

Section 4(1-1/2)—Private Resales of Restricted or Control Securities

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I. INTRODUCTION

This Article deals with the availability of an exemption from the registration provisions¹ of the Securities Act of 1933 (the Act or Securities Act)² for a private sale by a holder of securities which were initially issued in a private placement³ (restricted securities) or of securities owned by an affiliate⁴ of the issuer (control securities). "Holder" refers herein to a person who holds restricted or control securities. "Purchaser" refers herein to a buyer of restricted or control securities from a Holder. The Article focuses on the ordinary case when none of the securities or other exemptions contained in section 3 of the Act⁵ are applicable. It should be noted that the anti-fraud provisions under the federal securities laws⁶ provide significant investor protection and remain applicable to all sales, even those exempt from the Act's registration requirements.

The general question this Article addresses is how a Holder of restricted or control securities may sell them privately without registration at a time when he could not sell them publicly. The problem has been recognized for many years.⁷ The applicable exemption, which is gleaned by interpretation from section 4 of the Act as an amalgam of principles underlying sections 4(1) and 4(2),⁸ is colloquially referred to as "section 4(1-1/2)," although no such section appears in the Act.

The Act's statutory pattern, and the judicial and administrative precedents accumulated over the more than half century since its adoption, provide a poor theoretical framework for determining the precise limits of the section 4(1-1/2) exemption. At best, the accumulated body of authority can be characterized as unclear and full of contradictions. Some conclusions set forth herein regarding the

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1. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1982) [hereinafter Securities Act]. See Securities Act rule 506, 17 C.F.R. § 230.506 (1987) (providing a "safe harbor" for any issuer able to meet the rule's requirements).

2. 15 U.S.C. §§ 77a-77aa (1982 and Supp. IV 1986).

3. Securities Act § 4(2), 15 U.S.C. § 77d(2) (1982).

4. See Securities Act rule 144, 17 C.F.R. § 230.144(a)(1) (1987).

5. 15 U.S.C. § 77c (1982).

6. Securities Act §§ 12(1)-(2), 17(a)-(b), 15 U.S.C. §§ 77l(1)-(2), 77q(a)-(b) (1982); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1982)[hereinafter Exchange Act]; Exchange Act rule 10b-5, 17 C.F.R. § 240.10b-5 (1987).

7. Discussions of the problems appear in a Report to an ABA committee, *The Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted" Securities*, 34 BUS. LAW. 1961 (1979) (this author provided a background paper for the Report that established some of the terminology used therein); Olander & Jacks, *The Section 4(1-1/2) Exemption—Reading Between the Lines of the Securities Act of 1933*, 15 SEC. REG. L.J. 339 (1988); Goldwasser, *The Practitioner's Comprehensive Guide to Rule 144*, Chapter 12 (PLI 1975); Comment, *Reinterpreting the "Section 4(1-1/2)" Exemption from Securities Registration: The Investor Protection Requirement*, 16 U.S.F. L. REV. 681 (1982).

8. 15 U.S.C. § 77(d)(1)-(2) (1982).

precise limits of the section 4(1-1/2) exemption are supported by authority. But, as to others, no simple answer is compelled by the available authorities, and support can be found for a number of different conclusions. In the last analysis, at least some of the conclusions suggested herein for the section 4(1-1/2) exemption are based principally on this author's judgment as to how the goals and policies of the Act will be implemented most effectively. They are offered as a proposed balance among competing policy considerations.

To the extent that transactions are registered under the Act, investors are protected through information disclosure and the special liability provision in section 11 of the Act.⁹ But investors often derive comparable benefits under the federal securities laws even in unregistered transactions. They have other means to obtain reliable information. Indeed, for most publicly owned companies, essentially the full range of registration statement information is already publicly available through Securities Exchange Act of 1934 (the "1934 Act" or "Exchange Act") filings.¹⁰ Likewise, other antifraud provisions¹¹ that largely overlap the liability protections of section 11 of the Act provide additional protection for investors.

A requirement to register securities to be sold in secondary transactions also poses disadvantages from the overall public interest perspective. These disadvantages must be balanced against the benefits. To the extent that Holders are restricted in making resales, such investors lose liquidity, a valuable attribute to them. The nonliquidity of unregistered securities will make it more costly and difficult in the long run for companies to raise capital, an undesirable result. If registration is required, the burdens of expense and staff time normally must be borne by issuers and their existing investors. Accordingly, there are many circumstances when overall public policy is best served by exempting private secondary sales from the burdens of registration.

This Article provides answers to many recurring questions in the context of private resales. It raises, but does not answer, some others. Regarding the unanswered questions, it is suggested that counsel in each individual case must exercise judgment in determining whether registration is required, based upon all of the particular facts and circumstances. This Article is intended to provide practitioners with useful guidance by focusing attention on and exploring the relevant issues and considerations of private resales, even if no universally applicable solution to a particular problem is offered.

Much of the law and lore in this area is based upon the response of the Securities and Exchange Commission (the "Commission" or "SEC") to "no action letter" requests.¹² In evaluating SEC no action responses, it should be noted that many

9. 15 U.S.C. § 77k (1982).

10. Reports are filed pursuant to the Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1982).

11. See *supra* note 6. See also Exchange Act § 14(a), 15 U.S.C. § 78n(a) (solicitation of proxies in violation of rules and regulations).

12. The term "no action letter" is used generically herein to describe: (1) both favorable and unfavorable responses to private requests for SEC Staff to recommend to the Commission that it not prosecute particular securities transactions; and (2) Staff advisory and interpretive positions taken in response to private inquiries. No action letters are cited herein by name of the party to whom addressed by the SEC, reporter cite (when reproduced therein), and date made available

Commission refusals to grant no action positions may be based upon policy considerations perceived by the SEC, rather than upon a conclusion based solely on the legal availability of an exemption. A negative response should not necessarily be interpreted as a legal conclusion that the law would prohibit the transaction covered by the request, nor does a favorable position always reflect the Commission's conclusion that the conduct is lawful.¹³ Additionally, the fact that a favorable letter recites a limitation or condition may simply reflect the terms on which the request was made, and does not necessarily mean that a favorable response would have been withheld absent the limitation or condition.¹⁴

II. THE STATUTORY PROBLEM

Section 4(2) exempts from registration "transactions by an issuer not involving any public offering."¹⁵ It is the general exemption for so-called "private placements." On its face, a sale by a Holder (a "secondary sale") is not a sale "by an issuer." A literal reading of section 4(2) renders it inapplicable to a sale by a Holder, and most authorities agree that section 4(2) does not exempt a Holder's private sale.¹⁶

Section 4(1) of the Act exempts from registration "transactions by any person other than an issuer, underwriter, or dealer."¹⁷ Assuming that the Holder is not a dealer, and by hypothesis he is not an issuer, this exemption applies so long as neither the Holder nor the Purchaser is an underwriter as the term "underwriter" is defined in section 2(11).¹⁸ Generally, a person is not an "underwriter" unless he acquires securities with a view to "distribution" or is participating in a "distribution." It is

to the public, *e.g.*, Professional Care Services, Inc., [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,542 (Oct. 12, 1973). No action letters are available on both Lexis and Westlaw databases.

