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The Private Offering Under Rule 144 and Proposed Rule 146: New Armor for an Old Warrior

NICK G. KALOKATHIS*

I. Introduction

The scheme of federal legislation pertaining to sales of securities has created certain well-worn pockets of ambiguity. When coupled with the pervasive scope of the regulatory scheme, even ordinary sales seemingly isolated become a potential trap for the unwary. One of these obstacles is the non-public offering exemption, a concept involving much more than the name implies.[1]

With the adoption of Rule 144,[2] and the release of its compliment, proposed Rule 146,[3] the uncertainties involving the application of the private offering exemption have been greatly ameliorated. No longer will it be necessary to grapple with the elusive concepts of investment intent or change of circumstances.[4] The transformation of the private offering exemption from formerly

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1. 1 Loss, Securities Regulation 653 (2d ed. 1961) [hereinafter cited as Loss].

2. 17 C.F.R. § 230.144 (1972).

3. 37 Fed. Reg. 26137 (1972); *See* SEC Securities Act Release No. 5336 (Nov. 28, 1972).

4. SEC, Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the 33 and 34 Acts, 160 (1969) [hereinafter cited at Wheat Rep]. *See also* Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959); Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957); SEC Securities Act Release No. 4552 (Nov. 6, 1962).

subjective esoterica into objective lineage is the subject of this paper.

The Wheat Report contributed the essential stimulus to this end and furnished the sustaining power to the rather lengthly rule making process from which Rule 144 emanated.[5] Even though prior versions had undergone extensive revision, in its final form, Rule 144 adopts the fundamental premise propounded by the Report. That premise recognizes an operative relationship between the registration requirements of the Exchange Act of 1934[6] and the disclosure requirements of the Securities Act. [7] This results in the availability of Rule 144 to those issuers who have complied with the Exchange Act reporting requirements.[8]

In contrast, proposed Rule 146 is of more recent vintage, developed out of the Commission's concern for the preservation of the classic means of obtaining venture capital.[9] Although independent in operation and scope, Rule 146 assumes a crucial position as a necessary compliment to Rule 144. Before becoming enmeshed in the specific details, a quick overview of the private offering exemption would be instructive.

II. General Background of the Private Offering Exemption

A. *The Legislative Setting*

In view of the scant legislative history of the private offering exemption,[10] the story is best told by one of the principal draftsmen of the final version of the Securities Act of 1933.[11] To such draftsmen, the first attempt to regulate securities at the national level required a choice between two basic approaches.

One approach would require the registration of the securities themselves before they could be sold freely. The second would require registration of the offering being distributed and conceivably would include offerings by non-controlling shareholders. The first approach involved a practice common to all blue sky legislation of that time, and because of general dissatisfaction, it was rejected. The second approach recognized the practical difficulty that non-controlling shareholders would face if required to force the issuer's compliance with registration. This result being undesirable, the legislative proposal specifically exempted non-controlling shareholders. Once it was decided that sales by non-controlling

5. Wheat Rep., *supra* note 4.
6. Securities Exchange Act of 1934 §§ 12, 13, 15, 15 U.S.C. § 78 l, m, o (1972). Sowards, *The Wheat Report and Reform of Federal Securities Regulation*, 23 Vand. L. Rev. 495, 497 (1969).
7. Securities Act of 1933, 15 U.S.C. § 77a-aa (1970).
8. Securities Exchange Act of 1934 §§ 12, 13, 15, 15 U.S.C. § 78 l, m, o (1970).
9. 1 Loss, *supra* note 1, at 653.
10. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959).
11. *Id.* at 37.

shareholders should not be regulated, a scheme of selective limited regulation began to unfold.

Consistent with this philosophy was the recognition that the sale of securities to a limited group of sophisticated investors should not concern the federal government. Thus, the Securities Act specifically exempted "transactions . . . not involving any public offering."[12]

B. *Interpretations*

Several years after the enactment of the Securities Act, the Commission's General Counsel issued an interpretive release out of concern for the undesirable and increasing tendency of large issuers to resort to the private offering exemption as a means of raising capital.[13] It was necessary to serve warning that many of such placements would be in jeopardy and require registration. Even though this early opinion was issued after only limited experience with the operation of the securities law, it remains remarkably viable.[14] Of immediate pertinence was the General Counsel's understanding that "the determination of what constitutes a public offering is essentially a question of fact in which all surrounding circumstances are of moment."[15] The approach defined the basic texture of the private offering exemption. By necessity that approach required an appreciation of the fundamental subjective parameters which underlie the private offering exemption. As in most areas in which the resolution of status depends upon the implication of subjective criteria, a predictable degree of uncertainty soon develops from which conflicting interpretations emerge. The private offering exemption was not destined to avoid this curse. Despite the lingering uncertainty, some 20 years elapsed before the Supreme Court ruled,[16] but any anticipation that the Court would offer a clear, workable definition was unfounded. In *SEC v. Ralston Purina Co.* an offering to "key employees"[17] was deemed to fall beyond the scope of the private offering exemption despite the issuers' attempt to limit the class of offerees. First, the notion that an offering to a few persons assures the availability of the private offering exemption, was

12. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970).
13. SEC Securities Act Release No. 285 (Jan. 24, 1935).
14. *But see* SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).
15. SEC Securities Act Release No. 285 at 1 (Jan. 24, 1935).
16. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
17. *Id.* Ralston Purina's idea of key employees included "artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk. . . ." *Id.* at 121.

laid to rest. The Court stated that "the statute would seem to apply to a 'public offering' whether to few or to many."[18] Moreover: (1) the offerees must have access to the type of information which a registration statement would disclose; (2) the offerees must be able to fend for themselves in matters of investment.[19]

More recently the Fifth Circuit has decided two private offering cases which are receiving wide notoriety.[20] There is concern that these decisions create impossible proof burdens, the consequences of which would tend to dry up the classical sources of "seed" capital required to finance new ventures. To negate this possibility and provide more specific direction, the Commission has recently proposed Rule 146.

