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The Securities Exchange Commission has recently adopted new rules governing exemptions from registration requirements for issuers of securities. In this, Part I of a multi-part article, Professor Carney examines the impact Rule 146 will have on the private offering exemption, particularly with respect to smaller issuers.

EXEMPTIONS FROM SECURITIES REGISTRATION FOR SMALL ISSUERS: SHIFTING FROM FULL DISCLOSURE-- PART I: THE PRIVATE OFFERING EXEMPTION, RULE 146 AND AN END TO ACCESS FOR SMALL ISSUERS

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INTRODUCTION

In the past several years the Securities and Exchange Commission (SEC) has made dramatic changes in the rules governing exemptions from registration for issuers of securities under the Securities Act of 1933.[1] These changes flowed from a critical review of the relationship between the Securities Act of 1933 and the Securities Exchange Act of 1934, and attempt to integrate the disclosure systems of the two acts, while at the same time providing a greater degree of certainty for those issuers able to utilize the exemptions.

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1. 15 U.S.C. § 77a—77aa (1970). All references to the "Securities Act" will be to the Securities Act of 1933.

Since the publication of *The Wheat Report*[2] a lengthy reappraisal has resulted in the adoption of a series of rules—Securities Act Rules 146, 147 and 240, which will significantly alter some aspects of securities practice.[3] This article, which will be in two parts, will attempt to analyze some of these changes, in the light of the problems of the small promotional issuer. To a large extent such issuers have been given less sympathetic attention by the SEC than larger, more established issuers.

This article will treat these three rules as they relate to the problems of the small new issuer. Either because of lack of seasoning or lack of business potential which would ultimately justify "going public," such issuers are generally unable to interest professional venture capitalists, but must look primarily to individual investors, often without much aid from investment bankers. The first part of this article will deal with the private offering exemption,[4] which until recently was perhaps the most popular of the exemptions for the small issuer, and with the changes in the use of this exemption for such issuers which are likely to result from the adoption of Rule 146. No attempt will be made to deal with the statutory exemption or the Rule in connection with the problems of the more established issuer with investment banking connections which is better able to arrange a more traditional type of "private placement" with institutions.

Central to the Securities Act is a requirement that no securities shall be offered until a registration statement has been filed with the SEC, and that no securities shall be sold until that registration statement has become effective.[5] The

2. DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS; THE WHEAT REPORT (1969).
3. SECURITIES ACT RULE 146, 17 C.F.R. § 230.146 (effective June 10, 1974) amended May 7, 1975, SEC Securities Act Release No. 5585, CCH FED. SEC. L. REP. ¶ 80, 168; RULE 147, 17 C.F.R. § 230.147 (effective March 1, 1974) and RULE 240, 17 C.F.R. § 230.240 (effective March 15, 1975).
4. The so-called "private offering" exemption is contained in Section 4(2) of the Securities Act, 15 U.S.C. § 77d(2) (1970) and provides that the provisions of Section 5 of the Act, requiring registration of securities, ". . . shall not apply to . . . (2) transactions by an issuer not involving any public offering." The exemption does not apply to the antifraud provisions of the Act, and a seller in an exempt private offering transaction is liable for fraud under Section 12(2), 15 U.S.C. § 77(*l*)(2) (1970).
5. Section 5 of Securities Act, 15 U.S.C. § 77e (1970), contains the requirements of registration. Subsection (a) makes it unlawful to

information required by the Act to be included in the registration statement is lengthy and detailed, perhaps excessively so.[6] Elaborate "forms" have been devised by the SEC to guide issuers in filing registration statements.[7] This system is intended to produce full and fair disclosure of all material facts about an issuer to investors, and failure to make such disclosure subjects the registrant and a wide variety of persons who participate in the offering to liability to investors.[8]

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make use of the mails or any means or instrumentality of interstate commerce (the "jurisdictional means") to sell a security, or to transmit a security after sale, unless a registration statement is in effect with respect to such security. Subsection (c) makes it unlawful for any person to use the jurisdictional means to offer to sell any security unless a registration statement has been filed with respect to such security. Subsection (b) requires that any prospectus (defined broadly as an offering document under Section 2(10) of the Act) which is sent through the jurisdictional means must meet the requirements of Section 10 of the Act, and prohibits the use of the jurisdictional means to transmit any security for the purpose of sale or delivery after sale unless accompanied by or preceded by a prospectus meeting the requirements of Section 10(a) of the Act.

6. *See, e.g.*, Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973). Judge Weinstein stated:

> In at least some instances, what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilize turgid prose to enshroud the occasional critical revelation in a morass of dull, and—to all but the sophisticates—useless financial and historical data. In the face of such obfuscatory tactics the common or even the moderately well informed investor is almost as much at the mercy of the issuer as was his pre-SEC parent. He cannot by reading the prospectus discern the merit of the offering.

Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971), quoted in SEC Securities Act Release No. 5275 (July 26, 1972).

7. The statutory list of information required by Section 10(a) of the Act, 15 S.E.C. § 77j(a) (1970), is contained in Schedule A of the Act for most issuers. 15 U.S.C. § 77aa (1970). The SEC is authorized by Section 10(a) (4) of the Act to authorize omission from any prospectus of information required by Schedule A which it designates as not being necessary or appropriate in the public interest or for the protection of investors. Section 10(c) authorizes the Commission to require inclusion of additional information, and Section 10(d) authorizes the Commission to classify prospectuses according to the nature and circumstances of their use or the nature of the security, issuer, or otherwise. The Commission has exercised this authority by adopting a series of "forms" for registration, which are not forms in the sense that blanks are to be filled in, but formats for making the disclosure required for different types of issuers and different types of securities. The forms adopted by the SEC for registration generally under the Securities Act are denominated forms S-1 through S-16. Conditions for their use are found at 17 C.F.R. § 239.11-.27 (1974). The forms themselves can be found in CCH FED. SEC. L. REP. ¶7121-7401.

8. Section 11(a) of the Securities Act, 15 U.S.C. § 77k(a) (1970), provides that any person acquiring a security registered under a registration statement containing a materially false or misleading statement may sue the issuer and a variety of persons connected with the issuer: every person who signs the registration statement, which includes the principal executive and financial officers, the controller, plus all persons who were directors at the time of filing of the registration statement or who were named

The process of registration under the Securities Act is designed to further the laissez-faire ideal—that given proper information, the market will make the optimum decisions about allocation of capital. No attempt was made by the Act to impose any "merit" requirements of the type found in many state blue sky laws with respect to whether the proposed offering will be fair to investors.[9]

Over the years the requirements imposed upon registrants have grown in length and complexity. A series of elaborate guidelines were developed which attempted to outline the major areas of concern within the SEC in reviewing registration statements.[10] Even these guidelines were only a beginning, and once a registration statement was filed it was subjected to close review by attorneys on the staff of the Commission, who almost invariably had lengthy comments on how disclosure might be made more meaningful to investors in the particular case. This entailed delays and developed a specialized and costly securities bar; specialized, not only because of the complexity of the area, but also because much of the knowledge of these practitioners was based on personal experience and hearsay,[11] and costly, because the

as about to become directors, plus experts named with their consent in the registration statement (but only as to their expertised portion of the registration statement) and every underwriter. Liability for the issuer is absolute; for others, a showing that they lacked knowledge of the misstatement or omission, and that in the exercise of due diligence could not have obtained such information, is necessary to defend the action. Plaintiffs need not prove reliance on the misstatements, but must prove they did not know of its untruth at the time of purchase under Section 11(a). *See* 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 8.24 (1974). The leading case on standards of due diligence is Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

9. State securities laws are generally referred to as "Blue Sky" laws. *See* LOSS & COWETT, BLUE SKY LAW (1958). The concept of "merit" is contained in many of these statutes, which authorize state securities commissioners to deny registration to securities where the terms of the issue are not "fair, just and equitable," *See e.g.* KAN. STAT. ANN. § 17-1260 (1974) CCH BLUE SKY L. REP. 19,109 (Kan)., authorizing the commissioner to deny effectiveness to any registration statement if he finds that the issuer's plan of business is unfair, inequitable, dishonest, or fraudulent, or finds that the securities to be offered or issued to promoters for property or services are in excess of the reasonable value of the consideration.

10. SEC Securities Act Release No. 4936 (Dec. 9, 1968), 17 C.F.R. § 231.4936 (1974), CCH FED. SEC. L. REP. ¶ 3760. *See also How to Answer Form S-1*, CCH FED. SEC. L. REP. ¶ 8001.

11. Over the years the Commission staff developed a practice of issuing "no action" letters to issuers. These are interpretative letters written in response to a request for an opinion by an attorney who states the relevant facts in his request, and gives his own opinion that based on these facts,

responsibilities and the risk of liability for the attorney and the benefits to the client of being able to raise money from the public were both high.

The result was that registration became extremely costly, when one included the fees of the attorneys for the issuer and the underwriter, accountants who were required to audit the financial records of the business in accordance with forms prescribed by the SEC, fees of other experts who might be involved, underwriters' commissions, printers' bills, and filing fees with the SEC.[12] In recognition of these high costs, the Act provided a series of exemptions from registration, which issuers could consider each time they wished to offer securities. The exemptions are of two types—exemptions of certain classes of securities which were thought not to involve serious risks of fraud to investors, under Section 3(a) of the Act,[13] and exemptions of certain transactions, as to which the need for registration was not thought great enough to justify the high cost involved. These exemptions appear in Sections 3(b) and (c) of the Act,[14] in Section 4,[15] and to a lesser extent in Section 3(a).[16] The exemptions for classes of securities are normally of no interest to the issuer attempting to raise capital for a new enterprise. However, there are several possible transactional exemptions which may be available to issuers—the private offering exemption, the intrastate offer-

(generally) registration of the securities is not required. Where the staff agrees, it will state that it will not recommend that the Commission take any action if the proposed course of action is followed. It was not until 1970 that the Commission began to publish this correspondence. 17 C.F.R. § 200.81 (1974). Letters of comment on registration statements are not published.

12. A recent article estimates the minimum expense for an S-1 registration at approximately $100,000, which, when added to the typical underwriting discount of 10% or more for small offerings results in a cost of at least $200,000 for a typical small registered offering of $1 million, leaving the issuer with net proceeds of no more than $800,000. Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities*, 74 COLUM. L. REV. 622 n.2 (1974).

13. 15 U.S.C. § 77c(a) (1970). Only subsections (1) through (8) involve exemptions for classes of securities; the remaining exemptions are transactional in nature.

14. 15 U.S.C. § 77c(b) & (c) (1970).

15. 15 U.S.C. § 77d (1970).

16. Section 3(a)(9) through (11) involves "transactional" exemptions, 15 U.S.C. § 77c(a) (9)-(11) (1970).

ing exemption, and the small offering exemption. Other exemptions are available to persons other than issuers attempting to sell securities without registration, which are not available to issuers.[17]

While this description might indicate a sympathetic approach to the registration obligation of issuers, in fact the risk of absolute liability for an issuer's failure to fill all conditions of an exemption changes the entire aura of the Act. So important is the registration requirement that failure to register securities before they are offered (much less sold), absent the availability of one of the exemptions, subjects the issuer to absolute liability under Section 12(1) of the Act,[18] regardless of the issuer's truthfulness in making the offering. The drafters of the Act probably thought this penalty necessary because they realized that registration would be so burdensome that many issuers might attempt to evade the registration requirement, and rely on one or more of the exemptions in bad faith. In an early commentary on the prospects of the Act, Mr. Justice (then Professor) Douglas noted what he called the "terroristic methods" of the Act in penalizing "even those who act reasonably and in good faith," and predicted that such methods would fail, because they would be evaded by subterfuge, and would be subject to political attack, strict construction and judicial emasculation.[19] History has shown that while it has taken nearly forty years, the "terroristic methods" of the Act have been expanded, have been given a generous interpretation by the courts, and have made issuers and all associated with them far more cautious than Mr. Justice Douglas might then have imagined.

17. Section 4(1) of the Act, 15 U.S.C. § 77(d)(1) (1970), exempts from the registration provisions of Section 5 of the Act "transactions by any person other than an issuer, underwriter or dealer," thus exempting ordinary trading transactions; Section 4(3) exempts certain transactions by dealers, including underwriters who are no longer serving as underwriters, in trading transactions after passage of various lengths of time designed to assure adequate distribution of a prospectus to investors, and Section 4(4) exempts "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders." Section 4(2) is described in note 4 *supra*.

18. 15 U.S.C. § 77 (*l*)(1) (1970).

19. Douglas, *Protecting the Investor*, 23 YALE REV. (n.s.) 521, 529 (1934).

THE PRIVATE OFFERING EXEMPTION

Section 4(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering."[20] The legislative history was so sparse on this provision that it provided essentially no guides to interpretation.[21] The SEC declined to adopt any specific guidelines which would be of assistance to issuers, preferring to let them develop on a case by case basis, as it found situations where registration seemed more appropriate than exemption.[22] Over the next 35 years the Commission and the courts gradually provided some guidance to what offerings were not exempt, but little specific assistance to issuers as to what offerings were exempt. With the criticism of the subjective and highly complex approach to exemptions from registration in *The Wheat Report*[23] a rethinking began which resulted in the adoption of Rule 146,[24] which was intended to provide more specific guidelines for the utilization of the exemption, and after 40 years of uncertainty, a "safe harbor" for those who complied with the Rule.[25] Where appropriate, issuers

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20. 15 U.S.C. § 77d(2) (1970).

21. *See* 1 L. LOSS, SECURITIES REGULATION 653 n.43 (2d ed. 1961).

22. *See* SEC Securities Act Release No. 285 (Jan. 24, 1935), which noted the reliance on a numbers test by some issuers under Section 4(2), and cautioned that "the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment." The release listed four factors to be considered in making the determination: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering, and (4) the manner of the offering. *Id.* CCH FED. SEC. L. REP. ¶ 2741-44.

23. DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS; THE WHEAT REPORT (1969). Chapter 6 of the report dealt at length with the problems of uncertainty created by a subjective approach to the question of investment intent in determining who was an underwriter for purposes of determining when resales could be made, and ultimately led to the adoption of Rule 144, which allows such determination to be made in a more mechanical, although by no means simple, fashion. *The Wheat Report* was preceded and to a large measure inspired by Milton Cohen's article, *Truth in Securities Revisited,* 79 HARV. L. REV. 1340 (1966).

24. SEC Securities Act Release No. 5487 (April 28, 1974) adopted Rule 146, 17 C.F.R. § 230.146 (1974), which became effective June 10, 1974. The Rule was amended in SEC Securities Act Release No. 5585 (May 7, 1975). CCH FED. SEC. L. REP. ¶ 80, 168.

25. Rule 146(b) provides that "Transactions by an issuer involving the offer, offer to sell, offer for sale or sale of securities of the issuer that are part of an offering that is made in accordance with all the conditions of this rule shall be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act." The "safe harbor" is provided by the Rule and the provision of Section 19(a) of the Act, 15 U.S.C. § 77s(a) (1970) which states that "No provision of

were to be given assurance that the expense and delays of registration could be avoided without substantial risk of absolute liability for failure to register the securities offered.

The adoption of Rule 146 made final and definitive what had been hinted rather broadly in a number of recent court opinions: the "private offering" exemption has become the "private placement" exemption, available only to those issuers which were able to interest financial institutions and a few individual investors of like sophistication. While Rule 146 may increase the certainty of the availability of the exemption for larger, more established issuers already reporting under the Securities Exchange Act of 1934,[26] (the 1934 Act), it provides little comfort for smaller issuers. For the small issuer, or the entrepreneur with an idea searching for seed money, unable to interest the larger and more demanding venture capitalists, and forced to look for individual investors, the Rule still leaves them with a level of uncertainty and expense which most will find unacceptable. The increased concern of the SEC and the courts with the quality of information available to investors in private offerings and with the ability of the investors to obtain such information on their own and to evaluate it may have two effects which seem opposed to this concern. Either small and untested issuers will find the cost of capital greatly increased by virtue of the cost of compliance with the rigorous requirements of the Rule and the reduced group of offerees to whom offers can safely be made, or such issuers will turn to the exemptions where no formal disclosure requirements exist, such as the intrastate offering exemption[27] and the new small offering exemption provided

this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason."

26. 15 U.S.C. § 78a-78jj (1970).

27. Securities Act of 1933, Section 3a(11), 15 U.S.C. § 77c(a)(11) (1970) exempts "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." Rule 147, 17 C.F.R. § 230.147 (1974) provides certain non-exclusive "safe harbor" criteria which, if satisfied, create a presumption that the issuer is entitled to rely upon the intrastate offering exemption.

by Rule 240.[28] Resort to exemptions not requiring formal disclosure as a condition of their use will enable issuers to avoid the risks of absolute liability for failure to comply with all of the elaborate conditions of the private offering exemption, either under Rule 146 or the existing judicial and administrative interpretations of Section 4(2).

A. *Private Offering Case Law and Administrative Interpretations: Growing Restrictiveness and Uncertainty.*

1. Early Problems.

Rule 146 is expressly intended not to be the exclusive means by which an issuer can utilize the private offering exemption of Section 4(2),[29] although some commentators have expressed the belief that ultimately it may well be exclusive.[30] In light of the policy of the Rule, and the fact

28. Rule 240 was proposed for comment in SEC Securities Act Release No. 5499 (June 3, 1974) as a new exemption to be adopted by the Commission under the authority of Section 3(b) of the 1933 Act, 15 U.S.C. § 77c(b) (1970), which provides:

> The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $500,000.

The Commission had previously provided an exemption under this section for filings under Regulation A, 17 C.F.R. §§ 230.251-230.263 (1974). The exemption provided by Regulation A is limited to a maximum offering of $500,000 (except for certain cases involving selling shareholders not in control of the issuer where the aggregate may be as high as $800,000) and the procedures required to obtain the exemption, including filing of a notification of the proposed offering together with an offering circular with the appropriate regional office of the SEC are time consuming and costly. Rule 240 was adopted effective March 15, 1975 in SEC Securities Act Release No. 5560 (Jan. 24, 1975). Rule 240 will be dealt with more fully in the second half of this article.

29. Preliminary Note 1 to Rule 146 provides in part:

> The Commission recognizes that no one rule can adequately cover all legitimate private offers and sales of securities. Transactions by an issuer which do not satisfy all of the conditions of this rule shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available for such transactions. Issuers wanting to rely on that exemption may do so by complying with administrative and judicial interpretations in effect at the time of the transactions. Attempted compliance with this rule does not act as an election; the issuer can also claim the availability of Section 4(2) of the Act outside the Rule.

See also SEC Securities Act Release No. 5487 at 1 (April 23, 1974).

30. *See* Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Secur-*

that many issuers will not be able to assert that they have complied with the Rule in its entirety, the existing case law and administrative interpretations of the exemption are likely to retain vitality in the near future, at least, if not in the long run.