13. Regarding the Staff's position on no action letters, see Professional Care Services, Inc., [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,542, at 83,479 (Oct. 12, 1973).

14. See, *e.g.*, First Nat'l Bank of Md. (avail. Feb. 22, 1988), in which the favorable letter was based on the recited facts and the Staff enumerated specific items that should not have been necessary conditions to the availability of the § 4(1-1/2) exemption—*e.g.*, the fact that the sale price of the security would be determined by appraisal. See also Capital Facilities Corp. (avail. July 8, 1982); American Sec. Bank, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,407 (May 29, 1980); Astro Mfg. Co. (avail. Jan. 15, 1979); Banner Publishers, Inc. (avail. Nov. 14, 1975).

15. 15 U.S.C. 77d (2) (1982) (emphasis added).

16. See *supra* note 7. See also *Leiter v. Kuntz*, 655 F. Supp. 725 (D. Utah 1987) (denying motion to dismiss), which involved a sale by two 50% stockholders to a single buyer. In an analysis that is not particularly helpful, the opinion suggests that § 4(2) might apply if all of the private placement tests are met, and also that § 4(1) might be inapplicable on the ground that controlling persons might be "issuers" for this purpose. I disagree with both suggestions.

It has been suggested that the Holder may somehow be the "agent" of the issuer and is continuing the initial nonpublic sale of the issuer, so that § 4(2) is applicable. However, this line of reasoning seems somewhat artificial, at least when the Holder has purchased the security for his own account and assumed the investment risk, as opposed to serving as a mere conduit in retransferring the securities to others. Even this line of reasoning would not apply, by its own terms, to sales of control securities by a Holder who is an affiliate and who acquired his shares on the open market.

On the other hand, if a direct purchaser in an issuer's proper § 4(2) private placement purchases securities with the explicit purpose of serving as a conduit from the issuer to other buyers, *i.e.*, as the issuer's private placement "underwriter," it would seem reasonable to treat the issuer's § 4(2) exemption as applying to the intermediary's private resale. *North Elkhorn Co.* (avail. Nov. 30, 1987) (favorable letter in which, as part of a restructuring, partnerships purchased shares of a surviving corporation in exchange for partnerships' assets, for the purpose of immediately distributing the shares to their partners—performing, in effect, as underwriters in a private placement). See *Fuller v. Dilbert*, 32 F.R.D. 60 (S.D.N.Y. 1962) (purchaser in a secondary private sale could designate persons to share in his purchase obligation, so long as he did so in a manner not resulting in a distribution).

17. 15 U.S.C. § 77d (1) (1982).

18. 15 U.S.C. § 77b(11) (1982).

generally accepted that the term "distribution" in section 2(11) is essentially synonymous with "public offering" as used in section 4(2).¹⁹

Although section 4(1) is the exemption applicable to most open market or public transactions by individual security holders who hold neither control nor restricted securities, this section does not by its terms preclude reliance thereon for private sales by security holders who cannot or choose not to make public sales. The better reasoned authorities conclude that section 4(1) exempts a private secondary sale of restricted or control securities that are sold privately when they cannot be sold publicly.²⁰ But such an exempt sale under section 4(1) must have some of the private sale characteristics associated with section 4(2) in order to avoid having the selling Holder become an underwriter, for whom section 4(1) is unavailable.²¹ It has become common, therefore, to refer to the exemption as "section 4(1-1/2)."

Regulation D²² provides a safe harbor exemption from the registration requirements for private placements. It applies by its terms only to sales by an issuer, and therefore is inapplicable to private sales by a Holder. Regulation D supplies useful guidance, however, to the extent that a section 4(1-1/2) sale should be modeled after a private sale by an issuer. The policies reflected in the American Law Institute (ALI) Federal Securities Code also provide useful guidance.²³

The SEC Staff positions on precisely which exemption applies to private secondary sales are less than satisfactory. An important SEC release acknowledges the existence of the section 4(1-1/2) exemption which it characterizes as a "hybrid exemption not specifically provided for in the 1933 Act but clearly within its intended purpose . . . so long as some of the established criteria for sales under both Section 4(1) and Section 4(2) . . . are satisfied."²⁴ Over time, the Staff has taken a variety of positions and nonpositions.²⁵

19. *But see* Applicability of Broker-Dealer Registration to Banks, Exchange Act Release No. 22,205, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,800, at 87,589 n.58 (July 1, 1985); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 627 F. Supp. 695, 709 n.12 (D.D.C. 1986).

20. *McDaniel v. Compania Minera Mar De Cortes, S.A.*, 528 F. Supp. 152 (D. Ariz. 1981); *Neuwirth Inv. Fund, Ltd. v. Swanton*, 422 F. Supp. 1187 (S.D.N.Y. 1975) (in which the Holder was a broker-dealer); *Value Line Fund, Inc. v. Marcus*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. Mar. 31, 1965). Other cases, however, seem to treat § 4(2) as the exemption applicable to a private resale of outstanding securities by an existing security holder. *See, e.g., Swenson v. Engelstad*, 626 F.2d 421 (5th Cir. 1980) (finding the exemption unavailable on the facts).

21. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); *United States v. Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959).

22. Securities Act rules 501 to 506, 17 C.F.R. §§ 230.501-.506 (1987).

23. American Law Institute, *FED. SEC. CODE* (1980).

24. *Employee Benefit Plans*, Securities Act Release No. 6188, 45 Fed. Reg. 8960, 8977 n.178 (Feb. 1, 1980). *Candela Laser Corp.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,530 (Oct. 28, 1987); and *Re Rule 145* (avail. April 23, 1981), *discussed in Staff Acknowledges Availability of Section 4(1-1/2) Exemption*, VI Corporate Counsel 7 (No. 3, May-June 1981), also acknowledges the existence of Section 4(1-1/2).

