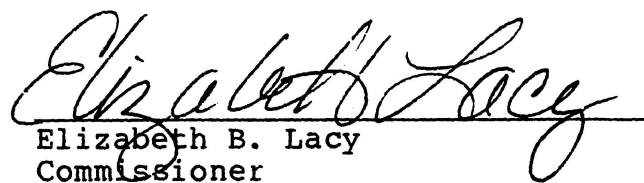

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GLOSSARY*

AMEX. - The American Stock Exchange.

Initial Public Offering (IPO). - The original sale of a company's securities to the public.

Issuer. - Legal entity that has the power to issue and distribute a security. Issuers include corporations, limited partnerships, municipalities, foreign and domestic governments and their agencies, and investment trusts.

National Association of Securities Dealers, Inc. (NASD). - A nonprofit organization made up of over-the-counter securities dealers. Its purpose is to regulate the over-the-counter securities market with the oversight of the Securities and Exchange Commission.

NASDAQ & NASDAQ/NMS. - National Association of Securities Dealers Automated Quotations systems. NASDAQ electronically provides information about over-the-counter securities, such as current bid and ask price quotations and volume traded. NASDAQ/NMS provides up to the minute price and volume information on selected over-the-counter securities.

Nonissuer Distribution. - A secondary distribution, it refers to the sale of previously issued securities, as distinguished from new issues or a primary distribution, where the seller is the issuing corporation. It involves a transaction not directly or indirectly for the benefit of the issuer.

Over-the-Counter (OTC) Market. - A market in which securities transactions are conducted through a telephone and computer network connecting security dealers, rather than on the floor of an exchange.

Secondary Trading. - A term used to describe the trading of securities other than a new issue.

*Sources: Barron's Dictionary of Finance and Investment Terms.
North American Securities Administrators Association, Inc. Glossary.

Securities Act of 1933. - First law enacted by Congress to regulate the securities market. Enforcement responsibilities are vested in the Securities and Exchange Commission.

Securities Exchange Act of 1934. - Federal legislation which established the Securities and Exchange Commission. Its purpose is to provide regulation of securities exchanges and the over-the-counter markets and to protect investors from unfair and inequitable practices.

Security. - Any note, stock, bond, evidence of debt, interest or participation in a profit sharing agreement, investment contract, voting trust certificate, fractional undivided interest in oil, gas, or other mineral rights, or any warrant to subscribe to, or purchase, any of the foregoing or other similar instruments.

Senior Security. - A security that has claim prior to a junior obligation and equity on a corporation's assets and earnings. Senior securities are repaid before junior securities in the event of liquidation.

Stock Exchange. - An organized marketplace in which stocks, common stock equivalents, and bonds are traded by members of the exchange, acting both as agents (brokers) and as principals (dealers or traders). Such exchanges have a physical location where brokers and dealers meet to execute orders from investors to buy and sell securities. Each exchange sets its own requirements for membership.

EXECUTIVE SUMMARY

The 1988 Session of the General Assembly adopted House Joint Resolution 179 which requested the State Corporation Commission to study several exemptions from the securities registration requirements of the Virginia Securities Act and determine if revisions are necessary to enhance the goal of the Virginia Securities Act of protecting investors. The following exemptions are the subject of this study:

1. The "Exchange" Exemption (§13.1-514(a)(8)), which waives registration requirements for securities listed on the New York, American, and Midwest stock exchanges;
2. The "Criteria Based" Exemption (§13.1-514(a)(13)), which waives registration requirements for securities listed on exchanges or quoted on automated quotation systems approved by the Commission; and
3. The "Manual" Exemption (§13.1-514(b)(2)), which waives registration requirements for secondary trading in securities of firms listed in any approved securities manual.

The Exchange Exemption

This study concludes that competition for listings and the development of new securities have significantly changed the marketplace since this exemption was enacted. These changes present potential conflicts with the purpose of the Virginia Securities Act. There is a need to amend the Exchange Exemption.

The State Corporation Commission recommends the following:

- Delete the Midwest Stock Exchange from the exemption. The listing criteria of the Midwest Stock Exchange are significantly lower than the criteria used by the New York and American stock exchanges.

- Amend the statute to exclude Initial Public Offerings (IPO's) from the exemption. Substantive review of initial public offerings is at the heart of effective state regulation, and it is difficult to provide adequate investor protection if new security offerings are exempted from effective state review.

- Amend the statute to exclude securities of a listed corporation that are: "...senior or substantially equal rank [to the listed security]; any security called for by subscription rights or warrants admitted to trading in any of said exchanges; or any warrant or right to subscribe to any of the foregoing securities...." Senior securities, rights, and warrants should not be exempted, largely because investors cannot determine the investment risks of all of a company's securities by relying solely on the fact that the issuing company is listed on an exchange.

The Criteria Based Exemption

The Criteria Based Exemption is based on regulations adopted by Commission order which provide the standards and criteria for exempting securities from state registration requirements. The broad purpose of the Criteria Based Exemption is to establish uniform standards in place of the diverse and changing standards in force among the various exchanges and the National Association of Securities Dealers, Inc. (NASD).

The Criteria Based Exemption has a number of advantages over the Exchange Exemption. The primary advantage is that it allows the Commission to establish the criteria used for the exemption of securities. The Commission may modify the criteria in order to strike a proper balance between the legitimate needs of the national marketplace and adequate protection of the Virginia investor.

This is an effective, workable exemption that provides an adequate level of protection to the Virginia investor and places no unreasonable burden on the industry. No changes to this statute are recommended.

The Manual Exemption

The Manual Exemption provides an exemption for transactions involving securities of any company listed in an approved securities manual, such as Standard and Poor's Corporation Records. This exemption provides brokerage firms an easy way of determining whether a particular security may be traded in the secondary market without registration. Unfortunately, the exemption also provides an easy way for unscrupulous promoters to make use of legitimate manuals for an improper purpose--to sell questionable securities in Virginia without registration.

This study concludes that the Manual Exemption is inconsistent with the purpose of the Virginia Securities Act. Unregistered securities of little or no value may be promoted and sold in Virginia due to their listing in the securities manuals, a situation that the Act was designed to prevent. Secondary trading in quality securities will not suffer if the Manual Exemption is repealed. The State Corporation Commission recommends the repeal of the Manual Exemption.

I. INTRODUCTION

State securities laws were enacted early in this century to counter flagrant abuses occurring in the securities industry. In general, the state statutes accomplish their task through the registration of people and firms involved in the securities industry, as well as the securities that are offered and sold. A number of exemptions from registration are available for some securities. This study examines three of those exemptions and attempts to determine whether the Commonwealth should continue to grant these exemptions. It also explores whether the exemptions are relevant to today's securities markets and whether continued reliance on the exemptions by the Commonwealth is consistent with the purposes of the Virginia Securities Act. Each section concludes with recommendations to the General Assembly concerning that particular exemption.

Purpose and Methodology

The Virginia Securities Act provides for the following exemptions from registration among others: the Exchange Exemption, §13.1-514(a)(8), the Criteria Based Exemption, §13.1-514(a)(13), and the Manual Exemption, §13.1-514(b)(2). This study attempts to determine the responsiveness and relevance of these exemptions to current securities markets, particularly in light of the new types of securities that have emerged in recent years and the dramatic drop in security prices in October 1987, and whether the exemptions should be repealed or modified to enhance investor protection. To accomplish this task, the Commission's Division of Securities and Retail Franchising conducted interviews with representatives of the listing departments of the exchanges specified in the Exchange Exemption (New York, American, and Midwest stock exchanges) and with the listing department of the NASD's automated quotation system ("NASDAQ"), the only system currently accepted under the Criteria Based Exemption. In addition, discussions with counsel for Standard and Poor's (publisher of one of the

manuals accepted under the Manual Exemption) were held. The Staff reviewed contemporary writings to identify topics currently impacting the use of the exemptions and to develop historical background. Also reviewed were the transcript and filings of a hearing before the State Corporation Commission concerning the NASD's use of the Criteria Based Exemption. Joseph C. Long, a professor of law at the University of Oklahoma and noted authority on state securities regulation, provided technical and editorial advice.

Historical Development of the Act

The Virginia Securities Act ("Act") (Va. Code §§13.1-501-527.3) was enacted to prevent fraudulent securities offerings. The Act requires the registration of securities and persons involved in their offer and sale.¹ In this manner, the Commonwealth, through the State Corporation Commission (Commission), reviews an offering prior to its sale to the public to try to assess whether the offering would be fraudulent.

The current Act was adopted in 1956 by the General Assembly and became effective on January 1, 1957. It is based on an early draft of the Uniform Securities Act, which contained the Exchange and Manual Exemptions (as does the final draft of the Uniform Act). The exemptions were included because a majority of the states had similar exemptions at the time the Uniform Act was drafted. The federal Securities Act of 1933 and the Securities Exchange Act of 1934 do not have similar exemptions. In contrast, the Criteria Based Exemption was not added to the Virginia Act until 1974 and was amended in the early 1980's to include the NASDAQ National Market System, a trading system that provides up to the minute price and volume reporting for trades of over-the-counter securities.

The Act provides for a number of exemptions from the registration process. The exemptions are of two types: (1) registration exemptions for securities that have certain characteristics (exempt securities) and (2) registration exemptions for transactions that have certain characteristics (exempt transactions). Trading in securities in the Commonwealth can lawfully be effected in three ways: 1) registration of the securities; 2) trading of exempt securities; and 3) trading through exempt transactions.

Registered Securities. Registration of the securities before their sale provides the public with the highest level of

information about the security. The Commission reviews the prospectus and related information to verify that the information needed to make an informed investment decision has been disclosed. Registration is designed to prevent the sale of fraudulent securities in the Commonwealth. The majority of offerings registered in Virginia are coordinated with the Securities and Exchange Commission's registration process, thereby substantially reducing duplication of the registration process.