The approach of both the SEC and the Supreme Court to interpretation of the exemption is a classic example of the case method at work. Rather than inform issuers when the exemption would be available, or under what specific conditions it could be relied upon, the approach was to reserve all options at first, and gradually develop criteria which would determine when the exemption would *not* be available. While such a case by case approach may be appropriate in a private law context, it is of questionable value when dealing with administration of a public law, and in encouraging issuers to comply with the registration provisions of the Act.[31] In fairness, however, the exemption itself speaks in the negative: "not involving any public offering." In a 1935 opinion the General Counsel of the SEC outlined his views on the factors involved in determining whether a transaction was a public offering.[32] He noted that the opinion had been expressed that an offering to not more than approximately 25 persons does not involve a public offering, and in an apparent attempt to negate such a mechanistic approach, stated: "[T]he determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment. In no sense is the question to be determined exclusively by the number of prospective offerees."[33] The opinion then went on to list factors which were considered relevant, including (1) the number of offerees, (2) their relationship to each other and to the issuer,

ities, 74 COLUM. L. REV. 622, 643 (1974) and Schneider, *Comments of Mr. Schneider on Proposed Rule 146*, PLI FIFTH ANNUAL INST. ON SECURITIES REGULATION, 392 (Mundheim, Fleisher & Schupper eds. 1974); *contra*, Kerr & Morrow, *Revised Proposed Rule 146: An Introduction and Analysis*, *Id.* 335, 358.

31. Professor Loss observes, "It is, of course, easier to say what is a public offering than to say what is not." I L. LOSS, SECURITIES REGULATION 660 (2d ed. 1961).

32. Opinion of General Counsel, SEC Securities Act Release No. 285 (Jan. 24, 1935). CCH FED. SEC. L. REP. ¶2740.

33. *Id.*

(3) the number of units offered, (4) the size of the offering, and (5) the manner of offering. While these guidelines had the advantage of not tying down the administration of the exemption to an unworkable set of standards at an early date, they hardly provided any practicable guidelines for issuers. The leading case interpreting the private offering exemption, *SEC v. Ralston Purina Co.*,[34] only added to the uncertainty by imposing an additional, and general, requirement of investors' ability to fend for themselves. The company had made its stock available, apparently without aggressive solicitation, to a broad range of employees.[35] Rejecting any mechanical test, the Court declined to suggest specific criteria, stating:

> The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which "there is no practical need for [the bill's] application," the applicability of § 4(1) should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."[36]

The Commission urged a numerical test, but its argument was rejected by the Court, on the ground that "the statute would seem to apply to a 'public offering' whether to few or many."[37] During the years following *Ralston Purina* the

34. 346 U.S. 119 (1953).

35. A resolution of the Board of Directors authoribed the sale of stock to employees who inquired, without solicitation by the company, how to purchase company stock. The company argued that the stock was available only to key employees—those with special influence on others, but the record showed that among those responding to the opportunity were those with the duties of artist, bake shop foreman, chow loading foreman, clerical assistant and the like, with salaries as low as $2,435. As many as 414 employees purchased stock in a single year during the four year period shown on the record. *Id.* at 121.

36. *Id.* at 124-25.

37. *Id.* at 125. The court quoted dictum of Viscount Sumner, referring to a similar phrase in the English Companies Act: "'The public' . . . is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole." Nash v. Lynde, 1929 A.C. 158, 169, quoted *Id.* at n.11.

volume of private placements grew steadily.[38] As a result of *Ralston Purina,* attention began to shift from the criteria in *Release No. 285* to a balancing of the number of offerees against their sophistication, with authorities suggesting that the more sophisticated the group of offerees, the larger and less closely related to the issuer it could be.[39] Despite *Ralston Purina,* much of the discussion continued to focus on the number of offerees, although this focus was modified by consideration of their sophistication.[40]

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38. In the pre-Rule 146 period private placements of the kind reported by investment bankers appear to have passed their peak of popularity, perhaps due to changing market conditions as well as the increasing risks and uncertainty attending the private offering exemption. Professor Loss points out that for private placements:

> The annual figures increased more or less steadily from a mere $92 million in 1934 and $387 million in 1935 to a record of some $4 billion in 1952 and 1957, falling to $3.5 billion in 1958 and rising again to $3.8 billion in 1959. Percentagewise the dollar figures climbed from 23.2 percent of all corporate issues in 1934 to a high of 44.1 percent in 1951, falling to 30.2 percent in 1958 and rising once more to 39.0 percent in 1959.

I L. LOSS SECURITIES REGULATION 689 (2d ed. 1961).

Later statistics tend to support the view that private placements represent a smaller proportion of total offerings than formerly. In recent years the dollar figures showed that private placements represented the following percentages of total reported corporate issues: 53% in 1965; 43% in 1966; 29% in 1967; 26% in 1972; 28% in 1973 and 19% in 1974. 27 SEC STATISTICAL BULL. 16 (Feb. 1968); 34 SEC STATISTICAL BULL. 14 (Jan. 1975). These statistics appear to ignore the smaller private offerings not handled by investment bankers, since no method of obtaining such information is currently in existence. *But see* Form 240.

39. In 1959 Commissioner Orrick stated his views in the following manner:

> While there definitely is no magic number of offerees at which the line between a public and private offering is drawn, the Commission's General Counsel in Securities Act Release No. 285 suggested that for practical purposes approximately 25 offerees might be employed as a rough guide, provided all other circumstances surrounding the offering do not tend to negate the existence of a private offering. Accordingly, an offering to less than approximately 25 persons selected at random might be public, even though an offering to a larger number of persons composing a particular class closely interrelated among themselves and with the issuer might qualify as a private offering. Thus, where a close affiliation exists between the issuer and the offerees based upon a creditor, customer or attorney-client relationship or if the offerees are its directors or officers, slightly exceeding the limit of approximately 25 might be justified. However, the exemption probably should not be relied upon for an offering made to more than 25 persons, *where the offerees are neither sophisticated institutional investors having the means of obtaining all material information about the issuer nor key employees of the issuer* possessing specialized knowledge of the issuer.

Orrick, *Non-Public Offerings of Corporate Securities-Limitations On the Exemption Under the Federal Securities Act,* 21 U. PITT. L. REV. 1, 10-11 (1959). (emphasis added).

40. Illustrative of this approach is the description of the advice of counsel given in In Re: The Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957), CCH FED. SEC. L. REP. [Transfer Binder 1957—61 Decisions] ¶76,539, at 80,129, for a proposed private offering of $4 million of debentures:

Some of the criteria listed in *Release No. 285* either have not presented serious compliance problems or have become inapplicable. Generally the manner of offering has presented no problems, since issuers have been able to avoid general advertising and solicitations, and the problem of such general offers has generally arisen not in attempted private offerings but in the context of "gun-jumping" registered offerings or Regulation A offerings through press releases.[41] The size of the offering does not appear to have any relationship to the availability of the exemption, as long as it is truly privately placed. Commission staff members have approved offerings of many millions of dollars in the past.[42] Similarly, the number of units offered has dropped near the bottom of any list of important criteria, since a large number of units can be sold to a few offerees as readily as a few units.[43]

> The proposed financing was discussed in terms of a "private placement," i.e., that the securities would be sold as a private offering without registration under the Securities Act in reliance upon the exemption afforded by the second clause of § 4(1). Elliott and Company's counsel advised that it would be desirable in relying upon the "private offering exemption" to limit the offering to approximately twenty-five offerees."

The only offerees described in the release were either partners in investment banking firms, preferred customers, or relatives, all of whom were probably either sophisticated or advised by sophisticated investors.

41. For cases treating press releases as "offers" requiring registration, *see* note 111 *infra*.

42. With respect to the dollar amount of an issue, SEC Securities Act Release No. 285 (Jan. 24, 1935) stated: "[T]his exemption was intended to be applied chiefly to small offerings, which in their nature are less likely to be publicly offered even if redistributed." While SEC Securities Act Release No. 4552 (Nov. 6, 1962) mentioned the same factor, it was softened by inclusion in a discussion of the sophistication of the offerees: "The size of the offering may also raise questions as to the probability that the offering will be completed within the strict confines of the exemption. An offering of millions of dollars to non-institutional and non-affiliated investors or one divided, or convertible, into many units would suggest that a public offering may be involved." But Goldberg states flatly: "THE DOLLAR VALUE OF AN ISSUE OF SECURITIES IS NOT A SIGNIFICANT FACTOR IN DETERMINING WHETHER ANY GIVEN OFFERING IS PRIVATE OR PUBLIC IN CHARACTER." 2 S. GOLDBERG, PRIVATE PLACEMENT AND RESTRICTED SECURITIES § 2.2 (1974), and cites SEC Investment Company Act Releases approving issuance of as much as $115 million of securities under the exemption. *Id.* at 2-6, citing Investment Company Act Release No. 3703 (May 21, 1963).

43. While the number and size of units being offered are consistently referred to as factors to be considered in determining whether the offering is public or private, SEC Securities Act Release No. 285 at 2 (Jan. 24, 1935); SEC Securities Act Release No. 4552 at 2 (Nov. 6, 1962); In Re: The Crowell -Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957), all of the cases which involve a determination that a public offering was present turn not just on the presence of small units, but also on the actual fact of a distribution to the public within a short time after

The problem of the number of units offered relates not so much to whether the initial placement could be considered private as to whether it would stay private, or be resold by the original buyers in such a manner that they would be treated as underwriters. In the apparent belief that the most difficult problems of the issuer in dealing with and selecting offerees had been worked out with reasonable certainty, the Commission turned its attention to what might be treated as a refinement of the problem—the secondary distribution.[44] The problem of secondary distributions relates to whether a purchaser from the issuer is an "underwriter" within the meaning of Section 2(11) of the 1933 Act, either because he purchased with an intent to distribute the securities, or because he participated in the distribution by reselling, thus destroying the exemption, which is based upon lack of a distribution. The determination of investment intent has both

the initial purchase, indicating that the original purchasers were in fact underwriters. Silver Shield Mining & Milling Co., 39 S.E.C. 766 (1960); Earl J. Knudson & Co., 40 S.E.C. 599 (1961); In Re: The Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957); Shimer v. Webster, 225 A.2d 880 (D.C. App. 1967) (involving over 100 offerees). *But see* 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 3.1[a], at 3-3 to 3-6 (1973). While the number of units offered may be indicative of an intent to distribute such small, more marketable units to the public (as when $1,000 face amount debentures were convertible into common stock at a conversion price of $5 per share in the *Crowell-Collier* Release, *supra*) the possibility of a distribution beyond the original group of purchasers can be readily prevented with careful use of agreements not to resell, coupled with legends on certificates and stop-transfer orders to the transfer agent. Of course there is no way that an issuer can prevent a purchaser from reoffering the securities purchased, even where the issuer has control over transfers to prevent distribution, and in a theoretical sense, this would be enough to destroy the exemption since the law looks to offers, not only to purchases. Fortunately for issuers, no suggestion has been made that mere re-offers alone will destroy the exemption. For the purchaser attempting to show an unregistered public offering on this basis problems of proof of the offers would probably be insurmountable in most cases.

44. The Securities Act does not define a "distribution". Section 2(11) of the Act, 15 U.S.C. § 77b(11) (1970), defines "underwriter" broadly to include any person "[W]ho has purchased from an issuer with a view to . . . the distribution of any security. . . ." As *The Wheat Report, supra* note 23, at 162 pointed out:

> Thus, any person who purchases a security from an issuer with a view to a subsequent distribution (or public offering) is an "underwriter" and is not entitled to exemption from registration. A corresponding interpretation was given to the issuer's exemption in Section 4(2). If any of the several persons to whom an issuer sells securities in a private financing transaction happens to purchase the securities "with a view to" their later "distribution," the issuer's transaction is one "involving a public offering." It is therefore not exempt.

As Professor Loss states, "distribution" is thus "more or less synonymous with public offering.'" I L. LOSS, SECURITIES REGULATION 551 (2d ed. 1961).

a subjective and objective aspect. Subjectively, the Commission has never suggested a way for an issuer to truly assure itself of the intent of a purchaser, and has only indicated those intentions which will not satisfy the test.[45] A present intention to sell at some future date or on the occurrence of some event, regardless of time of sale, is considered sufficient to destroy investment intent. Practitioners have attempted to solve this problem by obtaining specific representations from purchasers that they were purchasing for investment and not distribution.[46] While the value of such letters has been questioned by the courts and the Commission.[47] their use has become not only commonplace, but the form has become somewhat stylized.[48] The value of such subjective representations is negligible when in hindsight it appears that a purchaser has resold at a time or under circumstances which suggest a lack of investment intent, as in the *Crowell-Collier* case.[49] Thus practitioners have developed the practice, re-

45. In the *Crowell-Collier* Release, *supra* note 43, at 80,132, the Commission stated: "Purchasing for the purpose of future sale is nonetheless purchasing for sale and, if the transactions involve any public offering even at some future date, the registration provisions apply unless at the time of the public offering an exemption is available."

46. This procedure is described in *The Wheat Report, supra,* note 23, at 163.

47. In the *Crowell-Collier* Release, *supra* note 43, at 80,132, the Commission expressed the following view about the value of such representations:

> Counsel, issuers and underwriters who rely on investment representations of the character obtained in these transactions as a basis for a claim to a non-public offering exemption under Section (4)1 of the Securities Act do so at their peril. * * * An exemption under the provisions of Section 4(1) is available only when the transactions do not involve a public offering and is not gained by the formality of obtaining "investment representations."

> The representations are quoted *Id.* at 80,129:

> In connection with the issuance and sale this day to the undersigned of $______ in principal amount of the 5% Convertible Debentures of your company, the undersigned hereby confirms to you that said Debentures are being purchased for investment and that the undersigned has no present intention of distributing the same.

48. A form of representation can be found in 2 S. GOLDBERG, PRIVATE PLACEMENT AND RESTRICTED SECURITIES, § 2.5[b] at 2-78 (1974). Another form can be found in 7A J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS, Form 19.73, at pp. 19-4622 to 4623 (1974). Some attorneys, including the author, prefer a somewhat longer form of letter which specifically negates an intent to sell on the occurence of certain events, such as a market rise or fall, or passage of a specific time period on a theory that such representations have educational value for the buyer, and may serve from time to time to remind him of the limitations on his ability to sell. They also serve a necessary disclosure function, informing buyers of material facts relating to their ability to resell. *cf.* Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973); SEC Securities Act Release No. 5226 (Jan. 10, 1972), CCH FED. SEC. L. REP. ¶2785; and Rule 146(e) (3) (ii) & (iii), 17 C.F.R. § 230.146 (e) (3) (ii) & (iii) (1974).

49. In Re: The Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957), CCH FED. SEC. L. REP. [Transfer Binder 1957—61

cognized in Commission releases as prudent, of placing legends on certificates giving notice that the shares may not be transferred without registration or the availability of an exemption from registration, and either delivering stop-transfer orders to transfer agents or placing a notation on the issuer's own stock transfer records, to prevent distribution.[50] While it is unrealistic to assume that any purchaser from an issuer takes without any intent to resell, these procedures provide some objective means for assuring that the purchaser does not become an underwriter by reselling, even if he so intends.[51]

Decisions] ¶76,539. The situation of a specific purchaser is discussed in Gilligan, Will and Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *cert. denied,* 361 U.S. 896 (1959).

50. SEC Securities Act Release No. 5121 (Dec. 31, 1970), CCH FED. SEC. L. REP. ¶2784, discussed the advisability of taking precautions against distribution beyond obtaining investment representations from the purchaser. The release stated:

> [S]ince the terms of an exemption are to be strictly construed against a claimant who has the burden of proving its availability, in many cases the issuer has placed a legend on such securities and stop-transfer instructions have been issued to the transfer agent. These precautions—placing the legend on the securities and issuing the stop-transfer orders—are not to be regarded as a basis for exemption, but they have proved in many cases to be an effective means of preventing illegal distributions. The use of the legend also alerts the buyer to the restricted character of the securities he has acquired and thus calls attention to material facts which assist in the protection of public investors.

From being good practice, this procedure has become mandatory in order to obtain the safe harbor exemption provided by Rule 146. Rule 146(h) requires the issuer to exercise "reasonable care" to assure that the purchasers of securities taken in a private offering pursuant to the Rule are not underwriters. The Rule goes on to mandate that "such reasonable care *shall* include, but not necessarily be limited to," making reasonable inquiry about the purchaser's investment intent, placing a legend on the certificate, issuing stop-transfer orders to the transfer agent, and, a factor not mentioned in the previous release, "obtaining from the purchaser a signed written agreement that the securities will not be sold without registration under the Act or exemption therefrom." Rule 146(h)(4), 17 C.F.R. § 230.146(h) (4) (1974) (emphasis added).

51. Once a purchaser's counsel has explained that unregistered securities must be taken for investment and not for distribution, except in the case of experienced and sophisticated offerees in private placements, the inevitable first question is, "That's fine, but when can I sell?" No rational purchaser likes restrictions being placed upon his ability to liquidate an investment, and it is only in consideration of the better price which he generally obtains in a private placement compared to a public offering that he is willing to put up with these restrictions. Nevertheless, every rational purchaser wishes to be *able* to sell as soon as possible, even if he does not *intend* to sell at the earliest possible moment. In addition, the price to be paid for the securities bears a direct, if immeasurable, relationship to the restraints on resale. Professor Loss has observed:

> [A] conscientious lawyer is placed in a difficult position if he examines the issuer or prospective buyers too closely on the question of investment intent; for few investors could honestly survive the examination, and a prospective buyer's very act of inquiring of

2. *Post Ralston Purina Problems—Fifth and Tenth Circuits.*

The ultimate difficulties for issuers attempting to utilize the private offering exemption did not arise from the difficult question of whether an issuer possessed a subjective intent to make a private offering—the question posed at some length by the Supreme Court's opinion in *Ralston Purina,* in terms of testing whether the issuer had selected a limited and identifiable group of offerees in advance.[52] The real difficulties came from the broad and conclusory guidelines of whether offerees were able to fend for themselves, and whether they needed the protection of the Act. Obviously such general statements provided little assistance to issuers.[53] Such

> counsel how long he must hold before reselling might require the answer that he has already entertained the fatal thought. Indeed, the prudent buyer's exaction of a registration covenant might itself damn the transaction.

I L. LOSS, SECURITIES REGULATION 671 (2d ed. 1961). Loss suggests this result would be absurd, and that while investment representations involving a fixed holding period would be a mistake, a one year holding period may be enough to draw "a strong inference" of investment intent, relying on SEC Securities Act Release No. 1862 (Dec. 13, 1938), CCH FED. SEC. L. REP. ¶ 1531. *Id.* The Commission staff has never accepted such a short holding period as sufficient evidence of investment intent absent a "change of circumstances". *See The Wheat Report, supra* note 23, at 164-66, and the Commission disavowal of a one-year holding period in the *Crowell-Collier* Release, *supra* note 43.