C. *The Nature of the Private Offering*

To understand the practical ramifications created by the persistent uncertainties which plague the private offering exemption, reference should be made to section 12(1) of the 1933 Act.[21] Section 12(1) provides a private right of action to the buyer of unregistered securities.[22] The plaintiff need only allege and prove a sale of unregistered securities by means of mails or interstate means. The seller's intent, or his knowledge of the registration violation is irrelevant. Conversely, the buyer's knowledge and appreciation of the investment risks, without more, is also immaterial. The only defense is an affirmative one—proof of the availability of an exemption, in this case the private offering exemption.[23] As the requirements necessary to establish the availability of the private offering exemption become more obscure, the greater the plaintiff's chance of success in a private action under section 12(1). Accordingly compliance—more essentially proof of compliance[24]—transforms a seemingly mechanical task into a precarious venture. Thus suits for rescission against the issuer should be considered to be a realistic possibility and their defense laced with

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18. *Id.* at 125.
19. *Id.* at 127.
20. Hill York v. American Int'l. Franchises, Inc., 448 F.2d 680 (5th Cir. 1971) (Finding of a public offering with thirteen sophisticated offerees). SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972) (Finding of a public offering because no affirmative proof that all offerees had full access to additional information).
21. 15 U.S.C. § 77 l (1) (1970).
22. III Loss, *supra* note 1, at 1692.
23. Proof of the availability of the non-public offering was considered to comprise at least two major elements as suggested by *Ralston Purina*: (1) Are the offerees in need of the protection accorded by registration, and (2) Do they have access to the kind of information contained in a registration statement to allow them to fend for themselves. The fact that the offering was limited numerically was not material. Katz v. Amos Treat & Co., 411 F.2d 1046, 1053-54 (2d Cir. 1969). *See generally* Orrick, *Non-public Offerings of Corporate Securities—Limitations on the Exemption under the Federal Securities Act*, 21 U. PITT. L. REV. 1, 9-10 (1959).
24. Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971).

uncertainty if a proposed venture financed through a non-public offering should turn sour. Obviously such uncertainty would only discourage an issuer from tapping an important source of venture capital.

The problems created by the uncertainty of application of the private offering do not stop with the real possibility of a private suit under section 12. They create an atmosphere which nurtures opinion shopping. There are instances which require the opinion of counsel regarding the status of a transaction under the Securities Laws.[25] Astute and knowledgeable counsel often hesitate to render a favorable opinion because of their appreciation for the ambiguous character of the non-public offering. But for those companies so inclined, there are others with a superficial understanding of the securities laws, ready and willing to render an opinion. This obviously undesirable practice should be discouraged.

Adding to this turmoil are two recent cases containing language which emphasized with even greater clarity, the uncertainties surrounding the private offering exemption. The major issue in both was whether the issuer had successfully sustained its burden of proving the availability of the exemption. *Hill York v. American International Franchises, Inc.*[26] undoubtedly was disposed of properly on the ground that the private offerees were given materially deficient information during the course of the issuer's sales activity. The salient feature of the case was the fact that the offers were limited to thirteen persons, all of whom were sophisticated in business matters. In practice, it was not at all unusual to view the non-public offering in terms of two practical parameters—quantity limitation and sophistication of the offerees.[27] *Hill York* demonstrates once again the persistent and enduring proposition that quantity limitations alone will not insulate a securities transaction from the federal regulatory scheme.

Unlike Hill York, the material disclosed in *SEC v. Continental Tobacco Co.*[28] was not deficient. However, the private offering was

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25. PLI FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION 61 (R. Mundheim, A. Fleischer, and D. Glazer, eds., 1970); PLI GOING PUBLIC: FILING PROBLEMS 35 (A. Levenson, ed., 1970); W.M. Kennedy, *The Case of the Scarlet Letter or The Easy Way Out on "Private Offerings,"* 23 BUS. LAW 23 (1967).

26. 448 F.2d 680 (5th Cir. 1971).

27. These parameters find no support as valid criteria, yet their influence as "planning guidelines" prompted SEC Securities Act Release No. 4552 (Nov. 6, 1962). *See also* I LOSS, *supra* note 1, at 654, 662, 664; Mulford, *Private Placements and Intrastate Offerings of Securities,* 13 BUS. LAW 297 (1958).

28. 463 F.2d 137 (5th Cir. 1972).

not available because the issuer failed to affirmatively prove that all offerees of its securities had access to additional information which they might have requested in order to verify for themselves the statements made to them as an inducement to purchase.[29]

While the requirement of access to the information is a well-established principle, the duty to provide access for verification is something new. In effect this requirement means that sales activities must be limited to persons having what amounts to an insider relationship with the issuer. By necessity the issuer's records would have to remain open for inspection for the purposes of verification. That the specific nature of this duty is not particularly well-defined, can be attributed to its ambiguous origins. But a discussion of this matter is reserved until later.

III. Proposed Rule 146

After repeated attempts[30] by the financial community aimed at convincing the Commission to adopt numerical criteria as a means of delineating the bounds of the private offering, the goal is now in sight. The invitation to the Commission to adopt such criteria was extended by the Supreme Court in *Ralston Purina*,[31] but the SEC has been consistent in its refusal.[32] Now proposed Rule 146 recognizes that offerings, if limited to 35 purchasers in any consecutive twelve month period, may qualify for the private offering exemption if other specific conditions are met.[33]

Besides extending recognition to the numerical test, the proposed rule contains another unprecedented feature—a quantity limitation with respect to purchasers only, not offerees.[34] This is contrary to all of the leading authorities which consistently have deemed the number of sales immaterial and that inquiry should focus upon offers.[35] In contrast, under the proposed rule, it is pos-

29. *Id.* at 161.

30. *See* Proposed SEC Rule 181, SEC Securities Act Release No. 5012 (Oct. 9, 1969); Comment, 74 Dick L. Rev. 422, 434 (1970). However, Proposed Rule 181 never became effective because it was displaced by Rule 145, 17 C.F.R. § 230.145 (1972).

31. 346 U.S. 119 (1953).

32. *See* note 27 *supra*.

33. Proposed SEC Rule 146(f), 37 Fed. Reg. 26137, 26141 (1972); *see* SEC Securities Act Release No. 5336 (Nov. 28, 1972). Rule 146(f) reads in part:

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

34. *Id.*

35. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1970). Loss observes that "[i]n so far as numbers are of any consequence, . . . the important criterion is the number of *offerees*." 1 Loss, *supra* note 1, at 653.

sible to extend offers to unlimited numbers, provided sales are limited to thirty-five.[36]

The former proposition, that the status of a proposed non-public offering is to be judged by the number of offers extended, rather than upon the number of sales consummated, has not been without its critics. Obviously it presents a trap for the unwary.[37] It is irrational to permit rescission by allowing the purchaser to point to the character of other offers when such other offers were never accepted. The inquiry should focus upon the quality of disclosure to the instant offeree and the ability of the offeree to appreciate its contents.[38] There is, however, an overriding consideration, and that involves the principle that when an offering assumes public dimensions it is the legitimate concern of government to insure the quality of those offerings. Although the offers are not accepted, nevertheless, regulation of such offers is necessary in order to preserve a healthy atmosphere in which investor confidence may flourish. Proposed Rule 146 preserves this notion without expressing outward concern over the number of offers made. It does so by announcing a series of stiff conditions within which such offers must be confined. Most of these conditions are well-known and accepted.

