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SECURITIES: THE PRIVATE OFFERING EXEMPTION AND RULE 146

Judson L. Temple

INTRODUCTION

The Securities Act of 1933¹ was enacted "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."² This Act followed an era in which the flotation of worthless securities³ was widespread which resulted in "tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities."⁴ The Act does not seek to prohibit the sale of worthless securities; it seeks to protect the investing public by compelling disclosure to the public of all information necessary for an accurate evaluation of the worth of the securities.⁵ The information required by disclosure is contained in a registration statement.⁶ Section 5⁷ of the Act provides that no securities shall be sold or offered for sale by means of interstate transportation or communication or use of the mails unless a registration statement has been filed and approved by the Securities and Exchange Commission⁸ as to those securities.

Certain securities and certain transactions are exempted from the registration requirements of Section 5.⁹ Section 4(2) contains what is commonly known as the private offering exemption: "The provisions of section 5 shall not apply to transactions by an issuer not involving any public offering."¹⁰ The scope of the private offering exemption is not defined in the Act.¹¹ Nor is the legislative history of the Act of much help in delimiting the scope of the exemption.¹² The exemption has taken on its present structure through the decisions of the courts and the interpretations of the SEC.¹³ The standards which have evolved

¹15 U.S.C. §§ 77a-77bbbb (1970).

²SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

³"Security" is defined in the Securities Act of 1933 § 2(1); 15 U.S.C. § 77b(1) (1970).

⁴H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).

⁵SEC v. Ralston Purina Co., *supra* note 2 at 124.

⁶Securities Act of 1933 §§ 2(8), 7; 15 U.S.C. §§ 77b(8), 77(f) (1970).

⁷Securities Act of 1933 §§ 5(a), (c); 15 U.S.C. §§ 77e(a), (c) (1970).

⁸hereinafter cited as SEC.

⁹Exempted securities are set out in Securities Act of 1933 § 3; 15 U.S.C. § 77(c) (1970).

Exempted transactions are set out in Securities Act of 1933 § 4; 15 U.S.C. § 77(d) (1970).

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

¹¹See SEC Securities Act Release No. 5430 (October 10, 1973) [hereinafter cited as Release 5430], 2 SEC DOCKET 551.

¹²See SEC v. Ralston Purina Co., *supra* note 2 at 122, 123.

¹³Additional information on the private offering exemption can be found in the following sources: 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES

have generated more confusion than certainty as to when the exemption is available. For this reason the SEC has proposed to adopt Rule 146 "to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed transactions not involving any public offering within the meaning of Section 4(2) of the Act and thus would be exempt from the registration provisions of the Act."¹⁴ Rule 146 was first promulgated in proposed form on November 28, 1972.¹⁵ The SEC revised the proposed rule on October 10, 1973, in response to criticisms of the rule in its original form.¹⁶ As of the date of this writing, Rule 146, as revised, remains in proposed form and it may well be adopted in this form early in 1974.¹⁷

This Comment has two purposes: 1) To trace the private offering exemption as it has developed by case law and SEC interpretations, and 2) To assess the impact of Rule 146 on the private offering exemption.

A security sold pursuant to the private offering exemption is a restricted security,¹⁸ i.e., there are limitations on the ability of the holder of the security to resell it to the public. It is clear that such a limitation is necessary. Otherwise, securities sold pursuant to the private offering exemption, without registration, might be distributed to the public through resales, defeating the objectives of the 1933 Securities Act. The problems associated with the resale of securities are beyond the scope of this paper.¹⁹

Even if Rule 146 is adopted, the present development of the private offering exemption by case law and SEC interpretations will remain of more than academic interest. This is true for two reasons: 1) Rule 146 is cast in light of existing private offering concepts so that an understanding of these concepts will aid the understanding of Rule 146, and 2) Rule 146 is a "safe harbor" rule only, i.e., an issuer who sells securities and who meets all the conditions of Rule 146 will be deemed to be within the bounds of the private offering exemption.²⁰ It will not be necessary to comply with Rule 146, however, to satisfy the private offering exemption. Failure to satisfy Rule 146 will not even raise a presumption that the private offering exemption is not met.²¹

(2d ed. 1973); 1 L. LOSS, *SECURITIES REGULATION* (3d ed. 1961); *SECURITIES LAW PRACTICE* (Ill. Inst. for CLE, 1973).

¹⁴Release 5430, 2 SEC DOCKET 550.

¹⁵SEC Securities Act Release No. 5336 (November 28, 1972) [hereinafter cited as Release 5336], 37 Fed. Reg. 26137 (1972).

¹⁶Release 5430, 2 SEC DOCKET 550.

¹⁷*SECURITIES LAW PRACTICE* (Ill. Inst. for CLE, 1973), Authors' Note on Chapter 3.

¹⁸See Rule 144(a), SEC Securities Act Release No. 5223 (January 11, 1972) [hereinafter cited as Release 5223] for a definition of a restricted security.

¹⁹Rule 144, Release 5223 sets forth reasonably objective conditions for the resale of securities acquired through a private placement under the Securities Act of 1933 § 4(2).

²⁰Release 5430, 2 SEC DOCKET 550.

²¹*Id.* at 557.

Thus, an issuer who is charged with the sale of securities without a registration statement and who raises the defense of Rule 146 will be found in violation of the Act only if the court independently finds that the issuer did not meet the conditions of Rule 146 and that the issuer did not satisfy the requirements of the private offering exemption as they have developed by case law and by SEC interpretations.