Exempt Securities. Exempt securities generally are issued or guaranteed by companies that are regulated by federal and state agencies or are issued by the governments themselves (e.g., municipal bonds). Two of the exemptions in the current Act, the Exchange Exemption and the Criteria Based Exemption, are included in this category. Instead of direct governmental regulation, these exemptions involve regulation by private corporations (i.e., the stock exchanges and the NASD) subject to the oversight of the Securities and Exchange Commission.

Exempt Transactions. Exempt transactions include (1) persons that should have greater knowledge about the company issuing the security than the ordinary investor would possess, (2) transactions that involve a limited number of people who have sufficient knowledge of the company, (3) companies which have met certain financial requirements for a specified amount of time, or (4) securities issued by companies about which information is publicly available. With transactions of this nature, the purchaser of the securities should have the ability to obtain the information needed to make an informed investment decision. The Manual Exemption exemplifies the last category.

Practical Considerations of the Exemptions

The exemptions are analogous to a contract between the Commonwealth and the exchanges, the securities association, and the manual publishers. The exchanges, the securities association, and the manual publishers promise to list or designate companies only of a certain quality, and the Commonwealth, in turn, does not require registration of securities so listed. This provides benefits to companies with securities listed on the exchanges, and these benefits create an incentive to list the company's securities on an exchange that has this exemption. The exchanges benefit from receiving revenues based on the listing of companies' securities. The revenues accruing to the exchanges due to

listings range from approximately 4% to 35% of their total revenues.²

Brokerage firms, the companies that deal in securities on the wholesale and retail levels, benefit from the exemptions. In Virginia, these firms cannot lawfully sell securities which are not registered under the Virginia Act unless an exemption is available. In addition to the brokerage firms using the exemptions, company insiders can make use of the exemptions to avoid registration in Virginia; in contrast, the federal securities acts prohibit the sale of unregistered securities by brokers and insiders in most cases.

If the unregistered security does not qualify for an exemption, the investor, to win his case, only has to prove that it was not registered in the Commonwealth at the time of the sale.

II. THE EXCHANGE EXEMPTION, §13.1-514(a)(8)

Rationale of the Exchange Exemption

Reliance on stock exchange listing requirements as a "seal of approval" is a century-old concept. By 1900, banks and trust companies would not accept a security as collateral unless it was listed on an exchange.³ As the industrial base of the country grew, investors had trouble distinguishing legitimate companies from shells with no substance. Reliance on exchange listing was one way around this problem; at least some disclosures were required by the exchanges, and the securities had been reviewed by the exchanges' listing committees. Price rises in securities, once listed status was obtained, escalated the movement to list securities.⁴

As demands for state securities laws ("Blue Sky" laws) grew, reliance on the various securities exchanges, as grantors of approval for securities, was incorporated into the states' securities laws. A 1920 Georgia statute exempted from registration any security on the New York, Chicago, Philadelphia, "or other stock exchanges of like standing ...[on which] the current prices [of the securities] shall have been quoted from time to time for not less than one year next preceding the offering...."⁵ After the 1917 United States Supreme Court decisions upholding the validity of Blue Sky laws, the Investment Bankers Association of America ceased its fight against state regulation of the securities industry and lobbied the state legislatures for uniform statutes that would lessen the impact on its industry.⁶ In 1926 Virginia amended its securities statutes to provide an exemption from registration⁷ for securities listed on the New York and Chicago exchanges.

The Uniform Securities Act of 1957 attempted to provide consistency in the area of state securities regulation. Louis Loss, the lead draftsman of the Uniform Act, noted that 38 jurisdictions had an exchange exemption in some form for listed securities and that the New York, American (AMEX), and

Midwest exchanges were mentioned in approximately 85% of the state statutes in effect during the time that the Uniform Act was being drafted.⁸ The draftsmen of the Uniform Act were critical of an exemption which indicated that securities listed on exchanges were "hallmarks of soundness and quality" but included it in the Act because of the number of state statutes that already contained a version of it.⁹

Current Listing Criteria of the Exchanges

Securities are used to finance the company that issues them. Therefore, an analysis of the company should give an indication of the viability of the security as a proper investment. Balance sheets, income statements, and changes in financial position provide the essential information used to make an informed decision. Review of important items on the statements, analysis of trends in ratios calculated from the statements, and comparison of the company's ratios to industry averages are all components of financial analysis. Although the listing requirements of the exchanges tend to concentrate on review of these important items, other aspects of financial analysis and some corporate governance considerations are also included in their reviews of potential listing candidates. Table 1 lists the requirements for listing common stock on the three exchanges specified in § 13.1-514(a)(8), and Table 2 lists the maintenance criteria that firms must meet to remain listed with the exchanges.

TABLE 1
Initial listing Criteria for the Exchanges
for Common Stock

	AMEX		New York Stock Exchange	Midwest Stock Exchange
	Alternative 1	Alternative† 2		
Net Tangible Assets	\$4,000,000*	\$ 4,000,000*	\$18,000,000	\$ 2,000,000
Pre-Tax Income	\$ 750,000	---	\$ 2,500,000	---
Net Income	\$ ---	---	---	\$ 100,000
Shares Outstanding	500,000/ 1,000,000	500,000/ 1,000,000	1,100,000	250,000
Number of Shareholders	800/400	800/400	2,000	1,000
Market Value of Publicly Held Shares	\$3,000,000	\$15,000,000	\$18,000,000	---
Minimum Price Per Share	\$ 3	\$ ---	---	---
Operating History	---	3yrs	---	3yrs
Reports to Shareholders	Required	Required	Required	Required
Annual Meetings	Required	Required	Required	Required
1/3 Quorum	Required	Required	Required	Reviewed
Proxies	Required	Required	Required	Required
Audit Committee	Required	Required	Required	Required
Independent Directors	Required	Required	Required	Required
Conflict of Interest Policy	Required	Required	Required	---

* Stockholder's equity

†Refers to companies in the development stage

TABLE 2

Maintenance Criteria for the Exchanges
for Common Stock
(minimum standards to be met to remain on the system)

	AMEX	New York Stock Exchange
Net Tangible Assets	\$2,000,000 (if net losses were sustained in 2 of last 3 years) or; \$4,000,000 (if net losses were sustained in 3 of last 4 years); however, A company cannot have sustained net losses in the last five years	\$8,000,000 (Avg. net income after tax for past 3 years is less than \$600,000)
Shares Outstanding	200,000	600,000
Number of Shareholders	300	1,200
Market Value of Publicly Held Shares	\$1,000,000	\$5,000,000
Market Value of All Shares Outstanding	---	\$8,000,000

TABLE 2
continued

Midwest
Stock Exchange

Maintenance Criteria
(minimum standards to be met to remain on the system)

Net Tangible Assets	----
Net Worth	Greater than 150% of last year's net loss or \$500,000
Shares Outstanding	100,000
Number of Shareholders	500
Market Value of Publicly Held Shares	----
Market Value of All Shares Outstanding	----
Net Income	----

The State Corporation Commission's Criteria for Reviewing Offerings

Listing criteria used by the exchanges are for the most part quantitative. In contrast, the Commission's emphasis when reviewing securities for registration is not on financial analysis of the company issuing the securities. The Commission's mandate is to prevent sales of unsubstantial or fraudulent offerings. Therefore, it focuses on the offering itself and the circumstances surrounding it to determine if factors are present that would create a fraudulent offering. While not an all inclusive list, the following items are given specific attention by the Commission staff who review securities filings:

1. promoters have invested insufficient equity capital in relation to the total capitalization that will exist after the completion of the proposed public offering; or
2. an excessive amount of "cheap stock"--shares issued to promoters and insiders at prices significantly less than the proposed public offering price--in the registrant's capital structure; or
3. an excessive number of options and warrants have been issued, or are reserved for issuance, in relation to the total capital structure after completion of the offering; or
4. the proposed public offering price is too high in relation to the market price, if a market exists, or in relation to the issuer's earnings history, or other factors; or
5. the underwriter's commissions and/or the selling expenses of the proposed offering are excessive; or
6. voting rights of the shares being offered to the public are inequitable; or
7. the issuer's historical earnings, calculated in accordance with generally accepted accounting principles, are insufficient to cover the interest charges on debt securities being registered or the preferred dividend on preferred shares being registered.¹⁰

Neither the Commission nor the exchanges focus exclusively on their respective criteria; both will consider other areas that may impact their reviewing criteria. However, none of the listing requirements of the exchanges specified in the Exchange Exemption directly address the Commonwealth's concerns for the "weeding out" of fraudulent securities.

Operations of the Exchanges' Listing Departments

The exchanges mentioned in § 13.1-514(a)(8) have developed a process to attract new listings. The New York Stock Exchange and the AMEX have the most developed systems, with the Midwest Stock Exchange currently developing a marketing system similar to the other two. The marketing division of each exchange identifies companies that meet their listing criteria and appear to have sufficient national investor appeal to warrant listing on the exchange. The exchange arranges meetings with the firm's management to explain the benefits of listing with them. Formal negotiations and a closer review by the exchange follow if the firm's management is interested. In addition to the exchanges competing for new listings, companies will approach the exchanges for listing status. Companies want a good secondary trading market for their securities for a variety of reasons. Ease of trading its securities is one benefit of being a listed company. While this benefit is an indirect one for the firm, it does provide a ready market for the company should it wish to offer additional securities to the public. Management often receives part of its compensation in the form of the company's stock or stock options; the original owners will usually own large blocks of the firm's common stock. Both of these groups can receive the value of their holdings only when the security is sold.

However the exchange and firm meet, once the initial decision to seek listing status is made, the exchange begins its review process. Each exchange has a listing department devoted to this process. This department reviews the quarterly and annual information submitted to the Securities and Exchange Commission, the firm's annual reports, prospectuses of recent issues of the company's securities, the company charter, and in some cases interviews the firm's senior staff and visits the company's headquarters. The department consults with in-house counsel and "Big 8" accounting firms if questions arise about a company's business or financial statements.

