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PROPOSED SEC RULE 146: THE QUEST FOR OBJECTIVITY

I. Introduction

It has been estimated that the use of the private offering exemption provided for in section 4(2)[1] of the Securities Act of 1933 has proliferated to such an extent that over one-half[2] of all the securities sold in the United States are privately placed. Nevertheless, while the exemption is one of the most widely used, its parameters and availability are uncertain, so that "subjective and sometimes unreconcilable standards have developed."[3] Accordingly, the SEC has promulgated proposed Rule 146,[4] which is expressly designed to provide greater assurance to the issuer in a private placement by providing more objective standards to be used in determining the availability of the exemption. This Comment will explore Rule 146 to see how effectively the stated goal will be achieved.

II. The Pre-*Ralston* Era

The Securities Act of 1933[5] which was enacted to protect investors from existing abuses[6] in the sale of securities, effectuated its purpose by requiring

1. 15 U.S.C. § 77d(2) (1970). This section was § 4(1) in the original Act, but was renumbered § 4(2) by the Security Act Amendments of 1964, Act of Aug. 20, 1964, Pub. L. No. 88-467, § 12, 78 Stat. 565, 580, amending 15 U.S.C. § 77d(1) (1958). The exemption is officially known as "non-public offering," but alternatively referred to as "direct placement" or "private offering." See, e.g., G. Goldberg, Preface to 2 S. Goldberg, Private Placements and Restricted Securities at vii (1972) [hereinafter cited by volume as Goldberg]; Victor & Bedrick, Private Offering: Hazards For The Unwary, 45 Va. L. Rev. 869 (1959) [hereinafter cited as Victor & Bedrick].

2. Preface to 2 Goldberg at vii. It is estimated that less than 3% of all debt securities were privately placed from 1900 to 1930. Friend, Longstreet, Mendelson, Miller & Hess, Investment Banking and the New Issues Market 336-37 (1967). Since 1933, however, private placements have accounted for more than one-third of all securities issued. See, e.g., 1 Loss, Securities Regulation 689-91 (2d ed. 1961) [hereinafter cited by volume as Loss]; Steffen, Private Placements Should Be Registered, 43 N.C.L. Rev. 548, 549 (1965) (dollar value of private placements has exceeded that of registered securities in every year since 1942). Private offerings of long-term debt securities totalled more than $5 billion in each of the last 10 years and in 1964 accounted for over 66% of all long-term debt security offerings. Garrett, Private Placements, in Sale and Resale of Restricted Securities: Private Placements, Rule 146, and Clarifications of Rule 144 at 81 (1973) [hereinafter cited as Sale and Resale of Restricted Securities]. See also 4 Loss 2662 (Supp. 1969). For an extensive discussion of the advantages and disadvantages of private placements, see 1 Loss 689-96; Corey, Corporate Financing by Direct Placement, 28 Harv. Bus. Rev. 67 (1950); Mendel, Institutional Investment through Private Placement of Corporate Securities, 53 Colum. L. Rev. 804 (1953).

3. Statement of former Chairman William J. Casey accompanying the release of Proposed Rule 146 (Nov. 28, 1972), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,108, at 82,396. See Harrison, Thirty-Eight Years Without Definition—The Private Offer Exemption, 24 Ark. L. Rev. 417 (1971) (asserts that lack of clarity appears to be the strength of the Act). See also note 59 infra.

4. Proposed Rule 146, 37 Fed. Reg. 26137 (1972).

5. Act of May 27, 1933, Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77bbbb (1970)).

6. The catastrophe which followed the market crash of 1929 was the catalyst for federal

that all participants in a public offering "provide full and fair disclosure[7] of the character of securities . . . ."[8] Accordingly, section 5[9] of the Act prohibits the use of any means of interstate commerce to sell or offer to sell securities unless a registration statement has been filed with the SEC. However, this broad prohibition is tempered by the exemption of certain transactions, among them being the private offering exemption which provides that the registration requirements of section 5 shall not apply to "transactions by an issuer not involving any public offering."[10] The cryptic phrase "public offering" is not defined nor is the legislative history of much assistance in determining when an offering is "not public."[11] Indeed, the House Report surmised only that the exemption would permit "an issuer to make a specific or an isolated sale of its securities to a

regulation of the securities industry. Annual investor losses prior to 1929 were $1,700,000,000; by 1932 the total losses on stocks and bonds amounted to $93 billion. 1 Loss 119-21; Note, The Investment-Intent Dilemma in Secondary Transactions, 39 N.Y.U.L. Rev. 1043 (1964) [hereinafter cited as Investment-Intent Dilemma]. For an extensive treatment of proposed federal legislation prior to the stock market crash, see 1 Loss 107-17.

7. Once Congress did decide to legislate, there were conflicting philosophies as to what course the legislation should take. There were those who argued that any preventive law, even of an injunctive nature, would not work and would impede honest business, and that strict enforcement of penal laws would be a preferable approach. See Meeker, Preventive v. Punitive Security Laws, 26 Colum. L. Rev. 318, 328 (1926). Nevertheless, Congress, opted for preventive legislation implemented by "disclosure," strongly influenced by the work of Louis D. Brandeis, Other People's Money (1914), which viewed "publicity" as a remedy for social and industrial ills. See, e.g., 1 Loss 121-28; Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 30 (1959) [hereinafter cited as Landis]. One commentary noted that although the Act was designed to guarantee that "the truth be told" and provide penalties for its disregard, it did not and could not control the speculative craze of the American people nor make them discriminating investors. Furthermore, the material required to be disclosed would be of little value to the investor who refrains from seeking professional advice, since the content and complexity would prove incomprehensible. Thus, the Act would function only indirectly to protect the investor by preventing fraudulent transactions through disclosure and by putting more information into the hands of investment advisors which would provide a more accurate appraisal of the worth of a security. Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 171-72 (1933) [hereinafter cited as Douglas & Bates].

8. H.R. Rep. No. 85, 73d Cong., 1st Sess. 1 (1933); see 1 Loss 178, 184-86. In recommending passage of the Act, President Roosevelt stated that "[t]his proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller." H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). See also SEC v. Guild Films Co., 279 F.2d 485, 489 (2d Cir.), cert. denied, 364 U.S. 819 (1960); Lynn v. Caraway, 252 F. Supp. 858, 861 (W.D. La. 1966), aff'd, 379 F.2d 943 (5th Cir. 1967), cert. denied, 393 U.S. 951 (1968); Landis 34-35.

9. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1970). The section provides, in part: "(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; . . . ."

10. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970).

11. See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119, 122 (1953); 1 Loss 653.

particular person"[12] and that it would be available "where there is no practical need for [section 5's] application or where the public benefits are too remote."[13]

Hence, it is not easy to determine just when a transaction is "private" rather than "public." Moreover, even if the initial transaction were found to be private since there was no need for registration or the public benefits were too remote, the exemption would still fail if the purchaser executed a secondary transaction evincing a distributive intent at the time of the initial offering, and thereby became a statutory underwriter,[14] broadly defined as "any person who has purchased from an issuer with a view to . . . distribution of any security . . . ."[15] The

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12. H.R. Rep. No. 85, 73d Cong., 1st Sess. 16 (1933). This designation is too narrow in view of the explicit determination of the draftsmen, in distinguishing between a public and private offering, to provide an exemption for all sales other than "by an issuer, underwriter, or dealer . . . replacing the concept of 'isolated transactions' theretofore traditional to blue sky legislation." Landis 37; see 1 Loss 653.

13. H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933); see SEC v. Ralston Purina Co., 346 U.S. 119, 122 (1953).

14. Securities Act of 1933 § 4(1), 15 U.S.C. § 77d(1) (1970). The provision is designed to prevent the redistribution of privately placed securities, since otherwise unregistered securities would almost immediately filter into the public market. One commentator notes that even with this provision, there is still the danger that if the requisite non-distributive intent is present at the time of the original purchase, the subsequent resale is exempted regardless of the consequences to the public. Investment-Intent Dilemma 1045. See also Israels, Some Commercial Overtones of Private Placement, 45 Va. L. Rev. 851, 852 (1959) [hereinafter cited as Israels]; Victor and Bedrick 871.

15. Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1970). Since distribution and public offering are considered synonymous (H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934); Hirtenstein v. Tenney, 252 F. Supp. 827, 829 (S.D.N.Y. 1966)) an ordinary investor can become an underwriter if he acts as a conduit in the chain of transmission of securities of the issuer. See Disclosure to Investors—A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts 161-62 (1969) [hereinafter cited as The Wheat Report]; Orrick, Some Interpretative Problems Respecting the Registration Requirements Under the Securities Act, 13 Bus. Law. 369, 370 (1958). Thus, the issuer has traditionally employed devices such as the investment letter, see note 103 infra and accompanying text, and legended certificates, see note 107 infra and accompanying text, to insure that the purchasers had not taken with a view to distribution and thereby destroyed the exemption. It was generally recognized, nevertheless, that such devices were neither conclusive nor determinative of the actual intent of the investor. See, e.g., Opinion of General Counsel, SEC Securities Act Release No. 603, (Dec. 16, 1935), 1 CCH Fed. Sec. L. Rep. ¶ 2,750, at 2,678-79; SEC Securities Act Release No. 1,862 (Dec. 14, 1938), 1 CCH Fed. Sec. L. Rep. ¶ 1,533, at 2,203 (a state of mind can be measured only by evidentiary factors). Regardless of such warnings, fairly loose practices developed concerning the precautionary devices. It was generally assumed that reliance could safely be placed on the representations of the investor and that even if he "did sell, even comparatively soon the consequences were not likely to be serious or difficult to cope with." Israels 853. These assumptions were exploded in Crowell-Collier Publishing Co., SEC Securities Act Release No. 3,825 (Aug. 12, 1957), [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,539, at 80,127. There, since the issuance of common stock was impractical because of the company's poor financial record, the company privately placed $3,000,000 worth of debentures, immediately convertible into common stock, with 27 persons including four broker-dealers. Each routinely signed the

issuer must, therefore, not only comply with the standards delineated by the SEC and the courts in the initial offering, but he must further be assured that the purchaser has not taken with a distributive intent.[16] Most importantly, although guidance is scarce,[17] the issuer must act with the realization that failure to comply with either facet of the exemption can be punished criminally[18] if the violation is willful. Even if the violation is unintentional, the issuer is subject to an injunction[19] and rescission or damages.[20] Accordingly, the SEC and the

standard investment letter. By closing date, however, over one-third of the debentures had already been resold to interested investors. A similar procedure was repeated in 1956. The SEC refused to exempt the transactions, and asserted that "[a]n issuer may not establish a claim to an exemption . . . merely by collecting so-called 'investment representations' . . . if in fact a distribution . . . occurs." Id. at 80,131.

16. Furthermore, a basis for the exemption could not be established merely by "[h]olding for the six months' capital gains period of the tax statutes," until the market rose or fell, or for a year. Crowell-Collier Publishing Co., SEC Securities Act Release No. 3,825 (Aug. 12, 1957) [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,539, at 80,132; see Gilligan, Will & Co. v. SEC, 267 F.2d 461, 468 (2d Cir.), cert denied, 361 U.S. 896 (1959); Dempsey & Co., 38 S.E.C. 371, 376 (1958); Orrick, Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under the Federal Securities Act, 21 U. Pitt. L. Rev. 1, 16 (1959); cf. United States v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959). Professor Loss points out that if taken as literally true that any vague intent to resell on change of market conditions destroys the non-distributive intent, "it is difficult to see how a resale could ever be made with safety except in the event of death, bankruptcy or other personal disaster." 1 Loss 671. Recently, the SEC promulgated Securities Act Rule 144, effective April 15, 1972, which, inter alia, modified the investment intent requirement by redefining underwriter, provided that current information concerning the issuer is available, the restricted securities have been held for a specified length of time, the securities sold after the passage of the specified holding period do not exceed a given percentage, and the sale takes place as a brokerage transaction in a specified manner. 37 Fed. Reg. 597-99 (1972). For extensive discussion of Rule 144, see SEC Securities Act Release No. 5,223 (Jan. 11, 1972), [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,487, at 81,049-64; SEC Securities Act Release No. 5,087 (Sept. 22, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,909, at 80,025-28; 2 Goldberg ch. 8. See also The Wheat Report 160-247 for a discussion of the law prior to Rule 144.