52. SEC v. Ralston Purina Co., 346 U.S. 117, 123 (1953), quoted with approval from SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (9th Cir. 1938):

> In its broadest meaning the term "public" distinguishes the populace at large from groups of individual members of the public segregated because of some common interest or characteristic. Yet such a distinction is inadequate for practical purposes; manifestly, an offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less "public," in every realistic sense of the word, than an unrestricted offering to the world at large. Such an offering though not open to everyone who may choose to apply, is none the less "public" in character, for the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made.

53. SEC v. Ralston Purina Co., 346 U.S. 117, 125 (1953). In Hill York Corp v. American International Franchises, Inc., 448 F.2d 680, 689 (5th Cir. 1971), after discussing the type of tests posed in *Release No. 285* and later releases, the Court stated:

> Even an objective testing of these factors without determining whether a more comprehensive and generalized prerequisite has been met, is insufficient. "The natural way to interpret the private offering exemption is in light of the statutory purpose." SEC v. Ralston Purina Co., *supra* at 984. "The design of the statute is to protect investors by promoting full disclosure of

a test merely states the general purposes of the Act, and exemplifies the problem with a case by case approach to the administration of a public law carrying heavy penalties for its inadvertent and unintentional violation.

Ultimately the problem of who can fend for themselves has been phrased in terms of "access" to information about the issuer—who is in a position to obtain all the information which a prudent investor might want,[54] and who is capable of evaluating such information once obtained. The latter requirement relates to knowing what information to ask for and in that sense is an access problem, while in another sense it is a question of the level of sophistication of the investor.

3. *Relationship of Offerees to Each Other.*

To the extent the courts and the Commission have focused on the problem of whether the offerees have some relationship to each other, it has seemed to be as an alternative to a relationship with the issuer. Commissioner Orrick suggested as much in 1959, when he suggested that as the number of offerees grew larger the offerees should either be more sophisticated, such as institutional investors, *or* key employees.[55] The Fifth Circuit Court of Appeals stated the requirement in the following manner:

> Also to be considered is the relationship between the offerees and their knowledge of each other. For example, if the offering is being made to a diverse and unrelated group, i.e., lawyers, grocers, plumbers, etc., then the offering would have the appearance of being public; but an offering to a select group of high executive officers of the issuer who have

information thought necessary to informed investment decisions". *Id.* Thus the ultimate test is whether "the particular class of persons affected need the protection of the Act."

54. In *Ralston Purina* the court explained the need for a relationship with the issuer in the following terms:

> We agree that some employee offerings may come within § 4(1), *e.g.*, one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement.

SEC v. Ralston Purina Co., 346 U.S. 117, 125 (1953).

55. Orrick, *Non-Public Offerings of Corporate Securities—Limitations on the Exemption under the Federal Securities Act*, 21 U. PITT. L. REV. 1, 10-11 (1959), quoted at note 39, *supra*.

> known each other and of course have similar interests and knowledge of the offering would more likely be characterized as a private offering.[56]

In some cases the courts seem to have relied on the relationship of the offerees to each other,[57] but in most such cases it is difficult to determine how important this factor would have been in the absence of a relationship with the issuer and sufficient experience to be able to fend for one's self. In *Hill York Corp. v. American International Franchises, Inc.*[58] the court's opinion cites with approval the manner in which the district court weighed all of the factors mentioned in *Release No. 285* in *Garfield v. Strain,* but a review of the factors in that case indicates that emphasis was placed not so much on the relationship of the offerees among themselves, but to the promoter of the venture.[59] While the importance of the relationship among the offerees is mentioned in a number of cases,[60] as a practical matter

56. Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971).
57. SEC v. Sunbeam Gold Mines Co., F.2d 699, 701 (9th Cir. 1938).
58. 448 F.2d 680 (5th Cir. 1971).
59. The Court of Appeals stated:

> The trial court specifically held that the sellers had sustained the burden of showing that the sale was exempt and the Act inapplicable on the following grounds: (a) "The smallness of the transaction and the insubstantial number of offerees;" (b) "The fewness of the units offered and sold;" (c) "* * * under the surrounding facts and circumstances, no public interest stood in need of protection afforded by registration and none of the offerees and purchasers stood in such need;" (d) "The close relationship and past dealings between plaintiffs [issuer] and the offerees and purchasers, including the defendant, refutes a claim that there was a public offering involved;" (e) "The close acquaintance between the defendant Garfield and T. C. Strain growing out of a former real estate transaction and personal visits of plaintiff Strain by invitation in defendant's home and with defendant and his wife;" (f) "The request of defendant made of Strain while in Denver after having made inquiries of Strain about Strain's oil business, to be given a chance to invest in some of Strain's future oil ventures;" (g) "The wide business experience of defendant Garfield in several businesses, including the stock market and ownership of oil stocks, place him in a class not needing the protection of the Act as to these particular secrities;" and (h) "Others of the purchasers or offerees of interests were experienced in the business of prospecting for oil or were close personal friends of the plaintiffs [issuers] and stood in no need of protection.

Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963).

60. Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972) mentions the relationship among offerees as a consideration, *Id.* at 1072, but only in a catalog of tests which should be considered, and not as a determinative factor. It is clear from the opinion that the total number of offerees was not proved, nor the manner of making the offering, which meant the issuer had not met its burden of proof on these crucial issues.

other factors seem far more important to the results in these cases, such as the relationship of the offerees to the issuer, and their ability to obtain and evaluate the information which they need for an investment decision. Hence the general view has been that the more sophisticated the offerees, the greater their number may be, and the less necessary it becomes that they have any relationship with each other prior to the offering.[61] It seems safe to say that absent access to information and sophistication, such relationships will not help an issuer establish the availability of the exemption.

4. *Access—Relationship of Offerees to Issuer.*

Far more important is the question of access—whether the offerees are in a position to obtain the information which is necessary to make an informed investment decision. *Ralston Purina* emphasized this factor in its discussion of whether all employee offerings should be exempt:

> The exemption, as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within § 4(1), *e.g.*, one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement.[62]

Under this test, offerings to business associates and persons with whom the offeror has had personal relationships over extended periods of time have traditionally been sanctioned.[63] But cases arising in the Fifth Circuit have placed issuers in a bind in attempting to predict when offerees will be found to have access. In *Hill York Corp. v. American International Franchises, Inc.*,[64] stock in a franchising com-

61. One author points out, "Where sophisticated or financially astute persons are involved, such as bankers, insurance companies, etc., as many as 100 offerees may be involved without loss of the private offering exemption." Owens, *The Private Offering and Intrastate Exemptions Under the Securities Act of 1933*, SELECTED ARTICLES ON FEDERAL SECURITIES LAW 165, 167 (Wander ed. 1968). *See Also* Orrick, *supra* note 55, at 33.

62. SEC v. Ralston Purina Co., 346 U.S. 117, 125-26 (1953).

63. 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 4.1(d) (1974).

64. 448 F.2d 680 (5th Cir. 1971).

pany was sold to persons who were likely to do business with the franchised operations, such as suppliers. The court's opinion conceded that the purchasers were all sophisticated:

> The defendants rely most strongly on the fact that the offering was made only to sophisticated businessmen and lawyers and not the average man in the street. Although this evidence is certainly favorable to the defendants, the level of sophistication will not carry the point. In this context, the relationship between the promoters and the purchasers and the "access to the kind of information which registration would disclose" become highly relevant factors.[65]

The opinion then reviewed the requirements necessary to establish "access," such as whether the offerees had a relationship with the issuer which enabled them to obtain material facts about the investment, and whether they in fact obtained such information. Finding that the promoters used a misleading offering memorandum, the court concluded that the offerees could not have had sufficient access, since they were in fact misled. The court went on to conclude as a matter of law that fraud always proves lack of access and a privileged relationship with the issuer, regardless of the sophistication of the offerees:

> No reasonable mind could conclude that the plaintiffs had access to accurate information on the foregoing points since the only persons who reasonably could have relieved their ignorance were the ones that told them the untruths in the first instance. This proof, as an *a priori* matter, inexorably leads to the conclusion that even the most sanguine of the purchasers would have entertained serious, if not fatal, doubts about investing in this scheme if completely accurate information had been furnished.[66]

The lesson of *Hill York* seems to be that sophistication in investment matters, and sufficient bargaining power to

65. *Id.* at 690.
66. *Id.* at 691 (footnote omitted). If fraud always establishes conclusively that the buyer needed the protection of the Act, what conclusion would the Fifth Circuit draw from fraudulent statements in a registration statement?

insist on information is not enough by itself, without actual possession of and an opportunity to verify personally the information which has been obtained from the issuer. A few years earlier the Fourth Circuit had made the observation that investment sophistication was no substitute for access to the kind of information which a registration statement would disclose in *United States v. Custer Channel Wing Corp.,*[67] but the opinion had far less impact than *Hill York* since the case involved the use of three "associates" who served as conduits for investments by some 136 individuals who apparently had no contact whatever with the issuer or its representatives.[68]

Having held that it was impossible to establish access where it was later shown that offerees had not received complete and totally truthful information, the Fifth Circuit then proceeded in its next opinion to emphasize what had been implicit in *Hill York,* that proof of receipt of truthful information was not enough by itself to establish the exemption unless the issuer could also show that the offerees were persons who could have obtained such information on their own, even if not volunteered by the issuer. In *SEC v. Con-*

67. 376 F.2d 675 (4th Cir. 1967), *cert. denied,* 389 U.S. 850 (1967).

68. It is possible to see the beginnings of this approach in Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *cert. denied,* 361 U.S. 896 (1959), where the purchasers included Gilligan, a partner in a brokerage firm, Alter, a member of the American Stock Exchange, and the wife of the broker arranging the private placement of several million dollars of convertible debentures of Crowell-Collier Publishing Company. Gilligan was told by the underwriter, Elliott, that Crowell-Collier had "turned the corner" from an unprofitable period, and received no other information about the company, apparently because he asked for none. There was no personal contact with officers of the issuer. In concluding that the private offering exemption was not available under these circumstances, the opinion stated:

> The stipulation of facts here expressly states that the purchasers "were not supplied with material information of the scope and character contemplated by the Securities Act nor were the purchasers in such a relation to the issuer as to have access to such information concerning the company and its affairs." Such a stipulation, which from the additional stipulated facts, appears equally applicable to Gilligan, the registrant, Alter, Mooney [a buyer whose profession and investment experience were not disclosed by the opinion] and Mrs. Elliott, concedes the very proposition of which the petitioners had to establish the negative in order to prevail, and we therefore think it dispositive of the question whether petitioners "purchased with a view to distribution."

Id. at 466-67. Gilligan, Will and Company was a leading specialist on the American Stock Exchange at the time, and surely had the skill to obtain and evaluate information, had Gilligan wished to do so.

tinental Tobacco Co.,[69] the court was met with vigorous arguments from the Commission staff on the need for a preexisting relationship between offerees and issuers, despite evidence that they actually obtained information.[70]

Continental Tobacco involved a plan of refinancing a bankrupt corporation by selling $200,000 of common stock in a private offering,[71] although the promoters were only able to raise $140,000.[72] The financing was arranged by two attorneys with an interest in the corporation, who were aware that the corporation had previously run into difficulties with the securities laws, and was the subject of a preliminary injunction pending in this action.[73] In order to

69. 463 F.2d 137 (5th Cir. 1972).

70. A report on the SEC Staff brief can be found in *Commission Stresses Burden of Proof Necessary to Support Use of Private Offering Exemption,* 127 BNA SEC. REG. & L. REP. A-17 to A-18 (Nov. 17, 1971), which quotes from the brief:

> The issuer must affirmatively demonstrate by "explicit, exact," evidence that *each* person to whom unregistered securities were offered was able to "fend" for himself—in other words, that each offeree had a relationship to the company tantamount to that of an "insider" in terms of his ability to know, to understand, and to verify for himself all of the relevant facts about the company and its securities.

Id. at A-18. The brief also argued that preparation of a disclosure document refuted any claim that the offerees were knowledgeable or sophisticated. A report on the SEC reaction to the result in *Continental Tobacco* and to the criticism of its brief appears in 144 BNA SEC. REG. & L. REP. B-1 (Mar. 22, 1972). The staff argued that its position was only a logical extension of earlier cases. Phrased another way, the argument is that an offeree must have access at the time the offer is made, not at some later date when he receives a private placement memorandum. One article suggests this is the logical conclusion of *Ralston Purina.* Borton & Rifkind, *Private Placement and Proposed Rule 146,* 25 HASTINGS L. J. 287, 294 (1974). Commissioner Owens attempted to limit the impact of the staff's position, stating:

> My interpretation of the Commission's position in this case is that (1) the offerees must be shown to have access to material information concerning the issuer and (2) the access criteria cannot be met by merely providing, gratuitously, a promotional prospectus purporting to afford instant access and by having each offeree and purchaser sign a letter saying he has received and read such document.

152 BNA SEC. REG. & L. REP. G-1, G-2 (May 17, 1972). At a meeting subsequent to the decision in *Continental Tobacco* one member of the SEC Staff stated: "The bar wanted objectivity in this area; so we gave it to them—no private placements." Cook & Levenson, *SEC Staff Views on Continental Tobacco and the Need for Regulatory Guidelines in the Private Offering Area,* PLI FOURTH ANNUAL INST. ON SEC. REG. 49 (1973). Mr. Cook then went on to suggest that the position of the brief was not intended to eliminate the use of private offering memoranda as a means of providing information. *Id.* at 51.

71. SEC v. Continental Tobacco Co., 463 F.2d 137, 146 (5th Cir. 1972).

72. *Id.* at 153.

73. *Id.* at 154.

claim the private offering exemption, the corporation prepared a prospectus which apparently resembled a prospectus which would be furnished by one filing a registration statement.[74] It included unaudited financial statements, and was revised from time to time to reflect changes in the company's circumstances. A movie showing the company's method of producing what it claimed was a unique cigarette was prepared and shown to offerees.[75] The prospectus was delivered to all but two of the 35 persons who purchased the stock,[76] and an investment letter, acknowledging receipt of the prospectus and an opportunity to obtain whatever further information the buyer desired, and stating the buyer's intent to hold for investment, was signed by nearly all of the purchasers.[77] The stock certificates carried a legend in red noting that the shares had been issued pursuant to an exemption from registration, and could not be resold without either registration or an opinion of counsel that registration was not required.[78]

At the inception, the precautions taken appear similar to those which any careful attorney might advise in connection with a planned private offering, and it is probably this similarity which caused some of the bar's consternation. Having taken these precautions at the outset, the manner of offering by the promoters, both in the choice of offerees and in the general nature of the meetings held, destroyed the exemption. The Court of Appeals noted:

74. *Id.* at 146. The SEC's brief argued that the prospectus was:

> [P]urposefully designed to look like an SEC disclosure document used for public offerings, and its issuance in no less than four editions over a period of about one year was hardly consistent with Continental's attempt to invoke the private offering exemption.

Commission Stresses Burden of Proof Necessary to Support Use of Private Offering Exemption, 127 BNA SEC. REG. & L. REP. A-17, A-18 (Nov. 17, 1971). Obviously such an argument places the issuer attempting to comply with the private offering exemption and the antifraud provisions of the Securities Act in a bind, since such a document is perhaps the only way one can be sure offerees have been supplied with sufficient information to avoid the fraud penalties. To a large extent the consternation of attorneys representing issuers was caused by the way the SEC Staff attempted to turn what many attorneys regarded as good practice into damning evidence of a violation of § 5.

75. SEC v. Continental Tobacco Co., 463 F.2d 137, 148 (5th Cir. 1972).

76. *Id.* at 160.

77. The form of letter is found at *Id.* at 146-47. The court conceded that some of the investors signed the letter. *Id.* at 159.

78. *Id.* at 147.

> The record does not establish that each offeree had a relationship with Continental giving access to the kind of information that registration would have disclosed. The offers of common stock were to dentists, physicians, housewives, and businessmen, who had no relationship with Continental other than that of shareholder once the purchases were made. None of the purchasers had any actual opportunity to inspect Continental's records or to verify for themselves statements made to them as inducements for the purchases. Some of the purchasers had never met any officers of the company prior to acquiring the stock.[79]

While the opinion does not hold expressly that there is an absolute requirement of a previously existing relationship between issuer and offerees, the recital of facts seems to indicate what the court found determinative. Elsewhere in the opinion, the same treatment is given to the required sophistication of offerees—a damning description without a specific holding that the particular offeree was unqualified:

> Anthony DeGirolamo, a patient of Dr. Tendrich [an enthusiastic dentist who purchased Continental stock], testified as to investing in the common stock of Continental after having been informed of Continental's investment prospects by Dr. Tendrich. During a visit to Dr. Tendrich's office to have his teeth cleaned, DeGirolamo was informed by Dr. Tendrich of his prior investment in Continental's common stock. At that time, DeGirolamo told Dr. Tendrich "that he would like to look into it and think it over a little later." On April 9, DeGirolamo gave Dr. Tendrich "consent that he would buy some, and he gave him a check for it." As to his ownership of common stock in Continental, DeGirolamo testified: "That is all I own, this paper here. It was made out to my name, but it is not on the counter, so I guess it is private stock. I went along with Dr. Tendrich. I don't know too much about the stock. I have all my faith in Dr. Tendrich".[80]

79. *Id.* at 158.
80. *Id.* at 152.

The opinion also noted the relatively large size of some of the meetings held to promote the sale of the stock, with approximately sixteen persons known to be at one such meeting.[81] Thus the case was an object lesson in what could go wrong with a private offering where the attorney in charge of the offering did not take care to supervise the offering at every step of the way, but simply relied on relatively unsophisticated or careless company officers to follow his advice about choosing only sophisticated investors already known to such officers. Many of the statements of the court about the applicable law were taken from the earlier opinion in *Hill York*. One quote from *Hill York* was related to a numbers test, and appears both illogical and irrelevant:

> The definition of a class to which an offer of securities can be made in reliance on the private offering exemption may, accordingly, be summarized as follows: where the number of offerees is so limited that they may constitute a class of persons having such a privileged relationship with the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection, then the exemption is available.[82]

Obviously the number of offerees has no necessary relationship to whether they have such a privileged relationship with the issuer that registration is unnecessary for their protection. A bridge club of eight is clearly a sufficiently limited number of offerees to pass every numbers test which has ever been suggested; yet the limited number is no guarantee that the members do not need the protection of a registration statement. Language such as this must be regarded as little more than lip service to the rather tentative criteria first mentioned in *Release No. 285*[83] A more meaningful approach, which bears little relationship to the above quoted language, is provided in the remainder of the same paragraph:

81. *Id.* at 147-49.
82. *Id.* at 159, citing Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 688 n.6 (5th Cir. 1971).
83. SEC Securities Act Release No. 285 (Jan. 24, 1935), CCH FED. SEC. L. REP. ¶ 2740.