The listing department reports its findings to a listing committee. This committee usually comprises vice presidents and senior management of the exchange, and it decides if there is sufficient reason to list the company. It also decides whether waivers from the listing criteria should be granted. Waivers may be granted from any of the criteria. Recently, the most-waived criteria appear to be the corporate governance criteria, mainly due to the influx of foreign companies obtaining listing status. Foreign corporations operate under substantially different, and often times less stringent, laws and customs than American corporations. The exchanges, with the approval of the Securities and Exchange Commission (SEC), have allowed these differences to exist. Requirements concerning the number of shares outstanding and public shareholders tend to be the least-waived criteria, probably because these criteria are directly linked to the amount of business that can be generated from trades and, therefore, the ultimate profitability of trading in the security.

Companies that are issuing securities for the first time can be listed on any of the exchanges. Because there is usually a lack of information available to the public about these companies, they are of particular concern to the regulators of the securities industry. The Midwest Stock Exchange notes that it does not allow any waivers regarding the original listing criteria when it reviews initial public offerings (IPO's). While the New York Stock Exchange will waive some of the criteria for IPO's, it notes that the majority of IPO's that it lists tend to be spin-offs from established companies or closed-end mutual funds that tend to be highly capitalized.

Once the listing committee approves the application, the exchange and the company enter into a contract formalizing the relationship. This distinguishes a listed security from an unlisted security. An unlisted security can be traded on an exchange, and the issuer is not bound by an agreement to supply the exchange with information or conform to its disclosure requirements.

The company must submit to the exchange copies of the filings it is required to submit to the SEC. The exchange continues to monitor the company for compliance with the exchange's maintenance requirements. These requirements for continued listing are lower than the initial listing requirements. While the SEC filings provide the primary data that the exchanges use to monitor the performance of their

listed companies, information from news services and from monitoring trading activity is used to varying degrees by the exchanges. The AMEX has devised the most elaborate system with formal computerized links to the department in charge of monitoring adherence to the maintenance criteria.

Should a company develop problems with meeting the maintenance criteria, the exchange staff will discuss the problems with the firm. The firm generally presents its plans to the exchange to bring the corporation back into compliance with the listing criteria. Usually the same committee that approved the original listing of securities will decide if a waiver from the maintenance criteria is warranted. There is no particular time limit on waivers of this type; it depends on the specific situation and the progress made by the firm.

Companies that the exchange believes will not meet the maintenance criteria in a timely manner have their securities delisted from the exchange. The New York Stock Exchange has the most formal process in this regard. After receiving the audited annual report of a firm having problems meeting the criteria, the Listing and Compliance Committee of the Exchange may determine that a firm should be removed from the list. The company is then given written notice of the prospective action along with the opportunity to request a hearing on the matter. If the company requests a hearing, the company and the Listing and Compliance Committee present their opposing viewpoints before a Committee of the Board of Directors, which is composed of three public directors and three industry directors of the Exchange. This committee renders a decision after taking testimony from both sides.

Inherent Problems of the Exchange Exemption

Virginia's interest in securities registration differs from the exchanges' interests in developing listing and maintenance criteria. Therefore, reliance on the exchanges' listing criteria is an imperfect method by which to accomplish the objectives of the Virginia Securities Act. Bankrupt companies, foreign securities, IPO's, senior securities that have no relation to the operations of the companies that issued them, and new types of securities are examples of areas that are often identified as being inappropriately addressed by the Exchange Exemption. Additionally, competitive pressures on the listing criteria due to changes in the securities industry present questions concerning the validity of the exemption. Each of these

matters is discussed below.

Bankrupt Companies. Companies with financial difficulties may be allowed to retain their listed status while they attempt to work out their problems. Sometimes the company is able to effect a turnaround and become stronger. A case in point is Chrysler Corporation. In the early 1980's, Chrysler was on the brink of bankruptcy and required federal loan guarantees to remain afloat. Its common stock traded at approximately \$5 a share. Today, Chrysler Corporation common stock (after several splits) trades in the \$20 to \$27 range, and its operations are now profitable.

Concern for the waiver of maintenance requirements centers on the companies that cannot meet the exchange requirements after an extended period and are subsequently delisted from the exchange. An exchange listing can be considered a "seal of approval" with investors relying on listing status as an indication of quality. Condoning continued trading under the exemption--i.e., allowing brokerage firms to actively promote the stock while the security does not meet the maintenance requirements--is inconsistent with the purpose of the Virginia Act.¹¹

Competitive Pressures on Listing Standards. The integrity of exchange listing requirements has recently come into question due to increased competition for listings. The New York Stock Exchange faced defections of listed companies because the companies wished to create classes of common stock with unequal voting rights, a situation that contravened the Exchange's rules. Hershey Foods Corporation, Coastal Corporation, Dow Jones & Company, and the General Cinema Corporation decided to delist from the "Big Board".

Because competitors of the New York Stock Exchange allow unequal voting rights for common stock, the Exchange refused to delist the securities until it had studied its standards. "One share, one vote" has been a hallmark of the New York Stock Exchange for 60 years. Negotiations between the NASD, AMEX, and the New York Stock Exchange failed to produce an agreement on this issue.¹²

Recently, the SEC released a ruling on the voting rights problem. The ruling allows the New York Stock Exchange to abandon its one share, one vote criteria under certain circumstances. Due to the complexity of the ruling and its numerous exemptions, its full impact on securities regulation cannot be discerned at this time. However, this situation

illustrates the potential for changes in listing criteria due to the requests of companies seeking listing status.

Foreign Securities. Foreign securities present unique problems when considering exchange listing requirements vis-à-vis state and federal security laws. Prior to 1982, foreign companies were required to meet the same disclosure requirements under the federal securities acts as domestic companies. Foreign firms were also required to use the same generally accepted accounting principles (GAAP) to prepare their financial statements that were used by U.S. companies. Today, foreign companies are allowed to use different types of accounting principles to prepare their financial statements, but they must provide an explanation of the principles used and their differences from U.S. GAAP. In addition, foreign companies are not required to make the same detailed disclosures as their American counterparts, and most of them are exempt from the proxy and insider trading requirements of the federal Securities Exchange Act of 1934.¹³

Ignoring the inequity of this position, problems arise with some of the information disclosure requirements enumerated in the Virginia Act. Compared worldwide, the U.S. state and federal securities statutes have the most stringent financial disclosure requirements. Removal of foreign companies from the financial disclosure requirements lessens the information that flows to the U.S. securities market. Therefore, dependence on the exchanges for enforcement of their listing criteria is of paramount importance to the public investor when investing in foreign securities.

Regardless of the enforcement of the exchange requirements, substantial legal problems exist for investors with respect to investment in foreign companies. For example, an investor may find it difficult to obtain service of process on a foreign corporation, and the enforcement of judgments rendered by Virginia and federal courts against a foreign corporation might be difficult or impossible.¹⁴

Foreign countries often limit the amount of foreign investment in their companies.¹⁵ This fact, coupled with the exemption from compliance with the proxy and insider trading requirements of the SEC, could cause American investors in foreign securities to lose rights that affect their economic interest in such investments.

Initial Public Offerings. Initial public offerings have

traditionally been the area of greatest concern to the Commission with respect to securities offerings. Many IPO's are offered by companies that are still in the formative stage and do not have an operating history, a product, experienced management, or a clear idea of what it will do with the proceeds of the offering. John Shad, former Chairman of the SEC, stated in regard to IPO's, "You don't have much to investigate. And you don't have a historical operating record. You don't have financial statements. You don't have anything."¹⁶

There is some merit in the argument that the standards maintained by the exchanges preclude securities manipulation of the type for which the Commission reviews.¹⁷ While securities of companies of a certain size are harder to manipulate, the fundamental problems associated with IPO's still exist, especially if a small group controls the issuer. Complicating the issue are some strategies used to produce "spin-off" companies. A company that cannot find a buyer for one of its subsidiaries will "spin-off" that entity to its current shareholders (an exempt transaction under the Virginia Securities Act) or will take the subsidiary public by selling its shares to the general public. In some cases, the assets of the spun-off company will have been retained by the parent company, producing serious doubt as to the viability of the former subsidiary.

Senior Securities and New Types of Securities. The Exchange Exemption allows for securities of either senior or substantially equal rank to the security listed on the exchange to be exempt from the registration provisions of the Act, as well as the issuing company's warrants and rights. With regard to common stocks and bonds, the argument that there is a substantial correlation between the quality of the listed security and its brethren is appealing. Assuming that the quality of a security is a function of the firm that issued it, all issues of a firm should share the same quality attributes. However, determining whether one issue is substantially the same as another issue may be difficult, especially with the amount of dual class voting stock and high risk/low grade debt instruments (i.e., "Junk" bonds) that are being issued today.

All securities issued by firms are not of the stock and bond variety; the quality of some securities bears little relationship to the quality of the listed securities. Investment contracts involving oil and gas leases have quality characteristics that are solely dependent on the

particular deal and property covered by the contract. The investor in this "senior security" has the possibility of a total loss of his investment, while the company as a whole will have a profitable year. The company will usually make money on the deal, even if the contract is not profitable. This is accomplished through management fees and promoter fees paid up front. It is possible to arrange these contracts so that only operations with a marginal chance at profitability are sold to outside investors.

The increasingly international nature of commerce requires companies to be sensitive to currency exchange rates. New types of securities have been developed to handle these problems. Ford Motor Credit Co. has issued currency warrants tied to the Japanese yen. The warrants allow the investor to receive a certain amount of dollars when the warrants are exercised, the amount depending on the price of dollars in relation to the yen. Should the dollar rise above a break-even point in relation to the yen, exercising the warrants would be profitable.¹⁸

Both of the preceding examples have a weak nexus, if any, to the overall operations of the companies that issued the securities. The "senior security" theory fails in light of the "exotic" securities that have been, and are being, developed to finance the needs of industry.