17. Obtaining advice of counsel will not insure the availability of the exemption and is no defense to an action brought for failure to register the securities. Hayden Lynch & Co., SEC Securities Exchange Act Release No. 7,935 (Aug. 10, 1966), [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,402, at 82,712-20; The Wheat Report 177.

18. Securities Act of 1933 § 24, 15 U.S.C. § 77x (1970), provides in part: "Any person who willfully violates any of the provisions of this subchapter . . . shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both."

19. Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (1970), provides in part: "(b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which consitute or will constitute a violation of the provisions of this subchapter . . . it may in its discretion, bring an action . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond." The application of this injunctive power depends on whether "there is a reasonable expectation that the defendants will thwart the policy of the Act by engaging in activities proscribed thereby." SEC v. Culpepper, 270 F.2d 241, 249 (2d Cir.

courts have attempted to establish the parameters of the private offering exemption.[21]

The initial attempt at administrative construction led to the assumption that the exemption would be available if the offering were to less than a substantial number. This misconception had a basis in fact. In 1933, the Federal Trade Commission, which administered the Act prior to the creation of the Securities and Exchange Commission,[22] stated in a release that an offering would be considered public if made to a "substantial number."[23] Moreover, in 1935, the Securities and Exchange Commission proffered that "[t]he opinion has been previously expressed by this office that an offering of securities to an insubstantial number of persons . . . under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering."[24] This presumption, however,

1959). See also SEC v. Los Angelos Trust Deed & Mortgage Exch., 186 F. Supp. 830, 876 (S.D. Cal.), aff'd and modified on other grounds, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961); SEC v. Mono-Kearsarge Consol. Mining Co., 167 F. Supp. 248, 262 (D. Utah 1958).

20. Securities Act of 1933 § 12, 15 U.S.C. § 771 (1970) provides in part: "Any person who—(1) offers or sells a security in violation of § 77e of this title . . . shall be liable to the person purchasing such security from him, who may sue . . . to recover the consideration paid for such security with interest thereon, . . . upon the tender of such security, or for damages if he no longer owns the security."

21. See Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963); Woodward v. Wright, 266 F.2d 108, 115 (10th Cir. 1959); Dodd, Amending the Securities Act—The American Bar Association Committee's Proposals, 45 Yale L.J. 199, 205 (1935); Douglas & Bates 185.

22. Securities Exchange Act of 1934, Act of June 6, 1934, Pub. L. No. 291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78hh-1 (1970)).

23. FTC Securities Act Release No. 97 (Dec. 28, 1933), 1 CCH Fed. Sec. L. Rep. ¶ 1,025, at 2,054.

24. Opinion of General Counsel, SEC Securities Act Release No. 285 (Jan. 24, 1935), 1 CCH Fed. Sec. L. Rep. ¶ 2,740, at 2,676 [hereinafter cited as Release 285]. While the Commission insisted that a quantitative test, standing alone, could not be considered grounds for a private offering exemption, the assumption, nevertheless, retained vitality. See Campbell v. Degenther, 97 F. Supp. 975 (W.D. Pa. 1951), where the court, in finding a private offering, emphasized that the offering was limited to a "small number of participants." Id. at 977. (The case is criticized in 1 Loss 655 n.47, and 2 Goldberg § 2.3(c)(2)). The Supreme Court in SEC v. Ralston Purina Co., 346 U.S. 119 (1953), conclusively held that the statute would seem to apply "whether to few or many." Id. at 125 (footnote omitted). See SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830, 870 (S.D. Cal.), aff'd and modified on other grounds, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961); Repass v. Rees, 174 F. Supp. 898, 904 (D. Colo. 1959); Nash v. Lynde, [1929] A.C. 158, 169.

However, the Ralston Court softened its rejection of the numerical test by stating that "nothing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims." 346 U.S. at 125. This dictum led to the assumption that the less than 25 offerees opinion enunciated by the Commission was still a viable criterion for gauging the existence of the exemption. For example, in conjunction with the 1954 Security Act Amendments, the House Committee was tempered by the same release which noted that the existence of the private offering exemption was essentially a question of fact and that "all surrounding circumstances" must be considered in determining its availability.[25] The release delineated a number of evidentiary factors of variant importance to be used in this determination. It clearly established, for example, that it was the number of *offerees* which would be considered—not the number of actual purchasers,[26] and that the exemption would fail if the issuer could not affirmatively prove the actual number of offerees.[27] Thus, in *Corporation Trust Co. v. Logan*,[28] where an offering of open-ended voting trust certificates provided that "[a]ny present or future holder of Class 'B' Stock of the Corporation . . . may at any time become a party to this Agreement, as fully as though such holder had executed this Agreement in the first instance,"[29] the court held that the offering was public, since "the offer palpably runs to thousands of persons."[30]

The Commission also regarded as significant the relationship between the

report stated that the amount of the offering was irrelevant provided that the offering was private, "which the Commission by rule of thumb construes as being to no more than some 25 offerees." H.R. Rep. No. 1542, 83 Cong., 2d Sess. 19 (1954); see Collier v. Mikel Drilling Co., 183 F. Supp. 104, 111-12 (D. Minn. 1958); 1 Loss 661; Orrick, Some Observations on the Administration of the Securities Laws, 42 Minn. L. Rev. 25, 33 (1957). However, this assumption was again restrained in Gilligan, Will & Co. v. SEC, 267 F.2d 461, 467 (2d Cir.), cert. denied, 361 U.S. 896 (1959), and Dempsey & Co., 38 S.E.C. 371, 376 (1958). In both cases, although the exemptions were clearly lost on other grounds, the courts explicitly rejected the contention that, even after Ralston, a quantitative test was a viable contention. See 4 Loss 2644 (Supp. 1969); D.F. Bernheimer & Co., 41 S.E.C. 358, 363 (1963); Advanced Research Associates, Inc., 41 S.E.C. 579, 587-91 (1963); SEC Securities Act Release No. 4,552 (Nov. 6, 1962), 1 CCH Fed. Sec. L. Rep. ¶ 2,771, at 2,683-84 [hereinafter cited as Release 4,552]. Nevertheless, courts have continued to consider the number of offerees as a relevant factor in determining the existence of the private offering exemption. See also Hirtenstein v. Tenney, 252 F. Supp. 827, 830 (S.D.N.Y. 1966); Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,970 n.14 (S.D.N.Y. 1965).

25. See Release 285, at 2,676; SEC v. Ralston Purina Co., 346 U.S. 119, 126 n.12 (1953); Woodward v. Wright, 266 F.2d 108, 115 (10th Cir. 1959); Release 4,552, at 2,683.

26. Release 285, at 2,676. The Commission noted that an "offer" was not limited to formal proposals in an attempt to procure firm commitments, but included any attempt to dispose of the security; thus, any preliminary conversations with prospective purchasers might constitute a public offering. Id. Release 4,552, at 2,684 ("general solicitations" constitute an offer); 1 Loss 655-56.

27. In Repass v. Rees, 174 F. Supp. 898 (D. Colo. 1959), the court noted that although the issuer affirmatively proved there were only 13 actual purchasers, it was still a public offering since it was incumbent on the issuer to prove the actual number of offerees; this not having been done, "they must suffer the consequences." Id. at 904. See, e.g., Henderson v. Hayden, Stone Inc., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,504, at 92,436-38 (5th Cir. 1972); Nicewarner v. Bleavins, 244 F. Supp. 261, 265 (D. Colo. 1965).

28. 52 F. Supp. 999 (D. Del. 1943).

29. Id. at 1001. Voting trust certificates are within the Act's broad definition of securities. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1970).

30. 52 F. Supp. at 1002.

issuer and the offerees prior to the offering. "Thus, an offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage."[31] Although the underlying rationale of this distinction is that such a class is more likely to have greater knowledge of the business affairs of the offeree, the fact that the transaction was between "friends and acquaintances" has been given independent significance by the courts.[32]

Also considered significant factors were the size of the offering[33] and the number of units offered,[34] since if the offering were large or the units were in small denominations, there would be an increased probability of public distribution. Lastly, since it was believed that private offerings would be limited to

31. Release 285, at 2,677; Release 4,552, at 2,683. Thus, if the offerees are strangers prior to the transaction, an implication is raised against the availability of the exemption. See Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971); Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969); 2 Goldberg § 4.1(d). The manner of selecting the offerees is significant. An offering to a comparatively large class, determined by some pre-existing standard, would more likely be private than the same offering to an even smaller class selected at random or without an ostensible standard. See Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971).

32. In Campbell v. Degenther, 97 F. Supp. 975, 977 (W.D. Pa. 1951), the court noted that the transaction was a "close-knit arrangement among friends and acquaintances on a purely personal basis . . . ." Id.; accord, Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963); Woodward v. Wright, 266 F.2d 108, 115 (10th Cir. 1959). See also Mulford, Private Placements and Intrastate Offerings of Securities, 13 Bus. Law. 297, 300-01 (1958). However, it should not be assumed that a close relationship will in and of itself guarantee the exemption. In Republic Cement Corp., 38 S.E.C. 19, 26 (1957), the Commission held the exemption not available even though the offerees were friends and acquaintances, since they were a diverse group, and had no special means of informing themselves about the issuer. Factors such as scattered location tend to negate the inference of a close relationship (Edwards v. United States, 374 F.2d 24, 25 (10th Cir. 1966), cert. denied, 389 U.S. 850 (1967)), and diverse occupations can be indicative of an offering open to the general public (Chapman v. Dunn, 414 F.2d 153, 160 (6th Cir. 1969)).

33. Release 285, at 2,677; Release 4,552, at 2683. See also Shimer v. Webster, 225 A.2d 880, 884 (D.C. App. 1967); Crowell-Collier Publishing Co., SEC Securities Act Release No. 3,825 (Aug. 12, 1957), [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,539, at 80,127-31.