EARLY DEVELOPMENTS

There is very little in the legislative history of the 1933 Securities Act which sheds light on the intended scope of the private offering exemption. H.R. Rep. No. 85 notes that the Act "carefully exempts from its application certain types of securities transactions where there is no practical need for its application or where the public benefits are too remote."²² A subsequent reference says that the private offering exemption permits "an issuer to make a specific or an isolated sale of its securities to a particular person. . . ."²³ Finally, H.R. Rep. No. 152 states that "[s]ales of stock to stockholders become subject to the act unless the stockholders are so small in number that the sale to them does not constitute a public offering."²⁴

The first definitive work on the private offering exemption was SEC Release No. 285.²⁵ Release 285 first held that what was a private or public offering was a question of fact to be determined upon all the circumstances of the individual case.²⁶ The release then listed four main criteria to be applied in the determination:

1. The Number of Offerees and Their Relationship to Each Other and to the Issuer;²⁷
2. The Number of Units Offered;²⁸
3. The Size of the Offering;²⁹
4. The Manner of Offering.³⁰

The release noted that an offering to "an insubstantial number of persons" was presumptively a private offering³¹ and that "under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number. . . ."³² This

²²H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933).

²³*Id.* at 16.

²⁴H.R. REP. NO. 152, 73d Cong., 1st Sess. 25 (1933).

²⁵SEC Securities Act Release No. 285 (January 24, 1935) [hereinafter cited as Release 285], 1 CCH FED. SEC. L. REP. ¶ 2740.

²⁶Release 285, 1 CCH FED. SEC. L. REP. ¶ 2740.

²⁷*Id.* ¶ 2741.

²⁸*Id.* ¶ 2742.

²⁹*Id.* ¶ 2743.

³⁰*Id.* ¶ 2744.

³¹*Id.* ¶ 2740.

position was qualified in that the basis on which the offerees were selected was highly relevant in determining what constitutes a substantial number. Thus, a class of offerees chosen on the basis of "some pre-existing standard"³³ or who had "special knowledge of the issuer"³⁴ was more likely to result in a private offering than an arbitrarily chosen group of offerees. Further, an offering in which the number of units offered was small was more likely to be a private offering than an offering of a large number of units which carried a greater likelihood of eventual distribution to the public.³⁵ Similarly, an offering of small size (i.e., small dollar value) was less likely to be public than an offering of a larger size.³⁶ Finally, the manner of offering was relevant. Offers or sales effected by "direct negotiation" between the issuer and offeree or buyer were more likely to be private than those effected by means of "the machinery of public distribution."³⁷

*SEC v. Sunbeam Gold Mining Co.*³⁸ contributed to the developing body of law in this area. In order to finance the purchase of the assets of Golden West Consolidated Mines, Sunbeam solicited loans from stockholders of Sunbeam and Golden West. Each contributing stockholder received a promissory note, denoted a "shareholder's receipt"³⁹ containing the promise of Sunbeam to repay the sum loaned with interest. The SEC charged that the shareholder's receipt was a security and must be registered pursuant to Section 5 of the 1933 Securities Act. Sunbeam claimed that the transactions were exempt from registration in that they constituted a private offering. Sunbeam claimed that since the transactions were conducted only with stockholders of Sunbeam and Golden West and were not open to the general public, the offering was private. Sunbeam claimed that an offering was a public offering only if it was open to everybody. The district court accepted this argument, but the Circuit Court of Appeals reversed:

In its broadest meaning, the term 'public' distinguishes the populace at large from groups of individual members of the public segregated because of some common interest or characteristic. Yet such a distinction is inadequate for practical purposes; manifestly, an offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone and Telegraph Company, is no less 'public,' in every realistic sense of the word, than an unrestricted offering to the world at large. Such an offering, though not open to everyone who may choose to apply, is nonetheless 'public' in character, for the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made. For the purposes of an offering of securities, red-headed men, residents of San Francisco, and stockholders of General Motors are as much members of the

³³*Id.* ¶ 2741.

³⁴*Id.*

³⁵*Id.* ¶ 2742.

³⁶*Id.* ¶ 2743.

³⁷*Id.* ¶ 2744.

³⁸*SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699 (9th Cir. 1938).

³⁹*Id.* at 700.

public as their antithetical counterparts. To determine the distinction between 'public' and 'private' in any particular context, it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction.⁴⁰

The Court concluded that an offering limited to the stockholders of a single company could be a public offering. The Court also made two important evidentiary holdings: the burden of proof lies on the person claiming the private offering exemption; and the terms of such an exception to the Act must be "strictly construed" against the person claiming its benefit.⁴¹ Since Sunbeam had no facts to submit other than that all offerees were stockholders, it failed its burden of proof that the offering was private.

At this juncture the issuer contemplating a private offering had a number of criteria to guide him: the number of offerees and their relationship to each other and to the issuer, the number of units offered, the size and manner of the offering, and the fact that an offering need not be open to the general public to be a public offering. But these tests were not capable of objective measurement, and there was little indication of how they inter-related with each other. With this as a background,⁴² the U.S. Supreme Court decided the case of *SEC v. Ralston Purina Co.*⁴³ In *Ralston Purina*, the U.S. Supreme Court squarely faced for the only time the scope of the private offering exemption. The Court's decision completely altered the approach taken to the private offering exemption.

THE RALSTON PURINA CASE

Ralston Purina manufactured and distributed feed and cereal products. It undertook a program to encourage stock ownership among its employees. Apparently mindful of the lesson of Sunbeam that an offering of company stock to all its employees would be a public offering requiring registration, Ralston Purina sought to gain the shelter of the private offering exemption by limiting its offer to those employees who took the initiative in buying Ralston Purina stock and who were "key employees."

A key employee . . . is not confined to an organization chart. It would include an individual who is eligible for promotion, an individual who especially influences others or who advises others, a person whom the employees look to in some special way, an individual, of course, who carries some special responsibility, who is sympathetic to management and who is ambitious and who the management feels is likely to be promoted to a greater responsibility.⁴⁴

⁴⁰*Id.* at 701.