Current Developments in the Exchange Exemption

In 1985 the National Conference of Commissioners on Uniform State Laws redrafted the Uniform Securities Act. While much of the earlier Uniform Securities Act was retained, the redraft did contain some adjustments. Regarding the exchange exemption the Commissioners required that "...quotations have been available and public trading has taken place for the class of security before the offer or sale of a security in reliance upon this exemption...."¹⁹ This language eliminates IPO's from the scope of this exemption. Because IPO's occasionally will be oversubscribed before they are issued, secondary trading (trading that is not for the benefit of the company that issued the security) can take place almost immediately. As these "hot issues" are prone to the abuses of manipulation, a "seasoning" or "cooling off" period would be helpful in this area.

Conclusions

While reliance on the listing of a security on an exchange as a hallmark of quality is a 19th century concept, there still is some merit in continuing the exemption but in a modified form. The exchanges maintain departments to clear the issues for listing and constantly review the security issuers for compliance with their standards. These actions are consistent with the intentions of the Act and, therefore, are in the public's interest.

There are some problems with maintaining the relationship between the Commonwealth and the exchanges. These problems include decreases in the listing and maintenance criteria due to competitive pressures, initial public offerings, foreign securities, senior securities, rights, warrants, new products, and waivers of the listing and maintenance requirements. The New York Stock Exchange, AMEX, and the Midwest Stock Exchange each use different listing and maintenance criteria. The New York and AMEX standards, combined with the Commonwealth's 62 years of experience with these two exchanges, are sufficient for an exemption from the Virginia Securities Act's registration requirements for trading seasoned securities in the Commonwealth.

On the other hand, the Midwest Stock Exchange should be excluded from this exemption because its criteria is not comparable to that of the AMEX and the New York Stock Exchange. Excluding the Midwest from the exemption should have minimal impact on investing in Virginia--the Midwest has 15 exclusive listings, and approximately 90% to 95% of its trading volume is in New York Stock Exchange listed securities which are already exempt. Should the Midwest Stock Exchange want an exemption, it may be able to qualify under the Criteria Based Exemption (§ 13.1-514(a)(13)) if its listing standards are raised.

This study concurs with the Uniform Commissioners regarding the exclusion of IPO's from the exemption; some sort of "seasoning period" should be attached to the exemption. In addition, senior securities, rights, warrants, and securities of substantially equal rank as the listed securities should be excluded from the exemption.

The granting of exemptions under the Virginia Act provides a substantial economic benefit to issuers of

securities. During the Commission's hearing on the NASD's use of the Criteria Based Exemption in February, 1988, testimony to this effect was given. Issuers will list securities on exchanges that have the exemption. This tendency could have the undesirable effect of interfering with competition between the exchanges for listings.

At this time, no additional securities exchanges or automated trading systems should be included in this exemption. Future requests for exemptions from exchanges or national securities associations, if appropriate, should be granted under the Criteria Based Exemption. The Criteria Based Exemption addresses many of the problems associated with the Exchange Exemption and allows the Commonwealth to respond rapidly to changes in the marketplace.

III. THE CRITERIA BASED EXEMPTION, §13.1-514(a)(13)

Automation of the over-the-counter (OTC) market in the 1970's revolutionized the securities industry. Companies that normally would request listed status for their securities on major exchanges were remaining with the OTC market and its organizer, NASDAQ. Simultaneously, other changes in the marketplace caused states to rethink the Exchange Exemption and the problems that had developed by relying on it. This led to the enactment of the Criteria Based Exemption in 1974.

Development of the Criteria Based Exemption and the Rise of NASDAQ/NMS

By the early 1980's, it became apparent that the problems mentioned in the preceding section were changing the 60-year relationship between the exchanges and the states regarding reliance on the Exchange Exemption. Paramount in this change was the rise of the National Association of Securities Dealers' NASDAQ system and the upper tier of securities on the NASDAQ, which compose the NASDAQ National Market System, or "NASDAQ/NMS". The NASD is an association of dealers in over-the-counter securities. Prior to 1971, the OTC market was an unorganized conglomeration of dealers who telephoned several other dealers to determine the best price when they bought or sold OTC securities. The prior day's prices were published in the "pink sheets" and distributed to the brokerage firms.

In 1971 the NASD computerized the OTC price quotes and called its system the National Association of Securities Dealers Automated Quotations system, or "NASDAQ". NASDAQ enhanced the reputation of the OTC market. The system developed with the prodding of NASD officials and the oversight of the SEC. During the late 1970's, Congress mandated that a national market system be developed to increase competition in the securities field.²⁰ In 1982 NASDAQ/NMS debuted with 40 securities. This system provided

real time quotes and last trade and volume information. As the NASD relaxed its NMS criteria, more companies elected to join this system.²¹ By 1987 trading in NASDAQ/NMS-designated securities was second only to trading in securities listed on the New York Stock Exchange.²²

This development destroyed what was once the natural order in the securities industry. Traditionally, a new company would issue securities in the OTC market, and as the company grew, it would list its securities on the AMEX. From the AMEX, companies would graduate to the New York Stock Exchange.²³ Today, companies are not as eager to list their securities with the New York Stock Exchange and AMEX.²⁴ The reduction of this "upward" flow of securities has increased competitive pressures on listing standards. The Criteria Based Exemption was designed to counter the problems inherent in the Exchange Exemption caused by this competition and other factors.

Virginia's Modified Exchange Exemption

Development of the Criteria Based Exemption originally centered on identifying quantitative attributes of companies that would pass the registration process with a minimum of problems. These attributes are reflected in Securities Act Rule 502, adopted by the Commission in 1981. Brokerage firms could solicit trades in NASDAQ securities that met the criteria of the Rule without the securities being registered in the Commonwealth. Because the exemption is self-executing, the Commission has not received any feedback concerning its use. In 1987 the NASD requested that a new rule be promulgated to give NASDAQ/NMS-designated securities exemption status equal to securities listed on the exchanges mentioned in the Exchange Exemption. During the hearing on the NASD's request, testimony indicated that Rule 502 did not accomplish its objectives, mainly because brokerage firms could not interpret the Rule in a manner that would give them comfort concerning the availability of the exemption.

Following that hearing, the Commission adopted Securities Act Rule 504. Rule 504 (set out in Appendix II) retains the emphasis on quantitative and qualitative criteria and, at the same time, makes it easier for brokerage firms to take advantage of the exemption. Brokerage firms can telephone the NASD to confirm that the company which issued the securities designated on the NASDAQ/NMS is currently meeting the reporting and listing requirements established in Rule 504, thereby significantly decreasing the effort needed

to properly use the exemption. However, stockbrokers are not relieved from the NASD's Rules of Fair Practice which requires them to recommend securities that are suitable for the investor. This investigation of the security and the issuing company, known as "Due Diligence" in the securities industry, is required by securities regulators. In addition, the stockbroker is required to have sufficient knowledge of the investor and his finances in order to make suitable recommendations to the investor.

The criteria set out in Securities Act Rule 504 were taken from a NASD memorandum filed with the Commission concerning their proposed changes in NASDAQ/NMS listing standards. The proposed listing standards are very close to the standards currently used by the AMEX. A comparison of the NASDAQ/NMS listing criteria and the AMEX's reveals that the only differences are the amount of net income required (the AMEX only requires pre-tax income), the net tangible assets (in the case of the AMEX, stockholder's equity) required for companies in the early development stage (the AMEX requires \$4,000,000), and the minimum price per share for companies qualifying under alternative 1 (the AMEX requires \$3 minimum price per share). Listed in Tables 3 and 4 are the proposed (as of September 6, 1988) initial listing and maintenance criteria for NASDAQ/NMS.

Rather than simply exempting securities listed on the NASDAQ/NMS, the Commission has specified in Rule 504 the criteria that NASDAQ/NMS securities must meet to be exempt from registration. Additionally, the Commission specified the broad categories of securities eligible to use the exemption and the amount of information that would have to be publicly available before the exemption could be used. Because both requirements were coordinated with the federal securities acts, no further regulatory burden was imposed on the issuers of such securities.

The company issuing the security must have met all of its reporting obligations under the federal Securities Exchange Act of 1934 for 180 days prior to the sale for the security to be exempt from the Virginia Act. Usually the 180-day period will allow domestic companies to have filed at least two quarters of financial information and most foreign companies at least one filing besides the prospectus. This period provides a "cooling off" or "seasoning" period for new issues. This seasoning period is important as the Commonwealth develops experience with the NASDAQ/NMS that is comparable to the performance of the exchanges listed in the

Exchange Exemption.

TABLE 3

Initial Designation Criteria for the
National Association of Securities Dealer's
National Market System

	Alternative 1	Alternative† 2
Net Tangible Assets	\$ 4,000,000	\$12,000,000
Capital & Surplus	---	---
Pre-Tax Income	\$ 750,000	---
Net Income	\$ 400,000	---
Shares Outstanding	500,000	1,000,000
Number of Shareholders	800/400	800/400
Market Value of Publicly Held Shares	\$ 3,000,000	\$15,000,000
Minimum Price Per Share	\$ 5	---
Operating History	---	3yrs
Reports to Shareholders	Required	Required
Annual Meetings	Required	Required
1/3 Quorum	Required	Required
Proxies	Required	Required
Audit Committee	Required	Required
Independent Directors	Required	Required
Conflict of Interest Policy	Required	Required

† Criteria for Companies in the Developmental Stage

TABLE 4

National Association of Securities Dealer's
National Market System
Maintenance Criteria
(minimum standards to be met to remain on the system)

Net Tangible Assets	\$ 2,000,000 (if net losses were sustained in 2 of last 3 years); or
	\$ 4,000,000 (if net losses were sustained in 3 of last 4 years)
Shares Outstanding	200,000
Number of Shareholders	400/300
Market Value of Publicly Held Shares	\$1,000,000

Conclusions

For the Commonwealth's purposes, this exemption is superior to the Exchange Exemption. It allows the Commonwealth to control the criteria used as the basis of the exemption. Consequently, many of the problems associated with the older Exchange Exemption can be addressed on a more timely basis. By using the NASD's criteria, the Commission fosters the development of a national market system that allows securities to trade in several different marketplaces as envisioned by Congress in 1975. Use of these criteria for all the OTC and regional exchanges would create uniformity among the securities traded under this exemption and provide some indication of the security's level of quality. Finally, these criteria provide a model for other exchanges desiring an exemption for their listed securities.