34. Release 285, at 2,677. The Commission believed that the exemption was intended to be applied chiefly to small offerings, which by their nature are less likely to be public. However, the dollar value of the offering as a significant factor was deemphasized in a later release which distinguished the institutional and non-institutional investor, the dollar value being tangentially relevant only to the latter category. Release 4,552, at 2,684. The courts likewise have ignored the size of the offering. See United States v. Leslie Salt Co., 350 U.S. 383 (1956) ($4,000,000); Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,953 (S.D.N.Y. 1965) ($3,246,000); Fuller v. Dilbert, 244 F. Supp. 196 (S.D.N.Y. 1965), aff'd per curiam sub nom. Righter v. Dilbert, 358 F.2d 305 (2d Cir. 1966) ($1,000,000). On the other hand, a quantitatively small offering does not guarantee that it is private. See 2 Goldberg § 2.2(b). But see Campbell v. Degenther, 97 F. Supp. 975, 978 (W.D. Pa. 1951); 1 Loss 655 n.47.

situations "wherein the issuer desires to consummate a few transactions with particular persons,"[35] the Commission stated that transactions by direct negotiations are more likely to be non-public,[36] and public advertising would be incompatible with the claim of a private offering.[37]

In theory, at least, the "surrounding circumstances" test provided flexible and objective standards for determining the existence of the exemption.[38] However, as the test evolved, the predominant factors examined by the courts were the number of offerees[39] and their relationship to the issuer,[40] and neither were sufficiently clear to give any assurance to the issuer desiring to transact a private offering. For example, in *SEC v. Sunbeam Gold Mines Co.*,[41] the SEC sought an injunction against the offering of the defendant company, which had entered into an agreement to purchase all the assets of Golden West Consolidated Mines. While the agreement was pending, the defendant company solicited pledge loan agreements from the 530 existing stockholders of both companies for the purpose of completing the purchase.[42] The defendant contended that "public" meant "an offer to everyone," and since the present offer was limited to existing shareholders, it was a private rather than a public offering.[43] The court rejected the contention, and stated that:

> 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 . . . bear no sensible relation to the purposes for which the selection is made.[44]

While the "sensible relation" test developed by the court in *Sunbeam* provided protection for the offerees in the sense that the issuer could not establish arbitrarily a "class" of offerees in order to make the offering private, on closer analysis it was clear that the protection was not broad enough.[45] Within the case itself, for example, it was certainly arguable that existing stockholders bore a "sensible relation" to the purpose for which the selection was made; perhaps the court would have found a private offering if the offering had been limited to only stockholders of the existing company. Nevertheless, this relationship would by no means indicate that the offerees were such that they did not need the dis-

35. Release 285, at 2,677.

36. Id.

37. Release 4,552, at 2,685. While public advertising defeats the claim of the exemption, lack of it does not insure its availability. See, e.g., Republic Cement Corp., 38 S.E.C. 19, 26 (1957).

38. The criteria delineated are objective in that the intent of the issuer is irrevelant. If the requisite relationship was lacking or public advertising was employed in disseminating the information, then the claim would be defeated regardless of the intent of the issuer. See Investment-Intent Dilemma 1048.

39. See note 23 supra and accompanying text.

40. See note 31 supra and accompanying text.

41. 95 F.2d 699 (9th Cir. 1938).

42. Id. at 700.

43. Id. at 701.

44. Id.

45. See Investment-Intent Dilemma 1049.

closure protection of the Act. Finally, in 1953, the Supreme Court attempted to shed light on the elements necessary to constitute a private offering in *SEC v. Ralston Purina Co.*[46]

III. *Ralston Purina:* ACCESS AND FENDING FOR THEMSELVES

Ralston Purina Company had nearly 7,000 employees scattered throughout the United States and Canada.[47] Consistent with the company's policy of encouraging stock ownership among its employees, between 1947 and 1951, the company issued nearly $2,000,000 worth of unregistered securities[48] until enjoined by the SEC. While admitting that an offering made indiscriminately to all employees would be a public offering, the company contended that the present offering was within the confines of the exemption since it was made solely to "key employees,"[49] among them being those with duties of artist, foreman, copywriter, electrician, clerk, production trainee and veterinarian. The Court rejected the company's classification of key employees,[50] and held that the private offering exemption should be interpreted in light of the statutory purpose of the Act—the protection of investors through the disclosure of all information necessary for an informed investment decision.

> Since exempt transactions are those as to which "there is no practical need for [the bill's] application," the applicability of § 4(1) [now § 4(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."[51]

The Court concluded that since the exemption "turns on the knowledge of the offerees,"[52] they must be "shown to have access to the kind of information which registration would disclose."[53]

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46. 346 U.S. 119 (1953).

47. Id. at 120-21. The Court noted that the offerees "lived in over fifty widely separated communities." Id. at 121. See note 32 supra and accompanying text.

48. 346 U.S. at 121.

49. Id. Key employees meant those within the organization that influenced and advised others, had special responsibilities, were sympathetic to management, and were likely to be promoted. Id. at 122.

50. Id. at 126-27. Thus, corporate employees, as a class, would not be deprived of the protection of the Act in the absence of a position giving them access to the same information that registration would disclose. In 1934 a legislative proposal to this effect was defeated. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934). The Commission had noted that an offering to a class with special knowledge would be less likely to be public, particularly a class of high executive officers. Release 285, at 2,677. See also Release 4,552, at 2,684. Once a special relationship has been established, the offering may be made to a larger group. See 1 Loss 657-59.

51. 346 U.S. at 125, quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933); see Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir.), cert. denied, 361 U.S. 896 (1959).

52. 346 U.S. at 126.

53. Id. at 127. Some confusion has been engendered by the fact that the Court mentioned both the "registration statement" and "registration" in its discussion of the "access" require-

While presumably the evidentiary factors previously delineated by the Commission are still significant,[54] the "needs test" enunciated in the *Ralston* decision has become the fundamental standard for determining the availability of the exemption. Under this test, there clearly can be no broad classification of offerees, such as employees[55] or stockholders,[56] since while some of them may be able to "fend for themselves," others may need the protection afforded by the Act. However, the "needs test" belies easy application, since the Court introduced, but left undefined, the concepts of "access" and "fending for themselves."[57] It is not clear, for example, whether the position of the offerees was a necessary element

ment. See id. at 125-27. However, the registration statement provides more extensive information than would be provided if the securities were registered. Compare Schedule A, 15 U.S.C. § 77aa (1970), with the statutory prospectus, § 10(a)(1), 15 U.S.C. § 77j(a)(1) (1970), which provides that some information contained in Schedule A need not be included. This confusion has not been clarified in subsequent releases. See, e.g., Silver Shield Mining & Milling Co., 39 S.E.C. 766, 769 (1960) (registration statement); Cameron Indus. Inc., 39 S.E.C. 540, 546 (1959) (prospectus). Nor have the courts been consistent in deciding what degree of information is required. See, e.g., Katz v. Amos Treat & Co., 411 F.2d 1046, 1054 (2d Cir. 1969) (registration); United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir.), cert. denied, 389 U.S. 850 (1967) (Schedule A). See also Sargent, Private Offering Exemption, 21 Bus. Law. 118, 119-20 (1965), wherein the author contends that "no matter what information an issuer may supply to any investor, absent registration, it could not possibly be comparable to that which comes out of the registration process." Id. at 120.

54. See Patton, The Private Offering: A Simplified Analysis of the Initial Placement, 27 Bus. Law. 1089 (1972), wherein Patton contends that the availability of the exemption is established by proof that the offerees are sophisticated, have access to the information, and have taken with the proper investment intent. However, the courts have mistakenly applied the "surrounding circumstances" test directly to the availability of the exemption rather than as evidentiary factors with the result being "uncertainty, complexity, and irrationality where a meticulous, reasoned approach is required." Id. at 1104. Patton recommends that the Commission rescind Release 285 since it has been a source of confusion rather than clarification. Id. at 1105.

55. The decision turned on the fact that the employees were not shown to have access to the kind of information which registration would disclose. "The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with § 5." 346 U.S. at 127.

56. The number of offerees permissible in stockholder offerings has generally been large, since they are members of a particular class. However, the relationship is not a substitute for furnishing the requisite information, unless there is a correlation between the position and access to the information. 2 Goldberg § 4.2(b); see SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 702 (9th Cir. 1938) (offering to existing stockholders held public). The lack of correlation was evident in Robinette & Co., SEC Securities Act Release No. 7,386 (Aug. 11, 1964), [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,118, at 82,057, where the offerees, although existing stockholders, had no special relationship to the issuer, lacked sophistication, and were "woefully lacking in knowledge of the issuer's affairs." Id. at 82,058.

57. See Israels 852-53. The statute was challenged as unconstitutionally vague in United States v. Crosby, 294 F.2d 928, 952 (2d Cir. 1961), cert. denied, 368 U.S. 984 (1962). The court conceded that the statute might have previously been challenged, but the judicial gloss placed on the legislation in Ralston Purina cured any defect. 294 F.2d at 952.

of access, or whether offerees could "fend for themselves" independently of access because of their bargaining power and sophisticated business experience. Furthermore, it was not clear whether the access requirement imposed a duty to actively disclose the information, or merely make it available.[58] Subsequent courts, therefore, have attempted to establish the meaning as well as relationship of these terms.[59]

The fact that the *Ralston* standards were not clearly understood was demonstrated in *Garfield v. Strain.*[60] There, an experienced geologist, in order to raise money for the drilling of a test well, undertook to sell fractional interests in the oil and gas leases. Garfield, who admitted that he was "not even an ignoramus in matters pertaining to the oil business,"[61] entered into a contract to purchase a one-half interest in the leases, and the issuer sent him geological maps and other data pertaining to the leases. When the proposed test well was subsequently found to be dry, Garfield refused to pay the contract price since he contended the offering was public. The Tenth Circuit Court of Appeals held that it was a private offering, since the defendant had wide business experience, including ownership of oil stocks, and " '[t]he close relationship and past dealings between plaintiffs and . . . the defendant, refutes a claim that there was a public offering involved . . . .' "[62]

Although the court expressed allegiance to the *Ralston* decision, the reasoning used by the court seems antithetical. It was expressly shown that the offeree was unsophisticated and that the information supplied was both unintelligible to the offeree and certainly not as extensive or of a kind that would be supplied if registration were required. Nevertheless, the court concluded that the offeree was "in a class not needing the protection of the Act."[63] However, since the exemption turns on the knowledge of the offerees, it is anomalous that a "close relationship," absent either sophistication or access, could presumptively be a substitute for the protection that registration provides.[64]

The first analysis of the *Ralston* "access" standard was supplied by the Second Circuit Court of Appeals in *Gilligan, Will & Co. v. SEC.*[65] There, Gilligan, Will & Co., which had been suspended from membership in the National Association

58. Compare Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,953, 94,970 (S.D.N.Y. 1965), with Lively v. Hirschfield, 440 F.2d 631 (10th Cir. 1971); United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969).

59. See generally Harrison, Thirty-Eight Years Without Definition—The Private Offering Exemption, 24 Ark. L. Rev. 417 (1971); Orrick, Some Observations on the Administration of the Securities Laws, 42 Minn. L. Rev. 25 (1957); Victor & Bedrick 869.

60. 320 F.2d 116 (10th Cir. 1963).

61. Id. at 119 n.3.

62. Id. at 119.

63. Id.

64. Cf. Woodward v. Wright, 266 F.2d 108, 115 (10th Cir. 1959) (on-sight inspection and apparent "sophisticated discernment" satisfied the requirements of the Act); Vicioso v. Watson, 325 F. Supp. 1071 (D. Cal. 1971) (offering to two doctors who had no prior experience in oil speculation). See also Patton, The Private Offering: A Simplified Analysis of the Initial Placement, 27 Bus. Law. 1089, 1090-92 (1972).

65. 267 F.2d 461 (2d Cir.), cert. denied, 361 U.S. 896 (1959).

of Securities Dealers, Inc., for five days because of its participation in distributing the shares of Crowell-Collier Publishing Co., petitioned for review of the suspension, claiming, *inter alia*, that the offering was private.[66] Although there had been a stipulation of fact that they " 'were not supplied with material information . . . nor were the purchasers in such a relation to the issuer as to have access to such information,' "[67] the company argued that the definition of *Ralston* was not exclusive, and that since there were only four actual purchasers, the offering was private. The court rejected the argument that a quantitative limit could determine the existence of the exemption, and stated that "the additional stipulated facts . . . concedes the very proposition of which the petitioners had to establish the negative . . . ."[68] The court held that the standard in determining the existence of the claimed exemption was "whether the persons to whom the offering is made are in such a position with respect to the issuer that they either actually have such information as a registration [*sic*] would have disclosed, or have access to such information."[69]

Although the *Ralston* decision focused only on whether the offerees had access, the inclusion of the "actual possession" classification by the court in *Gilligan*, was a justified interpretation since the exemption turns on the knowledge of the offerees.[70] This access-knowledge distinction was reiterated in *SEC v. Tax Service, Inc.*,[71] where the company made the offering to purchasers of its tax calculators and of its publications. The court noted that since the exemption turns on the knowledge of the offerees, where they have "neither knowledge of nor 'access to the kind of information which registration would disclose,' the offerees are in need of the protection of the Act . . . ."[72]

Thus, the "access" standard could be satisfied where the offerees are shown either to actually have the requisite information,[73] or have access to it. However,

66. Id. at 463, 467.

67. Id. at 466.

68. Id.

69. Id. But see Nicewarner v. Bleavins, 244 F. Supp. 261, 265 (D. Colo. 1965), wherein the court reasoned that although the Ralston decision appeared to make registration optional, "the seller must show that all offerees are given the information which a registration statement would make available or that they did not need this protection." Id. at 265. Although the court found a public offering due to failure of proof on the number of offerees, the court read the Ralston standards in such a way that a showing of either access or, in the alternative, sophistication, would justify the claimed exemption. Id.; accord, Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,953 (S.D.N.Y. 1965). Contra, Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971).