> Conversely, the term 'public offering' must refer to all offerings of securities where the public interest is not remote and the relationship between the issuer and offeree does not create special advantages in the offerees substantially different from the status of members of the public at large to be able to obtain all necessary information about the issuer and its securities.[84]

The court then stated two tests of whether the exemption would be available:

> First, the offeree must have such information as registration would have disclosed [the ultimate test used in *Hill York*] or have access to such information and, secondly, the purchasers must take for investment.[85]

The court conceded that the evidence clearly established an investment intent on the part of the purchasers,[86] and turned to the question of access. The court noted the lack of personal contact of some of the offerees with officers of Continental, and that several buyers had neither personal contact with such officers, nor access to a prospectus, so that in this respect Continental failed in its burden of proof with respect to several offerees—enough to destroy the exemption.[87] This was the essence of the case, but it was dicta which quoted from the brief of the Commission staff which caused the greatest consternation:

84. SEC v. Continental Tobacco Co., 463 F.2d 148, 159 (5th Cir. 1972).

85. *Id.* citing United States v. Custer Channel Wing Corp., 247 F. Supp. 481, 489 (D. Md. 1965), *aff'd*, 376 F.2d 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967).

86. SEC v. Continental Tobacco Co., 463 F.2d 148, 159 (5th Cir. 1972).

87. *Id.* at 160. The court noted further "we find no testimony or evidence introduced by Continental that it had made no offers other than those [38] described in the evidence entered on behalf of the Commmission." *Id.* at 161. Thus Continental had failed to prove the negative about offerees and to discharge its burden of proof once the Commission made a prima face case.

Stuart Goudberg observes that

> Due to the fact that this tremendous burden of proof is placed on the seller [in establishing the availability of the private offering exemption], it is not surprising that in the 146 cases and matters discussed in this book, which represent the main body of law on this subject [of private offerings], wherein the availability of the private placement exemption was called into question, the seller was able to prevail in but a handful of offerings.

2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES xxiii (1974).

> As pointed out by the Commission, "Even if it were assumed that Continental's prospectus provided those offerees to whom it was disseminated with all the information that registration would disclose, this would not suffice to establish the requisite relationship of those offerees to the company." That the mere disclosure of the same information that would be contained in a registration statement does not assure exemption was emphasized by this Court in Hill York v. American International Franchises, Inc., supra . . . .[88]

Contrast this approach with the approach of *Hill York,* where the same court, when dealing with investors apparently sophisticated enough to fend for themselves, held as an a priori matter that proof of misrepresentations leads to the conclusion that the requisite relationship between offerees and issuer does not exist. In *Continental Tobacco,* the Fifth Circuit came very close to holding that as an a priori matter if it is necessary to present investors with a prospectus which contains all the information which a registration statement might provide, then the investors lack the relationship with the issuer which is required to prove access. The net result of the two opinions, if the dicta is to be believed, is that the only way in which access can be established is to show that the issuer volunteered nothing, and the offerees were able to extract through their sophistication, previously existing relationship with the issuer, personal contact with officers of the issuer and their bargaining power, all of the information which registration might provide, and that nothing was omitted which was material, or which was necessary to make any of the statements made, or information provided, materially misleading. For any issuer to steer its way between this Scylla and Charybdis would require both consummate skill and incredible good fortune. It must

88. SEC v. Continental Tobacco Co., 463 F.2d 148, 160 (5th Cir. 1972). The opinion quoted with approval from IV L. Loss, SECURITIES REGULATION 2632 (2d ed. Supp. 1969):

> [T]his says too much if it implies that the exemption is assured, no matter what the circumstances, by giving each offeree the same information that would be contained in a registration statement, though without the statutory safeguards and sanctions.

Obviously one should not be able to provide such an offering document and avoid registration without more.

be obvious that the only groups of offerees which could possibly provide the issuer with a chance of meeting the *Continental Tobacco* and *Hill York* tests are present officers and directors of the issuer, or investment bankers and institutional investors, already familiar with the issuer, and generally possessing more skill and knowledge than the issuer itself.[89]

5. *Access—The Ability to Fend for One's Self: Sophistication.*

While the Fifth Circuit opinions were quite clear on the need for a previously existing relationship with the issuer which allowed the offeree to extract information, they did not deal expressly with the question of what level of investment skill and experience was necessary to establish that the investor knows what to do with such information. Some of the Fifth Circuit cases involved investors who were concededly sophisticated, as the millionaire portfolio manager in *Henderson v. Hayden, Stone, Inc.*,[90] or the experienced businessmen and attorneys in *Hill York,* while *Continental Tobacco* involved some unsophisticated investors, although the court did not reach the question, since the issuer's proof failed on other grounds. The question of sophistication has been left to the Tenth Circuit to elucidate. The answers are designed to discourage smaller issuers.

In *Lively v. Hirschfeld*,[91] there were approximately 20 to 25 offerees and eight purchasers. Apparently these offerees had previously known the promoters of the corporation, although the opinion did not dwell on this side of the access problem. The defendants produced evidence about the general nature of the education and business sophistication and experience of the offerees, not discussed in any detail in the opinion, which the Court of Appeals indicated was "woefully short of the requirement" of *Ralston Purina*.[92] But

89. One observer suggests that even this requires a broad reading, and that the literal language of *Continental Tobacco* may limit offerings to insiders, which he characterized as "a patently absurd result." H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 4.05[1], at 4-35 (1975). A recent Fifth Circuit opinion does not read *Continental Tobacco* so narrowly. Wolf v. S. D. Cohn & Co., CCH FED. SEC. L. REP. ¶ 95,223, at 98,164 (5th Cir. 1975).
90. 461 F.2d 1069 (5th Cir. 1972).
91. 440 F.2d 631 (10th Cir. 1971).
92. *Id.* at 633.

even more ominous for issuers was the specific treatment of one plaintiff who appeared as a witness, where the record showed:

> [H]e wan an experienced airline pilot who had considerable business experience and who had purchased stocks from time to time. He testified he was told the number of shares outstanding, par value, names of the officers, and other bare essentials of the corporate structure. He apparently asked for no information and thus none was withheld. This purchaser testified he made his purchase of the shares after the exercise of a considered business judgment.[93]

The Tenth Circuit read *Ralston Purina* as allowing in private offerings: "only persons of exceptional business experience, and [in] 'a position where they have regular access to all the information and records which would show the potential for the corporation'.[94] The court concluded that the plaintiff in question lacked the exceptional business experience and skill which would enable him to fend for himself. While the decision has been criticized as a misreading of the standard of *Ralston Purina*,[95] it has been reinforced by a more recent decision of the same circuit, *Andrews v. Blue*.[96] Andrews was a co-investor with the two Blue brothers and their attorney in a parcel of real property which was to be developed by the defendants. While Andrews was to have no control over the enterprise, in addition to a cash contribution he was expected to contribute "his real estate expertise as a consultant for the enterprise."[97] The form of legal entity which the enterprise would take was left to the

93. *Id.* at 632.
94. *Id.* at 633. While not true in *Lively v. Hirschfeld*, it does seem that many of the opinions in this area tend to confuse fraud with the lack of availability of the exemption, on the basis that the buyers, in hindsight, needed the protection of a registration statement. This reasoning becomes a priori in Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 689 (5th Cir. 1971), quoted in text accompanying note 66 *supra*. The problem, of course, is explaning what an investor needed when it is shown that material misrepresentations were made in a registration statement.
95. *See* H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 4.05[1], at 4-36 (1975).
96. 489 F.2d 367 (10th Cir. 1973).
97. *Id.* at 371.

Blues and their attorney, who chose to incorporate and issue all of the shares to the Blues, who held 20% of the stock for the benefit of Andrews. Subsequently the Blues determined to merge this company with another, and assured Andrews that he would receive shares representing his 20% interest in the existing corporation, and that the shares would be free-trading stock in a corporation whose securities were registered under the 1934 Act.[98] In fact the stock issued in the merger carried a legend that it had not been registered, and could not be sold without either registration or the availability of an exemption from registration.[99] The result was that Andrews received shares which had little market value, compared to the value of his 20% interest in the real property, and he brought suit under Section 12 of the Securities Act as well as under Section 10(b) of the Securities Exchange Act.[100]

The decision in *Andrews v. Blue* turned in part on whether the merger transaction, in which stock in the surviving corporation was issued to Andrews and the two Blue brothers, was a private offering. While the merger apparently involved some other companies, the opinion did not discuss the problems of proving that the offerees involved in those transactions were sufficiently sophisticated and otherwise had sufficient access to satisfy what the court determined were the requirements of *Ralston Purina*. The Court of Appeals determined that the district court, which apparently relied on *Hill York* to determine the question of what constituted "access" had applied the correct standard, and quoted from the conclusions of the trial court on the question of sophistication: "Moreover, although he [Andrews] was a sophisticated real estate investor, he was a babe in the woods when it came to stocks."[101]

Andrews had been reassured about the nature of the stock he would receive, and about its value under those circumstances, representations which turned out to be false,

98. *Id.*
99. *Id.* at 372.
100. Securities of 1933, § 12, 15 U.S.C. § 77*l* (1970); Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970).
101. Andrews v. Blue, 489 F.2d 367, 373 n.3 (10th Cir. 1973).

since he received his certificate with a restrictive legend. Andrews' lack of actual knowledge of the value of the stock he would receive, despite his close relationship with the Blues and his real estate experience, made him an offeree without access, one might conclude a priori, consistent with the approach of *Hill York*. The principal difference here was Andrews' specific skill in real estate development and familiarity with the property which was still not enough to constitute access, in view of his lack of actual knowledge of maneuvers designed to diminish his interest in the property.[102] The court emphasized what was already implicit in *Lively v. Hirschfeld,* that the failure of any one offeree to meet the required sophistication level on all aspects of the offering or to have actual access to truthful information was enough to destroy the entire exemption.[103]

Andrews v. Blue and *Lively v. Hirschfeld* seem to overrule sub silentio earlier cases in the same circuit sustaining the use of the private offering exemption in oil and gas ventures where the opinion of the court discloses nothing which would suggest the offerees came close to meeting the current standard of investment sophistication.[104]

Recent decisions sustaining the use of the exemption offer little comfort to small or inexperienced issuers. These

102. Defendants argue that plaintiff was a sophisticated investor with access to all relevant information. This argument fails, not only because the trial court's findings to the contrary were based on substantial evidence, but also because of the fiduciary relationship and the duty to disclose arising thereform. The duty was particularly clear in view of the repeated specific inquiries directed by plaintiff to the defendants. Plaintiff had a basis for believing that his twenty percent interest in the enterprise would be protected. He was not placed on notice that defendants were carrying out legal maneuvers designed to depreciate plaintiff's interest and enhance their own.
Id. at 373.

103. Was the offering exempt because the other offerees might have been able to fend for themselves? We conclude that it was not. The statute is intended to promote full disclosure to every investor regardless of his particular business background. *See* Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971). Ralston Purina rejects the idea that an exemption exists based only on the individual sophistication of the offeree and without regard to his actual knowledge concerning the issuer. [citing I LOSS, SECURITIES REGULATION 657 n.53 (2d ed. 1961)]
Id. at 373-74.

104. Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959); Garfield v. Strain, 320 F.2d 116 (10th Cir. 1963).

decisions involve district court opinions where it was clear that the investors were persons of considerable experience, and in one case, were assisted by experts in areas where they might otherwise have been deficient.

In *Bowers v. Columbia General Corp.,*[105] the approach of the trial court in the context of a merger was different from that in *Andrews v. Blue,* possibly because of the absence of any evidence of actual fraud on the part of the offeror. Of the four individual stockholders of the acquired corporation, three had at least 25 years experience each in operating a substantial business, and they were advised by experienced law and accounting firms. After a showing of rather lengthy negotiations and full disclosure by the issuer, the court held that the offerees were able to fend for themselves—a fact evidenced by the negotiations, and the lack of any claim of fraud:

> If sophistication or lack thereof is relevant, the focus must be not so much upon prior experience with the purchase and sale of securities, but rather upon whether the offerees knew what to look for in and how to interpret, the available information concerning the issuer's business and its profit potential. There are of course, degrees of sophistication and the men who negotiated the transaction . . . may not be as sophisticated as some other business executives. The term must be given a realistic construction, however.[106]

On a motion for preliminary injunction the court determined that there was not a very great likelihood that the plaintiffs could show that the private offering exemption was not available to the issuer, and denied the preliminary injunction.[107] The case seems of little assistance to issuers, since the offerees were relatively experienced businessmen and had the assistance of "offeree representatives" who were able to fill in some of their own lack of experience. One might ask whether an offeree who rejects an offer at an early stage must also have such expert assistance on legal and ac-

105. 336 F. Supp. 609 (D. Del. 1971).
106. *Id.* at 624.
107. *Id.* at 625.

counting matters. In a subsequent district court decision, *Livens v. William D. Witter, Inc.*,[108] the court held that an investment analyst, a graduate of the Harvard Business School, could not claim lack of access where the only items not furnished him were certified financial statements of the issuer, because of the auditor's inability to verify accounts payable, a matter known to the offeree at the time he made his investment.

These decisions present the greatest difficulty for small and inexperienced issuers, where the principals themselves do not possess the requisite investment experience and expertise to become purchasers under the private offering exemption. Must counsel advise their clients that in searching for offerees they must approach only persons with sufficient skill and experience to be managers of large investment portfolios? While a more reasonable standard might be that offerees need be no more sophisticated and experienced in investment decisions than the principals of the offeror, the cases thus far have not even mentioned the possibility of such a standard.[109] Thus in the interest of protecting unsophisti-

108. 374 F. Supp. 1104 (D. Mass. 1974).

109. There may be a relationship between the likelihood that the courts will find the private offering exemption is not available and the disparity of bargaining power and investment experience between promoters and offerees, which at some point reaches the level of constructive fraud, and persuades courts to allow rescission on the basis of lack of "access." In *Andrews v. Blue*, the defendants held record title to all of the shares of stock in the enterprise, in which Andrews had a 20% interest. In rejecting the argument that Andrews was a sophisticated investor, the court, Andrews v. Blue, 489 F.2d 367, 373 (1973), noted the fiduciary relationship existing by reason of the Blues' ownership of record of all of the shares of the company, and presumably because of their total control of the management of the company. Because of this, the court was able to find an affirmative duty to disclose which might not have been quite so strict in the absence of such a relationship. While a fiduciary relationship generally does not exist between a buyer and seller, at some point the court may find such a disparity of bargaining power, and such a dependence by one party on the skill of the other, that it will presume fraud and overreaching on the part of the more able party to the transaction, and require him to account as if he were a fiduciary.

> The principle on which a court of equity acts in relieving against transactions on the ground of inequality of footing between the parties is not confined to cases where a fiduciary relation is shown to exist, but extends to all the varieties of relations in which dominion may be exercised by one over another, and applies to every case where influence is acquired and abused, or where confidence is reposed and betrayed.

Sears v. Hicklin, 13 Colo. 143, 148, 21 P. 1022, 1023 (1889), citing KERR, FRAUD & MISTAKE 183. To the extent such equitable considerations influence courts in determining when "access" is present, it may be that whenever equal bargaining power exists between a relatively inexperienced cated investors from fast-talking promoters, the courts and the Commission may have built a barrier between unsophisticated investors and unsophisticated offerors in many smaller business financings. Such unsophisticated offerors may not fully appreciate the strictures imposed by the courts, in which case offerees who accept an offer will nearly always have a "put" under Section 12 of the Act.[110]

The difficulties in advising inexperienced principals of a small or new enterprise about the private offering exemption may well be insuperable. Consider the problems of explaining the concept of "offer" as including every attempt to condition a prospective purchaser;[111] of explaining that the law looks to all "offers" and not just to "sales"; of relating the standards of offeree sophistication and access set out in the foregoing discussion; and, if one is successful in these attempts, of explaining the concept of "integration" of various offerings.[112] Restrictions on resale of such sec-

investor and promoter, or between two relatively experienced ones, the courts will be less likely to find a lack of access, even where the rigidly high standard expressed by the Tenth Circuit in recent cases has not been attained. *For* a summary of the treatment of constructive fraud in 10b-5 cases, *see* 2 A. BROMBERG, SECURITIES LAW FRAUD: SEC RULE 10b-5 § 8.4, at 620 (1973).

110. Section 12(1), 15 U.S.C. § 77(*l*)(1) (1970), grants to the purchaser of securities offered and sold without registration the right to rescind the transaction and recover the purchase price, unless an exemption from registration is available.

111. *For* cases holding that news releases can be offers, *see In re* Carl M. Loeb, Rhoades, and Co., and Dominick and Dominick, 38 S.E.C. 843 (1959); SEC v. Arvida Corp., CCH FED. SEC. L. REP. [1957-61 Transfer Binder] ¶ 90,891; Chris-Craft Industries, Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970).

112. The problem of integrating various offers arises because the exemption applies to "transactions by an issuer not involving any public offering," and issuers must determine which offers and sales are part of the same "issue." The problem also arises in connection with the intrastate exemption under Section 3(a)(11) of the Act, which exempts offerings which are "part of an issue offered and sold only to persons resident within a single State or Territory. . . ." 15 U.S.C. § 77c(a)(11) (1970). In SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, the Commission noted that which offerings were to be considered as part of the same issue was a question of fact, and stated:

> *Any one* or more of the following factors may be determinative of the question of integration: (1) Are the offerings part of a single plan of financing; (2) do the offerings involve the issuance of the same class of security; (3) are the offerings made at or about the same time; (4) is the same type of consideration to be received; and (5) are the offerings made for the same general purpose. (emphasis added).

Some writers believe the Commission softened its view somewhat in SEC Securities Act Release No. 4552 (Nov. 6, 1962), CCH FED. SEC. L. REP. ¶ 2770, which discusses the integration problem in the context of the urities have become more manageable because of the adoption of Rules 144 and 237.[113] The result, in the case of the entrepreneur unfamiliar with securities regulation will likely be a glazed look in his eyes and a suspicion that the only function of attorneys is to create roadblocks to the financing of private enterprise. The attorney, for his part, may feel a sense of frustration at his inability to communicate all of these cautions in a clear and concise manner to his client, and may also fear that his advice will be honored primarily in the breach.[114]

Finally, explaining to a promoter of a new enterprise what he must do in order to establish access under the Fifth Circuit decisions presents a problem of considerable difficulty. While volunteering all of the information which a registration statement may disclose may help, it also creates an argument for rescinding buyers, that if the offerees were sufficiently sophisticated, such a presentation would not have been necessary.[115] Even if such a presentation is pos-

private offering exemption. While the Release lists the same factors, it introduced them by stating "The following factors are relevant to such question of integration . . . ." Obviously, if the approach of *Release No. 4434* is to be followed, it is possible to show that almost any sales are part of the same issue. On the other hand, if the approach of *Release No. 4552* is followed, some kind of balancing must take place, as in Livens v. William D. Witter, Inc., 374 F. Supp. 1104 (D. Mass. 1974). The clearly has been the approach of most practitioners, and one experienced practitioner, Carl Schneider, has characterized decisions about integration as an art and not a science. Schneider, *The Intrastate Offering Exemption*, PLI SECOND ANNUAL INST. ON SEC. REG. 22, 25-26 (Mundheim & Fleischer, eds. 1971). The integration problem will be discussed in more detail in the second part of this article, in the discussion of the intrastate offering exemption.