⁴¹*Id.*

⁴²See also *Corporation Trust Co. v. Logan*, 52 F. Supp. 999 (D. Del. 1943); *Campbell v. Degenther*, 97 F. Supp. 975 (W.D. Pa. 1951).

⁴³*SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

⁴⁴*Id.* at 121-122.

In actuality, key employees included an "artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer, and veterinarian."⁴⁵ The U.S. Supreme Court endorsed the holding of Sunbeam that "to be public an offer need not be open to the whole world."⁴⁶ But the Court went further:

Exemption from the registration requirements of the Securities Act is the question. The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which 'there is no practical need for (the bill's) application,' the applicability of §4(1) [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.'⁴⁷

Thus, in every case the crucial question is the need of the class of offerees for the protection of the Act or the ability of the class to fend for themselves. Did the "key employees" of Ralston Purina need the protection of the Act's registration provisions? Yes, they did.

The employees here 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 §5.⁴⁸

Thus, the private offering exemption was not available to Ralston on these facts. The Court did find that some offerings to employees might come within the folds of the private offering exemption, e.g., offerings made "to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registrative statement."⁴⁹ The Court also addressed itself to the relevance of the number of offerees to the private offering exemption. The Court refused to hold, as a matter of statutory interpretation, that an offering to a "substantial number" of the public was necessarily a public offering or that an offering to just a few was necessarily private.⁵⁰ But, the SEC remained free to impose a numbers test in determining when to investigate claims of a private offering exemption from registration.⁵¹

THE AFTERMATH OF RALSTON PURINA

The U.S. Supreme Court has not spoken since the Ralston Purina case on the scope of the private offering exemption. The U.S. Circuit

⁴⁵*Id.* at 121.

⁴⁶*Id.* at 123.

⁴⁷*Id.* at 124-125.

⁴⁸*Id.* at 126-127.

⁴⁹*Id.* at 125-126.

⁵⁰*Id.* at 125.

⁵¹*Id.*

Courts of Appeal have had the role of determining when a class of offerees was not in need of the protection afforded by registration under the 1933 Securities Act so that the offering could be properly classified as private.⁵² The U.S. Supreme Court held an offering was private whenever the offerees could "fend for themselves." On the facts of the Ralston Purina offering, the offerees could fend for themselves only if they had access to corporate financial information of the type that would be available to executive personnel of the corporation. "Access" was a requirement on the Ralston facts, but did this mean that in no case could an offeree "fend for himself" unless he had "access"? Or could an offeree "fend for himself" in some situations merely by possessing investment experience and financial sophistication? Would the "access" requirement be met, when it was required, if the issuer opened up the company books to the offeree? Or did the "access" have to stem from a pre-existing relationship between the issuer and the offeree such as employment of the offeree in an executive capacity by the issuing company?

An analysis of the decisions of the Circuit Courts of Appeal indicates that "access"—or its absence—is one of the factors most heavily weighted in determining whether the offering is public or private.⁵³ In many cases "access" (or the knowledge which can be gained through access) is equated with the "need of the offerees for the protection the Act provides" or with their ability to "fend for themselves."⁵⁴ *SEC v. Tax Service, Inc.*,⁵⁵ is merely illustrative. There the issuer offered to sell stock to purchasers of or subscribers to the issuer's publications and to the members of a county bar. The court noted that the status of subscriber or attorney did not provide the offeree with access to the

⁵²The following cases are particularly relevant, though not an exhaustive listing: Second Circuit: *Gilligan, Will and Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959); *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir. 1960); *Katz v. Amos Treat and Co.*, 411 F.2d 1046 (2d Cir. 1969); Fourth Circuit: *SEC v. Tax Service, Inc.*, 357 F.2d 143 (4th Cir. 1966); *United States v. Custer Channel Wing Corporation*, 376 F.2d 675 (4th Cir. 1967); Fifth Circuit: *Hill York Corp. v. American Internat'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971); *Henderson v. Hayden, Stone, Inc.*, 461 F.2d 1069 (5th Cir. 1972); *SEC v. Continental Tobacco Co. of S.C.*, 463 F.2d 137 (5th Cir. 1972); Sixth Circuit: *Chapman v. Dunn*, 414 F.2d 153 (6th Cir. 1969); Tenth Circuit: *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959); *Garfield v. Strain*, 320 F.2d 116 (10th Cir. 1963); *Edwards v. United States*, 374 F.2d 24 (10th Cir. 1966); *Lively v. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971).

⁵³*Gilligan, Will and Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959); *SEC v. Guild Films Co.*, 279 F.2d 485, 490 (2d Cir. 1960); *SEC v. Tax Service, Inc.*, 357 F.2d 143, 144 (4th Cir. 1966); *United States v. Custer Channel Wing Corporation*, 376 F.2d 675, 678 (4th Cir. 1967); *Hill York Corp. v. American Internat'l Franchises, Inc.*, 448 F.2d 680, 690 (5th Cir. 1971); *SEC v. Continental Tobacco Co. of S.C.*, 463 F.2d 137, 158-159 (5th Cir. 1972); *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971).

⁵⁴*Gilligan, Will and Co. v. SEC*, *supra* note 53 at 466; *SEC v. Guild Films Co.*, *supra* note 53 at 490; *SEC v. Tax Service, Inc.*, *supra* note 53 at 144; *Nicewarner v. Bleavins*, 244 F. Supp. 261, 265 (D. Colo. 1965); *Bryant v. Uland*, 327 F. Supp. 439, 442-443 (S.D. Tex. 1971); *Bowers v. Columbia General Corporation*, 336 F. Supp. 609, 623-624 (D. Del. 1971).