At the same time, some of the problems associated with the Exchange Exemption are addressed by the Criteria Based Exemption. For example, IPO's have a "seasoning" period as suggested by NASAA and other interested parties during the hearing on the Criteria Based Exemption and by the Uniform

Commissioners in their redraft of the Uniform Securities Act. Most importantly, by specifying the criteria for the exemption, the competitive pressures on listing standards (i.e., the "race to the bottom" argument that has been heard frequently in discussions of exchange listing criteria) can be addressed, as can the proliferation of new types of securities that do not have track records.

The exemption allows the Commonwealth to experiment with criteria until arriving at the proper combination to prevent insubstantial securities from entering the marketplace without prior scrutiny, while advancing the needs of legitimate capital formation.

To further the formation of Virginia's national market system exemption, the Commission recommends the deletion of the Midwest Stock Exchange from the Exchange Exemption. The Midwest Stock Exchange may apply for an exemption for securities registered on its exchange under the Criteria Based Exemption. By deleting the Midwest Stock Exchange from § 13.1-514(a)(8), uniformity between the Exchange Exemption and the Criteria Based Exemption would be enhanced, thus preventing attempts by exchanges and securities associations to circumvent the certification process implied by §13.1-514(a)(13).

IV. THE MANUAL EXEMPTION §13.1-514(b)(2)

The Manual Exemption is another exemption contained in the Blue Sky laws enacted in the first decade of this century. The exemption has spread to a majority of the states through the Uniform Securities Act. The exemption allows brokers to solicit sales of securities if the issuing company is listed in an approved manual. Today, unfortunately, the exemption creates an easy way for brokers to avoid the registration requirements of the Virginia Securities Act, while not supplying the information necessary for investors to make intelligent investment decisions.

Development of the Manual Exemption

In 1915 the Michigan legislature enacted the first Manual Exemption in an attempt to appease the securities industry.²⁵ At the time, Michigan's securities law, adopted in 1914, was under attack by the business community. The investment banking community, as it was then called, opposed laws subjecting it to government scrutiny and, therefore, had fought the spread of Blue Sky statutes since the first enactment in Kansas in 1911. Originally, investment bankers attacked the Manual Exemption as the "'Michigan idea' of providing an easy way out of the act at all times....It is not so much an exemption of existing standard securities as a working exemption available for new offerings to be listed as issued."²⁶ Today 40 jurisdictions have a Manual Exemption because the exemption was included in the 1957 Uniform Securities Act.²⁷

Review of Other Jurisdictions With Manual Exemptions

Of the 53 jurisdictions (50 states, Puerto Rico, Guam, and the District of Columbia) that have enacted Blue Sky laws, 13 states do not have a Manual Exemption, and 22 jurisdictions have the Manual Exemption as promulgated in the 1957 Uniform Securities Act, which states:

Any nonissuer distribution of an outstanding security if (A) a recognized securities manual contains the names of the issuer's officers and directors, a balance sheet of the issuer as of a date within eighteen (18) months, and a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations, or (B) the security has a fixed maturity or a fixed interest or dividend provision and there has been no default during the current fiscal year or within the three (3) preceding fiscal years, or during the existence of the issuer and any predecessors if less than three (3) years, in the payment of principal, interest, or dividends on the security.

The majority of the remaining 18 jurisdictions have developed a variation of this exemption.²⁸

The variations for the most part modify only section A of the exemption and, in some cases, drop section B. Michigan, Minnesota, and New Hampshire require the firm to have been in continuous operation for at least five years prior to the transaction taking place. New Mexico and Oklahoma modify section A to require the class of securities involved in the transaction be outstanding in the hands of the public for at least 180 days prior to the transaction. Similarly, Maine requires that the firm be listed in the manual at least 90 days prior to the transaction, and it dropped the B section of the exemption. The Revised Uniform Securities Act (1985) modifies the exemption in this manner. Florida requires 2 years of income statements, and North Dakota limits the exemption to companies organized in the U.S. and its possessions.

Most of the remaining states have enacted statutes that are not readily categorized; however, they generally disallow section B of the exemption. A few of them require that the sales price be related to the current market price.

Virginia and Arizona have the least restrictive statutes, requiring only a listing in an approved manual.

Transactions Allowed Under This Exemption

The Manual Exemption is unusual among the exemptions granted under subsection (b) of § 13.1-514 because it applies to "nonissuer distributions" rather than the more common "transaction". Distributions generally involve the movement

of securities from the issuing company to the public; transactions are of a more isolated nature. A nonissuer distribution is defined as "...any transaction not directly or indirectly for the benefit of the issuer."²⁹ For example, if XYZ Corporation received the proceeds from the sale of its stock, the transaction would be for the benefit of the issuer, in this case, XYZ Corporation. However, if investor A sells his XYZ Corporation stock to investor B, the transaction (usually called secondary trading) would not normally be considered for the benefit of the issuer.

Questions of benefit to the issuer arise when this exemption is used by company insiders. Using this exemption, company insiders can purchase large blocks of unregistered company stock and sell considerable amounts of the stock to the public shortly after its purchase from the company. In this instance, the insider is a conduit for the stock to pass from the issuing company to the public without registration.³⁰ While the federal Securities Act of 1933's Rule 144 ("dribble out rule") would remove the danger for the most part, it is possible to combine a federal exemption with the Manual Exemption to create a nebulous offering that circumvents the intention of the Virginia Securities Act.

Brokerage houses can profit from this exemption by purchasing large blocks of stock from insiders and then reselling the stock to the general public without review under the Virginia Securities Act. Allowing the sale of stock without any required exemptive criteria invites illegal behavior because of the abundance of "products" (i.e., bankrupt companies) and the relative ease in hiding violations. Blind pools, stock issues that are offered without announcing the specific purposes for the proceeds of the offering, are particularly susceptible to this type of abuse.³¹

Listing Standards of the Manuals

Both Moody's and Standard and Poor's have flexible listing standards based in part on the amount of money paid to the publisher. Inclusion in Moody's depends on the interest shown by brokerage firms in a particular stock.³² Once qualified for inclusion, the company can choose between five types of coverage with a sliding price scale. The Standard section contains a synopsis of the balance sheet, but most of the companies in this section have income statements, some information on the corporation's directors and officers, and historical data about the company. The

Corporate Visibility section, a step above the Standard section, contains an expanded section describing the company's business, five years of the company's balance sheets and income statements, and a description of the company's capital structure including ratings of the company's preferred stock and debt. The **Corporate Visibility-Select** section contains balance sheets and income statements for seven years of operations and a section on financial and operating ratios. The company data includes information on major business segments and the locations for the firm's major operations. The capital structure is discussed and ratings are given on the preferred stock and debt. The **Corporate Visibility-Plus** section expands on the Corporate Visibility-Select section by printing most of the information contained in the company's annual report. While the manual lists a **Corporate Visibility Ultra** section, no listing was found for the section.

Moody's gathers information for its manuals from reports filed by the company with the SEC and, in some cases, from the stockholder reports issued by the company. Moody's does not guarantee that the information is accurate or complete.³³

The Standard and Poor's Corporation Records manual uses a similar approach; inclusion in the manual is afforded to companies that have net sales of \$3,500,000 and a market value of \$2,000,000.³⁴ Coverage is available in three forms with increasing amounts of information available in each. The **Brief Description** section contains income statements and balance sheets for the most recent periods (3 years for the income statement and 2 years for the balance sheet) and historical and current information about the company. **General Coverage** and **Full Coverage** provide more information (generally better corporate background) and receive priority in scheduling company updates and news. Companies that elect this type of coverage are charged a fee that depends on the exchange on which they are listed and the amount of additional information that they want printed.

A fourth type of listing available from Standard and Poor's for companies that do not meet the initial listing requirements is the **Tabular Listing**. This type of listing includes financial data that Standard and Poor's considers important, yet does not include a full balance sheet or income statement. Companies with a tabular listing can be upgraded to other types of listings with the payment of a fee.

Problems Associated with Reliance on the Manual Exemption

The Manual Exemption is based on the idea that sufficient information about a certain security is readily available to the investing public through reputable manuals to enable the investor to make an informed investment decision. The theory also presumes that the securities listed in the manuals are of a quality precluding the need for active supervision by the Commonwealth.

Virginia's Manual Exemption exempts:

Any nonissuer distribution by a registered broker-dealer of a security if information regarding the issuer of such security is included in one or more of the standard securities manuals in general use....

Commission Securities Act Rule 501 defines "standard securities manuals" as the following:

Standard & Poor's Corporation Descriptions (Volumes A-Z),
Moody's Industrial Manual (current bound volume),
Moody's Bank and Finance Manual (current bound volume).

The statute does not stipulate the type, amount, or timeliness of the information that is to be published in the manual; problems occur with all three areas. As noted above, tabular listings which include one-line entries of summary financial data are published in Standard & Poor's. Moody's, in its standard coverage section, provides a brief synopsis of the company's history and business, balance sheet and income statement, and a discussion of the company's debt structure.

In comparison, Virginia Code § 13.1-510, registration by qualification, requires the following information about the promoters and personnel of the corporation:

(b) A registration statement under this section shall contain the following information:

(1) With respect to the issuer and any significant subsidiary: its name, address and form of organization; the state (or foreign jurisdiction) and date of its organization; the general character of its business; and a description of its physical properties and equipment; and a statement of the general competitive conditions in the industry or business in which it is

or will be engaged;

(2) With respect to every director and officer of the issuer (or person occupying a similar status or performing similar functions): his name, address and principal occupation for the past five years; the amount of securities of the issuer held by him as of a specified date within ninety days of the filing of the registration statement; the amount of the securities covered by the registration statement to which he has indicated his intention to subscribe; and a description of any material interest in any material transaction with the issuer or any significant subsidiary effected within the past three years or proposed to be effected;

(3) With respect to persons covered by paragraph (2) of this subsection: the remuneration paid during the past twelve months and estimated to be paid during the ensuing twelve months, directly or indirectly, by the issuer (together with all predecessors, parents, subsidiaries and affiliates) to all such persons in the aggregate;

(4) With respect to any person owning of record, or beneficially if known, ten percent or more of the outstanding shares of any class of equity security of the issuer: the information specified in paragraph (2) of this subsection other than his occupation;

(5) With respect to every promoter if the issuer was organized within the past three years: the information specified in paragraph (2) of this subsection, any amount paid to him within such period or intended to be paid to him and the consideration for any such payment;

(6) With respect to any person other than the issuer on whose behalf any part of the offering is to be made: his name and address; the amount of securities of the issuer held by him as of the date of the filing of the registration statement; a description of any material interest in any material transaction with the issuer or any subsidiary effected within the past three years or proposed to be effected; and a statement of his reasons for making the offering....