113. Rule 144, 17 C.F.R. § 230.144 (1974), provides that resales of securities purchased pursuant to the private offering exemption after a two-year holding period will not be deemed a "distribution" if certain conditions of the Rule are complied with. Rule 237, 17 C.F.R. § 230.237 (1974), allows resales of such securities after a five-year holding period, where the issuer does not report under the 1934 Act, or make such information publicly available.

114. Past frustrations of attorneys advising clients on when securities could be resold are dramatized in Kennedy, *The Case of the Scarlet Letter or the Easy Way Out on "Private Offerings,"* 23 BUS. LAW. 23 (1967).

115. *Continental Tobacco* represents a dividing line in thinking about the use of private offering memoranda. In 1961 Professor Loss anticipated this problem when he wrote:

> Nevertheless, in view of the intimations of the SEC and the Second Circuit that the critical factor is not so much the sophistication of the offerees as their possession of (or at least access to) information regarding the issuer—and perhaps with a weather eye on the fraud provisions—some lawyers who handle "private placements" advise that each buyer receive a set of certified financial statements comparable to those called for in a statutory prospectus

sible and advisable, it may be self-defeating, since the primary reason for the exemption is to avoid the costs and delays of registration where the public interest in full disclosure in the formal manner required in registration is not great. But if one attempts less disclosure, how much less is tolerable? If the offerees fail to ask for some of the information which registration would disclose, is this evidence of lack of access, or of lack of investment intent?[116] Quite aside from questions about the state of financial information which is furnished by the issuer,[117] has the issuer considered what will happen to the proceeds of the distribution if not all desired

> and be given an opportunity to examine the research memorandum prepared by the investment banker who arranged the placement. Of course, this device cannot be pushed too far or it would, in effect, make registration optional with the issuer in borderline cases.

I L. LOSS, SECURITIES REGULATION 664-65 (2d ed. 1961). Goldberg takes the view that it is sufficient to establish access by showing that offerees were actually furnished with a private offering memorandum of this type. 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 2.4[c] (1974). Bloomenthal views the SEC Staff's position in *Continental Tobacco* as arguing the opposite: "The arguments of the staff in the brief referred to appear to be tantamount to a view that (1) use of a privately prepared disclosure statement which has not been processed by the SEC is an acknowledgement that the investors are not sophisticated . . . ." H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 4.05 [1][f], at 4-31 (1974). Such an argument proves too much: do mutual funds and insurance companies become "unsophisticated" and lack access to information simply because the issuer anticipates some of their questions and prepares a memorandum answering them? Rule 146, discussed below, represents a backing off from such an approach, recognizing that it is good practice to furnish prospective investors with information in an organized form, regardless of whether registration is involved.

116. In Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *cert. denied,* 361 U.S. 896 (1959), Gilligan, a partner in a brokerage firm, asked for no information about the issuer and received none, and the court held he lacked "access," since there was no personal contact with corporate officers. The holding seems misplaced; clearly Gilligan had the experience, bargaining power and sophistication to obtain information had be desired it. The real reason for holding that the transaction was not a private offering was that the lack of inquiry was evidence of a lack of investment intent, supported by evidence that the shares were later distributed to the public in trading transactions. Gilligan was not interested in the long-term prospects of the issuer because he did not intend to hold long enough for them to matter.

117. Apparently the difficulties involved in furnishing financial statements are not limited to small, unsophisticated businessmen on Main Street. A recent article observes, in connection with the availability of the private offering exemption for mergers and acquisitions of brokerage firms, that "[M]any brokerage firms, especially partnerships, have never prepared statements of profit and loss on an annual basis; such statements, if prepared, have rarely been audited." Voran, *Broker-Dealer Combinations* 7 REV. SEC. REG. 919, 920 (1974). Furnishing audited financial statements may not be absolutely necessary under the holding of Livens v. William D. Witter, Inc., 374 F. Supp. 1104 (D. Mass. 1974). *Cf.* SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972), but these cases will be of little comfort to most issuers, since relatively complete financials, albeit unaudited, were furnished in both cases.

funds are raised? Is this an "all or nothing" offering or will the issuer sell what it can? How much dilution will take place in the investments of offerees because of promoter shares? Is market research adequate to disclose whether a market truly exists for the company's product or service? Other areas may pose similar problems. These problems make it extremely difficult to rely on Section 4(2) except for sales to promoters or to institutional investors.

B. *Rule 146 and the Small Offering.*

Rule 146, adopted in 1974,[118] while creating problems of its own, at least eliminates some of the uncertainty about the "access" question and the sophistication of offerees.[119] Given the uncertainty created by judicial decisions, many issuers will be grateful for its existence. The Rule is an attempt at a somewhat mechanical approach to determining when the private offering exemption is available to an issuer.[120] The issuer which satisfies all of the conditions of the Rule shall be deemed to have engaged in a transaction not involving a public offering within the meaning of Section 4(2) of the Act.[121] The "safe harbor" provided by the Rule and

118. Rule 146, 17 C.F.R. § 230.146 (1974), was first proposed in SEC Securities Act Release No. 5336 (Nov. 28, 1972), was proposed in revised form in SEC Securities Act Release No. 5430 (Oct. 10, 1973), adopted in final form in SEC Securities Release No. 5487 (April 28, 1974), became effective on June 10, 1974, and was amended May 7, 1975 by SEC Securities Release No. 5585.

119. From the viewpoint of the attorney, compliance with the Rule in a mechanical fashion for the company already reporting under the 1934 Act and proposing a private placement with sophisticated institutional investors is reassuringly mechanical. *See* Bromberg, *Private Offering Checklist*, 7 REV. SEC. REG. 867 (1974). Green & Wittner, *Private Placements of Securities Under Rule 146*, 21 PRAC. LAW 9 (1975) provides more detailed forms and checklists.

120. Preliminary Note #6 to the Rule provides that "the rule is available only to the issuer of the securities and is not available to affiliates or other persons for sales of the issuer's securities." Thus controlling persons and holders of restricted securities received in non-public offerings must find another exemption. "Safe harbors" are provided for these persons by Rule 144 with respect to companies reporting under the 1934 Act or providing similar information to the public, and Rule 237 for companies which do not so report. In addition, such persons may be able to sell their shares in a "private offering" under the existing judicial and administrative interpretations of the private offering exemption, or pursuant to Regulation A, 17 C.F.R. § 230.251 *et seq.* (1974).

121. Rule 146(b) provides as follows:

Conditions to be Met. Transactions by an issuer involving the offer, offer to sell, offer for sale, or sales of securities of the issuer that are part of an offering that is made in accordance with by Section 19(a) of the Act[122] should be appreciated by many issuers and their counsel.

The application of Rule 146 to a variety of transactions has been amply discussed elsewhere.[123] It is the purpose of this article to review the Rule from the point of view of the small or new issuer—the entrepreneur with a good idea, for whom it appears the Rule will provide little comfort.

For the small issuer, the limitations of Rule 146(c) on the manner of offering present no serious problems, since few such issuers could seriously expect to find financing through general solicitation or advertising absent representa-

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all the conditions of this rule shall be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act.

122. Section 19(a) of the Securities Act of 1933, 15 U.S.C. § 77s(a) (1970) provides in part:

> No provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

This sentence was added to the Act in the 1934 amendments. Pub. L. No. 291, 73d Cong.

123. H. Bloomenthal, SECURITIES AND FEDERAL CORPORATE LAW 4-40 to 4-42.17 (1974); S. Goldberg, PRIVATE PLACEMENT AND RESTRICTED SECURITIES, Ch. 10, "Proposed Rule 146" (1973); Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities*, 74 COLUM. L. REV. 622 (1974); Borton & Rifkind, *Private Placement and Proposed Rule 146*, 25 HASTINGS L. J. 287 (1974); Connolly, *Private Offering Exemption*, 8 REV. SEC. REG. 919 (1975); Cassidy & Berkowitz, *Proposed Rule 146*, 6 REV. SEC. REG. 949 (1973); Erwin, *Goodbye Private Placement, Hello 146—Recent Appellate Court Decisions Suggest that Investment Bankers Should No Longer Rely On the Private Placement Exemption*, 6 CREIGHTON L. REV. 127 (1972/73); Finebaum, *Proposed Rule 146—A Temporary Solution*, 23 BUFF. L. REV. 67 (1973); Green & Wittner, *Private Placements of Securities Under Rule 146*, 21 PRAC. LAW. 9 (1975); Kalokathis, *Private Offering Under Rule 144 and Proposed Rule 146: New Armor for an Old Warrior*, 77 DICKINSON L. REV. 585 (1973); Kindeman, *The Private Offering Exemption: An Examination of its Availability Under and Outside Rule 146*, 30 BUS. LAW. 921 (1975); Rosenfeld, *Rule 146 Leaves Private Offering Waters Still Muddied*, 2 SEC. REG. L. J. 195 (1974); Wander & Shevitz, *Proposed Rule 146*, 7 REV. SEC. REG. 959 (1974); Comment, *Proposed SEC Rule 146: The Quest for Objectivity*, 41 FORD. L. REV. 887 (1973); Comment, *SEC v. Continental Tobacco Co. and SEC Proposed Rule 146 as Attempts to Define a Private Offering: The Insecure Exemption From Registration Under the Securities Act of 1933*, 41 GEO. WASH. L. REV. 582 (1973); Comment, *Reforming the Initial Sale Requirement of the Private Placement Exemption*, 86 HARV. L. REV. 403 (1972); Comment, *Private Offering: Rule 146 and Offeree Sophistication*, 25 MAINE L. REV. 295 (1973); Comment, *Securities: The Private Offering Exemption and Rule 146*, 35 MONT. L. REV. 299 (1974); Comment, *Securities Regulations—Private Offering Exemption: SEC Proposed Rule 146*, 48 WASH. L. REV. 922 (1973); Comment, *SEC Rules 144 and 146: Private Placements for the Few*, 59 VA. L. REV. 886 (1973).

tions which would probably constitute fraud.[124] The limitation to not more than 35 purchasers (not offerees) similarly creates no serious problems for the small issuer, and in fact will be far easier to police than any limitation on offerees.[125] Limitations on resale imposed upon the purchasers by Rule 146(h) are the same ones which careful counsel have already been requiring issuers to impose where the private offering exemption has been invoked. The principal differences are two: What was formerly merely good practice has become a condition for the availability of the exemption, and what was only a precaution against a sale to an underwriter now seems to provide greater assurance that the subjective intent of the purchaser will not be allowed to destroy an exempt issuer transaction.[126]

124. Rule 146(c) prohibits any form of general solicitation or advertising, except seminars and meetings where the issuer is certain that the requirements of Rule 146(d) are met with respect to the investment sophistication of the offeree, or if he does not meet the standards, he is able to bear the risk of the investment and is accompanied by offeree representative(s) who meet the qualifications of Rule 146(d)(2)(ii).

125. Rule 146(g) limited the number of purchasers (not offerees) to 35 purchasers excluding cash purchasers of securities of the issuer in the aggregate value of $150,000 or more. The 1975 amendment liberalizes the requirement to read: "The issuer shall have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that there are no more than thirty-five purchasers of the securities of the issuer from the issuer in any offering pursuant to the Rule." CCH FED. SEC. L. REP. ¶ 2709.

126. Rule 146(h) requires the issuer to exercise reasonable care to assure that the purchasers of the securities are not underwriters, and requires, in the course of exercising such care, that the issuer make reasonable inquiries to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons, place a legend on the certificate which states that the securities have not been registered, and which sets forth or refers to restrictions on transferability and sale of the securities, to issue stop transfer instructions or, if the issuer transfers its own securities, as is generally the case with small new companies, to make a notation in the appropriate records of the issuer, and to obtain a written agreement from the purchaser that the securities will not be resold without registration under the Act or exemption. Good practice for years has suggested the same precautions. Prior releases from the SEC reflected this practice. As the SEC noted in *Securities Act Release No. 4552:*

> [T]he risk of possible violations of the registration requirements of the Act and consequent civil liabilities . . . has led to the practice whereby the issuer secures from the initial investors representations that they have acquired the securities for investment. Sometimes a legend to this effect is placed on the stock certificates and stop-transfer instructions issued to the transfer agent. However, a statement by the initial purchaser, at the time of his acquisition, that the securities are taken for investment and not for distribution is necessarily self-serving and not conclusive as to his actual intent. Mere acceptance at face value of such assurances will not provide a basis for reliance on the exemption when inquiry would suggest to a reasonable person that these assurances are formal rather than real. The additional precautions of placing a legend on the security and issuing stop-transfer orders have proved in many cases to be an effective means of pre-

The most difficult problems for the small issuer are posed by the requirements of Rule 146(d) with respect to the nature of the offerees and purchasers, and the requirements of Rule 146(e) with respect to the access of offerees to information, or, in the alternative, the furnishing of information by the issuer. While both requirements are more certain than previous judicial requirements and eliminate the dilemma posed by *Hill York* and *Continental Tobacco,* that is not the end of the problem. A review of the requirements will show that as a general rule, only companies already filing reports under the 1934 Act and those able to utilize an investment banker or investment adviser can be reasonably confident of compliance with Rule 146. For the small new issuer, which neither files such reports nor utilizes investment professionals, Rule 146 may be even more dangerous than the private offering exemption under existing judicial and administrative interpretations.

1. *The Sophistication of the Offeree.*

Unlike the previous standards, Rule 146(d) divides the problem of determining the sophistication of the offeree into two time periods: immediately prior to making an offer, and immediately prior to making any sale, on the reasonable assumption that an issuer has a greater opportunity to investigate the qualifications of a prospective investor during the course of negotiations, and ultimately it matters little if an issuer mistakenly approaches a person unable to fend for himself, as long as the issuer does not actually sell to such a per-

> venting illegal distributions. Nevertheless, these are only precautions and are not to be regarded as a basis for exemption from registration. The nature of the purchaser's past investment and trading practices or the character and scope of his business may be inconsistent with the purchase of large blocks of securities for investment.

SEC Securities Act Release No. 4552 (Nov. 6, 1962), CCH FED. SEC. L. REP. ¶ 2777. SEC Securities Act Release No. 5121 (Dec. 30, 1970), CCH FED. SEC. L. REP. ¶ 2784, discusses the same precautions in more detail, and in what might be described as a more positive manner than the earlier release, perhaps reflecting THE WHEAT REPORT criticisms of the unduly subjective nature of the tests of investment intent. DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS; *The Wheat Report,* ch. VI (1969). The effect of Rule 146 seems to be to make these precautions more certain as a means of assuring the availability of the exemption. The Rule only requires that an issuer take reasonable care to assure that purchasers are not underwriters. It does not make issuers insurers of such status.

son.[127] The requirements of the Rule with respect to the level of knowledge and assurance of the issuer concerning the offeree's qualifications reflect this approach. Immediately prior to making an offer, the issuer or its representative need have only reasonable grounds to believe and shall believe either:

> (i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or
>
> (ii) that the offeree is a person who is able to bear the economic risk of the investment.[128]

This portion of the Rule contains no requirement of investigation to ascertain the actual facts, so hearsay regarding the experience or affluence of the prospective offeree should be sufficient to support a reasonable belief. For the first time, the requirement is phrased in an alternative which allows an investor to be other than a "sophisticated" investor, if he is able to bear the risk of the investment. While the Section 4(2) standard probably did so without stating it as clearly, it is clear now that the Commission has moved in the direction of a suitability standard with regard to what generally will be speculative investments, so only persons

127. Rule 146(d)(1) requires the issuer and its agents, prior to making any offer to sell, to have reasonable grounds to believe, immediately prior to any offer, that the offeree is either sophisticated or affluent, while Rule 146(d)(2) requires the issuer and its agents, prior to making any sale, after making reasonable inquiry, to have reasonable grounds to believe in the sophistication of the offeree, or in the sophistication of the offeree's representative and the ability of the offeree to bear the risk of the investment. This approach should avoid the criticism voiced by one author of the proposed version of the rule:

> Nevertheless, determining whether an offeree is sufficiently wealthy to bear the economic risk is a subjective consideration which requires a closer analysis of an offeree's financial position. Practically speaking, the information needed to make the subjective determination may prove impossible to obtain since persons who are only prospective investors have little desire to expose their precise financial status to an issuer or a person acting on its behalf.

Rosenfeld, *Rule 146 Leaves Private Offering Waters Still Muddied*, 2 SEC. REG. L. J. 195. 202 (1974). Since the issuer must obtain information on a reasonable investigation only for those who actually purchase, and not for those who are still in the position of "prospective investors," obtaining detailed financial information can be left for the latter stages of the selling process, when, if the investor is sold on the issuer's prospects, he should be willing to make more detailed disclosures. *But see* Connolly, *Private Offering Exemption*, 8 REV. SEC. REG. 919, 920 (1975).

128. Rule 146(d)(1).

of some means will be allowed to invest, unless they are otherwise sophisticated, such as investment analysts.[129] Unfortunately, the Rule provides no guidance on what level of affluence is required in order to meet the standards.[130] Will

129. *See, e.g.*, Livens v. William D. Witter, Inc., 374 F. Supp. 1104 (D. Mass. 1974). Suitability tests, phrased in terms of the ability of an investor to bear the risk of the investment, which are imposed on broker-dealers as part of their responsibility to their customers, are discussed at note 168 *infra*.

Blue sky law suitability requirements in terms of assets or tax bracket, all of which are aimed at assuring that investors are able to bear the economic risk of highly speculative investments with benefits peculiarly available to high-bracket investors, do not seem to have impaired the ability of promoters to market oil and gas drilling funds. For example, the *Guidelines for the Registration of Oil and Gas Drilling Programs* adopted by the North American Securities Administrators Association on October 7, 1971, CCH BLUE SKY L. REP. ¶ 4582, require a minimum purchase of $5,000 and a minimum initial investment in a program of the same amount. *Id.* ¶ 4583 at 493-15. And the *Statement of Policy on Oil and Gas Interests* of the Central Securities Administrators Council, approved by Indiana, Michigan, Minnesota, Missouri and Wisconsin, requires the broker-dealer or issuer to "take all action reasonably required to insure that program interests are sold only to purchasers for whom such interests are suitable, on the basis of information furnished by each such purchaser after such reasonable inquiry as may be appropriate concerning the purchaser's financial situation and other relevant factors." CCH BLUE SKY L. REP. ¶ 4861, at 676. The standards for real estate investment are summarized in R. HAFT, TAX SHELTERED INVESTMENTS § 4.06, at 4-5 (2d ed. 1974), and are somewhat less restrictive than the standards for oil and gas investment. While the standards for real estate investment speak generally of investors who can reasonably benefit from a program's tax losses in the early years, the following appears: "Unless the administrator approves a lower suitability standard, participants shall have a minimum annual gross income of $20,000 and Net Worth of $20,000, or in the alternative, a minimum Net Worth of $75,000. Net worth shall be determined exclusive of home, furnishings and automobiles." *Statement of Policy* adopted by Midwest Securities Commissioners Association on Feb. 28, 1973, amended Feb. 25, 1974, CCH BLUE SKY L. REP. ¶ 4821, at 637. The volume of tax shelter offerings suggests that obtaining the information necessary to satisfy these standards has not been a major obstacle, at least after the issuer is able to convince the prospective investor of the worth of the offering. Speculative private offerings by new promotional issuers presumably will appeal to the same group of prospective investors as such tax-shelter offerings.