70. See 2 Goldberg § 2.4(c)(2).

71. 357 F.2d 143 (4th Cir. 1966).

72. Id. at 144.

73. See Dempsey & Co., 38 S.E.C. 371, 375 (1958), where the court emphasized that the offerees were neither in a position to have access, nor did they receive the requisite information. See also Hazel Bishop Inc., 40 S.E.C. 718, 730 (1961); Crowell-Collier Publishing Co., SEC Securities Act Release No. 3,825 (Aug. 12, 1957), [1957-1961 Transfer Binder]

it is not clear what position one would have to occupy to have access. Moreover, simply furnishing the offerees with the requisite information would not guarantee that the offering was private. The Commission noted that "[s]uch a construction would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards and sanctions of the Act."[74]

Assuming that one had the requisite position, and had either actual possession of the information or at least potential access, it was still questionable whether the "fending for themselves" language of *Ralston*[75] implied a standard separate and distinct from access.[76] For example, could a class of offerees, because of their sophisticated business experience and bargaining power enabling them to demand and receive all the information for an informed investment decision, be judged capable of "fending for themselves," independently of any prior relationship or a determination of access? Furthermore, it was unclear whether a showing that the information was indeed available, although not actually transmitted, would justify the claimed private offering exemption.

These questions were explored in *Value Line Fund, Inc. v. Marcus*.[77] There, five mutual funds purchased more than $3,000,000 worth of unregistered securities. When approximately one year later the market price of the securities collapsed, the purchasers brought a rescission action, claiming that they lacked a position giving access to the information and had not, in the alternative, actually received it, and were therefore incapable of making an informed investment decision.[78] The court found that the offering was private, and based its decision on the sophistication of the offerees, mature businessmen who had participated in an arm's length transaction. The court stated that they were sophisticated enough to demand and had enough leverage to receive all the information necessary.[79]

CCH Fed. Sec. L. Rep. ¶ 76,539, at 80,127-30; cf. SEC v. Continental Tobacco Co., 463 F.2d 137, 159 (5th Cir. 1972).

74. Release 4,552, at 2,684. Goldberg asserts that the statement logically means that a voluntary furnishing of information will not, in and of itself, automatically make the exemption available. "However, when the other elements of a private placement have been satisfied, the offerees must then have access to, or be supplied with, the required information." 2 Goldberg § 2.4(c)(1). But see text accompanying note 122 infra.

75. 346 U.S. 119, 125 (1953).

76. See Israels 852-53.

77. [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,953 (S.D.N.Y. 1965).

78. Id. at 94,955. During the course of negotiations, Value Line informed the issuer that their agents were in possession of all public information. Relying on this representation, the issuer supplied no information. Id.

79. Id. at 94,970; accord, Fuller v. Dilbert, 244 F. Supp. 196, 206, 212 (S.D.N.Y. 1965), aff'd per curiam sub nom. Righter v. Dilbert, 358 F.2d 305 (2d Cir. 1966). There, seasoned investment bankers, who had agreed to act as guarantors of a private placement, brought a contract rescission action claiming that there had been oral misrepresentations concerning the financial condition of the company. The court affirmed the contract, finding it incredible that sophisticated investors, if in fact such a representation had been made, would have participated in the transaction without requiring that the representations be reduced to writing.

The fact that they failed to investigate properly "cannot be twisted into any valid claim that [they] did not have access to information and were not in a position to fend for themselves."[80]

While the offerees in *Value Line* were institutional investors, which have always been viewed favorably in private placements,[81] the decision stands for the proposition that if the offerees are a class which can "fend for themselves" then nothing else need be shown to justify the claimed exemption.

However, the *Value Line* analysis is contrary to that in *Gilligan, Will & Co.*, wherein it was noted that the *Ralston* language "does not support the view that the availability of an exemption depends on the sophistication of the offerees or buyers, rather than their possession of, or access to, information,"[82] and was not applied to individual investors in *United States v. Custer Channel Wing Corp.*[83] There, the issuer contended that although none of the purchasers of the stock had access to the information, the exemption was still available since all the purchasers were mature businessmen and sophisticated investors, and thus could fend for themselves.[84] The court rejected the contention and cited *Ralston* for the proposition that " 'sophistication' is not a substitute for 'access to the kind of information which registration would disclose.' "[85]

80. [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,970 (S.D.N.Y. 1956). The court noted, in dictum, that a contrary conclusion would limit the availability of the private offering exemption to only key employees of the issuer who would possess or have access to the requisite information. Id.

81. The Commission has shown a clear preference for institutional investors in private placements, since they are clearly a class which is highly sophisticated and able to fend for themselves. Indeed, a member of the original commission which formulated the Act noted that "[t]he sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government." Landis 37; accord, Orrick, Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under the Federal Securities Act, 21 U. Pitt. L. Rev. 1, 11 (1959); Victor & Bedrick 871-72. Nevertheless, while the institutional investor sometimes demands more information than even the SEC, and offerings to them are rarely overturned, they are still subject to the criteria delineated in Ralston. See Gilligan, Will & Co., 38 S.E.C. 388, 393 (1958), aff'd, Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), cert. denied, 361 U.S. 896 (1959). Given this anomaly, many authorities have suggested that the Commission unequivocally provide that all sales to banks, insurance companies, and other institutional investors constitute exempt transactions under section 4(2) of the Act. See Victor & Bedrick 883. See also ALI Fed. Sec. Code § 242 (Tent. Draft No. 1, 1972).

82. 38 S.E.C. 388, 393 (1958), aff'd, Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), cert. denied, 361 U.S. 896 (1959); see note 67 supra and accompanying text.

83. 376 F.2d 675 (4th Cir.), cert. denied, 389 U.S. 850 (1967).

84. Id. at 678; see Collier v. Mikel Drilling Co., 183 F. Supp. 104, 112 (D. Minn. 1958) (investment experience in the specialized area of fractional shares in oil leases equivalent to being able to fend for themselves). However, prior investment experience, even in connection with previous private placements, does not replace the right to receive the requisite information.

85. 376 F.2d at 678. In Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971), the court stated that "[o]bviously if the plaintiffs did not possess the information requisite for a registration statement, they could not bring their sophisticated

Finally, in *Lively v. Hirschfeld*,[86] the Tenth Circuit Court of Appeals coalesced the concepts of "access" and "fending for themselves." There, the defendant sold some 8,000 shares from 1967 through 1968. One of the plaintiffs, an airline pilot with considerable business experience, testified that he was told the bare essentials of the corporate structure, and since he had asked for no further information, it could not be said that any was withheld. Furthermore, he made the purchase only after "considered business judgment."[87] The court held that the offering was public, and stated that "[t]he Supreme Court in its description of a possible 'private' group in Ralston Purina includes only persons of exceptional business experience [sophisticated], and 'a position where they have regular access to all the information and records . . . .' "[88]

Thus, the standards of "access" and "fending for themselves" have proved evasive, and neither their meaning nor their relation to each other have been sufficiently clarified. Under the access standard, the issuer must determine whether the offeree is in such a position that he has access to the information, or in the alternative, whether information should be supplied.[89] Arguably, the issuer can presume that the offeree has access in at least two situations. On the one hand, where the offeree has a "special relationship," which is at least more than being a mere employee or stockholder, it can be presumed that by virtue of his corporate position he has access to the information. However, since this special relationship has not been objectively defined, and the exemption is to be strictly construed, reliance on this presumption, except in the clearest of cases, would be ill-advised, since the relationship might not support the presumption. On the other hand, the presumption that the offeree has access to the information has rarely been questioned when the offeree is an institutional investor, since "[t]hey are quite able to satisfy themselves as to what they are getting into before putting their money down."[90] In other situations, the issuer must employ the alternative, a determination of whether the information should be supplied, and be capable of showing that the offerees actually have the information necessary for an informed investment decision. Merely opening the corporate books or relying on the fact that the offerees desired no further information will not meet this burden of proof. Moreover, voluntarily supplying the information will not guarantee the exemption, since there must be some relationship between the parties prior to making the offering. Thus, it is clear that the difficulty is most acute when dealing with individual offerees, since the issuer must subjectively

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knowledge of business affairs to bear in deciding whether or not to invest . . . ." Id. at 690. See United States v. Hill, 298 F. Supp. 1221, 1228 (D. Conn. 1969) (no investor is per se sophisticated and can fend for himself only if he has access to the information). One author notes that while there is a wide split of authority on the significance of sophistication, the lack of it places a heavier burden on the issuer to supply all the required information. 2 Goldberg § 4.1(b).

86. 440 F.2d 631 (10th Cir. 1971).

87. Id. at 632.

88. Id. at 633; see 1971 Duke L.J. 1017, 1020-23.

89. See notes 65-70 supra and accompanying text.

90. Victor & Bedrick 872.

determine both how much information is necessary and whether the relationship is such as to justify the claim of the exemption.

The "fending for themselves" standard, which is synonymous with "sophistication," has proved no less confusing. The difficulty does not present itself when the offeree is an institutional investor, since, as with access, it can safely be presumed "sophisticated."[91] Apart from institutional investors, however, one cannot be sure of what the phrase actually means, since it has been used in two different senses. On the one hand, it has been stated that no one is per se sophisticated without access to the information.[92] As used in this sense, the term simply means that access is a prerequisite to sophistication, and an independent inquiry of sophistication would be unnecessary. On the other hand, it has been stated that sophistication is not a substitute for access[93] and that one must be shown to have access *and* be sophisticated.[94] In this sense, the phrase has significance independent of the offering and even of the access requirement. It implies that an individual deciding to partake in a private offering, by virtue of his education, business acumen and prior investment experience, etc., will arguably be able to understand and evaluate the information, enabling him to make an informed investment decision. Hence, the issuer would have to prove that the offeree had "access," and in addition, that he could "fend for himself." In either situation, however, the overriding consideration is whether there exists the elusive relationship which would justify relying on the exemption in the first instance. This consideration was explored in the following decision of the Fifth Circuit Court of Appeals.[95]

IV. *Continental Tobacco:* AN ANOMALY?

A. *The Decision*

Continental Tobacco Co. was incorporated in 1965 under the laws of South Carolina for the purpose of engaging in the manufacturing and sale of cigarettes.[96] To secure new financial support, the company attempted to sell various unregistered securities. Numerous meetings, which were described as " 'boiler room operation[s],' "[97] were held with prospective purchasers. Since the offerees were a diverse group, and many lacked both access and sophistication, the 1967 offering

91. Value Line Fund Inc. v. Marcus, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,970 (S.D.N.Y. 1965).

92. United States v. Hill, 298 F. Supp. 1221, 1228 (D. Conn. 1969); Patton, The Private Offering: A Simplified Analysis of the Initial Placement, 27 Bus. Law. 1089, 1094 (1972) (asserting that the Hill analysis is counter-productive since it combines two separate tests, i.e., the test of access and the test of sophistication).