Further information is required by §13.1-510 relating to the securities offering, such as amount and uses of proceeds, underwriting commissions, options outstanding and

ownership of such, unusual business dealings as a result of the sale of securities, a balance sheet within four months of the filing and income statements for the past three fiscal years, and various other disclosure requirements needed for effective investing.

While other exemptions granted under Virginia Code § 13.1-514 do not require such detailed personal, business, and financial information as is required in a registered offering, the majority of the exemptions are predicated on legislatively determined substitutes for governmental securities regulation. Substitutes include oversight by other governmental agencies, such as the Commission's Bureau of Insurance and Financial Institutions, or regulation by a self-regulatory securities organization ("SRO"), such as a stock exchange. (For a discussion of problems associated with registration exemptions for securities listed with SRO's, see section II of this study.) A few exemptions are based upon the idea that the persons involved with the transaction are insiders and should have access to the required information.

Stale Information. Standard & Poor's updates information periodically depending on the type of coverage for which a firm has contracted. In no case will more than 15 months elapse before a company's listing is updated. Moody's Industrial Manual is published once a year and contains information as much as 12 months old. Therefore, some sales involving the Manual Exemption could be based on information that is two years old.

Manuals not Limited to High Quality Firms. Quality is not the primary requirement for listing in the manuals. Firms listed in Moody's have securities outstanding that carry ratings ranging from AAA to C. C designates issues that are "...regarded as having extremely poor prospects of ever attaining any real investment standing."³⁵ Further, both publishers make statements that information contained in the manuals is not to be construed as recommendations to buy or sell a particular security.

Investor not Required to Receive Information. Regardless of the information contained in a manual, there is no assurance that the investor will see this information or use it in making his investment decision. The current statute does not impose on the brokerage firm an obligation to supply the customer with the information listed in the manual. Thus, the customer is left to his own devices to gather information

on the prospective investment beyond what the salesperson gives him during the sales pitch. Most purchases are solicited by the broker--not initiated by the investor.

Brokerage Firms Do Not Verify Information. It is generally believed that the brokerage firm has no duty to verify the information that is printed in the manuals. At the same time, both publishers issue disclaimers concerning the accuracy and completeness of the information published in the manuals.

An Example of Problem Listings. The April 28, 1988, offering of CheckRobot, Inc., exemplifies the problems created by use of the Manual Exemption. CheckRobot wanted to issue 517,500 units (a unit consisted of 2 shares of common stock and 1 warrant) of which 50,000 units were slated to be sold in the Commonwealth. The total amount of sales within the Commonwealth would have been \$462,500. Upon review, the Commission's staff noted that the underwriter's commission was 10% of sales and approximately 10,350 warrants, a relatively high amount for commissions, plus a \$108,000 consulting fee. The warrants were freely transferable after one year, a practice that allows the underwriter to introduce more shares into the market, usually after a price rise. An option to purchase 15,000 shares of the company at below market rates was granted to Mr. Alfred W. Vitale, a vice-president of the underwriter and a director of CheckRobot, Inc. Because the company had lost money since 1984 and did not specify what it was going to do with the proceeds of the stock offering, the Commission's staff objected to the proposed offering. Once the objections of the staff were heard by counsel for the company, the registration was withdrawn.

This withdrawal from the registration process, however, did not prevent the brokerage community from actively promoting the stock in Virginia once the offering was sold in neighboring states. This occurred because of a column and a third listing in Standard & Poor's Corporation Records. This listing contains a one sentence description of the company's business and lists the company's board of directors and officers, number of stockholders (including stockholders owning more than 10%), price range for 1985 and 1986, abbreviated income statements (1985, 1986, 1987), and balance sheets (1986 & 1987). No auditor's opinion or footnotes to the financial statements were published, nor was it disclosed that a stock offering was in the process of being registered for distribution.

Reduced Liability Is Created When the Manual Exemption Is Used

The Manual Exemption does not carry with it the same criminal and civil liabilities associated with registration of the securities. Registration creates company and underwriter liability for the information submitted to the Commission; in contrast, the stockbroker is not required to verify the information printed in the manual when using the exemption, nor is he required to give the information to the investor at anytime. An Iowa court, however, held that the brokerage firm was obligated to determine if the entry in a recognized securities manual "makes a fair disclosure of the status of the company involved."³⁶ Because this viewpoint is not widely held, it should be considered an aberration.

Conclusions

The Manual Exemption is not consistent with the purpose of the Securities Act, i.e., the prevention of insubstantial or fraudulent schemes by regulating the promotion and sale of securities.³⁷ At one time, the publishers of the manuals may have maintained sufficient standards for inclusion in the manuals for the Commonwealth to rely on their screening processes. Since the 1970's, this situation has degenerated to the point where unregistered securities of little or no value can be sold in Virginia, due to their listing in the manuals--a situation that the Act was designed to prevent. The Commission recommends that the Manual Exemption be repealed.

The effect of repealing this exemption will be minimal. As noted in the introduction, securities can be lawfully traded in the Commonwealth if they are an exempt security, registered, or traded through exempt transactions. Investors will be able to purchase and sell their securities by using exempt transactions. Brokers can use exempt transactions or register the security if they want to solicit sales. Because the Manual Exemption is limited to nonissuer transactions, issuing companies cannot avail themselves of the exemption in the first place.

V. SUMMARY

Since Virginia's Securities Act was passed in 1957, fundamental changes have occurred within the securities industry. The changes reflect a growing sophistication in the ways companies are financed and how their securities are traded. Modifications to the exemptions from the Commonwealth's securities registration requirements are necessary to meet these changes.

In the case of the Exchange Exemption, competitive pressures have emerged along with different types of securities that cast doubt on the continued viability of this exemption in its current form. The Commission recommends that the Midwest Stock Exchange be stricken from this exemption, along with the registration exemption for senior securities, rights, warrants, securities that are substantially equal in rank as the listed securities, and initial public offerings. Removing the Midwest Stock Exchange raises the minimum criteria that a firm must meet before its securities are exempt from the registration requirements of the Virginia Securities Act. As noted in section II, financing efforts of major companies now include senior and other types of securities that are far removed from the preferred stock and bonds that were common when the Act was adopted. These securities require more information than general knowledge about the issuing company to evaluate them completely. Initial public offerings have traditionally been an area of concern for the Commonwealth due to the issuing company's lack of operating history and the sales effort used to promote the stock.

The Criteria Based Exemption provides a workable solution to some of the problems found with the Exchange Exemption. The Commonwealth is able to specify the criteria that a trading system must use for its securities to be exempt from registration. In addition, the rule-making process used by the Commission allows interested parties to provide input into the formulation of specific criteria. The

Commission does not recommend any changes to this exemption at this time.

The Manual Exemption provides minimal protection to investors at best. Virginia's Manual Exemption does not meet the standards of the 1957 or 1985 Uniform Securities Acts, and it is less protective of investors than the majority of other jurisdiction's manual exemptions. Currently, securities not meeting the information requirements of the Virginia Securities Act can be sold in the Commonwealth because of this exemption. The Commission recommends that the Manual Exemption be repealed.

FOOTNOTES

1 Pollok vs. Commonwealth, 217 Va 411, 229 S.E. 2d 858 (1976).

2 Interviews with various exchange officials.

3 Question asked of George Ely, Secretary of the New York Stock Exchange, before a House Subcommittee on Banking and Currency, June 11, 1912, Infra note 4, p. 216.

4 Sobel, The Curbstone Brokers, New York: MacMillan, p. 172. (1970).

5 Investment Bankers of America Bulletin, IX, No. 4 (Jan. 20, 1921), p. 129.

6 Parrish, Securities Regulation and the New Deal, New Haven and London: Yale University Press, p. 23, (1970).

7 1926 Supplement to the Virginia Code of 1924 Annotated, Section 3848(35).

8 Loss and Cowett, Blue Sky Law, Boston: Little, Brown and Co., p. 359.

9 Warren, "The Status of the Marketplace Exemption, State Securities Registration" 41 Business Lawyer 1511, 1513 (August 1986).

10 Tyler, "More About Blue Sky", 15 Securities Law Review, 645, 649 (1983).

11 Additionally, § 13.1-513 allows the Commission to deny effectiveness for an offering of a company that is insolvent, either in the sense that its liabilities exceed its assets or in the sense that it cannot meet its obligations as they mature.

12 Blumstein, "Big Board Panel Urges Eased Listing Standard", New York Times, Jan. 4, 1985, p. D2.

13 Rubenstein, "State Securities Regulation: Merit Review of Foreign Equity Offerings", 25 Virginia Journal of International Law, No. 4, 946.

14 While the majority of foreign companies issuing securities for sale in the United States consent to the jurisdiction of federal and state courts in New York, enforcement of the judgment is a different matter. Plaintiffs will have to submit to foreign jurisdictions to determine if the judgment is in the public interest of the foreign issuer's country. This could result in modification of the judgment or, in the worst case, non-recognition. Even if the judgment would have been consistent with public policy in the foreign country, the plaintiff might be required to submit to a de novo action. See Supra, note 13 pp. 952-953.

15 Supra note 13, p. 957.

16 Testimony of John Shad before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, U.S. Senate 98th Congress 1st Session, Hearing 98-603.