A. *Advertising—Promotional Meetings*

Since advertising is inconsistent with the concept of the non-public offering, its use is prohibited as a means of attracting prospective purchasers.[39] It does not appear whether the tombstone ad is to be considered general advertising. However, in view of the special circumstances under which the tombstone ad finds application,[40] it appears as though the use of this method falls within the category prohibited.

Moreover, promotional meetings are outlawed, doubtless as a result of Continental Tobacco.[41] A humorous aspect of that case dealt with a specific episode where meetings were held for the purpose of selling stock to a limited audience. During the

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36. The proposed rule, however, would not count toward the thirty-five person limitation those sales which are in excess of $250,000. Proposed SEC Rule 146(f), 37 Fed. Reg. 26137, 26141 (1972); *see* note 33 *supra*.
37. R. Victor and M. Bedrick, *Private Offering: Hazards for the Unwary,* 45 VA. L. REV. 869 (1959).
38. Garfield v. Strain, 320 F.2d 116 (10th Cir. 1963).
39. Proposed SEC Rule 146c(2), 37 Fed. Reg. 26137, 26140 (1972), *accord,* Hill York v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).
40. Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10) (1970); *see* SEC Rule 134, 17 C.F.R. § 230.134 (1972).
41. 463 F.2d 137 (5th Cir. 1972).

course of one meeting, the person conducting it was interrupted on several occasions by long distance phone calls. Upon returning from one such call, he reported that Gloria Swanson had just reordered a carton of the revolutionary super low tar cigarette "Venture," the primary product of Continental Tobacco. This scheme no doubt, was borrowed from a page of well-known land promotion chicanery. In the typical promotional meeting the potential for fraud is rife. Even though the literature and content of the oral statement may be free from misrepresentations, nevertheless members of a group, albeit small in number, are vulnerable to subtle techniques calculated to induce "quick money fever" of the group variety. Phonies posing as respectable members of the community may be part of this select number, chosen to be given the "exclusive opportunity" to buy into the once-in-a-lifetime deal. Of course any favorable buy reaction from the phony plant, once having gained the confidence of the innocent lambs, can bring favorable results to the promoter. That the above scheme involves criminal law and indeed securities law problems is undeniable. However, proof is difficult. Accordingly, by confining sales activity within the "negotiated transaction," as the rule proposes, the above scenario would be neutralized.

B. *Negotiated Transaction*

The term is defined as:

> [A] transaction in which securities are offered and the terms and arrangements relating to any sale of securities are arrived at through direct communications between the issuer or any person acting on its behalf and the purchaser or his investment representative.[42]

Direct communication implies personal conduct or communication that provides an opportunity to ask questions and receive answers.[43] While this requirement minimizes the chances for group pressure, the requirement of close direct personal contact is the basic ingredient of the confidence game. If the prophylactic qualities of the rule were to stop here, there would be room for concern. But there are more.

C. *Nature of Offerees—Ability to Bear Risks*

The authorities have been consistent in requiring that the offerees possess the degree of sophistication to be able to appreciate the nature of the risks being offered.[44] The proposed rule adopts

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42. Proposed SEC Rule 146(a)(3), 37 Fed. Reg. 26137, 26140 (1972).

43. SEC Securities Act Release No. 5336 (Nov. 28, 1972).

44. This might be an overstatement. *See* PLI FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION at 40 n.32 (R. Mundheim, A. Fleischer and D. Glazer, eds., 1970), where the following observation is made:

> Some cases seem to suggest that the purchasers must be sophisticated, i.e. able to "fend for themselves" *and* have access to the kind of information which registration would disclose. *See* United States v. Custer Channel Wing Corp., 376 F.2d 675, 678

this notion. In addition it introduces a new requirement: issuers must have reasonable grounds to believe that the offeree is able to bear the economic risks of the investment.[45] This additional requirement is unique to the non-public offering, indeed unique to the basic scheme of federal regulation envisioned by Congress. The Securities Act never did purport to concern itself with the financial status of the purchaser, or even the issuer. Although there were early attempts to require the federal government to pass judgment upon the investment character of the security, these efforts were never incorporated into the law.[46] As long as the issuer fully disclosed his business history and present status, the investor could not find comfort in the federal regulatory scheme for his mistaken investment judgment.

The Commission has departed from this entrenched philosophy by requiring that the offerees be able to bear the economic risks of investment. To support this requirement the Commission quotes the famous passage from *Ralston Purina*: "An offering to those who are shown to fend for themselves is a transaction not involving any public offering."[47] But the above passage fails to support the Commission's position because it was quoted out of context. A sentence, from *Ralston Purina* preceding the above quote is revealing: "The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[48] Accordingly, when *Ralston Purina* speaks about "fending" it means that the information given to an offeree must be of the quality normally required in a registration statement.[49]

(4th Cir.), *cert. denied*, 389 U.S. 850 (1967); D. F. Bernheimer & Co., 41 S.E.C. 358, 363 (1963). Others suggest that, if the purchasers are in fact sophisticated, it is sufficient if they are in a position to receive all information relevant to making a fully informed decision. *See* Value Line Fund, Inc. v. Marcus, *CCH Fed. Sec. L. Rep.* ¶ 91,523 at 94,970 (S.D.N.Y. Mar. 31, 1965). A third interpretation is suggested in Nicewarner v. Bleavins, 244 F. Supp. 261, 265 (D. Colo. 1965) (suggests that purchasers must either be given information which a registration statement would make available *or* that they be "'sophisticated"). The Commission apparently disagrees. *See* Securities Act Release No. 4552 (Nov. 6, 1962): "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."