93. See Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971).

94. Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971).

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

96. Id. at 142-43.

97. Id. at 143. The term connotes a high pressure effort in which deceptive tactics are used to increase investor interest.

was temporarily enjoined as a violation of section 5 of the Act.[98] Subsequent to bankruptcy and a change of management, Continental in 1969-1970 again sought financing through the issuance and sale of unregistered securities,[99] and in an 18 month period raised approximately $140,000 through the sale of the securities to 35 of the 38 persons contacted. Since virtually the same tactics as used in 1967 were again employed, the SEC sought to have the temporary injunction made permanent pursuant to section 20(b) of the Securities Act of 1933.[100] The district court, however, held that the offering was private, and, therefore, exempt from registration.[101] Reversing, the Fifth Circuit Court of Appeals held that the district court's finding was induced by " 'an erroneous view of the law.' "[102] The court noted that Continental, in order to lay the groundwork for the private offering exemption,[103] drafted a standard investment letter to be signed by all the offerees, stipulating, *inter alia*, that the shares were being acquired for investment only, and that their present intention to hold the securities was unconditional[104] so that only an unforeseen change in circumstances would justify distribution,[105] which, in any event, would not be undertaken without first obtaining an opinion of counsel on the legality of the distribution.[106] The investment letter also stated that each offeree understood the nature of the investment and the risks involved, had received a prospectus and an unaudited financial statement, and that no further questioning of the officers of the company or further information was necessary to make an informed investment decision. Continental also issued a brochure and placed a legend on the certificates of

98. Id. at 145; 15 U.S.C. § 77e (1970). See note 9 supra and accompanying text.

99. 463 F.2d at 146.

100. 15 U.S.C. § 77t(b) (1970). See note 19 supra and accompanying text.

101. SEC v. Continental Tobacco Co., 326 F. Supp. 588 (S.D. Fla. 1971), rev'd, 463 F.2d 137 (5th Cir. 1972). Apparently, the court arrived at this conclusion because almost all of the investors executed an investment letter, received and had access to additional information, had personal contact with the officers of Continental, intended to hold the stock as an investment, knew the risk, and had the experience necessary to make an informed decision. Id. at 589-91.

102. 463 F.2d at 157; see United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948); Chaney v. City of Galveston, 368 F.2d 774, 776 (5th Cir. 1966).

103. 463 F.2d at 146; see note 15 supra and accompanying text. Although the investment letter may indeed be a meaningless recital, failure to provide for it can be deemed as disregarding the significance of investment intent. The Wheat Report 171-72.

104. 463 F.2d at 146 n.1. Since the intent at the time of the original purchase is a question of fact, an expressed limitation on resale, whether for a stated period of time or under certain circumstances, "would tend to raise a question as to the original intent . . . ." Release 4,552, at 2,685; Batkin & Co., 38 S.E.C. 436, 447 n.24 (1958); note 16 supra and accompanying text.

105. 463 F.2d at 146 n.1. The non-distributive intent cannot be conditioned on any external event. See Advanced Research Associates, Inc., 41 S.E.C. 579, 588 (1963); note 16 supra and accompanying text.

106. 463 F.2d at 146-47 n.1. This device is designed to insure the issuer some control over the distribution of the securities; it should specify that it is the attorney of the issuer that must be consulted. See Petrillo v. Seven Arts Productions, Ltd., [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,921, at 96,171 (N.Y. Sup. Ct. 1967).

stock which provided that the shares "may not be sold, transferred, pledged, or hypothecated."[107] However, the record revealed that not all of the purchasers had signed or even seen the investment letter.[108] More importantly, however, the measures employed by Continental were precautions only,[109] and would not establish the existence of the exemption " 'in the absence of proof that the purchasers actually had access to the kind of information that a registration statement would have disclosed.' "[110] Moreover, since the Act was remedial legislation for the protection of investors,[111] the exemption would be strictly construed[112] and persons claiming it would have to prove[113] its existence by exact and explicit evidence.[114] While the SEC had established a prima facie case,[115] the court noted that Continental had failed to prove the exact number of offerees,[116] and that the actual purchasers lacked any nexus among themselves or relationship to the company, since many had never met the officers of Continental prior to their purchase of the securities.[117] Under these circumstances, the court concluded that even if all the offerees had been provided with the requisite information, this fact alone would not insure the exemption; it would not establish the necessary relationship that must exist between the issuer and the offerees.[118]

107. 463 F.2d at 147. This type of restriction, while only a precaution, is encouraged by the Commission. See, e.g., Cameron Indus., Inc., 39 S.E.C. 540, 546 (1959); Release 4,552, at 2,685. Furthermore, the absence of such a restriction might imply that the intention of the purchasers was not bona fide. See United States v. Kelly, 349 F.2d 720, 733 (2d Cir. 1965), cert. denied, 384 U.S. 947 (1966).

108. 463 F.2d at 150-53.

109. Id. at 160; see notes 15-16 supra and accompanying text.

110. 463 F.2d at 160, quoting United States v. Custer Channel Wing Corp., 376 F.2d 675, 679 (4th Cir.), cert. denied, 389 U.S. 850 (1967); Release 4,552, at 2,685.

111. 463 F.2d at 155; see A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38 (1941); SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), cert. denied, 364 U.S. 819 (1960).

112. 463 F.2d at 155. See, e.g., Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 689 (5th Cir. 1971); Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971).

113. 463 F.2d at 156. The burden of proof has been placed uniformly on the one claiming the exemption. See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953); Chapman v. Dunn, 414 F.2d 153, 159 (6th Cir. 1969); Advanced Research Associates, Inc., 41 S.E.C. 579, 587-88 (1963).

114. 463 F.2d at 156. See Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971); Repass v. Rees, 174 F. Supp. 898, 904 (D. Colo. 1959).

115. 463 F.2d at 155-56. The essential elements of a prima facie case are that (1) no registration was in effect, (2) the defendant sold or offered to sell unregistered securities, and (3) interstate facilities were used. Id. at 155. See Lennerth v. Mendenhall, 234 F. Supp. 59, 63 (N.D. Ohio 1964); 3 Loss 1693.

116. 463 F.2d at 161; see note 26 supra and accompanying text.

117. 463 F.2d at 158. Not all of the offerees, who were, inter alia, dentists, physicians, and housewives, had even seen the prospectus or had any occasion to meet the officers of Continental.

118. Id. at 160; see Release 4,552, at 2,684; 4 Loss 2632 (Supp. 1969).

B. *Analysis*

It is clear that the Continental offering violated the Securities Act[119]—the offerees lacked sophistication as well as access. However, the court, in relying heavily on *Hill York Corp. v. American Int'l Franchises, Inc.*,[120] and on the brief of the SEC, defined the requisite "relationship" in such a way as to deny the exemption in many financings where it had been thought to be available. The court stated that the exemption would be available only 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 . . . .[121]

The SEC brief further opined that:

Before the statutory protections may be safely eliminated in any case, the issuer must affirmatively demonstrate . . . that *each* person to whom the 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. This type of offeree through his own knowledge, sophistication and unfettered access to the citadels of corporate power and decision-making can protect himself; he does not require the protections of the Act . . . .[122]

The brief also noted that the fact that the officers felt it necessary to disseminate information in a prospectus "tends to demonstrate that its offerees were not knowledgeable or sophisticated and that they lacked meaningful access to corporate information."[123] Moreover, the fact that the investors relied on an attorney demonstrated unfamiliarity with the company,[124] since there "is no substitute for a direct relationship giving the investor first-hand access to corporate information."[125]

Combining the "tantamount to an insider" language of the SEC brief with the "privileged relationship-present knowledge" test promulgated by the court, the result would seem to require that the relationship be such that, independently of the offering, the offeree has a right, by virtue of his position, to demand and have access to the information. This interpretation is feared by some as signalling the end to the traditional interpretation of the private offering

119. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1970); see note 9 supra and accompanying text.

120. 448 F.2d 680 (5th Cir. 1971).

121. 463 F.2d at 159 (emphasis added), quoting Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 n.6 (5th Cir. 1971).

122. Brief for Appellant at 28 (emphasis added in part) (footnote omitted).

123. Id. at 29.

124. Reply Brief for Appellant at 3.

125. Id. at 3.

exemption.[126] Under tests previously enunciated, the offeree had to be shown to either possess or have access to the information. Thus, while some relationship had to exist independently of the offering, there were clearly different types of relationships, and the access requirement varied accordingly. On the one hand, where there existed a "special relationship," there was no need to furnish the information, since all sources of information were readily available by virtue of the position. On the other hand, where the relationship was such as only to distinguish the offerees from the general public, then the issuer had to prove that they had the information necessary for an informed investment decision. In either case, the necessary result was knowledgeable investors, capable of making informed investment decisions. Under the *Continental* decision, however, the issuer is in a precarious position. If the offeree lacks the necessary information, the exemption will fail, and if the issuer furnishes the information, the exemption will likewise fail, since that would show a lack of first-hand knowledge. The logical conclusion, then, is that the knowledge must be possessed prior to and independent of the offering. This anomalous result flows from the fact that the "special relationship-present knowledge" test employed by the court in *Continental* was taken out of context from a law review article.[127] In the article, former SEC Commissioner Orrick, was specifying a situation in which it would not be necessary to furnish information, since by virtue of a special relationship, the offeree would already have the requisite information. The description of what this "special relationship" entailed was not intended to define an exclusive class. Indeed, if the class were exclusive, then inquiries into access and sophistication would be unnecessary, since both would be presumed by virtue of the special relationship.

Although the Fifth Circuit did not employ verbatim the "tantamount to an insider" language of the SEC brief, which Commissioner Hugh F. Owens felt was overly restrictive and "could lead to such a narrowing of the exemption that even an institutional investor could not qualify,"[128] a literal reading of the "present knowledge" test would still require that the offerees, in addition to being informed investors, would have to have a special relationship before they could "fend for themselves." Arguably, *Continental* does not reflect the present state of the law on private offerings.[129] Nevertheless, the decision makes

126. Goldberg, The Continental Tobacco Case: Private Placements 1972, 169 N.Y.L.J., Jan. 12, 1973, at 1, col. 1.

127. The article cited was Orrick, Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under the Federal Securities Act, 21 U. Pitt. L. Rev. 1, 8 (1959). In the preceding paragraph Orrick noted that "Congress recognized that under certain circumstances it might be either impractical or unnecessary for an issuer to make available as a matter of public record all material information . . . [w]here adequate safeguards . . . do in fact exist . . . ." Id.

128. BNA Sec. Reg. & L. Rep. No. 152, at G-2 (May 17, 1972).

129. Id. See also id. No. 157, at A-10 to 11 (June 21, 1972). The reaction to the decision uniformly has been unfavorable. See, e.g., R. Garrett, Private Placements, in Sale and Resale of Restricted Securities 79, 83-85. Furthermore, former Chairman Casey envisions a more expansive, rather than restrictive, use of the private offering exemption. See BNA Sec. Reg. & L. Rep. No. 165, at F-1 to 3 (Aug. 16, 1972).

strikingly apparent the uncertainties surrounding the private offering exemption, and was certainly an impetus to the promulgation of proposed Rule 146.