17 "Stock Exchange Listing Agreements as a Vehicle for Corporate Governance," 129 Univ. Penn Law Review 1427, 1447 (1981).

18 "Ford's Credit Unit Sells Warrants Tied To Dollar Yen Rate", Wall Street Journal, June 19, 1987, p. 32 and Monroe, "Ford Unit Issues Warrants Pegged to Dollar and Yen", Wall Street Journal, Jan. 22, 1988, p. 49.

19 Revised Uniform Securities Act, CCH Blue Sky Law Reports, ¶5641 at 1672, 1674.

20 "SEC Seeks Broader Eligibility Rules in National Market", Wall Street Journal, Oct. 2 1981 p. 15.

21 Reprint of an article printed in Fortune magazine and supplied by the NASD: Louis, "The Stock Market of the Future - Now", Fortune Magazine, Oct. 29, 1984. See also Exchange Act Release No. 21583 (December 18, 1984), CCH Federal Securities Law Reports, ¶83,721 at 87,212.

22 Memorandum filed with the State Corporation Commission by the NASD in Case no. SEC870031, Document 870330156.

23 Phalon, "And Then There Were Three", Forbes, April 21, 1986, p. 31.

24 Kenney, "Over the Counter Trade Lures More Companies", The Milwaukee Journal, August 17, 1986. Reprint supplied by the NASD.

25 Investment Bankers Association of America, III, No. 9, April 27, 1915, 4.

26 37 Supreme Court Reporter, p. 232, 242 U.S. 568, (1917).

27 CCH Blue Sky Law Reports, ¶6301 at 2401-2406.

28 Various state statutes printed in CCH Blue Sky Law Reports.

29 Virginia Securities Act §13.1-501.

30 Long, Blue Sky Law, pp. 5-4, 5-11 (1986).

31 Schifrin, "Blinder, Robinson--Blind 'em and rob 'em", Forbes, April 20, 1987, pp. 33-38.

32 Long, supra note 30 p. 5-14.

33 Editors note, Moody's Industrial Manual, Dun & Bradstreet Corp., New York, p. iii.

34 CCH Blue Sky Law Reports, ¶6301B at 2406.

35 Supra, note 33 p. vi.

36 Transfer Binder 1971-1978, CCH Blue Sky Law Reports, ¶71,240 at 67,843.

37 Travelers Health Association vs. Commonwealth, 188 Va 877, 51 SE 2d 263 (1949), affirmed, 339 U.S. 643, 70 S. Ct. 927, 94 L.Ed 1154 (1950).

GENERAL ASSEMBLY OF VIRGINIA – 1988 SESSION

HOUSE JOINT RESOLUTION NO. 179

Requesting the State Corporation Commission to study securities registration exemptions of the Virginia Securities Act.

Agreed to by the House of Delegates, February 16, 1988

Agreed to by the Senate, February 25, 1988

WHEREAS, recent events in the national securities markets have resulted in substantial losses to Virginia investors, eroded the confidence of investors in the functioning of the securities markets and called into question the adequacy of protection afforded investors under existing securities laws; and

WHEREAS, securities are no longer limited to traditional equity and debt instruments and new and different securities products have emerged in recent years, giving rise to significant questions as to whether investors are fully apprised of the risks associated with investing in such securities; and

WHEREAS, the disclosure requirements associated with securities registration constitute the foundation of the Virginia Securities Act by providing for public dissemination and availability of information necessary to apprise investors of the specific risks of investing in a security and by requiring that such information is on file with the State Corporation Commission; and

WHEREAS, §§ 13.1-514 (a) (8), 13.1-514 (a) (13) and 13.1-514 (b) (2) of the Virginia Securities Act provide listing and marketplace exemptions from the securities registration requirements, and the continuation and modification of such exemptions should be periodically examined to ensure their relevance and responsiveness to current securities markets; and

WHEREAS, there has been no comprehensive examination in recent years of the listing and marketplace exemptions of the Virginia Securities Act to determine whether these exemptions need to be supplemented or revised in order to enhance investor protection; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the State Corporation Commission is requested to study the exemptions from the securities registration requirements in §§ 13.1-514 (a) (8), 13.1-514 (a) (13), and 13.1-514 (b) (2) of the Virginia Securities Act in order to determine whether revisions are necessary to enhance the goal of the Virginia Securities Act of protecting investors; and, be it

RESOLVED FURTHER, That upon completion of its study the State Corporation Commission shall report its findings to the Governor and the 1989 Session of the General Assembly as provided in procedures of the Division of Legislative Automated Systems for processing legislative documents.

Appendix II

Rule 504 NASDAQ/National Market System Exemption

In accordance with Virginia Code Section 13.1-514(a)(13), any security designated on the National Association of Securities Dealer Automated Quotations National Market System (NASDAQ/National Market System) is exempt from the securities registration requirements of the Act if the following criteria are met:

1. The issuer has a class of securities currently registered under Section 12 of the Securities Exchange Act of 1934 or in the case of an American Depository Receipt issued against the equity securities of a foreign issuer, such equity securities are registered pursuant to Section 12 of the Act.
2. The issuer, or in the case of an American Depository Receipt, the foreign issuer of the underlying equity securities, has been subject to the reporting requirements of Section 13 of the Securities Exchange Act of 1934 for the preceding 180 days and is current in its filings.
3. The National Association of Securities Dealers (NASD) shall require at least the following standards to be met for designation of securities of an issuer on the quotation system:

	<u>Alt. No. 1</u>	<u>Alt. No. 2</u>
Net Tangible Assets ¹	\$4,000,000	\$12,000,000
Public Float	500,000	1,000,000
Pre-Tax Income	750,000	-----
Net Income	400,000	-----
Shareholders ²	800/400	800/400
Market Value of Float	3,000,000	15,000,000
Minimum Bid	\$5/Share	-----
Operating History	-----	3 Years

The rules of the NASD shall require at least two authorized market makers for each issuer.

¹ "Net Tangible Assets" is defined for purposes of this Rule to include the value of patents, copyrights, and trademarks but to exclude the value of goodwill.

² The minimum number of shareholders under each alternative is 800 for companies with 500,000 to 1,000,000 shares publicly held and 400 for companies with over 500,000 shares publicly held and daily trading volume in excess of 2,000 shares per day for six months.

4. The NASD shall require at least the following minimum corporate governance standards:
- a. Distribution of Annual and Interim Reports.
 - i. Each issuer shall distribute to shareholders copies of an annual report containing audited financial statements of the company and its subsidiaries. The report shall be distributed to shareholders a reasonable period of time prior to the company's annual meeting of shareholders and shall be filed with the NASD at the time it is distributed to shareholders.
 - ii. Each issuer which is subject to SEC Rule 13a-13 shall make available to shareholders copies of quarterly reports including statements of operating results either prior to or as soon as practicable following the company's filing its Form 10-Q with the SEC. If the form of such quarterly report differs from the Form 10-Q, both the quarterly report and the Form 10-Q shall be filed with the NASD. The statement of operations contained in quarterly reports shall disclose, as a minimum, any substantial items of an unusual or nonrecurrent nature, net income, and the amount of estimated federal taxes.
 - iii. Each issuer which is not subject to SEC Rule 13a-13 and which is required to file with the SEC or another federal or state regulatory authority interim reports relating primarily to operations and financial position shall distribute to shareholders reports which reflect the information contained in those interim reports. Such reports shall be distributed to shareholders either before or as soon as practicable following filing with the appropriate regulatory authority. If the form of the interim report provided to shareholders differs from that filed with the regulatory authority, both the report to shareholders and the report to the regulatory authority shall be filed with the NASD.
 - b. Independent Directors. Each issuer shall maintain a minimum of two independent directors on its board of directors. For purposes of this section, "independent director" shall mean a person other than an officer or employee of the issuer or its subsidiaries or any other individual having a relationship which, in the opinion of the board of

directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

- c. Audit Committee. Each issuer shall establish and maintain an audit committee, a majority of the members of which shall be independent directors.
- d. Shareholder Meetings. Each issuer shall hold an annual meeting of shareholders and shall provide notice of such meeting to the NASD.
- e. Quorum. Each issuer shall provide for a quorum as specified in its by-laws for any meeting of the holders of common stock; provided, however, that in no case shall such quorum be less than 33 1/3 percent of the outstanding shares of the issuer's common voting stock.
- f. Solicitation of Proxies. Each issuer shall solicit and provide proxy statements for all meetings of shareholders and shall provide copies of such proxy solicitation to the NASD.
- g. Conflicts of Interest. Each issuer shall conduct an appropriate review of all related party transactions on an ongoing basis and shall use the issuer's audit committee or a comparable body for the review of potential conflict of interest situations where appropriate.
- h. Shareholder Approval Policy. Each issuer shall require shareholder approval of the issuance of securities in connection with the following:
 - i. Options plans or other special remuneration plans for directors, officers, or key employees.
 - ii. Actions resulting in a change in control of the issuer.
 - iii. The acquisition, direct or indirect, of a business, a company, tangible or intangible assets, or property or securities representing any such interests:
 - (1) From a director, officer, or substantial security holder of the issuer (including its subsidiaries and affiliates), or from any company or party in which one of such persons has a direct or indirect interest;

- (2) Where the present or potential issuance of common stock or securities convertible into common stock could result in an increase in outstanding common shares of 25% or more.

5. Voting Rights.

- a. The NASD rules shall provide that no rule, stated policy, practice, or interpretation shall permit the authorization for designation on the NASDAQ/National Market System (authorization), or the continuance of the authorization, of any common stock or equity security of a United States domestic issuer if, on or after September 1, 1988, the issuer issues any class of security or takes other corporate action that would have the effect of nullifying, restricting, or disparately reducing the per-share voting rights of holders of all of an outstanding class or classes of common stock of such issuer registered pursuant to Section 12 of the Securities Exchange Act of 1934.
- b. The following securities may be excluded from these voting rights requirements:
 - i. Any class of securities having a preference over the issuer's common stock as to dividends, interest payments, redemption, or payments in liquidation, if the voting rights of such securities only become effective as a result of specified events, not relating to an acquisition of the issuer's common stock, which reasonably can be expected to relate to the issuer's financial ability to meet its payment obligations to the holders of that class of securities.
 - ii. Any class of securities created as part of a merger or acquisition or a recapitalization or modification of voting rights within an existing single class of voting equity security if such merger, acquisition, recapitalization, or modification receives prior approval by a majority of the votes eligible to be cast by the issuer's

independent, disinterested directors³ and by a majority of the votes eligible to be cast by the issuer's public shareholders.