25. While the Staff has granted no action letters touching upon § 4(1-1/2) matters, it has as a matter of policy declined to interpret that exemption on other occasions. *Optelecom, Inc.* (avail. Apr. 5, 1982), *discussed in Staff Declines to Issue Advice on Hybrid § 4(1-1/2) Registration Exemption*, 14 SEC. REG. & L. REP. 667 (No. 15, Apr. 16, 1982) (citing Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice, Securities Act Release No. 6253, 45 Fed. Reg. 72,644 (Oct. 28, 1980), which indicates that the Staff will no longer express views on this general area).

Some Staff positions have stated that § 4(2) applies. *See Gralla Publications, Inc.* (avail. Feb. 18, 1977); *Mary Elizabeth Sealander* (avail. Sept. 19, 1977); *Colorado & W. Properties, Inc.*, *Danielson Turnpike Properties, Inc.* (avail. July 14, 1977). *But cf. Harris, Beech and Wilcox*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,773 (Apr.

III. REQUIREMENTS OF A PRIVATE SALE OF RESTRICTED OR CONTROL SECURITIES

Set forth below are suggested guidelines applicable to section 4(1-1/2) sales.²⁶ Unless otherwise stated, the following discussion assumes that a Holder wishing to sell privately would be unable to make an unregistered public sale at the time.²⁷ A Holder who is free to make an unregistered public sale in reliance on section 4(1) should be free to make a private sale as well in reliance on that exemption, without any of the further limitations imposed by section 4(1-1/2).²⁸ To illustrate, if a Holder who was never an affiliate of the issuer acquired securities in a private placement ten

14, 1972); Gadsby and Hannah, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,006 (Sept. 8, 1972); Karl Ehmer, Inc. (avail. May 9, 1975, reconsidered avail. July 17, 1975); Environmental Sciences Corp., [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,466 (July 30, 1973).

For several years, the SEC Staff has been discussing publicly various projects addressing resale issues, including the § 4(1-1/2) exemption. Apparently abandoning a more comprehensive project, it has been recently reported that the Staff is working on a more modest proposed rule (sometimes referred to by the Staff as "Rule 144A"), relating to institutional purchases of unregistered securities. Apparently such a rule will not address the broad range of § 4(1-1/2) issues, but the covering release may provide useful guidance on issues not covered by the rule itself.

On November 22, 1987, Linda C. Quinn, Director of the Division of Corporation Finance, delivered an address to an ABA committee entitled: "Redefining 'Public Offering or Distribution' for Today." This address raised a number of conceptual problems dealing with resales in a variety of contexts, including § 4(1-1/2), which was described as a "phantom" exemption.

While he was still Chief Counsel to the Division of Corporation Finance, Peter J. Romeo distributed an outline, dated March 30, 1984, of remarks presented at an April 7, 1984 ABA meeting, captioned "Resales Outside of Rule 144." The outline presented his personal views that had not been reviewed by the Commission, relating to a comprehensive statement of policy concerning resales. It touched on a number of § 4(1-1/2) issues and other issues. Staff members have referred to Mr. Romeo's outline from time to time, but the Staff is no longer actively considering as broad a safe harbor rule as Mr. Romeo contemplated.

Rule 144, 17 C.F.R. § 230.144 (1987), specifies in a nonexclusive manner those persons who are deemed not to be engaged in a distribution and, therefore, not underwriters in making public sales. In specifying the numerical limitation on shares that may be sold, rule 144(e)(3)(G), 17 C.F.R. § 230.144(e)(3)(vii) (1987) excludes the amount of securities sold privately from the permitted amount of public resales. As originally adopted, this subparagraph excluded securities sold: "pursuant to an . . . exemption provided by Section 4(2). . . ." 17 C.F.R. § 230.144(e)(3)(G) (1973) (emphasis added), amended by 17 C.F.R. § 230.144(e)(3)(vii) (1987). In 1974, the wording was changed, and the exclusion now covers: "a transaction exempt pursuant to section 4 of the Act and not involving any public offering. . . ." 17 C.F.R. § 230.144(e)(3)(vii) (1987) (emphasis added).

The foregoing amendment to this provision was not published for comments under the Administrative Procedure Act. The following statement appeared in the release promulgating the change in language from the original reference to § 4(2): The amendment, which changes the reference from Section 4(2) to a transaction exempt pursuant to Section 4 of the Act, and not involving any public offering, reflects the Commission's original intent in adopting the rule, as well as subsequent staff interpretations. Since this is an interpretative amendment for purposes of clarification, the Commission does not find it necessary to publish the amendment for comment pursuant to the Administrative Procedure Act.

Adoption of Amendment to Rule 144, Securities Act Release No. 5452, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,633 (Feb. 1, 1974) (emphasis added).

Note that the Commission fails to designate in rule 144 any particular subsection of § 4, but the final clause of the amended provision—"and not involving any public offering . . ."—tracks § 4(2) exactly. Is the Commission's "original intent" relevant? Is the matter now "clarified"?

26. Except as noted with respect to disclosure, it is suggested that substantially similar principles should apply to secondary sales by Holders who are controlling persons and by noncontrolling Holders who own restricted securities. There are some differences, however, in applying the integration principle. Sales by a noncontrolling Holder who has recently purchased restricted securities from the issuer may be subject to integration with all other related sales made directly by the issuer, and also with other direct and remote sales deriving through other related first tier private places. On the other hand, if the Holder is a controlling person who does not have restricted securities (*i.e.*, he does not have securities recently sold to him privately by the issuer), the sale to the Purchaser might have to be integrated with other sales tracing directly or indirectly back to the particular selling Holder. But, absent concerted action between such selling Holder and other sellers, it would not be necessary to integrate sales by the particular Holder with sales by the issuer or by any other Holder.

27. See *supra* note 3 and accompanying text.

28. See *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); *ValueLine*

years earlier, he would have completely free stock which he could sell publicly, without limitation, in reliance on section 4(1). Simply because such Holder may elect to sell the securities in a private transaction, there should be no additional section 4(1-1/2) type restrictions or obligations applying to his sale, or to his buyer's right to resell.