V. Proposed Rule 146: A Haven for Venture Capitalists?

The Commission noted in the release[130] accompanying Proposed Rule 146[131] that the vague and uncertain parameters of the private offering exemption "may be hindering the raising of capital by new businesses that are not sufficiently seasoned to attract investment banking firms willing to underwrite public offerings of their securities."[132] Yet from the standpoint of investor protection, it was clearly desirable that capitalization of new ventures come from sophisticated individuals and institutions through private placements. The purpose of Rule 146, then, is to provide greater assurance through the delineation of "objective standards upon which responsible businessmen may rely [in raising capital] and also to deter reliance on that section for offerings of securities to persons who are unable to fend for themselves in terms of obtaining information about the issuer and of assuming the risk of investment."[133] Since the Commission believed that the most significant concepts in determining when a transaction does not involve a public offering were "access to the information" and the ability to "fend for themselves,"[134] many of the conditions imposed in the Proposed Rule coincide with elements currently considered by the courts. The remainder of this Comment will analyze the conditions imposed by the Proposed Rule, with particular emphasis on whether the stated goal of "objectivity" will be satisfactorily attained.

A. *Limitations on the Manner of Offering*

Consistent with prior releases,[135] the Commission reiterated that limitations on the manner of the offering serve to assure that the persons to whom the offering is made have the necessary access to the information and can fend for themselves. Accordingly, section (c) of the Proposed Rule provides that general advertising is prohibited,[136] and that the securities can "be offered and sold only in a negotiated transaction,"[137] which is defined in section (a)(3)

130. SEC Securities Act Release No. 5,336 (Nov. 28, 1972), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,108, at 82,395 [hereinafter cited as Release 5,336].

131. 37 Fed. Reg. 26137 (1972).

132. Release 5,336, at 82,398.

133. Id. See also BNA Sec. Reg. & L. Rep. No. 165, at F-1 to 3 (Aug. 16, 1972).

134. Release 5,336, at 82,400.

135. Release 285, at 2,676; id., No. 4,552, at 2,683.

136. Proposed SEC Rule 146(c)(2), 37 Fed. Reg. 26137, 26140 (1972), provides: "Neither the issuer nor any person acting on its behalf shall offer or sell the securities by means of any form of general advertising, including, but not limited to, the following: (i) Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar medium; (ii) Any radio or television broadcast; (iii) Any seminar or promotional meeting; and (iv) Any letter, circular, notice, or written communication sent, given, or communicated to persons otherwise than in connection with a negotiated transaction."

137. Id. § (c)(1), 37 Fed. Reg. at 26,140.

as 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[138] or his investment representative."[139] While the term negotiated transaction is not new,[140] its present definition proves troublesome, since it is not clear to what extent the "terms and arrangements" must be negotiated. It hardly seems inconsistent with the claim of a private offering exemption, for example, that the issuer establishes a non-negotiable price or presents the offering on a take-it-or-leave-it basis, provided the offering is directly communicated. In fact, in many private offerings to institutional investors, "any negotiation which takes place will be between the issuer and one single lead investor . . . not authorized to act as investment representative for other investors."[141] Since the purpose of the limitation on the manner of the offering is to assure access and the ability to fend for themselves, it would seem that both criteria are amply provided for by the requirements of direct communication and the prohibition on public advertising. What is or is not negotiated could be left to the discretion of the parties; the offerees are always free to reject the offer.

Particularly significant is the fact that the issuer and offeree need never meet. The negotiated transaction can take place between one acting on behalf of the issuer and the investment representative of the offeree. Thus, if the offeree employs an investment representative, only he need be sophisticated, and the preparation of documents could be reduced to the minimum in light of the financial expertise of the investment representative.[142] However, it is first necessary to determine who qualifies as an investment representative. The term is defined in section (a)(2) as any person who:

> (i) has such knowledge and experience in financial and business matters that he is capable of evaluating the risks of a prospective investment;
> (ii) has been duly authorized by the person for whose account securities are to be purchased to act as agent for such person in effecting such purchase; and
> (iii) is independent of the issuer and is not acting on behalf of the issuer in connection with the transaction.[143]

Since section (a)(2)(i) provides that the investment representative must have knowledge and experience in both financial *and* business matters, it would appear that only large investment banking firms, with their extensive research

138. Since the offering can take place only in a negotiated transaction, the term "purchaser" should instead read "offeree." See Comment on Proposed Rule 146, Submitted by the Association of the Bar of the City of New York, Committee on Securities Regulation, in Sale and Resale of Restricted Securities 89, 100 [hereinafter cited as Committee Comment].

139. Proposed SEC Rule 146(a)(3), 37 Fed. Reg. 26,137, 26,140 (1970).

140. See Release 285, at 2,677.

141. Comment on Proposed Rule 146, Submitted by the Law Firm of Wolf, Block, Schorr & Solis-Cohen, in Sale and Resale of Restricted Securities 109, 113 [hereinafter cited as Wolf]. The commentary noted that there is a vast body of law dealing with bona fide negotiations, and that this should not be incorporated into the Proposed Rule. Id.

142. Goldberg, New SEC Rule 146: An Analysis, 168 N.Y.L.J., Dec. 1, 1972, at 4, col. 7.

143. Proposed SEC Rule 146(a)(2), 37 Fed. Reg. 26,137, 26,140 (1972).

departments, would qualify as investment representatives. Indeed, the Commission has "hinted broadly that lawyers and accountants will not qualify solely on the basis of their expertise in legal and accounting matters."[144] It is questionable whether even broker-dealer firms or investment advisors would qualify as representatives, for while they understand the marketplace, they do not necessarily have the requisite knowledge and experience in both business and financial matters.[145] Assuming that the knowledge and experience must relate to the field in which the issue is offered, then the investment representative would have to be a specialist in that field.[146] While this presents no particular difficulty where the offering is to a large institutional investor, the non-institutional investor generally will rely either on counsel or himself, and presumably neither would have the necessary qualifications. The question of qualifications is of more than casual significance, since the issuer or one acting on his behalf must make this determination and risk liability if he happens to be wrong.

The section further provides that the investment representative must be duly authorized to act as an agent of the person for whose account the securities are to be purchased. It is unclear what would constitute "authorization." For example, would the typical broker-dealer discretionary account, or a general power of attorney, be sufficient authorization, or must the authorization relate to this specific transaction? Even if one is clearly authorized, it is questionable whether any purpose is served by further requiring that he act as an agent. On the one hand, a purchaser may negotiate a transaction for himself but appoint an agent to attend the settlement and perform the ministerial functions of executing the documents, delivering the check, and receiving the certificates. Delegation of this type should hardly render the agent an investment representative. On the other hand, a purchaser may appoint an investment representative to study the transaction without delegating any agency powers, wishing instead to reserve the final investment decision to himself.[147] Neither of these arrangements should be inconsistent with the rule. The concept of investment representative is designed to insure that the purchaser has an advisor who can adequately protect his interests, and the existence of an agency relationship is immaterial. "If the purchaser has selected a person on whose judgment he will rely it should be immaterial whether that person is acting as agent, adviser, consultant or otherwise."[148]

The determination of what constitutes an investment adviser is further complicated since the definition provides that he must act independently of

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144. Freund, Private Placements—Effect of Rule 146, 168 N.Y.L.J., Dec. 11, 1972, at 28, col. 6. The author suggests "we will see the emergence of a new growth industry, self-styled 'qualified investment representatives.'" Id.

145. See Fleischman & Duff, Special Problems Raised by Proposed Rule 146, in Sale and Resale of Restricted Securities 257 [hereinafter cited as Fleischman & Duff].

146. Fleischman & Duff 258-62.

147. See Wolf 112. See also Committee Comment 97-100.

148. Committee Comment 97.

the issuer,[149] a requirement deemed "totally unrealistic in the light of prevailing commercial practice."[150] Indeed, commonly an investment banker retained by the issuer will structure the transaction, perhaps invest some of his own money, and then present the issue to some of his own clients. Moreover, it is not uncommon for the issuer to suggest one investment representative to the investors, since such an arrangement is practical, efficient and economical. Even where the purchaser independently retains an investment adviser, it is common for the issuer to bear the expense.[151] In all of these situations, even when the investment representative is clearly "not acting on behalf of the issuer,"[152] the independence requirement may well have been violated. The Commission stated that independence requires "at least, that such representative be selected by the investor rather than by the issuer."[153] Clearly, the intent of the requirement is to insure investor protection by preventing conflicts of interest. Since the key factor is the accountability of the investment representative to the offerees,[154] an expression to this effect would adequately set the confines of the relationship required between the offeree and the investment representative, and it would not call into question the viability of existing practices in relation to the conditions imposed by the Proposed Rule.

B. *Nature of the Offerees*

Since the Commission felt that an important requirement is the ability of the offerees to fend for themselves, the Proposed Rule is conditioned on the nature of the offerees. Accordingly, section (d)(1) provides that an issuer or one acting on his behalf must have reasonable grounds to believe prior to making the offer:

> (1) That either the offeree or his investment representative has such knowledge and experience in financial and business matters that he is capable of utilizing the information . . . to evaluate the risks of the prospective investment and of making an informed investment decision . . . .[155]

The Commission offered no suggestions for interpreting the section, other than to provide that sophistication is a necessary element of the "fending for themselves" requirement of *Ralston*.[156] Yet, as previously noted,[157] sophistication

149. Proposed SEC Rule 146(a)(2)(iii), 37 Fed. Reg. 26,137, 26,140 (1972).

150. Wolf 109.

151. See, e.g., Committee Comment 97; Fleischman & Duff 264.

152. Proposed SEC Rule 146(a)(2)(iii), 37 Fed. Reg. 26,137, 26,140 (1972).

153. Release 5,336, at 82,401.

154. Wolf 111. The relationship is analogous to an underwriter in a public offering, since he negotiates with the issuer and also sells the securities either as principal or agent. "Investors are quite willing and should be permitted to rely on the investment banker who acts for them and also the issuer . . . ." Id. at 110.

155. Proposed SEC Rule 146(d)(1), 37 Fed. Reg. 26,137, 26,140 (1972).

156. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953); see Release 5,336, at 82,401.

157. See notes 89-95 supra and accompanying text. Compare Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,523, at 94,956 (S.D.N.Y.

has been an intangible and elusive concept, incapable of objective application and measurement. When, for example, could an issuer or one acting on his behalf be safely assured that he has reasonable grounds to believe that the offeree or his investment representative can evaluate the risks *and* make an informed investment decision? While he can perhaps insure that the decision is informed by providing the offeree or his representative with the required information, this fact alone does not guarantee that he is capable of evaluating the risks. Indeed, self-serving statements, similar to letters of non-distributive intent, will be forthcoming, but they will certainly "carry very little weight in the face of more concrete facts and circumstances . . . ."[158] As a consequence, an issuer in order to protect himself must resort to extensive inquiry, considering such factors as the offeree's education and prior investment experience. Even after such inquiry, however, an issuer will have to evaluate what weight to give to the factors. For example, if the offeree is a professional in a field unrelated to either business or finance, would he be able to evaluate the risks? If one has extensive investment experience, but has consistently lost money, does this demonstrate a lack of sophistication? Since it is unclear how extensively the issuer must investigate or what weight can be given to evidentiary factors, it is not unreasonable to assume that the issuer, in order to protect himself, would require the offeree to procure expensive expert advice in the majority of offerings.

Not only must the issuer or one acting on his behalf have reasonable grounds to believe that the offeree or his representative is sophisticated enough to evaluate the risks of the investment, he must also believe that "the offeree is a person who is able to bear the economic risks of the investment."[159] The Commission gave no explanation for the inclusion of this provision other than to note its appropriateness since "as a purchaser of unregistered securities, he may not be able to resell such securities publicly without registration for a period of time after his initial purchase."[160] The Commission offered no criteria to aid the issuer in subjectively determining that the offeree can bear the risk, or, for that matter, what the phrase even means. It has been surmised that "at the

1965), with United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir.), cert. denied, 389 U.S. 850 (1967).

158. SEC Securities Act Release No. 1,862 (Dec. 14, 1938), 1 CCH Fed. Sec. L. Rep. ¶ 1,533, at 2,204; see also Release 4,452, at 2,685.