⁵⁵*SEC v. Tax Service, Inc.*, 357 F.2d 143 (4th Cir. 1966).

kind of information a registration statement would make available. The court concluded:

Thus where the class of offerees has 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 and the full disclosure derived from compliance with section 5.⁵⁶

Other cases have indicated that a factor to be considered along with "access" in assessing the need of the offerees for the protections of the Act is the "sophistication" of the offeree in financial and investment matters.⁵⁷ It is probably fair to say, however, that "sophistication" has been less stressed by the courts than has "access." Some of the more prominent decisions which have given emphasis to offeree "sophistication" have been from the Tenth Circuit.⁵⁸

In *Lively v. Hirschfeld*,⁵⁹ Hirschfeld sold 8,000 shares of stock. There were 20-25 offerees, who were "friends, educated persons, business associates and acquaintances"⁶⁰ of Hirschfeld. The court held that business experience and "access" were both requisites for a private offering.

The Supreme Court in its description of a possible 'private' group in *Ralston Purina* includes only persons of exceptional business experience, and 'a position where they have regular access to all the information and records which would show the potential for the corporation.'⁶¹

This case is notable for the narrow construction which the court gave to the private offering exemption. The plaintiff who testified the most was an airline pilot of "considerable business experience."⁶² He was told the essentials of the corporate structure, e.g., the number of shares outstanding, their par value, and the names of corporate officers. There was no evidence that any corporate information was withheld from him although he did not ask for information. But the court held that even as to this plaintiff, the private offering exemption was not available.⁶³ Apparently, the pilot did not have the "exceptional business experience" or the "regular access" to corporate records that was required. There were other offerees to whom only general references were made. Since to qualify for the private offering exemption, the offeror must prove that every offeree meets the conditions of the exemption, "[t]he testimony as to all other offerees was woefully short of the requirement."⁶⁴

⁵⁶*Id.* at 144.

⁵⁷*Woodward v. Wright*, 266 F.2d 108, 115 (10th Cir. 1959) (purchasers used sophisticated discernment); *Garfield v. Strain*, 320 F.2d 116, 119 (10th Cir. 1959); *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971); *Collier v. Mikel Drilling Co.*, 183 F. Supp. 104, 112 (D. Minn. 1958); *Repass v. Rees*, 174 F. Supp. 898, 904 (D. Colo. 1959); *Fuller v. Dilbert*, 244 F. Supp. 196, 212 (S.D. N.Y. 1965).

⁵⁸The first three cases cited in note 57.

⁵⁹*Lively v. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971).

⁶⁰*Id.* at 632.

⁶¹*Id.* at 633.

⁶²*Id.* at 632.

⁶³*Id.* at 633.

⁶⁴*Id.*

Several decisions have emphasized that offeree "sophistication" is not sufficient in the absence of "access."⁶⁵ In *Hill York Corp. v. American International Franchises, Inc.*,⁶⁶ the court said:

Obviously if the plaintiffs did not possess the information requisite for a registration statement, they could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest in this franchise sales center.⁶⁷

A line of cases either hold or can be interpreted to be in accord with the proposition that access of the offeree to the kind of information which the Securities Act would make available in the form of a registration statement does not exist by virtue of the fact that the issuer voluntarily makes this information available.⁶⁸ These cases require, or are consistent with the requirement, that there be a pre-existing relationship between the issuer and the offeree which causes the offeree to have "access." As indicated above, *Ralston Purina*⁶⁹ is consistent with this construction of "access" although the case is susceptible of a less narrow construction. The *Hirschfeld* court also indicated that it interpreted the private offering exemption to demand that the offerees held "a position where they have regular access to all the information and records which would show the potential for the corporation."⁷⁰ This is consistent with the present construction of "access." The SEC also adopted this construction of access:

The [Ralston] Court's concept is that the exemption is necessarily narrow. The exemption does not become available simply because offerees are voluntarily furnished information about the issuer. Such 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.⁷¹

That "access" requires a pre-existing relationship between the issuer and the offeree was adopted in a federal district court decision, *United States v. Hill*.⁷² The defendant, Hill, was struggling to finance two corporations he controlled. Hill personally authorized the sale of promissory notes to certain old friends and acquaintances of his. The sale was made by one of the corporations. The purchasers had no actual knowledge of the information that would have been available in a registration statement. The court found they also lacked the requisite access to such information. For there to be access "there must be some relation-

⁶⁵*United States v. Hill*, 298 F. Supp. 1221, 1228 (D. Conn. 1969); *United States v. Custer Channel Wing Corporation*, 376 F.2d 675, 678 (4th Cir. 1967); *Hill York Corp. v. American Internat'l Franchies, Inc.*, 448 F.2d 680, 690 (5th Cir. 1971).

⁶⁶*Hill York Corp. v. American Internat'l Franchies, Inc.*, *supra* note 65.

⁶⁷*Id.* at 690.

⁶⁸*United States v. Hill*, *supra* note 65 at 1229 and *SEC v. Continental Tobacco Co. of S.C.*, *supra* note 53 at 160 so hold. *SEC v. Talston Purina Co.*, *supra* note 2 and *Lively v. Hirschfeld*, *supra* note 59 are consistent with this interpretation of access.

⁶⁹*SEC v. Ralston Purina Co.*, *supra* note 2.

⁷⁰*Lively v. Hirschfeld*, *supra* note 59 at 633.

⁷¹SEC Securities Act Release No. 4552 (November 6, 1962) [hereinafter cited as Release 4552], 1 CCH FED. SEC. L. REP. ¶ 2773.

⁷²*United States v. Hill*, *supra* note 65.

ship between the members of that group and the issuer which demonstrates that the group has access to corporate information."⁷³ Here, the holders of the promissory notes had no such relationship.