A. *Limitations on the Number of Purchasers*

A Holder should limit the number of Purchasers from him to relatively few. Setting aside for the moment questions of integrating sales by other persons with those of the Holder, a Holder should be permitted to sell safely to twenty-five persons, a commonly recognized rule of thumb limit for private placements outside of the safe harbor provided by Regulation D and its predecessor, rule 146 (now repealed).²⁹ One wonders if the number can be as large as thirty-five persons, with aggregation of closely related persons counting as one for this purpose (plus an unlimited number of "accredited" Purchasers), as permitted by Regulation D.

Assuming no prearranged or concerted action, may each participant in a private placement resell to the same number of Purchasers? Obviously "pyramiding" is a potential problem. If each participant in a private placement could resell privately to only a few other Purchasers, and each of those Purchasers could resell privately in turn to a few additional persons, the total number of Holders could increase rapidly by geometric progression to a very large number. Accordingly, the right to resell of each participant in a private placement should be limited to some extent by the sales of other participants within a relevant time period. This is the general approach of the ALI Federal Securities Code.³⁰ Normal integration principles should apply. It might be appropriate for the buyers in a private placement to agree among themselves how resales will be handled, just as they might agree how jointly held registration rights will be exercised.

B. *Method of Sale*

The customary method of sale for private placements, including the restrictions on general solicitation and advertising, should apply to section 4(1-1/2) sales.³¹ Purchasers may be solicited directly by the Holder or through intermediaries.³²

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

29. While no action letters typically involve a single Purchaser, multiple Purchasers are sometimes involved. See, e.g., Karl Ehmer, Inc. (avail. May 9, 1975, reconsider. avail. July 17, 1975) (8 Purchasers); Elwill Dev., Ltd. (reconsider. avail. Jan. 17, 1975) (5 Purchasers).

30. Compare § 202(41)(B)(i) of the American Law Institute, FED. SEC. CODE (1980), defining "limited offering," the functional successor to a § 4(2) private placement. It would expressly permit private resales by private places so long as the resales do not result in more than 35 owners (with exceptions) at any one time within three years after the last sale by the issuer. As the Code's resale right is structured, a Holder who sold all of his securities could be replaced by his Purchaser, without any increase resulting in the number of owners at any one time. That is, if each person sold all of his securities to one other person, there could be an unlimited number of successor resales without causing any increase in the number of owners that had to be counted in applying the 35 owner limit at any one time.

31. Cf. Securities Act rule 502(c), 17 C.F.R. § 230.502(c) (1987).

32. Los Angeles Unified School Dist. (avail. May 17, 1976). The manner through which intermediaries identify

The question arises: To what extent may an available block of securities be publicly advertised when the block is to be sold to one Purchaser or a limited group of Purchasers, *e.g.*, advertised publicly to meet Uniform Commercial Code requirements?³³ Favorable no action letters often involve a large number of offerees, including public auctions or public advertising, so long as the entire block of securities is to be sold to a single Purchaser or very limited group.³⁴

C. Disclosure

What must the Holder disclose in a section 4(1-1/2) sale? I believe the answer should depend upon the Holder's status as an insider and also upon his access to material information that is unavailable to the Purchaser. The discussion below focuses solely on any disclosures that may be required under section 4(1-1/2) in order to avoid violating the Act's registration provisions. Of course, the general antifraud provisions remain applicable, and they might well require extensive disclosure to a Purchaser under circumstances when there are no separate disclosures required to establish the section 4(1-1/2) exemption as such. Thus, a Purchaser in a private secondary transaction who has been defrauded by inadequate or deficient disclosure could have a perfectly adequate remedy under the antifraud provisions, whether or not he has a separate remedy for violation of the Act's registration provisions.

If the Holder is an insider having access to nonpublic information, it would appear prudent for the Holder to make disclosures comparable to the disclosure required of an issuer in a section 4(2) or Regulation D transaction, except to the extent that the Purchaser is already aware of the information.

If the Holder is not an insider and has no material inside information, the Holder should not be required to make any disclosures to the Purchaser about the issuer. If there is information publicly available about the issuer, it would appear prudent for the Holder to advise an uninformed Purchaser where and how such information can

prospects may raise questions involving the presence of general solicitation and advertising. *See* Arthur M. Borden, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,344 (Sept. 15, 1977).

33. *See* U.C.C. § 9-504(3) (1977). *See also* First Nat'l Bank of Md. (avail. Feb. 22, 1988); Capital Facilities Corp. (avail. July 8, 1982); American Sec. Bank, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,407 (May 29, 1980); Astro Mfg. Co. (avail. Jan. 15, 1979); Banner Publishers, Inc. (avail. Nov. 14, 1975).

34. Lapeer County Bank & Trust Co. (avail. Oct. 27, 1986); Republic Bank of Oklahoma City (avail. Dec. 1, 1986); Adventure Campers, Inc. (avail. Jan. 10, 1974); Illinois Capital Inv. Corp. (avail. Apr. 14, 1975); American Telecommunications Corp. (avail. June 25, 1976); Banner Publishers, Inc. (avail. Nov. 14, 1975); York Terrace Lessee Venture (avail. Dec. 11, 1975); David E. Wise, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,738 (Sept. 17, 1976); United Properties of Am., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,627 (June 9, 1978).

Madison Plaza Ass'n (avail. Jan. 8, 1988) involved a default by at least 15 limited partners who failed to pay the notes given in payment for their limited partnership interests. A no-action position was granted allowing the partnership to publicly advertise the units in a foreclosure sale under the Uniform Commercial Code. A recited term of sale was that the units of *each* defaulting partner would be sold as a block to only one purchaser, which would permit a total of at least 15 separate purchasers. Since the resale of the defaulted units was by the issuing partnership itself, the transaction was a primary offering to which § 4(2) was applicable, rather than a secondary offering, but there is no reason to believe that the Commission would have reached a different result on the number of permitted purchasers if the foreclosure sale had been a secondary one for the account of a nonissuer holding a lien on the units.

Another term of sale was that prospective purchasers would be furnished with information "on request" concerning the financial condition of the partnership.

be obtained,³⁵ but the Holder should not be obligated to assemble the information for the benefit of the Purchaser.

If the Holder is not an insider, but does have material nonpublic information about the issuer, or if he has ready access to such information, he should disclose to the Purchaser whatever material information the Holder has or can readily obtain.³⁶ The Purchaser should be advised, unless the fact is apparent from the circumstances, that the Holder is not in a position to warrant the current accuracy of the information supplied or that the Purchaser is receiving all existing material information. The Holder might wish to have the Purchaser acknowledge expressly that the Purchaser is not relying on the Holder as an information source beyond such information as is actually disclosed.