159. Proposed SEC Rule 146(d)(2), 37 Fed. Reg. 26,137, 26,140 (1972). The condition, according to the Commission, is consistent with the concept of "fending for themselves." However, this interpretation is not supported by prior judicial decisions. See Advanced Research Associates, Inc., 41 S.E.C. 579, 589 (1963). See also SEC v. Royal Hawaiian Management Corp., [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,982, at 96,338 (1967). The financial status of the offeree and prior investment experience, have been treated as evidentiary factors rather than as essential requirements for the existence of the exemption. See Henderson v. Hayden, Stone, Inc., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,504, at 92,436-37 (5th Cir. 1972) (although the purchaser was a sophisticated investor and had a stock portfolio worth several million dollars, the court found a public offering).

160. Release 5,336, at 82,401-02.

very least, an offeree would have to be in a sufficiently liquid position to be able safely to lock-up some of his capital . . . ."[161] If this is the intent of the requirement, then the issuer must determine whether the investment is prudent in light of the financial status of the offeree. But would reasonable grounds for evaluating the risk-bearing ability of the offeree be provided merely by obtaining a financial statement from the offeree? Even if it were obtained, what percentage of one's net worth could safely be invested in restricted securities?[162] One commentator concluded that the suitability of the investment, *e.g.*, liquidity, was not the meaning of the "able to bear the economic risks" phrase; rather, it was "the ability to bear the loss of principal on the investment."[163] Under this interpretation, an issuer would have to determine what risk is inherent in the investment itself, as well as the risk-bearing ability of the individual investor. Furthermore, the latter determination "would turn not only on the financial circumstances of the investor (*e.g.*, the extent of his savings, earnings, other investments, etc.) but also his standard of living, his number of dependents, the state of his health, etc."[164]

The burden of proof placed on the issuer under the "reasonable grounds" test is indeed harsh. It may, in fact, be impossible to meet, except in situations where the issuer has prior knowledge of the offeree's personal financial affairs, since the reasonable grounds to believe that the offeree can bear the economic risk must be established "*prior to making an offer*."[165] As a practical matter, offers are commonly directed in the first instance to intermediaries, such as "bank trust departments, investment advisers or other 'investment representatives,' with the possible purchasing accounts then being unknown to the issuer."[166] In this situation, the issuer or one acting on his behalf would not even know who the prospective offerees might be, and would be risking section 5 liability if the intermediary made an offer to an unqualified offeree. The Commission, perhaps anticipating this difficulty, stated that an "inquiry to verify that belief [that the offeree is qualified] is not in and of itself an offer."[167] However, it is not unreasonable to assume that a prospective offeree would be reluctant to divulge personal financial information on the vague hope of developing an investment opportunity. Moreover, the issuer could hardly be expected to solicit information without at least mentioning the purpose of the inquiry and some details concerning the offering which, in light of the broad interpretation

161. Goldberg, New SEC Rule 146: An Analysis, 168 N.Y.L.J., Dec. 1, 1972, at 4, col. 7.

162. Fleischman & Duff 265. The authors further note that even if the ability to bear the economic risks of the investment could be objectively established simply by limiting the investment to a percentage of the net worth of the offeree, a further question would be whether the percentage should be different where some of the other assets of the offeree are speculative securities rather than cash or its equivalent. Id.

163. Wolf 116.

164. Id.

165. Proposed SEC Rule 146(d), 37 Fed. Reg. 26,137, 26,140 (1972) (emphasis added).

166. Committee Comment 102.

167. Release 5,336, at 82,402.

of what constitutes an offer,[168] could result in the loss of the exemption if the prospective offeree turns out to be unqualified.[169]

Over and above the practical difficulties in determining when an offeree can "bear the economic risks," the provision has been uniformly criticized on philosophical grounds:

> The 1933 Act is a *disclosure* statute. It does not require that investment decisions be appropriate for the investor, only that the decisions are based upon appropriate information which the investor can evaluate for himself. It should be sufficient to provide that the private placee is in a position to *understand* the investment risk, not that the issuer be satisfied that he can *assume* it.[170]

Indeed, the Act was designed to prevent fraudulent abuses by requiring registration of securities so that through disclosure an informed investment decision could be made. Once the investor is properly informed, the Act is not designed to protect the individual from himself or to control his speculative urge.

C. *Access to Information*

Under the Commission's interpretation of "fending for themselves," an offeree must be both sophisticated and have access to the information. Accordingly, section (e) of the Proposed Rule provides that during the course of the negotiated transaction the offeree or his investment representative must:

> (1) have the same kind of information that the Act would make available in the form of a registration statement, to the extent such information is available, or have access to such information . . . .[171]

Since the Commission made no attempt to define "access to the information," one must assume that its content is to be gleaned from prior releases and judicial decisions.[172] However, few areas in the private offering exemption have proved more evasive and incapable of objective application. One commentator surmised that the access standards are satisfied by either a voluntary giving of information or by the existence of facts which indicate that the offeree has access to the information.[173] In light of recent decisions, however, it is not clear that such a conclusion is justified. Except in the clearest of instances, the issuer cannot be sure that the offeree is in a position to have the requisite access, or that simply opening its books to the offeree would suffice. Thus, to protect himself,

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168. See note 26 supra and accompanying text.

169. See Wolf 114-15 (suggesting that qualifications should be established prior to completing the sale rather than prior to making the offer).

170. Id. at 115-16. See also Lederman, Proposed SEC Rule 146: An Analysis and Comment, 169 N.Y.L.J., Jan. 22, 1973, at 1, col. 4; Committee Comment 102-03 (suggesting that the clause be deleted, and, as an alternative, that the offeree or his investment representative be required to make this judgment rather than the issuer, since it relates primarily to the offeree's personal affairs. Id. at 103).

171. Proposed SEC Rule 146(e)(1), 37 Fed. Reg. 26,137, 26,140 (1972).

172. See section III supra.

173. Goldberg, New SEC Rule 146: An Analysis, 168 N.Y.L.J., Dec. 1, 1972, at 4, col. 7.

the issuer would use the alternative provision of actually providing the information to the offerees. However, under existing interpretations,[174] voluntarily providing the information might not satisfy the access requirements.[175]

The uncertainty in this area is further compounded by the fact that the Proposed Rule requires that the information must be of the same kind that would be made available in a registration statement,[176] but only "to the extent such information is available."[177] Immediately, one must inquire: when is such information available?[178] The registration statement requirement, taken literally, would require the issuer to develop a disclosure document similar to a going public prospectus. Since the information is, theoretically, always available provided that the issuer expends time and money in analyzing raw data to comply with the requirements of a registration statement, it would appear that the phrase refers to information available at the time of the offering. If this is a justified interpretation, would scanty or limited information satisfy the requirement? It would hardly seem that this was intended, since the offeree is in no less need of protection in either instance. Consequently, it is unclear how extensive the information must be or whether the issuer must take affirmative action to make the information available. In light of this ambiguity, it has been suggested that the provision be qualified by the phrase " 'without significant additional effort or expense.' "[179]

The Proposed Rule also provides that an offeree or his representative must "[h]ave access to any additional information necessary to verify the accuracy of such information."[180] No indication is given of what possible additional information the offerees need in order to verify the accuracy of information already received. Such a provision is normally associated with underwriters in a public offering because of their potential liability in effecting distributions under the Act. Perhaps the underlying purpose of the verification requirement was to define the type of relationship the offeree must have with the issuer.[181] Indeed, the Commission, in explaining the appropriateness of the requirement, cited a prior release which held that voluntarily supplying information would

174. See SEC v. Continental Tobacco Co., 463 F.2d 137, 159 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 688 n.6 (5th Cir. 1971).

175. See notes 122-25 supra.

176. Proposed SEC Rule 146(e)(1), 37 Fed. Reg. 26,137, 26,140 (1972); see note 53 supra and accompanying text. See also Wolf 119, wherein it is suggested that purchasers in private offerings do not necessarily expect to receive precisely the same type of information that would be provided through registration; thus, a more appropriate formula would be: "Such information as to the business done by the issuer . . . as will, in the opinion of management, indicate the general nature and scope of the business . . . and will be sufficient for an evaluation of the investment opportunity." Id.

177. Proposed SEC Rule 146(e)(1), 37 Fed. Reg. 26,137, 26,140 (1972).

178. See generally Freund, Private Placements—Effects of Rule 146, 168 N.Y.L.J., Dec. 11, 1972, at 28, col. 6.

179. Committee Comment 104.

180. Proposed SEC Rule 146(e)(2), 37 Fed. Reg. 26,137, 26,141 (1972).

181. Lederman, Proposed SEC Rule 146: An Analysis and Comment, 169 N.Y.L.J., Jan. 22, 1973, at 4, col. 1.

not insure the exemption, because of "the absence of statutory safeguards and sanctions attendant to the registration process."[182]

D. *Limitation on the Number of Purchasers*

Perhaps the most significant contribution to clarity provided by Proposed Rule 146 is the adoption of a standard numerical limitation which reduces the present confusion with respect to the number of allowable offerees. Section (f) of the Proposed Rule provides that:

> There shall not be more than 35 persons in any consecutive 12-month period who purchase securities of the issuer in transactions pursuant to this section, or not pursuant to this rule but otherwise in reliance on section 4(2) of the Act; provided however, there shall be excluded in determining such number any person who purchases securities from the issuer for cash in an amount not less than $250,000.[183]

One advantageous effect of this section is that an issuer, or one acting on his behalf, who does not use public advertising, can approach an unlimited number of offerees, provided that the actual number of purchasers does not exceed 35 in any consecutive 12-month period, "a number usually well in excess of the number needed to get a new venture off the ground."[184]

However, while the 35 purchasers limitation does indeed provide an objective standard, "the price of extracting relatively greater certainty . . . can be very high,"[185] since the restriction is more severe than is readily apparent. For example, there is no provision for exempting the institutional purchaser who purchases large blocks of securities in amounts less than $250,000.[186] Consequently, each account of the institutional investor would be considered as a separate person in computing the number limitation.[187] Moreover, no distinction is drawn between classes of securities.[188] If an issuer entered into "a long term revolving credit agreement with 20 banks (assuming less than $250,000 per bank), the issuer could not have a private placement qualifying under the Rule with more than 15 additional purchasers for a year thereafter,"[189] regardless of the distinct time, manner of offering, and purpose of the transactions. Finally, once the Proposed Rule is relied on, any subsequent private offering, even if outside the Rule, is limited to a number of purchasers that will not cumulatively exceed the 35 number limitation. These provisions have the effect of limiting the desirability of relying on the Proposed Rule. Indeed, under traditional interpretations of a transaction, if the offerings were sufficiently distinct in time, manner of offering, and purpose, they would be viewed separately rather than as a single integrated offering.[190] Furthermore, since at least theoretically

182. Release 5,336, at 82,402; see Release 4,552, at 2,684; 2 Goldberg § 2.4(c).
183. Proposed SEC Rule 146(f), 37 Fed. Reg. 26,137, 26,141 (1972).
184. Goldberg, New SEC Rule 146: An Analysis, 168 N.Y.L.J., Dec. 1, 1972, at 4, col. 8.
185. Garrett, Private Placements, in Sale and Resale of Restricted Securities 81 (1973).
186. See Release 5,336, at 82,402.
187. Id. at 82,401.
188. See Wolf 121-22.
189. Id. at 121.
190. See, e.g., Release 4,552, at 2,686.

the number of offerees is irrevelant provided the "requisite relationship" can be established, there would be little practical purpose to rely on the Proposed Rule.