130. In explaining its reasons for a suitability test, the Commission gave no hint about the specific qualifications of a suitable investor:

> The Commission has determined to retain the economic risk test for offerees who need the knowledge and experience of an offeree representative in order to be qualified purchasers. This is necessary in order to control the types of persons to whom offers can be made. The Commission believes that the determination of "ability to bear the economic risk" will vary with the circumstances. Important considerations are whether the offeree could afford to hold unregistered securities for an indefinite period, and whether, at the time of the investment, he could afford a complete loss.

SEC Securities Act Release No. 5487 at 9, CCH FED. L. REP. ¶ 2710 (April 23, 1974). One article suggests a dollar test based on net worth might have been more useful, but that the test might be higher in New York City, perhaps $250,000, than it would in Boise, Idaho. Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities*, 74 COLUM. L. REV. 622, 636 n.79 (1974). The test could well relate to other sources of income, and vary the level be lower in a smaller community, in order to allow local financing of local business? Strictly interpreted, the Rule could spell the end of private offering financing for local businesses. It definitely seems to preclude many smaller investors from making an isolated speculative investment with businessmen they know, unless the interpretation of the Rule's test is surprisingly liberal.

While the same tests of sophistication or affluence are imposed at the buying stage to determine whether an offeree is a qualified purchaser, there are two significant differences. First, when the offeree is only able to bear the risk of the investment, he must make use of "offeree representative(s)" who, together with the offeree, have the requisite level of business and investment sophistication. Second, prior to the sale the issuer must have more than a reasonable belief in this state of facts; such belief must be based upon a reasonable inquiry.[131] The principal advantage of the Rule in this regard is that the ability of an offeree to evaluate information can be buttressed by use of offeree representatives, a tactic of doubtful efficacy prior to the adoption of the Rule.[132]

But where the issuer is a small promotional issuer these provisions may be of little comfort. For example, where an issuer deals with offerees not represented by offeree representatives, the minimum level of sophistication required is still not clear. If one looks only to the most recent opinions on the question, the suggestion of the Tenth Circuit seems to

with the size of the investment, since it is obvious that a high-income person with few other assets could well afford a small investment carrying a high risk factor.

131. Rule 146(d)(2) provides that the issuer must believe:

> (2) Immediately prior to making any sale, after making reasonable inquiry, either:
>
> (i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or
>
> (ii) that the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment.

132. Bowers v. Columbia General Corp., 336 F. Supp. 609 (D. Del. 1971) suggested that experienced business executives with limited experience in purchasing stocks could be assisted in the evaluation of a merger by attorneys and accountants and thus meet the test of being able to fend for themselves.

be that anyone not an investment analyst is a dangerous buyer.[133] Where a small issuer is involved and has founders whose own business and investment experience is not extensive, it may be dangerous to rely on them to make such determinations about prospective purchasers. The defense of reasonable belief based on reasonable inquiry is most likely to succeed for a larger issuer with access to an investment banker with a list of investors who are generally interested in speculations, where the issuer believes that such persons have substantial investment portfolios of speculative securities. The cautious smaller issuer may look to his attorney for an opinion as to whether a particular investor qualifies, on the theory that good faith reliance on an opinion of counsel is the best evidence of a reasonable belief on a matter which is a mixed question of fact and law. It seems doubtful that many attorneys will be willing to give unqualified opinions on marginally qualified investors in the light of *Lively v. Hirschfeld*[134] and *Andrews v. Blue*,[135] particularly when there is risk of substantial liability.[136] Furthermore, since most

133. Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971) and Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973) suggest that investment experience, even in the field in which the issuer is doing business, may not be enough, but that "exceptional" or "unusual business experience and skill" may be required. *Lively v. Hirschfeld, supra* at 633, and *Andrews v. Blue* suggest that such skill must extend to all aspects of the transaction, including sufficient knowledge of securities regulation to realize the restraints on resale imposed upon a person holding "restricted securities" within the meaning of Rule 144, or securities subject to Rule 237. This standard is not challenged by Livens v. William D. Witter, Inc., 374 F. Supp 1104 (D. Mass., 1974), where the investor was in fact an investment analyst.

134. 440 F.2d 631 (10th Cir. 1971).

135. 489 F.2d 367 (10th Cir. 1973).

136. In Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973), one of the defendants, Austin, was an attorney who was an investor at the initial stage of the transaction, but whose interest had been bought out prior to the merger transaction which was the subject of the complaint. The opinion of the Court of Appeals discloses no evidence that Austin acted in any capacity other than as attorney for the Blues, the controlling investors, in connection with the merger. Apparently he participated in drafting a proxy statement with the acquiring corporation, and he delivered an opinion letter to the attorney for the acquiring company that the Blues, and not Andrews, had the right to vote the stock of the acquired corporation in connection with the merger vote. Yet the trial court held against Austin, and the Court of Appeals sustained the judgment, stating:

> Defendants also claim that the offering was exempt because they were neither issuers nor underwriters and hence are within the sweep of Section 4(1) of the 1933 Act. Section 2(11) of the 1933 Act provides that an issuer includes any person directly or indirectly controlling the issuer. Here defendants controlled the issuer Colorado and Western. As a legal consequence they were issuers. But they were also "underwriters." The shares dis-

investments in new small businesses are relatively risky, it is doubtful whether, under current standards of "suitability" for brokers' customers, such investments would be available for anyone but the most affluent venture capitalists.

One article concludes:

> Unless somewhat liberal interpretations are applied under Rule 146 to the question of sophistication, small businessmen will continue to be subject to substantial risks if they raise capital by non-public offerings to ordinary businessmen, lawyers, doctors, and similar private sources.[137]

One important qualification of these tests makes them less onerous for issuers than might otherwise be the case: the issuer is required only to "have reasonable grounds to believe and shall believe" that the requirements of the Rule with respect to the qualifications of offerees are met. In the release accompanying the adoption of the Rule, the Commission pointed out the crucial importance of this requirement:

> tributed to plaintiff were first issued to the Blues, who in name at least were the sole shareholders of Cherry Creek Drive Inc. Under Section 2(11) of the 1933 Act they were underwriters because they received Colorado and Western Shares for redistribution, *and Austin was also an underwriter because of his participation. See* Quinn & Co. v. SEC, 452 F.2d 943 (10th Cir. 1971).

Id. at 374. (emphasis added). This conclusion does not appear to be unique. *See* Black & Co. v. Nova-Tech, Inc., 333 F. Supp. 468 (D. Ore. 1971). The same theory, that at some stage, when his acts are sufficiently doubtful, the attorney may become a participant in a fraud under Rule 10b-5, is present in SEC v. National Student Marketing Corp., Civ. Action No. 225-72 (D.D.C., complaint filed Feb. 3, 1972), where attorneys for the corporate defendant are named as parties defendant to the action. For an extensive treatment, *see* Mathews, *Liabilities of Lawyers Under the Federal Securities Laws,* 30 BUS. LAW. 105 (1975).

137. Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities,* 74 COLUM. L. REV. 622, 635-36 (1974). A similar conclusion was reached in Rosenfeld, *Rule 146 Leaves Private Offering Waters Still Muddied,* 2 SEC. REG. L. J. 195, 221 (1974):

> However, the Rule may contain too many conditions which must be satisfied. Although it requires that all of its conditions must be satisfied before an offering is protected, the concept of substantial compliance must evolve or the Rule may well be unworkable.

A failure to comply in some relatively technical manner with Rule 146 may not leave the issuer with Section 4(2) of the Act to fall back upon, if the issuer has utilized the six-month "safe-harbor" integration provision of Rule 146(a)(2), since the passage of only six months since previous offers or sales may well involve the old integration standards, and the issuer's reliance on the limitation to 35 purchasers may have encouraged solicitation of a much wider group of unrelated offerees who will persuade a court that a "public offering" has taken place.

> If, as a result of inquiry after the offer, but before the sale, or otherwise, the issuer discovers that the offeree was not qualified, the Rule is still available as to the offer if the issuer had reasonable grounds to believe and believed, immediately prior to making the offer, that the offeree was qualified.
>
> The same would be true if it is discovered after a sale that the purchaser did not in fact meet the standards of subparagraph (d)(2), as long as the issuer had had reasonable grounds to believe, and had believed, that the offeree met the standards of subparagraph (d)(1) and, after making reasonable inquiry, that he met the standards of subparagraph (d)(2).[138]

The problem, of course, is that the issuer most likely to have a reasonable, but mistaken, belief in such facts is hardly the small new issuer in a small community dealing directly with individual investors of the kind likely to be interested in such investments. It will be the larger issuer dealing with relative strangers which will be more likely to take advantage of this defense. The small issuer will know its offerees; the problem will be one of drawing appropriate conclusions about sophistication.

2. *The Offeree Representative.*

Rule 146 not only eliminates the absolute liability which formerly resulted from a good faith mistake about the level of investment sophistication of any one offeree, but allows the issuer to continue to deal with an offeree who is subsequently found to be relatively unsophisticated with respect to the particular offering, provided he is sufficiently affluent to be able to bear the risk of the investment, and is willing to be represented by offeree representative(s) who are able to advise him.[139] Thus the rule adopts the approach of *Bowers v. Columbia General Corp.*,[140] that a person able to take the risk may obtain assistance in evaluating a prospec-

138. SEC Securities Act Release No. 5487, at 9 (April 23, 1974).
139. Rule 146(d)(2)(ii).
140. 336 F. Supp. 609 (D. Del. 1971).

tive investment. This concept is phrased in the plural so that several persons, such as a lawyer and accountant, may pool their knowledge and experience to advise an offeree who lacks the requisite skill and experience. While this offers a possible approach for the small issuer, use of multiple offeree representatives may well prove too cumbersome and costly for small offerings, and even then there may be some doubts about the ability of the particular representatives to supply the necessary investment counseling, since they may lack investment experience.[141] At present it seems more likely that offeree representatives will either be presently registered investment advisers or investment banking firms experienced in evaluating issuers, since attorneys and accountants not previously registered may be reluctant to subject themselves to the Investment Advisers Act.[142] Clearly offeree representatives will be a welcome safeguard for the issuer with established investment banking relationships, en-

141. A question unanswered by the Rule is whether an offeree representative must be experienced in advising about the desirability of a particular investment as a relative matter. Obviously attorneys and accountants with limited investment experience may be able to advise about the risks and prospects of a particular investment, based on the information they obtain from the issuer, without being able to advise whether it is a good investment relative to the other investment opportunities which may be available to the offeree. G. Bradford Cook suggested this in discussing *Continental Tobacco,* where the defendants urged than an offeree did not need the protection of a registration statement if he had consulted an attorney:

> And, I think it is important to keep that point in mind in analyzing similar problems where sophistication becomes an important issue. For example, in tax shelter deals, the offering circular often suggests consultation with an attorney or tax advisor. I question whether such persons are always capable of advising an otherwise relatively unsophisticated person as to the business merits or underlying values involved in the deal. Just because a man is a lawyer or accountant does not mean that he is an appropriate adviser.

Cook & Levenson, *SEC Staff Views on 'Continental Tobacco' and the Need for Regulatory Guidelines in the Private Offering Area,* PLI FOURTH ANNUAL INST. ON SECURITIES REGULATION 49, 51 (Mundheim, Fleischer & Schupper eds., 1973).

142. Investment Adviser's Act of 1940, 15 U.S.C. § 80b-1 (1970) Recent SEC correspondence indicates the Commission staff views law firms which function as offeree representatives as coming within the purview of the Investment Advisers Act, at least where the firm is listed as a prospective "offeree representative" by an issuer. Winsted, McGuire, Sechrest & Trimble, CCH FED. SEC. L. REP. ¶ 80, 131 (Jan. 22, 1975). The staff reply took note of the exclusion in Section 202(a)(11)(B) of any lawyer whose performance of investment advisory services is solely incidental to the practice of his profession, and stated "it would not appear that if your firm was included in a list of offeree representatives which was made available to potential investors, its activities could be considered solely incidental to its practice of the legal profession." *Id.* at 85,158.

abling the investment banker to approach its clients and serve as offeree representative, while being compensated for the services by the issuer.[143]

For a variety of reasons the concept will not work so smoothly for the small new issuer. This issuer will be far less likely to interest an investment banking firm, since the size of the offering will not justify the cost of the detailed investigation of the issuer which will be required by careful members of the securities industry. In smaller communities there may be no representatives of brokerage firms with sufficient skill to serve as offeree repesentatives, since investigation of prospective underwritings and large private placements are normally performed by a few officials at the main office of larger brokerage firms, or at a few regional offices at best, while small independent brokerage firms in smaller communities may not engage in any underwritings or private placements, limiting their activities to commission business. Finally, payment of any compensation by the issuer to a brokerage firm serving as offeree representative for individual investors may destroy the availability of the private or limited offering exemptions under blue sky laws, which often prohibit compensation to underwriters as a condition of their availability. Larger and more established issuers able to interest institutions will be able to utilize blue sky law exemptions for sales to institutions which are often not

143. There is no requirement in the Rule that the offeree representative be an independent third party, and the Rule concedes that this is not implied in the disclosure provisions of subparagraph (e)(3)(i), which require the issuer to disclose, in writing, prior to the sale, any material relationship between the offeree representative and the issuer for the preceding two years, and any compensation resulting from that relationship. Thus the issuer's investment banker can arrange for a fee in advance for serving as offeree representative, and then contact its clients who are able to bear the risk. Alberg & Lybecker, *supra* note 137, at 637, are far less certain the Rule allows the issuer to select a representative which it will recommend to offerees, or that the issuer should be able to pay the fees. These authors also raise problems of compliance with the Investment Adviser's Act for brokerage firms already registered as investment advisers. *Id.* at note 82. Prior to Rule 146 the common practice appears to have been for an issuer to pay any fee to an investment banker which advised its own clients on the desirability of investing in the issuer. Garrett, *The Private Offering Exemption Today*, PLI FOURTH ANNUAL INST. ON SEC. REG. 3, 29 Mundheim, Fleischer & Schupper eds. 1973). Nothing in the releases dealing with the Rule indicates an intent to end this practice. *See* Connolly, *Private Offering Exemption*, 8 REV. SEC. REG. 919, 921, text at n.8 (1975).

dependent upon an absence of commissions.[144] In the past, brokerage firms have not shown great interest in smaller offerings, and it is unlikely that Rule 146 will change their attitudes.

3. *Access Revisited.*

In addition to resolving some of the problems raised by recent Tenth Circuit cases on the required level of investor sophistication by allowing use of an offeree representative, Rule 146 has resolved many of the doubts raised by Fifth Circuit cases about the need for a previously existing and privileged relationship between the issuer and offerees. Rule 146(e) is phrased in the alternative, allowing the issuer either to select offerees with access to such information, or to provide the information for them and their offeree representatives, where no relationship existed prior to the offer.[145]

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144. If payments to the broker for serving as offeree representative are made by the issuer, it seems likely that state securities administrators will treat these payments as commissions, which will destroy the limited offering exemption under many state blue sky laws. *See* UNIFORM SECURITIES ACT § 402(b)(9), CCH BLUE SKY L. REP. ¶ 4932, at 731, and J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 21 n.18 1971. Section 402(b)(8) of the *Uniform Securities Act* exempts sales to institutions without reference to payment of commissions. CCH BLUE SKY L. REP. ¶ 4932, at 731. In addition, the requirements imposed on the offeree representative, in making recommendations to offerees, which presumably must include an investigation of the suitability of the investment for each offeree represented, as well as a thorough investigation of the issuer, may raise the cost of such representation to an uneconomic level. It has been suggested that in the context of a Rule 145 acquisition the fees for services of a conscientious investment banker to investigate both the acquired and the acquiring firm and the offerees may be in the neighborhood of $15,000 to $25,000. Schneider & Zall, *Comment Letter on Proposed Rule 146*, PLI CORPORATE LAW AND PRACTICE COURSE HANDBOOK, RULE 146 9, 35 (Cohen & Schneider eds. 1974). For the smaller offering, when coupled with attorney's fees, the amount may be prohibitive.

145. Rule 146(e)(1) provides in part:

> (1) Either
>
> (i) Each offeree shall have access during the course of the transaction and prior to the sale to the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense; or
>
> (ii) Each offeree or his offeree representative(s), or both, shall have been furnished during the course of the transaction and prior to sale, by the issuer or any person acting on its behalf, the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense. This condition shall be deemed to be satisfied as to an offeree if the offeree or his offeree representative is furnished with information, either in the form of documents actually filed with the Commission or otherwise, as follows: . . . .

The treatment of access in the Rule may broaden it somewhat from the position of *Continental Tobacco* that access can only exist by virtue of a previously existing relationship,[146] since the introductory note to subsection (e) of the Rule refers to bargaining power, as well as to such relationships,[147] and to this extent broadens the group of offerees to include those traditionally included in "private placements," such as institutional investors.[148] In addition, regardless of whether the issuer chooses to rely on the access of the offerees or to provide the kind of information required by the Rule where access is not so obvious, the issuer must make available an opportunity for either offerees or their representatives

146. SEC v. Continental Tobacco Co. 463 F.2d 137, 158 (5th Cir. 1972).

147. The introductory note to Rule 146(e) states:

> Access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate the merits and risks of the prospective investment.

Release No. 5487 adds little by way of explanation, other than a suggestion that the Rule was not intended to change existing law in the area: "The term 'access' is used in the Rule in the same sense that it has been used by courts and the Commissions in the past—to refer to the offeree's position with respect to the issuer." SEC Securities Act Release No. 5487 (Apr. 23, 1974), CCH FED. SEC. L. REP. ¶ 2710, at 2907-8.