If the Holder does disclose to the Purchaser material nonpublic information about a publicly owned issuer, the Holder, for his own protection, should extract the Purchaser's covenant not to trade further in the public market on the basis (or possibly while in possession) of the nonpublic information.³⁷ Otherwise, the Holder might under certain circumstances become a tipper, thereby committing an insider trading violation of the antifraud prohibitions, if his tippee (the Purchaser) engages in improper trading based upon (or while in possession of) the disclosed information.³⁸

If the issuer is a publicly owned company with current reports under the 1934 Act,³⁹ it is doubtful whether a noninsider Holder must make any additional disclosures, except to the extent that he has material adverse information which would prohibit his sale without disclosure under general antifraud provisions. Some Staff letters suggest that Purchasers be limited to those with access to information about the issuer,⁴⁰ but this should not be a necessary condition as a matter of law. More recently, Staff members advise informally that they would not impose such a requirement.

Apart from any issuer-related disclosure, the Holder should make appropriate disclosure to a Purchaser that the securities are unregistered and will be restricted in the Purchaser's hands.

35. See *Adventure Campers, Inc.* (avail. Jan. 10, 1974); *Land & Leisure, Inc.*; *Hanover Inv., Inc.* (avail. Apr. 1, 1976). This step should not be necessary if it is clear that the Purchaser is already aware of publicly available information sources. Thus, when an experienced institutional Purchaser buys of a large publicly owned company, its awareness of reports filed with the SEC may be presumed and the Holder should be under no duty to advise the Purchaser of such information source.

36. David E. Wise, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,738 (Sept. 17, 1976); *York Terrace Lessee Venture* (avail. Dec. 11, 1975). If a Holder has a contractual or other right to obtain information from the issuer, it would be prudent for the Holder to exercise that right and pass on the information so received from the issuer.

37. Under circumstances when the Holder is legally obligated to restrict the Purchaser's further trading, the Purchaser would most likely be aware of his own legal obligation to refrain from further trading independent of any contractual undertakings. If the Purchaser does violate the law by improper trading, however, the Holder would no doubt be in a better position to avoid his own liability by showing that he took reasonable steps to prevent improper use of the information that he disclosed in confidence to the Purchaser.

38. See *Dirks v. SEC*, 463 U.S. 646 (1983).

39. Reports are filed pursuant to the Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1982).

40. See, e.g., *Investors Mortgage Group, Inc.* (avail. Feb. 9, 1976) (taking a position that harks back to the SEC's controversial brief in *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972)).

D. Qualification of Purchasers or Offerees

A recurring question is whether Purchasers (or offerees) in a section 4(1-1/2) sale must meet any self-funding, risk bearing, or sophistication tests that are applicable under section 4(2) and/or rule 506. Assuming, *arguendo*, that such requirements exist under section 4(2), a proposition that can be debated,⁴¹ I believe that such requirements should not be imposed under section 4(1-1/2). On the other hand, courts may be more likely to impose the Purchaser qualification requirements if the Holder is a control person of the issuer, in contrast to a private placee who is simply a passive outside owner of restricted securities. There is a tendency to equate controlling shareholders with issuers for this purpose.⁴² Most favorable no action letters in the section 4(1-1/2) context do not reflect any information on the sophistication or risk bearing capability of the Purchasers or offerees, and the SEC Staff seems to require no showing in this regard as a general matter.⁴³

E. Holding Period or Investment Intent Before a Holder or Purchaser Can Resell

Must a Holder of restricted securities establish any holding period before he can make a private resale? Absent an integration or pyramiding problem that results in a distribution, and assuming that the Holder is not functioning as a mere conduit for passing securities to others, there should be no specific holding period requirement imposed before a Holder may resell.⁴⁴

41. There is fairly compelling support for the view that there are no purchaser qualification requirements (apart from access to information) under the self-implementing § 4(2) exemption. Rather, these requirements were introduced by the SEC in the safe harbors of Regulation D and its predecessor rule 146, as part of a tradeoff for relaxing other § 4(2) limitations. See *Swenson v. Engelstad*, 626 F.2d 421, 425-26 (5th Cir. 1980); *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 904 (5th Cir. 1977); *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir. 1975), *vacated and remanded on other grounds*, 426 U.S. 944 (1976). These precedents are analyzed in *Schneider, The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869, 874-75 (1981). After all, the basic protection of the Security Act's registration provisions lies in disclosure, and not in protecting inappropriate purchasers from their own analytic or economic incapacity.

42. *Cf. Securities Act* § 2(11), 15 U.S.C. § 77b(11) (1982).

43. There are, however, a few refusals to grant no-action requests that note the absence of information about the Purchasers and/or offerees or suggest that they must have rule 506 type qualifications. *Gralla Publications, Inc.* (avail. Feb. 18, 1977); *Mary Elizabeth Sealander* (avail. Sept. 19, 1977); *Colorado & W. Properties, Inc., Danielson Turnpike Properties, Inc.* (avail. July 14, 1977); *York Terrace Lessee Venture* (avail. Dec. 11, 1975).

44. See *Value Line Fund, Inc. v. Marcus*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. Mar. 31, 1965); *Fuller v. Dilbert*, 32 F.R.D. 60 (S.D.N.Y. 1962).

If the nonaffiliated Holder holds the securities long enough, he may make his own *public* sale under § 4(1), and the private characteristics of a § 4(1-1/2) transaction become unnecessary. See also rule 144(k), 17 C.F.R. § 230.144(k) (1987). Therefore, a Holder's holding period is highly relevant in determining whether § 4(1) applies.

Although good arguments can be made that successive nonaffiliate private Holders should be permitted to tack their holding periods for this purpose, current law and SEC interpretation do not generally permit tacking holding periods before and after a § 4(1-1/2) sale. If the Holder is an affiliate, he would be unable to sell his securities freely no matter how long his holding period, so the argument in favor of tacking would be somewhat weaker when the Holder is an affiliate. See *Candela Laser Corp.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,530 (Oct. 28, 1987) (sale by an affiliate Holder who had held fifteen years was exempt by § 4(1-1/2), but the securities were restricted in Purchaser's hands). Special interpretations, which may give benefits similar to tacking, relate to resales of securities issued to employee benefit plans. *Employee Benefit Plans*, Securities Act Release No. 6281, 46 Fed. Reg. 8446 (Jan. 15, 1981); *Employee Benefit Plans*, Securities Act Release No. 6188, 45 Fed. Reg. 8962 (Feb. 1, 1980); *Resale of Securities Issued Pursuant to Employee's Stock Plan*, Securities Act Release No. 5750, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,766 (Oct. 8, 1976).