Defendant has asserted that he would have supplied any information an investor desired. However, this is not what is meant by access to information about the issuer. . . . Such an arrangement would always permit a company to circumvent the registration requirements of the Act by the simple expedient of offering to open up the corporate books.⁷⁴

This construction of "access" reached a climax in *SEC v. Continental Tobacco Co. of S.C.*⁷⁵ In *United States v. Hill*, the offering was not carefully administered and failed as a private offering on other clear-cut grounds⁷⁶—so that the court's statements above were not necessary to the decision. But in *Continental*, the court found an offering to be public although the issuer had carefully planned the offering and had taken elaborate measures to insure that the offering would qualify for the private offering exemption.

Continental's management planned to offer and sell 200,000 shares of Continental common stock (\$0.10 par value, at \$1.00 per share).⁷⁷ To insure the privacy of the offering, Continental took the following steps. Continental prepared a brochure on its prospects, including unaudited financial statements.⁷⁸ The brochure was periodically updated. The brochure carried a legend on the front that the shares offered were not registered with the SEC and that purchasers of them must have an investment intent. Continental prepared a subscription agreement and investment letter to be executed by all purchasers of the stock.⁷⁹ The instrument recited that the purchaser understood the investment being made and its risks, that he had received a copy of the brochure and had read it, that the purchaser had questioned officers and counsel for the company concerning the business and financial statements of the company and did not desire further data concerning the company. Continental stamped a legend on each stock certificate sold pursuant to the offering which stated that the stocks were restricted.⁸⁰ The legal counsel for Continental who were engineering the placement of the securities met personally with prospective purchasers at meetings arranged to promote the sale of the securities.⁸¹

⁷³*Id.* at 1229.

⁷⁴*Id.*

⁷⁵*SEC v. Continental Tobacco Co. of S.C.*, 463 F.2d 137 (5th Cir. 1972) [hereinafter cited as *Continental*].

⁷⁶The defendant, Hill, did not utilize the basic techniques normally employed to prevent unauthorized resales. He continued primary sales although he had knowledge of resales. Resale purchasers possessed information inadequate for a private offering.

⁷⁷*Continental*, *supra* note 75 at 146.

⁷⁸*Id.*

⁷⁹*Id.*

⁸⁰*Id.* at 147.

⁸¹*Id.*

The Circuit Court of Appeals noted that the offers were made to "dentists, physicians, housewives, and businessmen, who had no relationships with Continental other than that of shareholder once the purchases were made."⁸²

Even if it were assumed that Continental's prospectus provided those offerees to whom it was disseminated with all the information that registration would disclose, this would not suffice to establish the requisite relationship of those offerees to the company.⁸³

In addition, a few offerees were shown not to have received the brochure or to have met with officials of Continental.⁸⁴ Consequently, the offering was held to be public.⁸⁵

These cases illustrate some of the approaches which have been taken toward the private offering exemption in the aftermath of the *Ralston Purina* decision. They also highlight the narrowness with which the exemption has sometimes been viewed. If the limitations imposed by these cases are taken together, then little would seem to be left of the private offering exemption. Thus, the "sophistication" of the offeree is no substitute for his "access" to the kind of information that a registration statement would disclose. Without "access," the offeree is in need of the protections of the Securities Act, and the private offering exemption does not apply. But "access" cannot be achieved by a voluntary disclosure by the issuer of the needed information. The "access" must stem from a pre-existing relationship between the issuer and the offeree. A mere employment relationship does not suffice, nor does that of stockholder of the issuer, nor that of subscriber to the issuer's publications. The only adequate pre-existing relationship expressed in the cases is that between the issuer and the offeree who is a high-level executive official of the issuer.⁸⁶

Finally, some courts have focused, not solely on concepts of access and sophistication, but on factors such as the size of the offering or the number of units offered.⁸⁷ The test of the number of offerees is nearly inevitably considered by the courts if only to disclaim it.⁸⁸ The courts have frequently denied a private offering exemption, not because

⁸²*Id.* at 158.

⁸³*Id.* at 160.

⁸⁴*Id.*

⁸⁵*Id.* at 161.

⁸⁶The SEC has taken the position that the sale of stock to promoters of a business would be a private placement. Release 4552, 1 CCH FED. SEC. REP. ¶ 2774.

⁸⁷*Hill York Corp. v. American Internat'l Franchies, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971); *Chapman v. Dunn*, 414 F.2d 153, 159 (6th Cir. 1969); *Woodward v. Wright*, 266 F.2d 108, 115 (10th Cir. 1959); *Garfield v. Strain*, 320 F.2d 116, 119 (10th Cir. 1963); *Edwards v. United States*, 374 F.2d 24, 28 (10th Cir. 1966); *Collier v. Mikel Drilling Co.*, 183 F. Supp. 104, 111 (D. Minn. 1958); *Repass v. Rees*, 174 F. Supp. 895, 903 (D. Colo. 1959); *Vicioso v. Watson*, 325 F. Supp. 1071, 1078 (C.D. Cal. 1971).

⁸⁸See the cases cited in note 52.

the quality of the defendant's proof was lacking, but because the proof failed to extend to each and every offeree.⁸⁹

PROPOSED RULE 146, AS REVISED

The focus of this discussion will be on the revised form of Rule 146.⁹⁰ The revised form contains a number of improvements over the original form⁹¹ and is the form most likely to be adopted.⁹² As used herein, the term "Rule 146" or "Rule" refers to the revised form of Rule 146.⁹³

Rule 146 is intended to "provide more objective standards" for the application of the private offering exemption.⁹⁴ This, according to the SEC, will serve two purposes:

First, such a rule should deter reliance on that exemption for offerings of securities to persons who are unable to fend for themselves in terms of obtaining and evaluating information about the issuer and in certain situations, of assuming the risk of investment. These persons need the protections afforded by the registration process. Second, such a rule should reduce uncertainty to the extent feasible and provide more objective standards upon which responsible businessmen may rely in raising capital in a manner that complies with the requirements of the Act.⁹⁵