45. Proposed SEC Rule 146(d)(2), 37 Fed. Reg. 26137, 26140 (1972).
46. 1 Loss, *supra* note 1, at 123-28.
47. SEC Securities Act Release No. 5336 at 7 (Nov. 28, 1972).
48. 346 U.S. 119, 124 (1953).
49. *See* SEC Securities Act Release No. 4552 (Nov. 6, 1962) wherein it is observed that the act of furnishing the appropriate information cannot be used in lieu of registration.

The inability of one to fend because of lack of sufficient disclosure is quite distinct from one's ability to absorb the economic risks of a bad investment. Because the Commission has confused these two concepts, the validity of the requirement concerning economic ability proposed by Rule 146 is in doubt.

That the Commission by rule may announce the terms and conditions under which it will refrain from exercising its enforcement powers is not denied. Accordingly compliance with proposed Rule 146 would serve as insurance against Commission action. However, federal agency rulings are not controlling upon the courts to the extent that interpretative provisions are inconsistent with the pronouncements of case law.[50]

The possibility of being confronted with this apparent paradox provides no reason to cast criticism against the Commission. Because the requirement of economic ability exceeds the criteria announced in *Ralston Purina,* any private offerings complying with proposed Rule 146 would become not only invulnerable to Commission challenge, but also impervious to attack through a private action.

D. *Proof Requirements*

Before any offers may be extended, there must be reasonable ground leading to the belief that the offeree has knowledge and experience in business and financial matters and is capable of evaluating the economic risks in view of the information presented.[51]

The burden of proving that such grounds exist rests with the offeror. If the negotiated transaction requirement was not enough to limit the scope of sales activity, the proof requirement will provide the practical denouement. It should be emphasized that this latter requirement extends to all offerees regardless of whether they eventually buy.

In order to produce evidence of significant quality to sustain the burden of establishing reasonable grounds, communication with prospective buyers is obviously required. However, any action tending to arouse investor interest, although falling short of an offer under the law of contracts, is deemed, nevertheless, to be an offer within the meaning of the Securities Act. Thus communication with a prospective offeree to determine the degree of sophistication and ability to assume the economic risks could easily be construed as an offer.[52] Fortunately the Commission has perceived this dilemma and has provided that inquiry to verify belief of reasonable ground is not in and of itself an offer.[53] It

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50. I. K. DAVIS, ADMINISTRATIVE LAW TREATISE § 5.03 (1958).

51. Proposed SEC Rule 146(d)(1), 37 Fed. Reg. 26137, 26140 (1972). In addition the offeror must have reason to believe that the offeree is capable of assuming the economic risks. *Id.* at (d)(2), 37 Fed. Reg. at 26140.

52. *In re* Loeb, 38 SEC 843 (1959).

53. SEC Securities Act Release No. 5336 at 7 (Nov. 28, 1972).

should be emphasized, however, that the scope of this preliminary inquiry for verification is not without limits and communication unrelated to this verification may be construed as an offer.

E. *Offeree's Access to Information—Verification*

A further provision of the rule requires that during the negotiated transaction, the offeree not only be given information of the character required in a registration statement, but also access to any additional information necessary to verify such information. The latter requirement of access for verification raises intriguing questions.

This theory of verification can be traced to a recent Tenth Circuit case, *Lively v. Hirschfeld,*[54] which involved a private action under Section 12.[55] The issue was whether defendant sufficiently sustained his burden of proving the availability of the non-public offering exemption. The Tenth Circuit cited *Ralston Purina* for the proposition that offerees must be in a position to have "regular access to all the information and records which would show the potential for the corporation."[56] The Fifth Circuit thereafter took the cue and in *Continental Tobacco* stated the test more explicitly by noting that: "None of the purchasers had any actual opportunity to inspect Continental's records or to verify for themselves statements made to them as inducements for the purchases."[57]

Without commenting upon the substantive merits of this verification requirement, it should be pointed out this requirement is of dubious derivation. The Tenth Circuit's view of the *Ralston Purina* case is not correct. *Ralston Purina* did not require access to the raw data for verification in addition to the requirement of full disclosure. Quite the contrary, and quoting from the opinion:

> We agree that some employee offerings may come within § 4(1), [now 4(2)], *e.g.*, one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement.[58]

The foregoing means that insider status is tantamount to full disclosure. It does not mean that full disclosure requires access for verification. Thus, access to insure complete disclosure is quite consistent, indeed demanded by *Ralston Purina.* But, access for

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54. 440 F.2d 631 (10th Cir. 1971).
55. Securities Act of 1933 § 12, 15 U.S.C. § 77 l (1970).
56. 440 F.2d 631, 633 (10th Cir. 1971).
57. 463 F.2d 137, 158 (5th Cir. 1972).
58. SEC v. Ralston Purina Co., 346 U.S. 119, 125-26 (1953).

verification is another matter.[59]

Despite the dubious origins of the verification requirement, the Commission should not be criticized for attempting to impose controls over the essential atmosphere of the private offering. However, adherence to this requirement might create more problems than it purports to solve. Can the issuer assume that only those records requested by an offeree need be presented? In *Lively v. Hirschfeld* the court seemed unimpressed by the fact that because the purchaser did not request information for the purpose of verification, none was made available.[60] Since the character of this duty has not yet fully developed, it can only present unforeseen obstacles until the Commission takes steps to further clarify its ramifications. There is one case, however, in which the duty to verify assumed a dominant role. In *Escott v. Barchris Construction Corp.*,[61] the failure to verify the accuracy of the registration statement defeated the availability of the due diligence defense. It would be unfortunate to impose by analogy the duty of care necessitated by *Barchris* into the verification requirement announced in Rule 146. Both derive from different generic origins. Neither involve analogous situations.

The duty regarding verification under Rule 146 is more akin to an open door policy by the issuer with respect to the prospective shareholder. It would appear to be enough if the issuer extended insider status to the offerees sometime during the course of the negotiated transaction.

F. *Restrictions on Disposition*

The Securities Act defines "underwriter" as one who purchases "with a view to . . . distribution."[62] Should a purchaser taking securities privately from an issuer or underwriter decide to resell, such purchaser would be deemed an underwriter if the securities were initially purchased with a view to distribution, and not with a view toward investment. The consequences of taking with a view to distribution would subject not only the resale to the registration requirements of the Securities Act, but also the initial attempt at private placement.[63]

59. In SEC Securities Act Release No. 4552 at 1 (Nov. 6, 1962) the Commission stated that: "The courts' concept [of the non-public offering] exemption is necessarily narrow." The *Release* never mentioned anything akin to a duty to provide access for verification. This concept first appeared in the proposed Rule 146 proceedings.