A special interpretive problem has arisen in the context of minimum/maximum or "all or none" private placements, in which a person associated with the sponsor or the offering broker wishes to purchase remaining securities in a sufficient

Must a Holder of restricted stock, or a Purchaser in a section 4(1-1/2) sale, have any form of investment intent? As a theoretical matter, a Holder's or Purchaser's resale would appear to be exempt so long as neither the Holder nor the Purchaser is participating in a "public offering," as that term is used in section 4(2), or is acting as an "underwriter" which in turn involves a "distribution," as those terms are used in section 2(11). Thus, there would appear to be no reason to preclude an intent (or at least reservation of the right) to make further *private* resales by the initial Holder or his Purchaser, absent a pyramiding problem that results in a public offering from a series of purportedly integrated private sales. The only limitations that should apply are: (1) to preclude resales in the public market, until some other exemption becomes applicable (*e.g.*, section 4(1) pursuant to the safe harbor of rule 144); and (2) to preclude a public distribution resulting in fact from too many successive private resales.

As a practical matter, however, to avoid the pyramiding problem, it would seem appropriate for the Holder to extract from the Purchaser some form of "investment" (or at least nondistribution) representation, especially if a trading market exists for the security. The Purchaser's investment representation is sometimes noted as a term of the sale in favorable no action letters.⁴⁵

Apart from any expression of investment (or nondistribution) intent, must the Purchaser have any specific holding period after his purchase from the Holder before he may make further private resales? Must the securities "come to rest" (whatever that often used phrase may mean) in the Purchaser's hands? Is it relevant to determine whether the Purchaser has the full investment risk or, alternatively, whether he is somehow protected against that risk—*e.g.*, by having a "put" back to the Holder, or by having given the Holder a nonrecourse note secured only by the security purchased?

If neither the transaction by which the Purchaser buys or the one by which he later resells is part of a public offering or distribution, there would appear to be no reason to require the Purchaser to have held the security for any period of time in order to qualify the private Purchaser's resale for a further section 4(1-1/2) exemption. In short, the general principles applicable to a Holder should apply to said Purchaser, with such Purchaser being, in essence, a new "Holder" in connection with his own later section 4(1-1/2) sale. Of course, resales by the Purchaser within close time proximity of his purchase, absent some explanation, may cast doubt on the bona fides of his original purchase and may suggest that he is serving as a mere

amount to complete the offering. In Securities Act Release No. 6455, 48 Fed. Reg. 10,045 (Mar. 3, 1983), interpreting Regulation D, the answer to question 79 indicates that such purchases "must be for investment and not resale"—apparently precluding private as well as public resales. The basis for this limitation is said to be Exchange Act rule 10b-9, 17 C.F.R. § 240.10b-9 (1987). See also Timothy M. Horner, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,194 (Oct. 16, 1985). This general interpretive approach has been challenged on the basis that, if the initial purchaser actually pays for the securities and assumes the investment risk, he should be able to resell the securities privately, so long as the overall transaction (including resales) does not (1) result in a distribution or public offering in violation of § 4(2), or (2) constitute the initial purchaser as an underwriter.

45. Mid-Continent Energy Corp. (avail. Dec. 22, 1976); Illinois Capital Inv. Corp. (avail. Apr. 14, 1975).

conduit between the seller to him and the buyer(s) from him. (Shades of the unlamented pre-rule 144 "change of circumstances" doctrine!)⁴⁶

On the other hand, to permit a Purchaser's bona fide resales after a short holding period by him raises a potential pyramiding problem—a public offering resulting in fact from too many integratable successive private resales in a too short period of time. Accordingly, I believe that a Purchaser should have no holding period requirement before he can make his own section 4(1-1/2) resales if, but only if, the entire series of integratable private transactions taken together does not constitute a public offering/distribution.

What obligation has the Holder to assure, and thereafter police, the nondistribution of the securities by the Purchaser? Should restrictive legends or stop transfer instructions to the transfer agent be used? Must the issuer comply with the Holder's request to use either or both techniques, since only the issuer can give binding instructions to the transfer agent or place legends on certificates newly issued to the Purchaser? Must the issuer independently insist that either or both techniques be used, if the Holder does not?

In terms of procedure, if there is or is likely to be any trading market for the security,⁴⁷ it would be prudent for the Holder to request that the issuer place a restrictive legend on the certificate or other document representing the securities in the hands of the Purchaser, and that stop transfer instructions be given if there is a transfer agent. Presumably, issuers generally would be willing to comply with these requests, although it is theoretically possible that an issuer might decline to accept the burden in limited circumstances.⁴⁸

F. *Type and Amount of Security and Nature of Purchaser*

In theory, neither the type of security, the amount of the security sold, nor the nature of the Purchaser should be germane in determining whether section 4(1-1/2) applies, but these factors may be of some practical relevance in situations in which the law is unclear—especially when dealing with risky securities and unsophisticated Purchasers. With respect to the amount of securities to be sold, it is clear that section 4(1-1/2) does not impose quantitative limits comparable to rule 144's one percent or

46. See *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 462-68 (2d Cir.), cert. denied, 361 U.S. 896 (1959) (court refused to allow change of circumstance defense when change was reasonably foreseeable at time of purchase); see also T. HAZEN, *THE LAW OF SECURITIES REGULATION* 146-47 (1985); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 357-66 (1988).

47. Practice varies regarding legends relating to nonregistration under the Act for securities of private companies. The overwhelming number of companies in the United States are privately owned, with no expectation of becoming publicly owned in the foreseeable future. Most such companies probably do not routinely legend securities regarding their nonregistered status under the Act.

48. The SEC takes the position that, in order to preserve the § 4(2) exemption upon which the issuer has relied, the issuer must police its own private placements against improper redistribution. But this rationale does not apply when the Holder is an affiliate who acquired shares on the open market. Nonetheless, many companies consider it prudent to place legends on stock held by affiliates, even if the stock was unrestricted when the affiliate acquired it through open market purchases.