All of the conditions of Rule 146 must be satisfied if the Rule is to be relied upon.⁹⁶ If all of the conditions are satisfied, then the issuer will be deemed not to have made a public offering.⁹⁷ A private offering can still be effected outside Rule 146, however, by meeting the criteria that have been developed in the case law and in SEC interpretations.⁹⁸ Failure to meet the conditions of Rule 146 will not raise a presumption that the private offering exemption is inapplicable.⁹⁹ Rule 146 is available only to the issuer of securities.¹⁰⁰ Securities acquired in reliance on Rule 146 will be restricted.¹⁰¹ Technical compliance with Rule 146 will not suffice to preserve the private offering where the

⁸⁹Hill York Corp. v. American Internat'l Franchises, Inc., *supra* note 87 at 691; Repass v. Rees, *supra* note 87 at 904; Nicewarner v. Bleavins, 244 F. Supp. 261, 265 (D. Colo. 1965); Bryant v. Uland, 327 F. Supp. 439, 443 (S.D. Tex. 1971).

⁹⁰For discussions of the private offering exemption and the original version of Rule 146, see: Recent Developments, *Securities Regulation—Private Offering Exemption: SEC Proposed Rule 146*, 48 WASH. L. R51. 922 (1973); Comment, *Proposed SEC Rule 146: The Quest for Objectivity*, 41 FORDHAM L. REV. 887 (1973); Note, *SEC Rules 144 and 146: Private Placements for the Few*, 59 VA. L. REV. 886 (1973).

⁹¹The changes made are discussed in Release 5430, 2 SEC DOCKET 590.

⁹²SECURITIES LAW PRACTICE (Ill. Inst. for CLE, 1973), Authors' Note on Chapter 3.

⁹³The revised form is appended to Release 5430, 2 SEC DOCKET 557.

⁹⁴Release 5430, 2 SEC DOCKET 550.

⁹⁵*Id.*

⁹⁶*Id.* at 558.

⁹⁷*Id.* at 559.

⁹⁸*Id.* at 558.

⁹⁹*Id.* at 557.

¹⁰⁰*Id.* at 558.

¹⁰¹*Id.* at 550.

real purpose of the offering is distribution of the securities to the public.¹⁰²

The following discussion will present the major features of Rule 146. Special consideration will be given to whether the Rule achieves its stated purposes: "to provide more objective standards" for the application of the private offering exemption.

OFFEREE REPRESENTATIVE—RULE 146 (a) (1)

The offeree representative is a person intended to act on behalf of the offeree in a private offering under Rule 146. He must be a person who is not "an affiliate, associate or employee" of the issuer (except in certain limited and well-defined situations),¹⁰³ who has investment sophistication,¹⁰⁴ who is acknowledged by the offeree to be his representative,¹⁰⁵ and who discloses in writing to the offeree any past, existing, or contemplated relationship with the issuer or its affiliates and any compensation received or to be received, flowing from the relationship.¹⁰⁶

The only serious ambiguity in the definition of offeree representative is the requirement that he have investment sophistication. The statutory language is that the offeree representative must have:

. . . such knowledge and experience in financial and business matters that he is capable of evaluating the risks of the prospective investment.¹⁰⁷

What financial or business background satisfies this requirement is not determined by the case law, and Rule 146 provides no answer. The "sophistication" requirement of the private offering exemption has been incorporated into Rule 146, but in equally subjective and uncertain terms.

NATURE OF OFFEREES—RULE 146 (d)

"The issuer and any person acting on its behalf" who make a Rule 146 offering "shall have reasonable grounds to believe prior to making an offer, and prior to making a sale" that the offeree or his offeree representative has investment sophistication, and, in case there is no offeree representative, that the offeree is a person able to "bear the economic risk of investment."¹⁰⁸

The requirement of Rule 146 that the issuer have reasonable grounds

¹⁰²*Id.* at 557, 558.

¹⁰³*Id.* at 558.

¹⁰⁴*Id.*

¹⁰⁵*Id.* at 559.

¹⁰⁶*Id.*

¹⁰⁷*Id.* at 558.

of belief prior to making the offer is probably a necessary requirement, but it is burdensome on the issuer. The issuer must carefully probe the backgrounds of the potential offeree and his offeree representative without making an offer in doing so. No indication is given of what constitutes reasonable grounds for belief by the issuer. If, however, he mistakenly believes that investment sophistication or ability to bear the economic risk is present when it is not, Rule 146 will still be available if no sale to the offeree is consummated.¹⁰⁹

Rule 146 does not define what is meant by the ability to "bear the economic risk of investment." This ambiguity is a thorn in the side of the issuer as he has the obligation of ascertaining that the offeree can bear the economic risk and the burden of proving that he has satisfied all conditions of the Rule.

LIMITATIONS ON MANNER OF OFFERING—RULE 146 (c)

An offering will not satisfy Rule 146 if it employs any means of "general advertising."¹¹⁰ This position is consistent with prior SEC releases.¹¹¹ Prohibited modes of communication include newspapers, magazines, radio, and television.¹¹² Also prohibited are seminars, meetings, and written communications which are attended by or directed to persons other than those possessing the requisite investment sophistication and ability to "bear the economic risk of investment."¹¹³

An important condition is that the offeree or his offeree representative shall have the opportunity, prior to sale, to ask questions of the issuer or any person acting on its behalf and to receive answers concerning information relevant to the decision to accept or reject the offering.¹¹⁴

This provision seems to be reasonably free of ambiguity.