60. 440 F.2d 631, 632 (10th Cir. 1971).

61. 283 F. Supp. 643 (S.D.N.Y. 1968).

62. Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1970).

63. SEC Securities Act Release No. 4552 (Nov. 6, 1962) states that:

> An important factor to be considered is whether the securities offered have come to rest in the hands of the initial informed group or whether the purchasers are merely conduits for a wider distribution. Persons who act in this capacity, whether or not engaged in the securities business, are deemed to be "underwriters" within the meaning of Section 2(11) of the Act. If purchasers

In order to discourage such resales, proposed Rule 146 imposes three conditions:

1. Placing a legend on the certificate indicating that they were not registered and cannot be transferred without registration or an available exemption.

2. Issuance of stop-transfer instructions to the transfer agent, if any, or an appropriate notation in the issuer's records, if the issuer transfers its own securities.

3. Obtaining a written agreement from the purchaser that the security will not be resold without registration or other compliance with the Act.[64]

The proposed rule, however, rejects the more classical language used in typical investment letters and perhaps for good reason. Such language included affirmations to the effect that the purchaser takes with a view toward investment and not to distribution. These self-serving statements are nothing but empty conclusions and of little value unless supported by consistent action.[65]

Of considerable significance is the length of time that a security is held.[66] The longer the holding period, the stronger the likelihood that such security was purchased with a view toward investment, but the holding period is not conclusive proof of investment intent. However, such evidence is highly persuasive. To be sure, if the duration of the holding period is relatively short, those statements typically contained in investment letters are virtually worthless as proof of intent, for the courts are more interested in conduct than representations.[67] Moreover, the length of the holding period is a more substantial need than the self-serving statements embodied in investment letters. It is for these reasons that proposed Rule 146 requires compliance with the above requirements. The operative effect of Rule 146 ends at this point. Criteria dealing with the length of time that a security must be

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> do in fact acquire the securities with a view to public distribution, the seller assumes the risk of possible violation of the registration requirements of the Act and consequent civil liabilities.

Id. at 2.

64. Proposed SEC Rule 146(f)(2), 37 Fed. Reg. 26137, 26141 (1972).

65. WHEAT REP., *supra* note 4, at 171. *See also* SEC Securities Act Release No. 4552 (Nov. 6, 1962).

66. WHEAT REP., *supra* note 4, at 164.

67. See Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959). In *Gilligan* the following representation in the face of inconsistent action was of little value:

> I hereby confirm to you that said debentures are being purchased for investment and that I have no present intention of distributing the same.

Id. at 465.

held in order to avoid liability under the Securities laws, is a subject reserved for Rule 144.

IV. REQUIREMENTS FOR RE-SALE—RULE 144

A. *Historical Development—Investment Intent and Change of Circumstances*

Unfortunately, the judiciary has been unable to supply objective guidelines delineating the moment at which a buyer is transformed into an investor. Moreover, the Commission has been unwilling to officially designate such an interval. Unofficially, the staff has been willing to accept a two year holding period as circumstantial evidence of investment intent. But, periods of from three to seven years have not been uncommon.[68]

Relief from this state of uncertainty could be obtained by requesting a no-action letter. This ad hoc procedure was used whenever a clash with the interpretation of Section 2(11) was foreseeable. However, this episodic approach proved to be inadequate. Moreover after *In re Ira Haupt & Co.*[69] the brokerage community's feeling of vulnerability reached a peak. Consequently, it demanded and received a more complete and institutionalized format.[70] It was this format, Rule 154, which served as a rough model for Rule 144.

Ira Haupt involved a situation in which a broker was executing sell orders on behalf of a control party. The argument that the broker's exemption applied was rejected and violations of the Securities Act were found because the selling activities fell within the precise statutory definition of "underwriter." The brokerage community feared that an innocent, routine execution of customers' sell orders, even for limited amounts, would create an unwarranted burden with insignificant results in terms of investor protection. Moreover, an otherwise innocent broker could inadvertently become a statutory underwriter if he were unwittingly involved in a distribution scheme in which multiple parallel selling channels were used. In such cases the broker being engaged in an otherwise innocuous sale, and believing the transaction to be an isolated one, would have little reason to think of himself as a statutory underwriter, even though other sale activity, unknown to the broker, created a "distribution" within the meaning of the Securities Act. To remove these nagging fears and provide administrative relief to the brokers, Rule 154 came into being.[71] It con-

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68. Lowenfels, *SEC "No Action" Letters: Some Problems and Suggested Approaches,* 71 COLUM. L. REV. 1256 (1971).

69. 23 SEC 589 (1946).

70. 17 C.F.R. § 230.154 (1951) *rescinded,* SEC Securities Act Release No. 5223 (Jan. 11, 1972). *See also* Clark, *SEC Regulation of Resale of Securities by Controlling Persons of Non-reporting Issues: The Ghost of Ira Haupt Reads the "Wheat Report" and Rule 144,* 20 DRAKE L. REV. 576 (1971).

71. SEC Securities Act Release No. 3421 (Jan. 21, 1951), *amended,* SEC Securities Act Release No. 3525 (Dec. 22, 1954).

tained two fundamental points. It first introduced the concept of defining a distribution in terms of a quantity limitation.[72] It next imposed upon the broker a duty to investigate the source and context of the particular transaction as a condition to the availability of the relief provided by Rule 154.[73] However, there was one irrational limitation; it applied only to sales on behalf of control parties and would not apply to sales on behalf of issuers.[74] Rule 154 remained operational for several years with a high degree of success, but rather than attempt to expand the scope of Rule 154, a more complete solution to the private exemption was sought and this triggered an intensive study of the problem within a much broader framework with emphasis upon disclosure.

Amid this background the Wheat Report emerged, recognizing the urgent need for the development of workable objective standards upon which a practitioner could rely with confidence. It insisted that a solution would have to be consistent with good disclosure policy.[75] Accordingly, the report quickly recognized the possibility of using the reporting requirements of the Exchange Act of 1934[76] as a means of providing to prospective purchasers enough information to allow them to fend for themselves. In addition, if such information were kept current by quarterly filings, the major pitfalls associated with the private offering would diminish. Of course such filing would be on record only in the National Office of the SEC in Washington, D.C., with no requirement for the delivery of a prospectus. Consequently, the requisite information would not be available to prospective investors unless specifically requested.[77]

But the major contribution of the Report was not only the recognition of the 1934 Act disclosure possibilities, but also its quest for objective standards which would transform the concept of investment intent into a workable framework. Before embarking on its course, the Report questioned the status of two firmly embedded but highly dubious parameters—the technique of investment letters and the change of circumstances doctrine.