148. *See, e.g.*, SEC Securities Act Release No. 4552 (Nov. 6, 1962) and Value Line Fund, Inc. v. Marcus, (S.D.N.Y. 1965) CCH FED. SEC. L. REP. ¶ 91,523 [1964-66 Transfer Binder] (purchase by five mutual funds); *but see* Gilligan, Will & Co., v. SEC, 267 F.2d 461 (2d Cir. 1959) where a court found insufficient access where admittedly sophisticated investors had no personal contact with representatives of the issuer, having negotiated solely with an underwriter. Whether this approach retains any vitality under Rule 146 is uncertain. When first proposed, the Rule contained a requirement that securities sold in reliance on the Rule could only be sold in "negotiated transactions." Rule 146(c), as proposed in Securities Act Release No. 5336 (Nov. 28, 1972), in addition to prohibiting general solicitations, required that "(1) The securities shall be offered and sold only in a negotiated transaction." Proposed Rule 146(a)(3) defined these transactions: "The term 'negotiated transaction' shall mean a transaction in which securities are offered and the terms and arrangements relating to any sale of securities are arrived at through direct communication between the issuer or any person acting on its behalf and the purchaser or his investment representative." In adopting the Rule without the negotiated transaction requirement, the Commission, in explaining the restrictions on manner of offering, stated, "The substance of the requirement that there be direct communication has been moved from paragraph (c) of the Rule to paragraph (e), 'Access to and Furnishing of Information.'" SEC Securities Act Release No. 5487, (Apr. 23, 1974), CCH FED. SEC. L. REP. ¶ 2710, at 2907-7. This may mean that mere bargaining power without more will not be enough, and that despite the wording of the Rule, some personal contact will be required by Commission interpretations of the Rule, giving life to *Gilligan, Will.* Requiring personal contact will add little protection for an affluent but inexperienced investor relying heavily on an offeree representative. It may preclude broker-dealers from investing discretionary accounts in Rule 146 placements, even where the investor's goal is speculation.

to ask questions and to verify information, within reasonable limits.[149]

Even in situations where the issuer is relying on the access of the particular offerees, formal disclosure requirements continue in certain areas. The issuer must disclose the necessity that the purchaser bear the economic risk of the investment for an indefinite period of time, and that certain mechanical restrictions will be imposed on transfer of the certificate—legends, stop-transfer orders, and that a written agreement not to resell without registration or the availability of an exemption will be required.[150] Many of these requirements can be met by any careful issuer, large or small, supervised by counsel, and to a large extent they represent good practice as it existed before Rule 146, so no drastic change in practice should be necessary. But assuming that the issuer and its counsel are not sufficiently confident that the bargaining power or previous privileged relationship of the offerees with the issuer qualify them as "access" offerees, they will probably take the conservative course of making the disclosure specified by the Rule as an alternative. For small promotional issuers the difficulties in compliance with this requirement will be considerable, if not insurmountable.

Even where the small issuer is able to meet the Rule's requirements relating to disclosure, the costs of the effort necessary to satisfy these requirements may well defeat one of the purposes of the exemption, which presumably is to avoid the cost of registration where the expense is not justified by the benefits to the public.[151] For the small issuer, the disclosure requirements of the Rule seem more onerous

149. Rule 146(e)(2).

150. Rule 146(e)(3). Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973), seems to impose substantially the same requirement.

151. To a very large extent any suggestions about the purpose of the exemption are surmise, since the legislative history is so sparse. The House Report on the bill deals with the exemption in the following language: "It carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote."
H. R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).
One assumes that one of the reasons for not requiring registration for private offerings, was recognition that the cost of such registration was far greater than the benefits to be obtained, and in that sense the benefits were "remote."

than the requirements of Regulation A,[152] and it might be fair to say that the Commission, for such issuers, has turned this exemption into another simplified form of registration, although no filings with the Commission are required.

The disclosure requirement of the Rule begins by requiring an issuer choosing to make disclosure rather than rely on "access" to furnish the same kind of information that is specified in Schedule A of the Act, to the extent the issuer has such information or can acquire it without unreasonable expense.[153] Having set an initial requirement as burdensome as registration, the Rule then proceeds to modify it for reporting companies, by stating that this requirement shall be deemed to be satisfied for such companies by delivering the information contained in the most recent reports filed by the company under the 1934 Act, including the most recent annual and quarterly reports, any definitive proxy statement used since the last annual report, and a supplementary description of the use of proceeds, the securities being offered, and any material changes in the issuer's affairs since the most recent filings with the SEC.[154] Reporting companies will thus be in a position to rely primarily on documents already on file with the SEC and to produce the financial statements which have been used for such purposes, which need be audited only for an annual report, which may

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152. Section 3(b) of the Securities Act, 15 U.S.C. § 77c(b) (1970) provides:

> The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $500,000.

To implement this section the Commission has adopted Regulation A, 17 C.F.R. § 230.251 to 230.263 (1974), which established a somewhat simplified procedure similar to registration, but requires filing with the regional offices of the SEC, an absence of certified financial statements and the complex "guidelines" adopted with respect to a full registration statement. While this may be termed an exemption from registration, it certainly is not an exemption from a costly disclosure process. It is also not an exemption from registration under various blue sky laws. One text describes it merely as "simplified registration." 1 G. ROBINSON & K. EPPLER, GOING PUBLIC § 108 at 470 (Rev. 1974).

153. Rule 146(e)(1)(ii).

154. Rule 146(e)(1)(ii)(a)(1) and (2).

be considerably out of date by the time of an offer.[155] To the extent that a fuller description of some matters may be required in a 1933 Act registration than will be disclosed by 1934 Act reports (see the Guidelines for examples)[156] the result will be considerable simplification of private offerings for such issuers.

In contrast, the Rule generally requires non-reporting companies to produce the information which would be required in a full registration statement filed on the appropriate form with omission or condensation of non-material information.[157] Cautious counsel will have to assume, absent some indication from the Commission to the contrary, that "information" will be read to include information and exhibits reguired by Part II of the forms, as well as all the cautionary language required by the SEC guidelines on filing registration statements, much of which is not required on Regulation A filings.[158] Thus the cost of drafting the disclosure document

155. While Form 10-K, 17 C.F.R. § 249.310 (1974), the annual report for companies with securities registered under the 1934 Act, must be filed within 90 days after the end of a fiscal year, (General Instructions, ¶ A(b), CCH FED. SEC. L. REP. ¶ 31,102) and must contain audited financial statements, (Instructions as to Financial Statements, ¶1, CCH FED. SEC. L. REP. ¶ 31,106), no audited financial statements need be filed with a registrant's quarterly reports on Form 10-Q, ¶ E, CCH FED. SEC. L. REP. ¶31,031. If a reporting company chooses to engage in Rule 146 sales in the first quarter of a fiscal year, before it has filed its current Form 10-K, its audited financial statements may be more than one year old.

156. *Guides for Preparation and Filing of Registration Statements*, SEC Securities Act Release No. 4936 (Dec. 9, 1968), *as amended*, CCH FED. SEC. L. REP. ¶ 3760.

157. Rule 146(e)(1)(ii)(b). The amendments to the Rule adopted in May of 1975 allow omission of non-material details or condensation where appropriate. Rule 146(e)(1)(ii)(b)A, added by SEC Securities Act Release No. 5585 (May 7, 1975). This amounts to a "substantial compliance" modification, which should have little impact on drafting, but a greater impact on avoiding liability for failure to comply with all conditions of the Rule.

158. *Compare, e.g.*, Form S-2, CCH FED. SEC. L. REP. ¶ 7141, to be used by companies in the development stage, *with* Form 1-A and Schedule I, CCH FED. SEC. L. REP. ¶ 7325, to be used in connection with Regulation A. In addition to the fact that the financials need not be certified on Regulation A, other items on Form S-2 not covered under Regulation A include a far more detailed description of the issuer's business (Item 4) and material transactions with management and promoters for the past 5 years (Item 12) rather than the two years required by Schedule I (Item 9(c)(1)). In Part II the registrant must disclose the interest of experts named in the registration statement (Item 15), all sales of unregistered securities for the past three years (Item 16), while Form 1-A requires such disclosure for only the past one year (Item 9). Exhibits required to be filed under Form S-2 are more voluminous. SEC Securities Act Release No. 5585 (May 7, 1975) makes it quite clear that disclosure includes Part II of the forms, since it excuses furnishing certain financial schedules required in Part II under certain circumstances, by amending Rule 146(e)(1)(ii)(b)(c).

may exceed the cost of a Regulation A offering, when coupled with the supervision of offerees and meetings with offerees to comply with the Rule. Under these circumstances it seems doubtful that use of the Rule will provide any significant advantage over Regulation A for smaller issuers.

Disclosure of an issuer's financial status poses more problems for the small issuer. While a reporting company can satisfy the requirements of the rule with financial reports already on file with the SEC, the burden on a non-reporting company is far greater. For established small issuers Form S-1 requires considerable financial disclosure in Part II, although the Rule has been amended to excuse production of these schedules where they have not been prepared.[159] Assuming an issuer in a promotional stage entitled to use Form S-2, the financial statements must be audited, and current to a date within 90 days prior to the date of filing a registration statement.[160] The Rule states that the issuer need not have audited financial statements where they cannot be obtained without unreasonable expense, but even as amended in May of 1975, the Rule makes it clear that even where unaudited financials are used, they must be in the form required by the registration statement. Only if such schedules are not available and cannot be obtained without unreasonable effort and expense, may the simpler forms required by Regulation A be furnished[161] From the rather negative comments in Release No. 5585 about Regulation A, it would appear that the mere fact that an offering is far less than $500,000 is not by itself enough to justify use of the simpler and unaudited Regulation A forms.[162]

159. Form S-1, CCH FED. SEC. L. REP. ¶ 7121, at ¶ 7127. Rule 146(e) (1) (ii) (b) provides in subparagraph (C) that if the issuer does not have these schedules prepared, they need not be furnished. This qualification was added by SEC Securities Act Releaie No. 5585 (May 7, 1975), CCH FED. SEC. L. REP. ¶ 80,168.

160. SEC Form S-2, CCH FED. SEC. L. REP. ¶ 7141, at Item 13, ¶ 7143 at 6249.

161. SEC Form 1-A, Schedule I, Item 11, CCH FED. SEC. L. REP. ¶ 8327 at 6446. Rule 146(e) (1) (ii) (b) (B) as amended allows use of the Regulation A form of financial statements only.

162. Rule 146(e) (1) (ii) (b) (B) specifically allows use of the Regulation A form of financial statements only; it does not apply to the remainder of the disclosures. SEC Securities Act Release No. 5585 (May 7, 1975), in making this change, stated:

If the requirements of the Rule mean fuller disclosure for the non-reporting company, it is only one more way in which the Commission has chosen to "integrate" its disclosure statutes by encouraging registration under the 1934 Act as a price for the utilization of the safe harbor rules relating to exemptions from registration under the Securities Act.

Even for an offeree with respect to whom the issuer is relying on access rather than an offering document containing the information specified by the Rule, the issuer must make certain that during the course of the transaction the offeree has access (presumably this goes beyond a relationship and means making the information available in a usable form) to the same kind of information which registration would provide, but only to the extent the issuer possesses such information or can acquire it without unreasonable expense or effort.[163] This portion of the Rule presumably applies only to promoters and those closely related to the enterprise, and it seems unwise to rely on it for any other buyers of the issuer's securities, given the reasoning of *Hill York*.

Regardless of whether the issuer chooses to rely on a disclosure document or on the "access" of the offerees, the issuer must make available an opportunity to ask questions and to verify information,[164] which the Commission has described as the substitute for the "negotiated transaction" requirement in the proposed rule.[165] If the issuer relies on offeree "access," the Rule does not answer the question, "what if the issuer gave a disclosure party and nobody came?" Does the ghost of *Gilligan, Will* loom in the background ready to destroy the exemption by concluding buyers

It should be noted in connection with this provision that the Commission does not consider the Regulation A offering circular to be a "registration statement filed under the Act" even if the issuer would be entitled to use Regulation A for its offering.

163. Rule 146(e)(1)(i).

164. Rule 146(e)(2).

165. *See* the discussion of the elimination of the "negotiated transaction" requirement and its replacement with a requirement of an opportunity to ask questions and verify information in note 148 *supra*, citing SEC Securities Act Release No. 5487 (April 23, 1974) CCH FED. SEC. L. REP. ¶ 2710, at 2907-7.

lack investment intent in such circumstances?[166] Assuming that a small new issuer is capable of holding such a meeting and answering questions which might be posed by sophisticated investors or their representatives, it is obvious this requirement will be more easily met by larger issuers with ready access to full information about their business. For the new issuer without full information, there is a grave danger that answers will be partial, and thus potentially misleading.[167] While issuers of all sizes have access to the excuse of unreasonable effort or expense in obtaining answers to questions in this situation, the Commission has again provided no guidelines to what amount constitutes such an expense, or whether it bears any relation to the size of the offering. In view of the rigid approach of the Rule to initial disclosures similar to a registration statement for non-reporting companies, regardless of the size of the offering, it seems

166. Gilligan, Will & Co., v. SEC, 267 F.2d 461 (2d Cir. 1959). The author does not believe access should be destroyed by lack of investor interest in attending such a meeting. In *Gilligan, Will* the lack of investor interest was coupled with an intent to resell and distribute the securities as soon as the capital gains period expired, and a transaction structured in such a way as to offer a speculation rather than an investment—debentures convertible into common stock at a ratio which offered a profit for immediate conversion and resale. Obviously, lack of investor attendance at a meeting, where access is relied upon rather than disclosure, raises serious questions about access and investment intent but does not conclusively dispose of the issue.

167. It seems likely that the format of meetings held to satisfy the requirements of Rule 146(e)(2) will become formalized, with the use of checklists for those conducting the meeting to make certain everything deemed necessary by counsel is covered. *See* Cohen, *The Practice and Procedure for Conduct of Meetings,* PLI CORPORATE LAW AND PRACTICE COURSE HANDBOOK, RULE 146 169 (Cohen & Schneider eds. 1974). These meetings will likely have an agenda, perhaps a prior meeting with offeree representatives to determine what questions are of interest to them, careful monitoring of the persons in attendance to comply with Rule 146(c)(2), and either detailed minutes or tape recordings of the meetings, to establish compliance with the Rule. Questions have been raised whether it is permissible under Rule 146(c)(2) to hold meetings with offeree representatives at which the offerees themselves are not present. Rosenfeld, *Rule 146 Leaves Private Offering Waters Still Muddied,* 2 SEC. REG. L. J. 202, 203 (1974). The purpose of the Rule is to prevent general meetings and solicitations, and a reasonable interpretation should not preclude officers of an issuer from meeting with one or even a few offeree representatives out of the presence of the offerees, to determine their areas of concern or to supply technical information. Perhaps this problem can be solved by assuming that no offers to sell or solicitations are being made at such meetings, since the offeree representatives are not considering purchasing the securities for their own accounts. While obviously such an approach is a fiction, it has been employed often enough in the past to have become somewhat respectable when dealing with the tangled web of the Securities Act. *See* Rules 134, 135 and 135a, 17 C.F.R. § 230.134, .135 & .135a (1974).

unlikely the Commission will adopt a relative approach to expenses in interpreting the Rule.

Finally, small unseasoned issuers must face the prospect where an investment banking firm serves as offeree representative for its clients in a small offering, that the offeree representative may, in an effort to avoid liability where risks seem high, make an unduly conservative and negative recommendation. Where an investment banking firm serves as an offeree representative, the firm will be faced with suitability rules which require that each investment recommended must be suitable for the particular investor, based on an individual evaluation of each customer's financial situation and investment needs.[168] What effect this rule will have on the recommendations of such offeree representatives evaluating new and untried companies remains to be seen, but one result could be undue conservatism, and recommendations of alternative investments carrying less risk, both for the investor

168. Exchange Act Rule 15b 10-3, 17 C.F.R. § 240.15b 10-3 (1974) provides:

> Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.

The National Association of Securities Dealers ("NASD") has a similar rule for its members, who constitute the bulk of securities dealers in the United States:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

Rules of Fair Practice, CCH NASD MANUAL ¶ 2152, art. III, § 2.

There has been considerable discussion of this topic of broker liability for breach of such rules. *See* Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L. J. 1604 (1971); Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233 (1966); MacLean, *Brokers' Liability for Violation of Exchange and NASD Rules*, 47 DENVER L. J. 63 (1970); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L. J. 445 (1965); Rediker, *Civil Liability of Broker-Dealers and SEC and NASD Suitability Rules*, 22 ALA. L. REV. 15 (1970); Lipton, *The Customer Suitability Doctrine*, PLI FOURTH ANNUAL INST. ON SEC. REG. 273 (1973). In connection with its consideration of the "hot issue" problem the SEC has recommended consideration by the NASD of further standards of suitability where first public offerings of speculative new issues are involved. Securities Act Release No. 5274 (July 26, 1972); SEC Securities Act Release No. 5275 (July 26, 1972). *See also* Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968), holding a broker liable for breach of this duty.

and the investment banking firm. The risk of breach of the suitability rule seems greater in Rule 146 transactions where no more than 35 buyers will make relatively substantial investments than in a public offering for such a company, where a greater number of buyers will spread the risk. An investor with $5,000 or $150,000 at stake is far more likely to bring suit than one with a $500 investment.

4. *The Effects of Rule 146.*

It should be obvious that neither Rule 146 nor the private offering exemption under Section 4(2) will provide an easy or certain exemption from registration for small issuers. To a large extent this is a result of the almost exclusive focus of the Act on protection of investors, to the exclusion of any consideration of the welfare of small companies in our economy. One would hope that before any major revision of the securities laws takes place Congress or the SEC will carefully consider whether the goal of investor protection should be pursued at any price, or more specifically, at the price of leaving small issuers with no economic or realistic way to raise capital. Perhaps the American Law Institute's proposed *Federal Securities Code*[169] will provide the occasion for such consideration by the 1980's.

In the meantime issuers must live with the problems of Section 4(2) and Rule 146, which the Commission insists will coexist.[170] Despite this insistence, it seems more likely that

169. The Federal Securities Code project was introduced to the bar by Professor Loss, Loss *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969). The Code has undergone numerous revisions. Tent. Draft No. 1 was published in 1972. Subsequent drafts of the Code include, at this date, Tent. Draft No. 2, (March 1973); Tent. Draft No. 3 (April 1, 1974); Reporter's Revision of Text of Tent. Drafts Nos. 1-3 (Oct. 1, 1974) and Tent. Draft No. 4 (April 1, 1975).

170. While one commentator has described Rule 146 as possessing an "aggressively non-exclusive quality," Merrow, Kerr & Merrow, *Revised Proposed Rule 146: An Introduction and Analysis*, PLI FIFTH ANNUAL INST. ON SEC. REG. 355, 358 (Mundheim, Fleischer & Schupper eds. 1974), others strongly disagree with that view. Even among those who agree that the Rule will become exclusive there is disagreement over whether this will benefit issuers. Contrast the views of Alberg and Lybecker with those of Schneider:

> Although rule 146 is expressly non-exclusive, it can be hoped and expected that those persons responsible for interpreting the legality of a nonpublic offering outside the scope of rule 146 will look to the criteria of rule 146 for guidance in making their decisions. If the standards of rule 146 do 'spill over' and

Rule 146 will become exclusive for planning purposes, although court cases where the issuer has failed to comply with the Rule may still involve consideration of Section 4(2) as a fallback position for defendants. Attorneys practicing in the Fifth and Tenth Circuits, at least, will be unlikely to risk use of Section 4(2) in view of the current cases in those circuits, and those cases must be taken into account as a relatively current reading of the position of the SEC staff and of the applicable standards of *Ralston Purina* by attorneys in other circuits. Many courts are unfamiliar with the intricacies of the cases interpreting Section 4(2), and seem likely to look to the Rule as a source of guidance, just as many courts have looked to Commission releases in the past. Finally, the inability to obtain no-action letters in most cases will discourage some counsel who might have relied on such letters in the past.[171]

In the short run, the Rule may increase the risks of liability under Section 12 of the Act for small issuers. Reliance on the Rule is likely to increase the number of offerees who will be approached by an issuer, and to lessen the issuer's

> begin to preempt the field, issuers should find appreciably diminished the present riskiness of making offerings in reliance of Section 4(2).