ACCESS TO OR FURNISHING OF INFORMATION—RULE 146 (e)

This provision embodies the judicial determination that without access to the kind of information made available by registration, there can be no private offering. This section provides in part that prior to sale, each offeree or his offeree representative shall:

- (1) have access to the same kind of information that is required by Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense; or

¹⁰⁹*Id.* at 559.

¹¹⁰*Id.*

¹¹¹Release 285, 1 CCH FED. SEC. L. REV. ¶ 2744; Release 4552, 1 CCH FED. SEC. L. REP. ¶ 2776.

¹¹²Release 5430, 2 SEC DOCKET 559.

¹¹³*Id.*

(2) have furnished to him by the issuer or any person acting on its behalf the same kind of information that is required by Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense.¹¹⁵

This provision is a departure from the prior SEC interpretation that "[t]he exemption does not become available simply because offerees are voluntarily *furnished* information about the issuer."¹¹⁶ The requirements of this section can be met alternatively by access on the part of the offeree or his offeree representative or by disclosure on the part of the issuer. If the issuer satisfies this section by disclosure, Rule 146 informs him in further detail what information he is obligated to furnish.¹¹⁷ This section provides substantially more objective standards than were previously available. Prior case law spoke only of access to the information that would be provided by registration in compliance with Section 5 of the Securities Act.¹¹⁸ It was not clear at all what constituted "access." Under the proposed Rule 146, the information that the issuer may provide in compliance with the Rule is explained in some detail.

As a cautionary note, if the Rule 146 access alternative is relied upon, the access must exist by reason of the "position" of the offeree or his offeree representative, with respect to the issuer.

Position means an employment relationship or economic bargaining power, that enables such person to obtain such information from the issuer, as distinguished from situations where such relationship does not exist and the issuer voluntarily offers to provide such information.¹¹⁹

Thus, the Rule 146 access standard resembles the restrictive standard embodied in *United States v. Hill*¹²⁰ and *Continental*.¹²¹ It is not clear what "employment relationship or economic bargaining power" will satisfy the requirements of this section. In practice, the issuer will probably prefer to rely upon the disclosure provisions of this section rather than trust to the access provisions.

BUSINESS COMBINATIONS—RULE 146 (f)

A "business combination" may be a "reclassification, merger, consolidation, transfer of assets, exchange of securities or other similar business reorganization."¹²² Rule 146 makes two special provisions relating to business combinations.

1. The term "offeree representative" is enlarged to include "any

¹¹⁵*Id.* at 559, 560.

¹¹⁶Release 4552, 1 CCH FED. SEC. L. REP. ¶ 2773.

¹¹⁷Release 5430, 2 SEC DOCKET 560.

¹¹⁸SEC v. Ralston Purina Co., *supra* note 2 at 125, 126.

¹¹⁹Release 5430, 2 SEC DOCKET 559.

¹²⁰*United States v. Hill*, *supra* note 65 at 1229.

¹²¹*Continental*, *supra* note 75 at 160.

affiliate, director or executive officer of a corporation or other organization being acquired pursuant to a business combination. . . ."¹²³ But such a person must meet all the requirements otherwise imposed on an offeree representative, and he must disclose "in writing to all security holders of the organization to be acquired any arrangements or terms of the transaction relating to [himself] that are not identical to those relating to all other security holders of the acquired organization."¹²⁴

2. The affiliate, director, or executive officer may solicit from the security holders of the acquired organization their acceptance of him as their offeree representative. Rule 146 will deem that such solicitation is not an offer.¹²⁵ Rule 146 strictly limits the manner in which this solicitation can occur.¹²⁶

This section does not seem to raise any problems of ambiguity.

NUMBER OF PURCHASERS—RULE 146 (g)

Rule 146 provides:

There shall be no more than thirty-five persons who purchase, from the issuer, securities of the issuer of the same or similar class in any consecutive twelve month period in transactions pursuant to this rule, or not pursuant to this rule, but otherwise in reliance on Section 4(2) of the Act.¹²⁷

This provision is subject to certain modifications and exclusions, all of which are well-defined.¹²⁸ The most important may be the exclusion of any person who purchases for cash securities of the issuer amounting to \$150,000 or more.¹²⁹ (For purposes of this section only, the term "person" includes "corporation, partnership, association, joint stock company, trust, unincorporated organization, or government or political subdivision thereof.")¹³⁰

This section presents no problems of ambiguity.

LIMITATIONS ON DISPOSITION—RULE 146 (h)

The issuer must (1) "make reasonable inquiry to determine if the purchaser is an underwriter";¹³¹ (2) place a legend on the securities indicating they are unregistered and have restricted transferability;¹³² (3) issue stop-transfer instructions with respect to the securities if the

¹²³*Id.*

¹²⁴*Id.* at 555.

¹²⁵*Id.* at 560.

¹²⁶*Id.* at 560, 561.

¹²⁷*Id.* at 561.

¹²⁸*Id.*

¹²⁹*Id.* This provision is Rule 146(g)(3)(ii)(a).

¹³⁰*Id.*

¹³¹*Id.*

issuer employs a transfer agent, or otherwise note in its own records that the securities have restricted transferability;¹³³ and (4) obtain "from the purchaser a signed written agreement that the securities will not be sold without registration under the Act or exemption therefrom."¹³⁴

The purpose of these requirements is to insure that the securities will not be redistributed to the public following the initial private placement.

The requirements present no problems of ambiguity.

REPORTS OF SALES—RULE 146 (i)

Unless certain well-defined conditions occur, the issuer must file with the SEC three copies of a report of sales effected in reliance on Rule 146.¹³⁵ The report is to be filed on the SEC's Form 146. Its purpose is to enable the SEC to monitor the operation of Rule 146.

This section also presents no problems of ambiguity.