Should the issuer involve itself in any disclosures which are made by the Holder to the Purchaser? Probably yes, if the Holder is an affiliate. Probably no (except to confirm compliance with SEC reporting requirements, if applicable), if the Holder is not an affiliate or other type of insider.

average weekly trading volume tests.⁴⁹ On the other hand, a relatively large amount of securities to be sold may be a factor that influences the SEC's Staff to deny a no action position.

With respect to the type of security and nature of Purchaser, a no action letter dealing with a proposed noninstitutional sale of relatively risky equity securities noted as a positive factor that the sale would be made only to a "financially sophisticated [purchaser] who can afford the risk."⁵⁰ On the other hand, a major portion of the total financing by U.S. companies is accomplished through the private sale of debt securities to institutions in relatively large blocks. Although these securities typically are held to maturity, the right of one institution to sell large blocks of debt securities to another without registration has never been seriously questioned. The secondary institutional market for privately placed debt securities has special characteristics, and there is a flexibility commonly accepted in practice that may not apply to noninstitutional resales of equity securities.⁵¹

G. Fungibility

If a Holder owns both restricted and nonrestricted securities of the same class and he makes a private sale, can he take the position that he has divested himself of the restricted securities? If so, must he be able to trace the particular securities sold (e.g., by certificate numbers) as being identifiable restricted securities?

The more enlightened approach would apply the fungibility concept, recognizing that for relevant securities laws purposes all securities of the same class are fungible, but use the concept to the Holder's advantage, not his disadvantage. That is, without the need to trace particular securities (tracing may have adverse tax or other consequences to the Holder personally), the Holder should be permitted, at his election, to designate his public sales as having come from his securities that can be sold publicly, and his private section 4(1-1/2) sales as coming from his securities that cannot be sold publicly. This approach, allowing a Holder to use fungibility to his advantage, is reflected in rule 144 and the ALI Federal Securities Code.⁵²

49. Securities Act rule 144(e), 17 C.F.R. § 230.144(e) (1987).

50. York Terrace Lessee Venture (avail. Dec. 11, 1975).

51. See *Resales by Institutional Investors of Debt Securities Acquired in Private Placements*, 34 BUS. LAW. 1927 (1979) (ABA position paper).

The American Stock Exchange has filed proposed rules with the SEC to create a new division of the exchange called System for Institutional Trading of Unregistered Securities ("SITUS"). SITUS would create a U.S. market limited to institutional investors as participants, for trading unregistered blocks of debt or equity securities of large, high-grade, nonreporting foreign issuers. SEC File No. SR-Amex-87-32 (Dec. 23, 1987). If the rules are approved, SITUS would become, in effect, an exchange market for § 4(1-1/2) sales to institutional buyers. Though the particular proposal relates to foreign securities, if the SEC approves the concept it might well apply to securities issued by domestic companies as well.

52. Securities Act rule 144(e)(3)(G), 17 C.F.R. § 230.144(e)(3)(vii) (1987); American Law Institute, FED. SEC. CODE § 202(41)(B)(ix) (1980 & 2d Supp. 1981). Cf. Interpretations of Rule 144, Securities Act Release No. 5306, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,000, at 82,157 (Sept. 26, 1972).

H. *The Holder's Status as a Dealer*

If the Holder of restricted securities happens to be a dealer in securities, literally neither section 4(1) nor section 4(2) would ever apply, even if the dealer sold the securities through another broker-dealer, since the transaction would "involve" a dealer. It would seem unduly harsh, however, to preclude a Holder who happens to be a dealer from ever making a private secondary sale under section 4(1-1/2). I feel confident that there should be a basis for a proper private resale by a Holder of restricted securities who happens to be a dealer.⁵³ Possibly the sale should be considered exempt on the rationale that, with respect to the particular investment, the Holder is not acting as a "dealer" for this purpose.

I. *A Working "Rule of Thumb"*

The preceding analysis raises many questions that are not fully answered. The following is offered, however, as a safe harbor test, in the sense that Holders should have section 4(1-1/2) available if the test is met:

Resales by a buyer in an issuer's private placement are exempt under section 4(1-1/2) if: (1) the issuer could have sold the securities directly to all of the direct buyers from it as well as all of the remote buyers who purchase from the direct buyers from it (or from any intermediate buyer), without losing the section 4(2) exemption, assuming with respect to remote buyers the inapplicability of any offeree qualification requirements and taking into account the aggregate number of ultimate buyers, the manner of sale to each, and the time period during which the sales occur; and (2) each person who resells discloses to the buyer from him the material information about the issuer known or reasonably available to the seller and not known or reasonably available to the buyer from such seller. No offeree qualification tests need be met by buyers who do not buy directly from the issuer, assuming that the intervening buyer-reseller has made a bona fide purchase for his own account, and is not serving merely as an intended conduit for a sale by the issuer indirectly to the ultimate buyer.

Illustration: An issuer sells to two first tier buyers in a private placement. Shortly thereafter, each first tier buyer sells a part of his holdings to two additional persons, increasing by four the total number of buyers to six. Shortly thereafter, each of the four second tier buyers sells a part of his holdings to four additional persons, increasing the total number of buyers by another sixteen to twenty-two. Each first tier buyer has the ability to understand and assume the investment risk. The issuer made adequate disclosure to the first tier buyers, and each reseller disclosed the material information available to him to his buyer. There are no further resales of the securities.

Analysis: Viewing the entire series of sales and resales as an integrated transaction, no distribution or public offering has occurred. No purchaser making resales is an underwriter. Every direct and remote buyer could have participated in the initial private placement as a direct buyer from the issuer without loss of the section 4(2) exemption, assuming that any purchaser qualification tests that may apply to the

53. See *Neuwirth Inv. Fund, Ltd. v. Swanton*, 422 F. Supp. 1187 (S.D.N.Y. 1975) (in which the Holder was a broker-dealer). See also *supra* note 14.

issuer's sale are inapplicable to a Holder's sale.⁵⁴ Therefore, the section 4(1-1/2) exemption should apply to all of the resales by the first tier or second tier buyers.

I hasten to emphasize that the foregoing is suggested solely as a nonexclusive safe harbor test—a clear case. No inference should be drawn that section 4(1-1/2) would necessarily be inapplicable if this safe harbor test were not met.