Alberg and Lybecker, *supra* note 137, at 643.

> If Rule 146 is adopted, the courts, many of which are unfamiliar with securities practice, may decline to strain with the dicta regarding the exemption independent of the Rule. To the extent that Rule 146 is intended as a safe harbor, it accomplishes relatively little. Despite problems lawyers may have had in rendering opinions because of broad dicta, as a practical matter, almost any transaction that complied with the terms of Rule 146 would satisfy the requirements of existing law. The major contribution of Rule 146 is to eliminate the significance of the number of offerees. Unless creeping exclusivity can be avoided by maintaining a viable exemption outside of the Rule which accords with commercial reality, the adoption of Rule 146 could prove to be more of a hindrance than a benefit from the public interest viewpoint.

Schneider, *Comments of Mr. Schneider on Proposed Rule 146*, PLI FIFTH ANNUAL INST. ON SEC. REG. 385, 392 (Mundheim, Fleischer & Schupper eds. 1974). Mr. Schneider takes the position that any requirement that a group of offerees have a pre-existing relationship with the issuer before "access" can be established does not accord with commercial reality. While this may be true, dicta in *Continental Tobacco* creates a substantial risk that future cases may decline to recognize commercial reality.

171. Securities Act Release No. 5487 at 14 (April 23, 1974) stated: "Although the staff will continue to consider no-action requests relating to Section 4(2) of the Act, such letters will only be issued infrequently and only in the most compelling circumstances." Rule 146's requirements are cited in a recent case involving an attempted private offering. Wolf v. S. D. Cohn & Co., CCH FED. L. REP ¶ 95,223, at 98,163-64 (5th Cir. 1975).

concern with any previously existing relationship with the offeree group. Assuming that many small issuers will fail to establish that they have complied strictly with all of the conditions of the Rule, which may be as simple a matter as a failure to keep proper records of all offerees approached and the facts known to the issuer which establish the offeree's qualifications under the Rule, these issuers will be thrown back on Section 4(2), and in many cases will fail to meet the judicial standards previously discussed.[172]

The more serious and long range problem with Rule 146 relates to the relative advantages of small and large issuers in obtaining capital for new ventures. Because of the curious design of the Securities Act, with its absolute requirement of registration before any offers or sales can be made, what Professor Loss has called "overly sophistic rules"[173] have grown up which tax the ingenuity of the most experienced attorneys. It has become such a demanding task to grapple with the complexities of securities regulation as it now exists that the primary energies of attorneys have been devoted to keeping the capital markets functioning under these handicaps of complexity and uncertainty, without attempting to develop a new structure. For these reasons, too little attention has been paid to the effect of these rules on the capital markets. Absent some assistance from economists who have been strangely absent from the councils of those considering the regulation of this most economic of activities, attorneys can only guess at the long range effects of Rule 146.

Regardless of the economic information now available, it seems clear that the complexities of Rule 146 will make it either risky or costly for small new issuers to raise capital from their traditional sources, which are generally not so-

172. As Schneider points out, *supra* note 170, perhaps the only significant difference between Rule 146 and Section 4(2) is that there is no limit on the number of offerees under the Rule. Thus if an issuer mistakenly relies on Rule 146 and fails to comply with all of the conditions, the large number and variety of offerees lacking previous relationships with the issuer may destroy the availability of the Section 4(2) exemption, which might otherwise have been available, assuming access, sophistication, delivery of adequate information, restrictions on resale, and no general solicitation. The 1975 amendments to the Rule will relieve some issuers from liability for some technical and non-material failures to comply with the Rule, but many small issuers will still face great difficulty.

173. Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27, 28 (1969).

phisticated venture capitalists.[174] Assuming that a small new issuer is either foolish enough or desperate enough to attempt a Rule 146 offering to individuals, the issuer will be at a severe cost disadvantage when compared to the larger and more established issuer. If an issuer is carefully supervised throughout the course of a Rule 146 offering by counsel, from reviewing the qualifications of offerees and their representatives to making the disclosures in an offering memorandum which correspond to those required by a registration statement, and holding the necessary meetings to answer questions, it seems likely that the cost of a Rule 146 transaction will exceed, or at least equal, the cost of a Regulation A offering, while the issuer utilizing Regulation A will not be faced with lingering doubts about the qualifications of buyers and offerees. These costs will be nearly as high for the small new issuer as for the reporting company.[175] While costs will

174. Prior to the adoption of Rule 146 Mr. Schneider commented:

> It's fairly obvious to me that the law has to legitimatize what is happening. In fact, there are many, many small companies that have no interest for the professional venture capitalist. There are private companies that open small retail stores, and if the proprietors need some money they go to their families. There are companies that have no prospects of being publicly owned. There are companies whose financial needs are far below the minimum threshold that will attract the sophisticated venture capitalist. Either business is going to stop and these companies will be cut off from financing, or we have to find some way that a non-fraudulent offering, reasonably restricted in terms of number of persons, will be legitimatized.

Schneider, commenting in Garrett, *The Private Offering Exemption Today,* PLI FOURTH ANNUAL INST. ON SEC. REG. 3, 33 (Mundheim, Fleischer & Schupper eds. 1973). It now seems doubtful that Rule 146 fills the need described by Mr. Schneider. At another point in the same program, commenting on the Staff brief in *Continental Tobacco* and the standards of sophistication developing prior to adoption of Rule 146, Mr. Schneider stated:

> In the real live world where stock is sold privately all the time, I think the working level of sophistication is really much lower than the average fellow who has a professional adviser.

Cook & Levenson, *SEC Staff Views on Continental Tobacco and the Need for Regulatory Guidelines in the Private Offering Area, supra* note 70, at 40.

175. For an attorney to adequately discharge his responsibility in a Rule 146 transaction will require careful planning, counseling with his client, drafting of an offering brochure similar to a registration statement, investigation of the level of sophistication of offerees, conduct of one or more meetings to give offerees an opportunity to ask questions and verify information, supervision of the building of a record to document compliance with the Rule, drafting investment letters and letters advising prospective buyers of the limitations imposed on resale of the securities, in addition to the organization of the enterprise and advice about blue sky laws, tax problems, and the like. Many of these costs will remain relatively constant, regardless of the size of the offering or the issuer's

probably increase somewhat with the size of the issuer, its business and the offering, it is unlikely that the increase in costs will be proportionate. For a small new issuer attempting to raise seed money these costs may be prohibitive. In addition, the promoter of the venture may have had preliminary discussions about financing before consulting an attorney, and it may be necessary for the attorney to advise his client that these discussions constituted offers, and that the offerees do not qualify under the Rule, thus making it necessary to wait through the six month period required to avoid integration.[176] In any event, the costs of compliance with the Rule for the small issuer will be almost as great as the risk of violating one of its conditions.

Another significant effect of the Rule seems to be imposition of a suitability test for investors in Rule 146 offerings. Given the level of sophistication which seems to be required by the Tenth Circuit's recent opinions, it seems likely that the Commission will insist that the only individual offerees who are sophisticated enough to fend for themselves are those with considerable investment experience, particularly in new, speculative and perhaps private offerings. If *Andrews v. Blue*[177] is to be believed, unless the offeree already has experience with restricted securities, he may not have sufficient experience to qualify. Further, where the

business. Organizational costs for the small issuer will be a cost not borne by an established issuer, although they may be offset by the necessary review of corporate records for established issuers.

176. Rule 146(b)(1) provides:

> For purposes of this rule only, an offering shall be deemed not to include offers . . . that take place prior to the six month period immediately preceding or after the six month period immediately following any offers . . . pursuant to this rule, *provided*, that there are during neither of said six month periods any offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

While it may sem absurd that a promoter who consults an attorney in good faith in an attempt to comply with the securities laws prior to making any sales will find himself in the dilemma of having already violated a condition of the Rule, the same result obtains under other provisions of the securities laws. *see, e.g.*, G.A.F. Corporation v. Milstein, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910, holding that a group of stockholders had "acquired" a 10% interest in a company, thus triggering filing requirements under Section 13(d) of the 1934 Act, when a family already holding over 10% agreed to act in concert in an attempt to gain control of a reporting company.

177. 489 F.2d 367 (10th Cir. 1973).

buyer lacks sufficient personal experience, and must rely on an offeree representative in order to make his decision, he must be able to bear the risk of the investment, which clearly becomes a suitability test, since only those with sufficient resources to be able to take a complete loss without serious consequences will be able to invest. Whether such a suitability approach to speculative investments is appropriate under the securities laws depends to a large extent on deeply rooted views about the function of capital markets and the proper amount of paternalism which government should exercise in such markets, matters beyond the scope of this article. But it may be that the trend is toward greater supervision of the way in which capital should be invested, and by whom. In this respect it is noteworthy that the thrust of much recent commentary on the problem of allowing small issuers to sell their securities while still in the promotional stage has been to the effect that some sort of merit requirements are necessary to protect investors, unless the investors are both very wealthy and sophisticated.[178]

178. This is hardly a new idea, since the debate over disclosure versus merit qualification has been with us since the enactment of the Securities Act. *See* I L. LOSS, SECURITIES REGULATION 121-29 (2d 1961). Mr. Justice (then Professor) Douglas criticized the Act on the basis, among others, that it was foolish to assume that great business enterprises could be clearly explained to small investors in a manner which they could understand, and that in this sense the Act represented a desire to return to a simpler time when enterprises were smaller, and were more directly answerable to stockholders. He suggested that rather than returning to such a simpler world, it was more important to undertake a method of regulation which " . . . when finally evolved must envisage a wide range—from the increments of profit and control (which are incident to the constitution and form of the organization) to the terms and conditions of the organization, the kind and amount of securities which may be issued, the terms on which they may be issued, and the persons to whom they may be sold." Douglas, *Protecting the Investor*, 23 YALE REV. (n.s.) 521, 530 (1934). More recently, McCauley has suggested "controlled" small offerings limited to "sophisticated" investors able to bear the risk of loss, with certain conditions imposed as a prerequisite, to the use of this type of exemption, which would perform some of the functions now performed by merit provisions in some states, such as eliminating cheap stock, requiring a minimum of 50% of the equity to be sold to the public, and minimum public representation on the board of directors. McCauley, *The Securities Laws—After 40 Years: A Need for Rethinking*, 48 NOTRE DAME LAW. 1092, 1095-97 (1973). Both McCauley and Professor Kripke suggest that venture capital pools or companies, managed by sophisticated investment analysts, should be encouraged to finance issuers in the promotional stage, rather than individual investors who may not be in a position to evaluate the risks, and bargain for as large a piece of the equity in return for assuming the risk, as professional investors. *Id.* and Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973).

Standing alone, Rule 146 could represent a considered policy that purchasers of the securities of small and unseasoned issuers should be at least as affluent and sophisticated as the institutions likely to purchase the securities of reporting companies utilizing Rule 146. The result of this policy would be a considerable limiting of the number of prospective offerees available to small new issuers, even though the Rule does not purport to place any fixed limit on the number of offerees.[179] Investment banking firms are most likely to be able to provide a ready list of relatively sophisticated and affluent investors with an interest in taking the risk involved in venture capital investment, but under many blue sky laws private or limited offering exemptions will not be available if compensation is paid as a commission to anyone for selling the securities, and it is likely that any fee paid by the issuer to such an investment banker will be treated as a commission.[180] Such treatment will foreclose small and new issuers from using investment bankers to reach the class of investors most likely to qualify under the Rule, which in many communities may leave few, if any, investors who can qualify as offerees. The result of this may be to leave venture capital firms as the only logical offerees.

It has been pointed out by the present SEC Chairman, Ray Garrett, Jr., that most small and promotional enterprises are not interested in raising venture capital from professional venture capital sources, in the context of a discussion of *Continental Tobacco*:

> In that case, the promoters did not seek, or were unable to obtain, capital from professional venture capital sources. Maybe they found those sources too greedy. One reason that promoters sometimes hesitate to go to such sources is that professional venture capital investors want a very, very big part of the action. In saying this, I do not mean to be critical of venture capitalists. One cannot blame them for de-

179. The Rule itself imposes no limitation on the number of offerees, referring only to the number of buyers (35 under Rule 146(g)) and restricting the manner of solicitation. Rule 146(c). But the restrictions on the nature of offerees will impose an effective limitation in many communities, especially if locating an offeree representative becomes a problem.

180. The problem of treatment of fees paid by the issuer to offeree representatives is discussed at note 144, *supra*.

> manding the chance of high return for accepting high risk.
>
> Promoters, on the other hand, dislike sharing their chance of extraordinary gains any more than is absolutely necessary. Many individual investors will make a modest investment in a promotional enterprise on terms that would never be acceptable to professional venture capitalists. This fact accounts for many registered public offerings of promotional enterprises. It also raises the question whether such registration should be permitted, much less sequired.[181]

It may be useful to attempt at least a tentative analysis of the reasons why venture capitalists bargain for more than individuals. The most obvious possible reason is that professional venture capitalists are far less sanguine than amateurs about the prospects of any new enterprise. Second, professionals, being more accustomed to bargaining with promoters, are simply able to drive a harder bargain by virtue of their experience. A third possible reason is that such venture capitalists have more market power—control over larger amounts of money and more investment opportunities than small individual investors. The result of Rule 146 may thus be to limit severely the freedom of access of small issuers to the capital markets. Assuming that the Rule encourages small issuers to rely almost entirely on institutional investors, it excludes from the capital market the large number of individual investors who have previously made up an important part of that market, especially in smaller communities. By limiting the number of prospective investors, the Rule grants greater market power to those remaining—insurance companies, venture capital firms, and the like.[182] To

181. Garrett, *The Private Offering Exemption Today,* FOURTH ANNUAL INST. ON SEC. REG. 3, 25-26 (Mundheim, Fleischer & Schupper eds. 1973).

182. Concentrated purchasing power—the opposite side of the monopoly coin, is called "monopsony." One author states:

> Quite commonly, also, the terms 'monopoly' or 'demand monopoly' are used to indicate complete control of the demand by one person, firm, or group acting in concert in a given market for some good or service. In recent economic writing the term *monopsony,* implying sole buyer, has been used considerably to indicate a monopoly of demand.

T. ANDERSON, OUR COMPETITIVE SYSTEM AND PUBLIC POLICY 25-26 (1958). This power may be accentuated if, in order to solve the difficulties of the extent such market power has already existed by virtue of the risks involved in soliciting relatively unsophisticated investors, it explains the more favorable terms which professional venture capitalists are able to extract from issuers in terms of a monopoly profit. A revised exemption system which places emphasis on the sophistication of offerees excludes individual investors from the market and forces them to invest, if at all, through venture capital firms, thus furthering the concentration of capital. The result will be a declining number of investors for speculative issues, with each such investor possessing increased market power. Whether this is a desirable result is to a large extent ignored in the discussions of reform of the securities laws.

The ultimate results of a declining number of prospective investors for new untried issuers are largely a matter of speculation at this time. Assuming that issuers are not able to find any other feasible way to raise capital for such ventures from individual investors of modest sophistication, the results point in the direction of increased barriers to entry for new enterprises in all fields of commercial and industrial activity. These barriers will either manifest themselves in some issuers being unable to interest the venture capital firms which may possess significant market power, or in some entrepreneurs selling their ideas to existing enterprises with ready access to capital rather than undertaking the arduous task of dealing with venture capitalists. Such increasing in-

Rule 146 and spread risks at the same time, a series of new venture capital firms develop which are designed primarily to purchase securities offered in Rule 146 transactions. Combining local investors in such a firm creates greater buying power, and reduces the bargaining position of the entrepreneur still further. Such concentrated market power in venture capital firms would exist not because there are not other prospective investors with funds available to place in small new enterprises, but because the cost of reaching these investors is so much higher. It may be higher because of several factors. One such factor is the cost and delay involved in registration, which in some cases may be more than the new enterprise can stand. Another reason may be the righ risk associated with the private placement, since one mistake in choice of offerees formerly meant that all purchasers had a right of rescission for one year, regardless of whether they were told the whole truth about the investment. Finally, the issuer attempting to find a large group of smaller investors faces the uncertainty that it may not be able to raise the amount of capital desired, which may mean that it will have to return the capital raised, if insufficient to mount the particular venture, or consider whether it has adequately disclosed to investors the additional risk involved if not all of the funds intended to be raised were actually raised.

dustrial concentration carries costs for all citizens, investors and consumers alike, which are not capable of precise measurement. But they are costs nonetheless, which should be recognized in any rulemaking process. Whether these costs are justified by the costs of the alternative, which involves the risk of loss in selling unregistered securities to investors of less than ideal sophistication, depends on one's views of the adequacy of other remedies present in the Securities Act, such as the fraud penalties, and one's view of the character of the American entrepreneur. Viewing Rule 146 alone, the view of the SEC seems to be that every weapon in its arsenal is necessary to protect investors, and that the cost is fully justified.

The reforms of the Act which protect investors by requiring registration do so on the basis of an ideal—a fully knowledgeable securities market where investors can compare all available alternatives and allocate their capital to the issuer most likely to succeed. The private offering exemption under Rule 146 now represents an approximation of this ideal—with both parties fully cognizant of all risks, costs and choices involved. When as in Rule 146, this ideal becomes the minimum standard for the use of an exemption, costs are imposed upon society which those imposing them have neither identified nor justified. Since perfect competition is not required in any other market, one wonders if the costs of its imposition are justified in this one instance.[183]

One other choice remains available to issuers—utilization of exemptions which require no disclosure at all—the

183. Perfect knowledge by investors is a very costly and probably unattainable goal. Obviously, such knowledge, or access to it, which presumably would be exercised by rational investors, would create more perfect competition in the capital market. As Professor Demsetz has observed:

> Knowledge cannot be disseminated nor can monopolistic elements be eliminated without cost. Complete absence of imperfections is consistent with efficiency only if the cost of accomplishing this objective is zero. Viewed this way, perfect competition is not clearly a good basis for forming public policy. Perfect competition is a sufficient condition for efficiency only in the sense that if the conditions required by perfect competition actually prevailed, then we could expect efficiency.

Demsetz, *Perfect Competition, Regulation and the Stock Market*, ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 1, at 3 (Manne ed. 1969).

intrastate exemption under Rule 147,[184] and the small offering exemption under Rule 240.[185] For at the same time the SEC has made the private offering exemption less attractive and certain for small issuers, it has added certainty and clarity to these exemptions. Their use will be treated in the second part of this article.

184. 17 C.F.R. § 230.147 (1974).
185. 17 C.F.R. § 230.240 (1974).