- iii. Any securities of an issuer distributed pro rata among the issuer's existing common stock shareholders.
 - iv. Securities outstanding at the time an issuer first had a class of securities held by 500 shareholders.
 - v. Any class of securities issued through a public offering with voting rights not greater than the per-share voting rights of any outstanding class of the issuer's common stock.
- d. The following terms shall have the following meanings for purposes of this Section, and the NASD rules shall include such definitions for purposes of the prohibition in paragraph a. of this Section:
- i. "Common stock" is any security of an issuer designated as common stock and any security of an issuer, however designated, which by its terms is a common stock (e.g., a security which entitles the holders thereof to vote generally on matters submitted to the issuer's security holders for a vote).
 - ii. "Equity security" is any equity security defined as such pursuant to Rule 3a11-1 under the Securities Exchange Act of 1934 (17 C.F.R. Section 240.3a11-1 as amended or superseded).
 - iii. "Public shareholders" are beneficial owners of the issuer's voting equity securities who are not directors, officers, or members of their immediate families or their affiliates, or affiliates of the issuer.
6. Maintenance Criteria. After authorization for designation of a security on the NASDAQ/National Market System, the issuer of such security must meet the

³ For those NASDAQ/National Market System issuers that do not currently have independent directors, an exception will be provided until such time as they are required to have independent directors, as provided by Schedule D Part III Section 5(J) of the NASD Manual. See CCH NASD Manual, at ¶ 1812.

following criteria in order for such designation to continue in effect:

- a. The issuer of the security has net tangible assets of at least:
 - i. \$2,000,000 if the issuer has sustained losses from continuing operations and/or net losses in two of its three most recent fiscal years; or
 - ii. \$4,000,000 if the issuer has sustained losses from continuing operations and/or net losses in three of its four most recent fiscal years;
 - b. There are at least 200,000 publicly held shares;
 - c. There are at least 400 shareholders or at least 300 shareholders of round lots;
 - d. The aggregate market value of publicly held shares is at least \$1,000,000; or
 - e. The issuer has complied with all NASD policies and procedures relating to the maintenance criteria for the NASDAQ/National Market System exemption.
7. The Commission may vacate this order pursuant to its authority under section 13.1-523, thereby revoking this rule, if the Commission determines that the requirements of the NASDAQ/National Market System have been so changed or insufficiently applied so that the protection of investors is no longer afforded.
 8. The Commission shall have the authority to deny or revoke the exemption created by this Rule as to a specific issue or category of securities.
 9. The NASD shall promptly notify the Commission when an issue of securities is removed from NASDAQ/National Market System designation.

Appendix III

Proposed Legislation

Section 13.1-514. Exemptions. - (a) The following securities are exempted from the securities registration requirements of this chapter:

(1) Any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state or any agency or corporate or other instrumentality of one of more of the foregoing; or any certificate of deposit for any of the foregoing;

(2) Any security issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing or any other foreign government with which the United States currently maintains diplomatic relations, if the security is recognized as a valid obligation by such issuer or guarantor;

(3) Any security issued by and representing an interest in or a debt of, or guaranteed by, the International Bank for Reconstruction and Development, or any national bank, or any bank or trust company organized under the laws of any state or trust subsidiary organized under the provisions of Section 6.1-32.1 et seq.;

(4) Any security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or by any savings and loan association which is organized under the laws of this Commonwealth.

(5) Any security issued or guaranteed by an insurance company licensed to transact insurance business in this Commonwealth;

(6) Any security issued by any credit union, industrial loan association or consumer finance company which is organized under the laws of this Commonwealth and is supervised and examined by the Commission;

(7) Any security issued or guaranteed by any railroad, other common carrier or public service company supervised as to its rates and the issuance of its securities by a governmental authority of the United States, any state, Canada or any Canadian province;

(8) Any security which is listed or approved for listing upon notice of issuance on the New York Stock Exchange, or the American Stock Exchange or the Midwest Stock Exchange, if, in either case, quotations have been available and public trading has taken place for the class of security listed before the offer or sale of a security in reliance upon this exemption; any other security of the same issuer which is of senior or substantially equal rank, any security called for by subscription rights or warrants admitted to trading in any of said exchanges; or any warrant or right to subscribe to any of the foregoing securities;

(9) (Repealed.)

(10) Any commercial paper which arises out of a current

transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within nine months after the date of issuance, exclusive of days of grace, or any renewal thereof which is likewise limited, or any guaranty of such paper or of any such renewal;

(11) Any security issued in connection with an employee's stock purchase, savings, pension, profit-sharing or similar benefit plan;

(12) Any security issued by a cooperative association organized as a corporation under the laws of this Commonwealth;

(13) Any security listed on an exchange registered with the United States Securities and Exchange Commission or quoted on an automated quotation system operated by a national securities association registered with the United States Securities and Exchange Commission and approved by regulations of the State Corporation Commission.

(b) The following transactions are exempted from the securities registration and the broker-dealer registration requirements of this chapter except as in this subsection expressly provided:

(1) Any isolated transaction by the owner or pledgee of a security, whether effected through a broker-dealer or not, which is not directly or indirectly for the benefit of the issuer;

~~(2) Any nonissuer distribution by a registered broker-dealer of a security if information regarding the issuer of such security is included in one or more of the standard securities manuals in general use;~~

(32) Any nonissuer distribution by a registered broker-dealer of a security that has been outstanding in the hands of the public for the past five years, if the issuer in each of the past three fiscal years has lawfully paid dividends on its common stock aggregating at least four percent of its current market price;

(43) Any transaction by a registered broker-dealer pursuant to an unsolicited order or offer to buy;

(54) Any transaction in a bond or other evidence of indebtedness secured by a real or chattel mortgage or deed of trust or by an agreement for the sale of real estate or chattels, if the entire indebtedness secured thereby is offered and sold as a unit;

(65) Any transaction in his official capacity by a receiver, trustee in bankruptcy or other judicially appointed officer selling securities pursuant to court order;

(76) Any offer or sale to a corporation, investment company or pension or profit-sharing trust or to a broker-dealer;

(87) Any sale of its securities by an issuer or a registered broker-dealer acting on behalf of such issuer if, after the sale, such issuer has not more than thirty-five security holders, and if its securities have not been offered to the general public by advertisement or solicitation. The

number of security holders of an issuer shall not be deemed to include the security holders of any other corporation, partnership, unincorporated association or trust unless it was organized to raise capital for the issuer. Notwithstanding the provisions of subsection (c) (2), the merger or consolidation of corporations shall be a violation of this chapter if the surviving or new corporation has more than thirty-five security holders and all the securities of the parties thereto were issued under this exemption, unless all of the parties thereto have been engaged in transacting business for more than two years prior to the merger or consolidation;

(98) Any transaction pursuant to an offer to existing security holders of the issuer including holders of transferable warrants issued to existing security holders and exercisable within ninety days of their issuance, if either (A) no commission or other remuneration (other than a standby commission) is paid or given directly or indirectly for soliciting any security holder in this Commonwealth, or (B) the issuer first notifies the Commission in writing of the terms of the offer and the Commission does not by order disallow the exemption within five full business days after the date of the receipt of the notice;

(109) Any offer (but not a sale) of a security for which registration statements have been filed under both this chapter and the Securities Act of 1933; but this exemption shall not apply while a stop order is in effect or, after notice to the issuer, while a proceeding or examination looking toward such an order is pending under either act;

(110) The issuance of not more than three shares of common stock to one or more of the incorporators of a corporation and the initial transfer thereof;

(111) Sales of an issue of bonds, aggregating \$150,000 or less, secured by a first lien deed of trust on realty situated in Virginia, to 30 persons or less who are residents of Virginia;

(112) Any offer or sale of any interest in any partnership, corporation, association or other entity created solely to provide residential housing located in the Commonwealth, provided that such offer or sale is by the issuer or by a real estate broker or real estate agent duly licensed in Virginia;

(113) The Commission is authorized to create by rule a limited offering exemption, the purpose of which shall be to further the objectives of compatibility with similar exemptions from federal securities regulation and uniformity among the states; providing, that such rule shall not exempt broker-dealers or agents from the registration requirements of this chapter. Any filing made to the Commission pursuant to this paragraph shall be accompanied by a \$250 fee.

(c) The following transactions are exempted from all the provisions of this chapter:

(1) The issuance of any stock dividend, whether the corporation distributing the dividend is the issuer of the

stock or not, if nothing of value is given by stockholders for the distribution other than the surrender of a right to a cash dividend where the stockholder can elect to take a dividend in cash or stock;

(2) Any transaction incident to a right of conversion or a statutory or judicially approved reclassification, recapitalization, reorganization, quasi-reorganization, stock split, reverse stock split, merger, consolidation, sale of assets or exchange of stock.

(d) In any proceeding under this chapter, the burden of proving an exemption shall be upon the person claiming it.

(comments below for change in Section 13.1-514 (a) (8))

COMMENTS: The new language has been taken verbatim from Section 401(b)(7) of the Uniform Securities Act of 1985 (CCH Blue Sky Law Reports, ¶ 5641). The purpose of this language is to exclude from the Exchange Exemption securities issued in an initial public offering. It is intended that the Commission will clarify by rule the phrases "quotations have been available and public trading has taken place" by limiting the applicability of the Exemption to securities which have been quoted and publicly traded on either exchange for at least 180 days prior to use of the Exemption. Such action by the Commission will make the Exemption and Securities Act Rule 504 consistent in these respects.