Because of the near impossibility of proving investment intent, the practice of soliciting investment letters from buyers be-

72. *See* note 82 *infra* for the specific terms of this limitation as applied by Rule 144.
73. *See* note 82 *infra.*
74. WHEAT REP., *supra* note 4, at 185.
75. *Id.* at 178-84.
76. Securities Exchange Act of 1934 §§ 12, 13, 15, 15 U.S.C. § 78 l, m, o (1970).
77. Sowards, *The Wheat Report and Reform of Federal Securities Regulation*, 23 VAND. L. REV. 495, 500-01 (1969).

came popular. Indeed, such practice attained the status of dogma. But the investment letter provided little solace to the party relying upon it if the buyer chose to ignore its terms and conditions. For this reason the Report summarily dismissed the effectiveness of investment letters and declared them to be of "dubious magic." The study found their use as a means of promoting a policy of disclosure to the public investor to be of little practical value.[78]

Not only are the once worshipped mystical qualities of the investment letter deflated, but also the report lays to rest any optimism that might have been brewing on behalf of the change of circumstances doctrine. It does so by posing an illuminating paradox: Assume A purchases 50,000 shares and B purchases 5,000 shares from the same issuer. A had encountered a "change of circumstances" so that he may now sell without registration. B, however, does not enjoy sufficient change of circumstances so that B must register.[79] Why, the report wonders, is A's change of circumstances relevant to the public investors' need to know. A better rationale must be advanced on behalf of the private offering. To that end, the report suggests three alternatives, rejecting two and adopting one.

The first approach would involve a retention of the test of investment intent for purposes of defining the underwriter status. To provide some certainty, the limited brokerage transaction similar to the provisions of Rule 154 would be adopted with a three-year holding period. However, only those issuers who have enjoyed gross revenues exceeding a minimum figure of several thousand dollars would be allowed to take advantage of the holding period, thereby preventing the parking of securities in dormant companies for the three-year period. This approach was rejected because it ignored the availability of information already required by the 1934 Act.[80]

A second approach required registration of all public resales of securities but would rely principally upon the Commissioners' power to specify the content of the registration statement depending upon the circumstances surrounding the transaction. Thus, the disclosure criteria would be far from uniform and would vary between the two extremes of the comprehensive S-1 form for nonreporting issuers and the one page prospectus for ordinary brokerage transactions. This was rejected due to the massive administrative burden without a clear benefit to the public.[81]

The third approach was the one adopted. It distinguished between reporting and non-reporting companies, and based on this distinction offered an extensive and objective definition of the term "distribution" under Section 2(11) of the Securities Act.

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78. WHEAT REP., *supra* note 4, at 166-72.
79. *Id.* at 168.
80. *Id.* at 179.
81. *Id.* at 180.

Thus, the status of those parties falling within the purview of the elusive term "underwriter" would be determined easily and efficiently by the newly proposed objective criteria for the term "distribution." The "leakage" approach of Rule 154 used to define the "distribution" would be adopted but the scope of the new definition would not be limited, as in Rule 154, to resales by control parties.[82] With this fundamental purpose in mind the Report announced the specifics of its proposed rules to accomplish that end.

While the reappraisal of the SEC's administrative policies involved a minimum amount of equivocation, the transition from theory to the working rule provided a rougher course. After one false start (known as the 160 series),[83] the Commission finally adopted Rule 144. The basic objection to the 160 series was not so much its substance, but rather its overly complex format. Rule 144 represents an attempt to simplify the first proposal, series 160; it appears that this noble aim was fulfilled.

B. *Rule 144*

Restricted Securities

Rule 144 adopts as its central theme the concept of "restricted securities," a notion embodied in its Rule 160 series predecessor, but appearing nowhere in the Securities Act. The term "restricted securities" means: "Securities acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer in a transaction or chain of transactions not involving any public offering."[84] Besides clothing the concept of restricted securities with administrative dignity, the above definition fixes the scope of Rule 144. For example, it does not apply to securities acquired from a reorganization, nor stock acquired as a dividend.[85] On the other hand, Rule 144 applies to securities acquired directly from an issuer, which effectively broadens the premise upon which former Rule 154 was based.

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82. The leakage provisions are embodied in Rule 144(e) 1, 2, 17 C.F.R. 230.144(e) 1, 2 (1972). Another concept borrowed from Rule 154 is the broker's transaction which is now found in Rule 144(g), 17 C.F.R. 231.144(g) (1972). *But see* SEC Securities Act Release No. 5307 (Sept. 26, 1972) for a recent change to Rule 144(g)(2).

It has been suggested that adherence to the broker's transaction requires compliance with the standards of inquiry announced in SEC Securities Act Release No. 5168 (July 7, 1971). PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 54 (R. Mundheim and A. Fleischer, eds., 1972).

83. SEC Securities Act Release No. 4997 (Sept. 15, 1969).

84. SEC Rule 144(a)(3), 17 C.F.R. § 230.144(a)(3) (1972).

85. PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 14 (R.

Exclusiveness

The earlier versions of Rule 144 created a fair amount of concern over whether the rule would be the exclusive device available for the disposition of restricted securities.[86] If the application of Rule 144 were to be deemed exclusive, then all selling practices would fall within its rigid purview, and rather than being welcomed for its relief from subjective uncertainty, it would be cursed for its inflexibility. In the final version of Rule 144, the Commission takes the position that the rule is not exclusive, but warns those brave enough to venture without it to proceed at their own risk.[87] Accordingly, close attention to the details of Rule 144 is necessary, with an analysis of those issuers who may qualify being a logical starting point.

Qualified Issuers

In keeping with the approach suggested by the Wheat Report, Rule 144 distinguishes between reporting and non-reporting companies by limiting its application to the former.[88] However, certain nonreporting companies may qualify if they make available to the public that information required by Rule 15(C) (2)-11 of the Exchange Act.[89]

Of course those companies having the capacity to meet the requirements of a qualifying issuer must comply with the appropriate reporting requirements. Compliance, however, implies that the reports filed be accurate and free of material omissions and misstatements.[90] Thus sellers relying upon Rule 144 would be at the mercy of the issuer's work product. To alleviate this persistent uncertainty, earlier versions of the rule required the Commission to keep a list of qualified issuers. In effect this compilation was tantamount to a representation by the Commission that the issuers listed therein had fully complied with the reporting requirements.[91] Consequently sellers could rely with confidence upon the list, unless a notice of deficiency were issued.