J. Other Possible Exemptions for Private Resales

If the Holder has securities that may be sold freely under an exemption other than section 4(1-1/2), he should be able to pass completely free securities to a Purchaser in a private sale made on a basis consistent with such applicable exemption, but without complying with the additional restrictions of section 4(1-1/2). The following possibilities are worthy of consideration:

The intrastate offering exemption contained in section 3(a)(11)⁵⁵ of the Act has been interpreted by the SEC as applying to affiliates if the exemption would have been available to the issuer, and an affiliate selling in reliance on the exemption need not be a resident of the state in question.⁵⁶ Presumably, the same principle should apply to a secondary sale by a nonresident Holder who is not an affiliate, assuming that the issuer's earlier private sale to the Holder would not be subject to integration as part of the same transaction with the Holder's later intrastate resales.

If a nonaffiliate Holder has held the securities for more than three years, the securities are likely to be, as a practical matter, completely free of further restriction in the hands of the Holder under rule 144(k). If privately placed securities have been held by a nonaffiliate Holder for a long period of time (*e.g.*, over five years), the Holder should be able to establish that section 4(1) applies, apart from rule 144, and that the securities are unrestricted in his hands.

The Securities Act registration requirements are inapplicable if a Holder's sale is accomplished without any use of the jurisdictional means,⁵⁷ although improper integratable resales through the jurisdictional means by the Purchaser may ultimately involve the prior Holder in a violation.

IV. AN APPROPRIATE RESPONSE FROM THE COMMISSION

The Commission has been urged to give guidance in the section 4(1-1/2) area through rulemaking or an interpretive release.⁵⁸ While there has been a project

54. See *supra* note 41. So long as the first tier buyers are purchasing in good faith for their own accounts, and not as mere conduits between the issuer and more remote buyers, I believe as a matter of policy that the buyer qualification requirements should be inapplicable.

55. 15 U.S.C. § 77c(a)(11) (1982). Preliminary Note 4 to rule 147, 17 C.F.R. § 230.147 (1987), a safe harbor rule under § 3(a)(11), makes the rule inapplicable to secondary sales.

56. Exemption for Local Offerings from Registration, Securities Act Release No. 4434, 26 Fed. Reg. 11,896, 11,897 (Dec. 6, 1961). But compare *Grenader v. Spitz*, 390 F. Supp. 1112 (S.D.N.Y. 1975), *rev'd on other grounds*, 537 F.2d 612 (2d Cir. 1976), which can be read to suggest (incorrectly, I believe) that an issuer's controlling person must also reside in the jurisdiction for § 3(a)(11) to be available. Preliminary Note 4 to rule 147 expressly makes that safe harbor rule inapplicable to nonissuer transactions.

57. Section 5 of the Securities Act, 15 U.S.C. § 77e (1982), applies only if the sale makes use of the mails, or the means or instruments of transportation or communication in interstate commerce.

58. See *Olander & Jacks, supra* note 7.

underway in this area for a number of years, it is apparently the intention of the present Staff to adopt a rather modest safe harbor rule dealing only with private sales of securities to institutions, without addressing section 4(1-1/2) issues more broadly.⁵⁹

I recommend that the Commission do nothing to address section 4(1-1/2) issues generally, apart from (1) actions taken on a particular set of facts (*e.g.*, in litigation or in response to a no-action request), and (2) its current plan with respect to institutional purchases. I come to this conclusion for the reason that the issues are so complex and interrelated, and can arise in such varied factual settings, that the Commission is not likely to give in the abstract any definitive or even helpful guidance beyond those clear cases in which no help from the Commission is required. It would be preferable to let the law develop, at the administrative and judicial level, on a case-by-case basis.

With respect to registration exemptions, experience teaches that some (although by no means all) so-called safe harbor rules are drawn so restrictively that they give comfort only in extremely limited circumstances when the law is completely clear in any event. Indeed, by suggesting highly restrictive standards, such safe harbors tend to be counterproductive from the viewpoint of those hoping to rely on the exemptions.⁶⁰ Such standards tend to spill over as an interpretive matter, potentially leading courts to narrow the exemptions contained in self-implementing statutory provisions by incorporating the safe harbor rule limitations. I fear that any rulemaking or general interpretive "help" from the SEC in the section 4(1-1/2) area would be so limited as to be counterproductive in this sense.

V. CONCLUSION

Congress intended to protect investors through the disclosure mandated by the registration process in certain transactions. On the other hand, it is clear that the vast majority of securities transactions are intended to be exempt. Two of the major exemptions apply to private sales by issuers, covered by section 4(2), and public or private sales that do not involve a distribution by or for the benefit of the issuer or a controlling person. The latter are covered by section 4(1). It would defeat the overall purpose of the statutory scheme to restrict secondary sales unduly by an overly expansive reading of the terms "underwriter" or "public offering" so as to render

59. See *supra* note 20 and accompanying text.

60. A classic example is rule 147, 17 C.F.R. § 230.147 (1987), creating a safe harbor in connection with the intrastate offering exemption of § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1982). To qualify for the safe harbor, an issuer must meet each of three separate 80% tests with respect to the jurisdiction in which it is making the offering relating to gross revenue, location of assets, and use of proceeds. The Securities Act itself requires simply that the issuer be "doing business" within the jurisdiction. As an appropriate interpretive gloss, the courts have confined the exemption to local financings by local businesses, and have required that the issuer have substantial or predominant business activities in the jurisdiction. See, *e.g.*, *Chapman v. Dunn*, 414 F.2d 153, 159 (6th Cir. 1969); *SEC v. McDonald Inv. Co.*, 343 F. Supp. 343 (D. Minn. 1972). This interpretative requirement could be met if the jurisdiction in question was more significant than any other, even though it represented less than a majority of the issuer's business (however business was to be measured). A majority of the business being local should certainly suffice under the pre-rule 147 judicial interpretations of § 3(a)(11). Prior to the adoption of rule 147, there was no precedent whatsoever for requiring that the local activities meet anything like the three-pronged 80% test in rule 147.

section 4(1) unavailable to private secondary transactions. The capital raising ability of both public and private companies would be impaired if their existing security holders were unreasonably restricted in making private resales. Similarly, a requirement that particular secondary sales be registered will ultimately impose additional costs and burdens on issuers, to the detriment of their other shareholders.

Accordingly, it is suggested that some reasonable balance must be struck in order to permit unregistered private secondary sales under circumstances when the Holder could not make public sales. This Article has attempted to suggest practical guidelines in establishing that balance.