Although the Commission provides no explanation for the exemption of purchases in excess of $250,000, it was apparently intended as a quasi-institutional exemption. Indeed, former Chairman Casey noted that adopting the dollar standard "avoids the complex task of defining an institution."[191] However, the $250,000 figure has been uniformly criticized as excessive.[192] One commentator notes that it will limit the potential of new businesses to obtain financing, since in venture capital transactions, where the investment risk is high, smaller purchases are often made.[193] Furthermore, the exemption is applicable only to cash purchases. As a consequence, each person receiving securities in the acquisition of businesses or properties will be included in the 35 purchaser limitation, regardless of the fact that the acquisition may in fact be in excess of $250,000.[194] Commentators have recommended that this anomolous result be rectified.[195]

E. *Conditions To Be Met and Non-Exclusivity*

Section (b) of Proposed Rule 146 provides that "[a]ny transaction . . . which meets all the conditions of this section shall be deemed not to be a transaction involving any public offering . . . ."[196] As presently structured, the Rule would not be applicable, for example, if an offering were to be made to one unqualified offeree, even though not an ultimate purchaser, or if the issuer neglected to legend the certificates in compliance with section (g)(2)(i),[197] or failed to report the sale in compliance with section (h).[198] Failure to comply with any

191. BNA Sec. Reg. & L. Rep. No. 165, at F-1 (Aug. 16, 1962).

192. See Committee Comment 105.

193. Lederman, Proposed SEC Rule 146: An Analysis and Comment, 169 N.Y.L.J., Jan. 19, 1973, at 4, col. 5.

194. Id., cols. 4-5. The author suggests that if the Proposed Rule retains the integration between cash purchases and acquisitions, then the acquisition purchases should not be arbitrarily excluded from the $250,000 exemption. Id., col. 5.

195. See, e.g., Committee Comment 104.

196. Proposed SEC Rule 146(b), 37 Fed. Reg. 26,137, 26,140 (1972).

197. Id. § (g), 37 Fed. Reg. at 26,141, provides that after reasonable inquiry, the issuer or one acting on his behalf must not be aware of circumstances indicating that the purchasers may be underwriters. Furthermore, to protect against deferred distribution, the issuer must take reasonable care which includes, but is not limited to, the placing of a legend on the certificate, issuance of stop-transfer instructions to issuer's agent, or, if the issuer lacks an agent, then placing a notation in the records of the issuer, and obtaining a signed written agreement from the purchaser that the securities will not be sold without registration or other compliance with the Act.

198. Id. § (h), 37 Fed. Reg. at 26,141, provides: "Within 45 days after the end of any quarter of the issuer's fiscal year during which sale of securities are effected in reliance on this section, the issuer shall file three copies of a report of sales on Form 146 . . . . Provided however, that such report need not be filed if the issuer has not sold securities in reliance on this rule within the twelve months preceding the first sale covered

one of the conditions prevents reliance on the Rule, and could result in section 5 liability and rescission by all the purchasers. This result is overly harsh and may adversely affect offerings that were clearly private, since the conditions are of varied importance. For example, section (g),[199] which is designed to prevent deferred distribution, and section (h),[200] which requires that the sale be reported, serve secondary functions, and are not designed to protect the initial investor. Accordingly, it has been suggested that these requirements be classified as precautionary or legal requirements rather than as conditions to the availability of the exemption. Thus, "[a]n issuer which failed to meet the requirements presumably would be exposed to minor sanctions for such violations, but . . . would not be subject to *liability for violating Section 5* merely because of a failure to comply with one of these documentation requirements."[201]

An overriding consideration of the Commission was to assure that it was clearly understood that the Proposed Rule was not an exclusive means of making a private offering under section 4(2), since "no one rule can adequately provide for the various circumstances surrounding the legitimate private offering . . . ."[202] The intended design, however, may prove illusory. First, the fact that the limitation on the number of offerees must include transactions outside the rule militates against the non-exclusive nature of the Rule. Second, since the Rule incorporates most of the criteria currently associated with private offerings under section 4(2), it is not unreasonable to assume that, in time, the interpretations offered by the Commission will be applied to all private offerings by courts and diligent counsel. Third, in light of the present confusion surrounding what "relationship" is required to qualify for a private offering exemption, Proposed Rule 146 may become exclusive, in practical effect, by default. Indeed, it has been noted that:

> there is very little if anything left of the private offering exemption. It is unlikely that a private placement which failed to meet the tests of Rule 146 would qualify under the dicta of *Continental Tobacco Co.* and its progeny. Almost every attribute of a private placement required by Rule 146 must be met, along with many other criteria . . . .[203]

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by the report in an amount which when added to the amount of sales covered by the report would exceed $50,000. Such report shall be deemed to have been filed if the issuer is subject to the periodic reporting requirements of the Securities Exchange Act of 1934 and has filed a report on Form 10-K . . . or Form 10-Q . . . which contains the information required by Item 6 and Item C, respectively, of such forms." (emphasis omitted).

199. Id. § (g), 37 Fed. Reg. at 26,141.

200. Id. § (h), 37 Fed. Reg. at 26,141. This is particularly significant since the reporting requirement applies chiefly to privately held companies or small publicly held companies, neither of which traditionally have been well-versed in SEC regulations. Hence, coupled with the broad definition of securities, there would be numerous inadvertent violations which would cause the exemption to fail if all the conditions must be uniformly met. See Wolf 122.

201. Wolf 124.

202. Release 5,336, at 82,402.

203. Wolf 128.

VI. Effects of the Proposed Rule

The purpose of Proposed Rule 146 is to insure greater access to venture capital[204] through private offerings by providing more objective standards and curtailing uncertainties "to the extent feasible."[205] While the Proposed Rule significantly changes the present law by providing that the issuer or one acting on his behalf can approach an unlimited number of offerees and that the negotiated transaction can take place entirely between representatives of the parties, it is questionable whether the stated goal is satisfied. Indeed, the only additional objectivity is the flat numerical limitation. Unquestionably, the issuer is assured that if the number of purchasers exceeds 35 in any consecutive 12-month period, exclusive of major investors, the exemption will not be available under the Proposed Rule. However, the areas of existing uncertainty are broader than the determination of the number of offerees. The major area of confusion has been what constitutes access, and the determination of when the offeree can fend for himself. Unfortunately, the Proposed Rule incorporates both areas, without even addressing the problem. The issuer can still only speculate on whether the offeree or his representative is sophisticated enough to utilize the information, or whether their position is such that they have access to the information, or in the alternative, whether information must be affirmatively supplied. In either case, the overriding consideration remains whether the information was broad enough to enable an informed investment decision. Given the current confusion in this area, it is hardly arguable that the Proposed Rule provides greater certainty for either the issuer or the courts. Admittedly, both Commission and court discretion are required in this area, since short of requiring that all offerings be registered or a lessening of investor protection,[206] a degree of subjectivity is unavoidable in determining whether the investor is sophisticated or has sufficient information to make an informed investment decision. Indeed, securities practitioners, while "cursing the uncertainties, ever mindful of the potential liabilities,"[207] have nonetheless managed "to shepherd the distribution of billions of dollars worth of securities into purportedly private hands."[208] Thus, although the ambiguity is not crucial, if the Proposed Rule is to operate satisfactorily, the Commission must present an extensive restatement,

204. Goldberg, New SEC Rule 146: An Analysis, 168 N.Y.L.J., Dec. 1, 1972, at 4, col. 8.

205. Release 5,336, at 82,398.

206. See ALI Fed. Sec. Code § 227(b)(1)(A) (Tent. Draft No. 1, 1972). The section provides that institutional investors and "not more than thirty-five other persons" qualify for a "limited offering," the counterpart to the private offering, without consideration of their sophistication or access to the information. Moreover, the number limitation applies to "buyers" rather than to "offerees." While this provision provides the maximum degree of objectivity by eliminating any consideration of the subjective standards of "sophistication" and "access," it leaves the non-institutional investor, short of fraud on the part of the issuer, virtually without any protection.

207. Freund, Private Placements—Effects of Rule 146, 168 N.Y.L.J., Dec. 11, 1972, at 28, col. 1.

208. Id.

establishing specific guidelines and repudiating factors no longer viable and dicta inconsistent with the intent of the private offering exemption.

Even though uncertainty is perhaps unavoidable in this area, the onerous effects can be miminized. For example, while the Rule attains a degree of objectivity by providing that only the number of purchasers must be considered in computing the 35 person limitation, it inexplicitly lessens the effectiveness of the provision by retaining broad protection for the offerees, since they also must be shown to have been qualified. Thus, the issuer must still refrain from inadvertently making an "offer," and must still be cognizant of the number of offerees, since he must be able to prove their qualifications. This requirement seems self-defeating. It is difficult to comprehend how an offeree who does not purchase can be injured.[209] Indeed, the Rule would operate just as effectively if the determination of sophistication or "nature" was limited solely to the purchaser. This would lessen the already harsh evidentiary burden on the issuer, and would not lessen the desired protection of the Rule. Furthermore, there is no danger that the offering would become inherently more public, since public advertising is prohibited. Also, the issuer would realize it is superfluous to make an offer to an unqualified offeree, since, if he did purchase, the exemption would fail.

Perhaps the primary contribution to clarity that could be made by the Proposed Rule would be to expressly provide for an exemption for institutional investors. Indeed, as previously noted, this often has been recommended,[210] and the courts, as a practical matter, have already recognized the distinction, since institutions are both presumptively sophisticated and have access to the information. Furthermore, the $250,000 exemption is obviously geared toward the institutional investor. However, while these purchasers are exempted from the 35 purchaser limitation, they are still subject to all the other requirements of the Proposed Rule.[211] Theoretically at least, the issuer would still have to determine whether the institutional investor was sophisticated, and whether it had access to the initial as well as additional information necessary to verify the accuracy of the information received. Since the Commission recognizes that the institutional investor does not need the protection of the Act, it would seem that, in spite of the difficulty inherent in defining an institutional investor, the effort to do so is dictated by practical considerations. Indeed, the First Tentative Draft of the *Federal Securities Code*, proposed by Professor Loss and adopted by the American Law Institute, provides that an offering can be made to an unlimited number of institutional investors, defined in section 242 as:

(a) a bank, insurance company, or registered investment company, or a parent of

209. See ALI Fed. Sec. Code § 227(b)(1)(A), Comment (2)(b) (Tent. Draft No. 1, 1972), wherein it is noted that the "draft goes over to the number of buyers, leaving the number of offerees unlimited, for two reasons: because the breadth of the definition of 'offer' makes it difficult to count offerees, and because it is difficult to see how an offeree who does not buy is hurt." Id. (emphasis omitted).

210. See note 81 supra and accompanying text.

211. Release 5,336, at 82,402.

any such person, except to the extent that the Commission provides otherwise by rule with respect to any such class of persons on the basis of such factors as financial sophistication, net worth, and the amount of assets under investment management, or (b) any other person of a class that the Commission designates by rule on the basis of such factors.[212]

This definition provides broad flexibility to the Commission, which can add or delete certain classes within the exemption, since "certain large universities, labor unions, and self-managed state or municipal pension funds are clearly better candidates for 'institutional investor' status than some country banks."[213] The addition of an unambiguous and unqualified exemption for institutional investors would facilitate the operation of Proposed Rule 146. It would eliminate the need for the issuer to inquire into the nature, sophistication, and risk bearing ability of the institutional investor, and would thus have the effect of encouraging issuers in private offerings to place their securities with institutional investors who can fend for themselves and clearly do not need the protection afforded by registration. On the other hand, where the issuer did decide to place unregistered securities with non-institutional investors in reliance on Proposed Rule 146, the Rule would provide definite numerical limitations, and the inherent subjectivity of the access and sophistication standards would be fair warning that the transaction will be closely monitored to insure adequate protection of the investor.

212. ALI Fed. Sec. Code § 242(a), (b) (Tent. Draft No. 1, 1972).
213. Id. Comment (2).