RULE 146: A CLOSER LOOK

The private offering exemption, prior to Rule 146, has been unsatisfactory because of the uncertainties inherent in it. The exemption was designed to benefit the issuer. It was designed to save him the expenses of registration in cases where offerees could "fend for themselves" and did not need the protections afforded by registration. The problem has been that the issuer has not known when he could safely rely on the exemption. The question he has had to pose to himself and his attorney has been, "Can I afford to risk reliance on the exemption for this offering?"

Rule 146 is designed to eliminate these uncertainties which plague the life of the issuer. It is intended to provide a "safe harbor" for the issuer, i.e., to establish objective and well-defined conditions (so that the issuer will not mistakenly believe that he has satisfied the conditions when he has not) which, if satisfied, guarantee to the issuer that the private offering exemption is available to him. Does Rule 146 fulfill its objectives? Not entirely. Three facets of Rule 146 bear scrutiny here: 1) the investment sophistication to be possessed by the offeree or his offeree representative; 2) the offeree's "ability to bear the economic risk of investment"; and 3) the access-disclosure dichotomy.

1. Under Rule 146, either the offeree or his offeree representative, if one is utilized, must possess investment sophistication. It is clear that this requirement will not be met on the basis that the offeree (or offeree representative) is a man of business experience or a man with

¹³³ *Id.*

¹³⁴ *Id.*

prior investment experience.¹³⁶ Rather, his knowledge and experience in financial and business matters must be such that he is capable of evaluating the risks of the prospective investment at hand. The obligation is on the issuer to see that this investment sophistication exists.

This condition is subjective, not objective. The condition would be objective if Rule 146 provided that a certified public accountant or a stockbroker with a specified number of years of experience would be deemed to have the requisite investment sophistication. But no such clear-cut guidelines are provided. The issuer continues to run a risk when he evaluates the investment sophistication of the offeree or offeree representative.

2. Except in a business combination, the offeree must be a person able to bear the economic risk of investment whenever an offeree representative is not utilized. According to the SEC, "the important considerations are whether the offeree could afford to hold unregistered securities for an indefinite period and whether, at the time of the investment, he could afford a complete loss."¹³⁷ Since "could afford" is ambiguous, this condition is subjective. The issuer has the obligation to assess whether the offeree can bear the economic risk of investment. The issuer makes this assessment at his own risk.

3. As explained earlier, the requirements of Section (e) of Rule 146¹³⁸ can be met alternatively by access on the part of the offeree or his offeree representative or by disclosure on the part of the issuer. The disclosure provisions of Rule 146 define with care and in an objective manner the information which must be furnished to the offeree or the offeree representative in compliance with this section. But the existence of access depends upon the subjective concept of an "employment relationship or economic bargaining power"¹³⁹ of the offeree with respect to the issuer which enables the offeree to obtain the information from the issuer.

How do these provisions affect the "access" requirement of the private offering exemption as it developed prior to Rule 146? Under the interpretation of "access" represented by *United States v. Hill*,¹⁴⁰ *Continental*,¹⁴¹ and adopted by the SEC,¹⁴² the "access" requirement required a pre-existing relationship between the issuer and the offeree. This construction of access is the one adopted by Rule 146 in Section (e).¹⁴³

¹³⁶Experience in the purchase and sale of securities, under existing case law, may not satisfy the "sophistication" requirement of a private offering exemption. *Bowers v. Columbia General Corporation*, 336 F. Supp. 609, 624 (D. Del. 1971).

¹³⁷Release 5430, 2 SEC DOCKET 554.

¹³⁸*Id.* at 559, 560.

¹³⁹*Id.*

¹⁴⁰*United States v. Hill*, *supra* note 65 at 1229.

¹⁴¹*Continental*, *supra* note 75 at 160.

¹⁴²Release 4552, 1 CCH FED. SEC. L. REP. ¶ 2773.

¹⁴³Release 5430, 2 SEC DOCKET 554.

The disclosure provision of Rule 146, which is an alternative to access, is new and does not have a counterpart in the pre-Rule 146 private offering exemption law.

The pre-Rule 146 "access" requirement of the private offering exemption has been largely responsible for restricting those offers in which the private offering exemption could be safely and surely relied on to the realm of offers to high-ranking executive employees of the issuer. The existence in Rule 146 of the disclosure alternative to access substantially broadens the number of offerings which can confidently be labelled as private under the Rule 146 umbrella.

The issuer will find that the alternative of disclosure is more useful than that of access because the disclosure requirement can be met with every offering whereas the access requirement is available only for limited offerings and also because the disclosure requirement is girded by more objective standards than the access requirement.

Finally, it bears repeating that Rule 146 places the burden of proof on the issuer that each and every condition of Rule 146 has been satisfied with respect to each and every offeree.¹⁴⁴ Prudence dictates that an issuer making an offering in reliance on Rule 146 proceed with the advice of legal counsel and that he maintain written records at each step of the offering which will enable him to discharge his burden of proof.

CONCLUSION

The scope of the private offering exemption to the 1933 Securities Act was unclear as this exemption developed through court decisions and SEC interpretations. The factors to be applied in determining if the exemption did exist were several and their relative importance not well-defined. The concepts of access and sophistication which followed *Ralston Purina* were subjective concepts which left the issuer unsure whether he had met the requirements of the exemption. Under its narrowest conception, the private offering exemption was virtually non-existent outside of an offering to high-ranking executive employees of the issuer.

Proposed Rule 146, as revised, has brought a measure of relief to this situation. It has largely succeeded in its goal of setting objective standards for the operation of the private offering exemption. There remain some ambiguities within the proposed Rule, especially the measure of investment sophistication to be possessed by the offeree or his offeree representative and what constitutes the "ability to bear the economic risk of investment." But there is clearly a limit to the extent to which the private offering exemption can be reduced to terms of mathematical certainty. Proposed Rule 146, as revised, is very helpful.