This neat proposal was not adopted, for the reason that it would unduly burden the administrative tasks of the Commis-

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Mundheim and A. Fleischer, eds., 1972). *See also* SEC Securities Act Release No. 5243 (April 12, 1972).

86. PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 6-7 (R. Mundheim and A. Fleischer, eds., 1972).

87. SEC Securities Act Release No. 5223, at 2 (Jan. 11, 1972). *See* National Student Marketing Corp. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,861 (July 19, 1972) where the owner of the shares had refused to sign a form 144 on the grounds that an exemption from registration was otherwise available. The Commission warned the owner that he proceeds "at his own risk."

88. SEC Rule 144(c) (1), 17 C.F.R. § 230.144(c) (1) (1972).

89. *Id.* at (c) (2), 17 C.F.R. § 230.144(c) (2).

90. PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 24 (R. Mundheim and A. Fleischer, eds., 1972).

91. WHEAT REP., *supra* note 4, Appendix VI, at 23.

sion.[92] Under the present version of Rule 144, the seller, nevertheless, is protected if the issuer has filed the necessary reports "unless he [the seller] knows or has reason to believe that the issuer has not complied with such requirements."[93] Accordingly, the risk of non-compliance turns upon the application of a subjective test akin to scienter.

Does the above standard imply a duty to ascertain, within reason, the accuracy of the material filed? It would be dangerous to answer "no." The basic inquiry, however, should be concerned with the character of the investigation required to fulfill the duty and the status of the party involved.

To begin the analysis by the application of the *Barchris* test is tempting;[94] however, its application within this context would be unwarranted. Because Rule 144 sellers do not necessarily enjoy official corporate status, the due diligence duty envisioned by *Barchris* would pose an impossible burden to non-insiders. Moreover, outsiders are not charged with any special responsibility for inaccuracies in the registration statement. Only a failure of logic would impose upon outsiders the duty of affirmative investigation to determine whether "full"[95] compliance has been achieved.

On the other hand, insiders appear under different light.[96] For purposes of analysis, insiders could be broken into two further categories: control party insiders and non-control party insiders.[97]

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92. PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 24 (R. Mundheim and A. Fleischer, eds., 1972).

93. SEC Rule 144(c)(1), 17 C.F.R. § 230.144(c)(1) (1972). In several instances the Commission has ruled informally that deficiencies in the periodic Exchange Act reports do not defeat the availability of Rule 144, provided the proposed transaction is not a part of a plan to circumvent the public information requirements of the rule. Electronic Transistors Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,942 (July 31, 1972). *See also* Revenue Properties Co. Ltd., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,235 (Feb. 26, 1973) where Rule 144 would be available provided the deficiencies were corrected to effect substantial compliance with section 13(a) of the Securities Exchange Act, 15 U.S.C. § 78m(a).

However, an issuer who has been granted an extension of time to file its 1934 Act report is not qualified. Tidal Marine International Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,889 (July 17, 1972).

94. Escott v. Barchris Construction Corp., 383 F. Supp. 643 (S.D.N.Y. 1968) (The due diligence defenses to civil liability are listed in the Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1970).

95. The concept of full compliance is considered to be distinct from mechanical compliance. Full compliance should be able to withstand Rule 10b-5, SEC Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970), attacks questioning the accuracy of the reports.

96. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

97. The term "control party insider" admittedly involves a redundancy. *See* N. LATTIN, THE LAW OF CORPORATIONS 320 (1959). While a

It is fundamental that public sales by control parties require registration.[98] Not so the public sales by non-control parties, even though insiders. However, I contend that insiders who fall short of the status of control parties should nevertheless be held to a higher standard than outsiders. Rule 144 requires that a balance be struck between the responsibility of accurate disclosure and the purchaser's freedom to resell within reasonable limits.

Accordingly, the following concomitant relationships should exist: (1) For the control party—no resale possible short of registration, Rule 144 inapplicable; (2) For the outsider—only a duty to ascertain whether the requisite reports have been filed (the essential accuracy of these reports is probably indeterminable in view of the non-insider's limited knowledge of corporate affairs); (3) For the non-control insider—the availability of Rule 144 depends upon the character of the information which he possesses as an insider. Obviously the more one knows about the affairs of the issuer the greater the burden to ascertain the accuracy of the statements contained in the periodic reports. The test is whether the insider possesses knowledge, which would lead one to question the accuracy of the materials filed, necessary to qualify the issuer under Rule 144.[99]

Source of Acquisitions: Fungibility

Because Rule 144 is limited to specific types of shareholder acquisitions,[100] *i.e.* those securities acquired in a transaction or chain of transactions not involving any public offering, the circumstances surrounding the acquisition of the securities destined for resale become an important consideration. Accordingly, the concept of fungibility must be considered. Its practical effect may be best explained by this example:

Suppose a purchaser acquires shares through the exchange in an ordinary trading transaction. Several years later the purchaser acquires an additional amount of stock in a transaction involving a private placement. Without registration, the SEC will not permit public resales of the shares acquired from purchases through the exchange. The Commission's position is based upon the concept of fungibility and it appears that the LIFO method of accountability is being applied.[101] However, if the sequence of the above acquisitions were reversed, the LIFO method should allow for the free resale of the stock purchased in a trading transaction

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control party is an insider, the obverse does not necessarily follow. *See In re* Merrill, Lynch, Pierce and Smith, Inc., SEC Securities Act Release No. 8495 (Nov. 25, 1968).

98. United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968).

99. SEC Rule 144(c)(1), 17 C.F.R. § 230.144(c)(1) (1972).

100. The term as used in this context is not to be confused with "corporate acquisitions."

101. WHEAT REP., *supra* note 4, at 172-73. *See also* PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 59-60 (R. Mundheim and A. Fleischer, eds., 1972).

through the exchange. Predictably the official position of the Commission is not entirely clear.[102]

Instead of a private placement being closely allied with an ordinary trade, suppose that successive purchase of stock pursuant to the private placement exemption transpired. Fungibility would apply here in computing the length of the holding period to be used as evidence of investment intent. But the SEC's position cannot be deemed a model of consistency. The staff in its response to "no-action" letters is guided by subjective criteria which often boil down to a gut reaction or feeling for a particular situation. The resultant inconsistencies are most troublesome and for this reason the Wheat Report proposed the introduction of objective criteria for this specific problem of fungibility.[103]

However, the transition from subjective to objective standards created more problems than it solved.[104] Rather than retreat to the old standards, however, the Commission, with an apparent sense of destiny, boldly abandoned the concept of fungibility.[105]

It now relies solely upon a set of technical rules with specific applicability to well-known examples.[106] There is a general feature, however, prescribing a two year holding period during which sales are forbidden.[107] Thereafter it limits the amount of stock

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102. WHEAT REP., *supra* note 4, at 172-73.

103. *Id.* at 176.

104. PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 59-60 (R. Mundheim and A. Fleischer, eds., 1972).

105. Despite the Commission's announced position, the doctrine of fungibility still appears to be viable. In Computer Automation Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,848 (June 9, 1972), the staff replied to a letter of inquiry as follows:

> The concept governing this case is that of fungibility of shares. Under the fungibility concept, shares of stock (as distinguished from the certificates evidencing the shares) are considered fungible in that each share represents the same economic interest in the issuer. . . . It is thus questionable whether a purchaser can have a bona fide investment intent with respect to any particular shares, if at the time he acquires them, he intends to distribute publicly other shares of the same issuer. When, therefore, a purchaser acquires shares from an issuer in a transaction not involving a public offering, he necessarily indicates an absence of any intent to distribute to the public any other shares of the same issuer which he then holds. . . .
>
> The practical effect of this as it pertains to the holding period is that the holding period for all investment securities held is measured from the time Mr. Smith most recently acquired shares.

This ad hoc resurrection of the fungibility doctrine should be compared to another informal ruling, Saga Administrative Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,027 (Sept. 25, 1972), which indicated that a donee holding previously acquired shares and thereafter acquiring by gift certain other shares is not subject to the Rule 144(e)(3)(c) sales limitations as to the shares already held.

106. SEC Rule 144 (d)(4), 17 C.F.R. § 230.144(d)(4) (1972).

107. *Id.* at (d)(1), 17 C.F.R. § 230.144(d)(1).

that can be freely sold to the lesser of, one per cent of the outstanding stock, or one per cent of the average weekly trading volume.[108]

Holding Period

Beneficial Ownership

The rule requires that securities shall have been beneficially owned for at least two years and that the full purchase price or other consideration shall have been paid or given at least two years prior to sale if the securities were acquired by purchase.[109] The requirement that the economic risks of ownership be assumed by the seller purports to minimize the opportunity for persons to act directly or indirectly as conduits for the issuer in connection with the public resale of unregistered securities.[110]

In accordance with this policy, the Rule further provides that giving promissory notes or other obligations toward the payment of the purchase price or entering into an installment purchase contract will not satisfy the requirements of full payment. However, full payment shall be recognized if the foregoing promissory instruments provide for full recourse against the purchaser of the securities, or are secured by sufficient collateral covering the fair market value of the securities, or are fully paid prior to resale.[111]

That there is a relationship between full payment and beneficial ownership is undeniable. However, it does not necessarily follow that beneficial ownership obtains as a result of full payment. The basic question is whether Rule 144 regards the payment of full consideration as being merely evidence of beneficial ownership or whether the payment of full consideration proves conclusively the fact of beneficial ownership. The Rule itself suggests that full payment does not necessarily result in beneficial ownership.[112] This gives rise to the proposition that suspension of the holding period may result from those acts which are inconsistent with beneficial ownership. Having thus stated the proposition, an attempt to define the concept of beneficial ownership within the context of Rule 144 follows.

The reason for requiring beneficial ownership stems from the fear that the unscrupulous might be tempted to use Rule 144 as a device to distribute unregistered stock publicly by using a series of transfers involving token consideration.[113] Accordingly, the basic thrust is directed against conduct inconsistent with investment intent and the requirement of full consideration is the means used

108. *Id.* at (e), 17 C.F.R. § 230.144(e).
109. *Id.* at (d)(1), 17 C.F.R. § 230.144(d)(1).
110. SEC Securities Act Release No. 5223, at 8 (Jan. 11, 1972).
111. SEC Rule 144(d)(2), 17 C.F.R. § 230.144(d)(2) (1972).
112. Under Rule 144(d)(3) the holding period is suspended when securities, even though fully paid, are subjected to a short position—an act inconsistent with investment intent.
113. SEC Securities Act Release No. 5223 (Jan. 11, 1972).

to control this evil. However, proof of the requirement of beneficial ownership should not necessarily follow from the fact of full consideration. Therefore, it is contended that beneficial ownership is not established by proof of payment of full consideration if the purchaser engaged in acts which are inconsistent with investment intent and which have the effect of circumventing the remedial purposes of the Securities Act.[114]

Convertible Securities

The final chapter in the controversy concerning the nature of convertibility within the context of a private placement is stated quite simply and directly in Rule 144(d)(4)(B).[115] For purposes of computing the holding period of the security acquired by conversion, the acquisition date of the underlying security initiates the period. This simple rule culminates a colorful debate which started with *Crowell-Collier Publishing Co.*[116] There the basic issue was whether the private offering exemption would be available in situations involving the private sale of debentures convertible into common. The Commission found that the concept of convertibility implied that the issuer was considered to be making a continuing offer of the common stock to any one purchasing the convertible debenture before conversion. In short, the Commission decided that the holding of the convertible portion is inconsistent with investment intent. In the words of the Commission:

> Purchasing for the purpose of future sale is nonetheless purchasing for sale and if the transactions involve any public offering even at some future date, the registration provisions apply. . . .[117]

The Commission's position proved to be the catalyst for a long term debate between the Commission and the bar concerning the nature of convertible securities. The two viewpoints—that of the

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114. At least on one occasion the Commission has taken an informal contrary position. In Datapax Computer Systems Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,958 (Aug. 21, 1972), the holding period was deemed to continue to run in favor of the original purchaser for shares subsequently transferred in escrow pursuant to a purchase agreement but then returned upon default by the new purchaser.

115. SEC Rule 144(d)(4)(B), 17 C.F.R. § 230.144(d)(4)(B) (1972) reads:

> If the securities sold were acquired from the issuer for a consideration consisting solely of other securities of the same issuer surrendered for conversion, the securities so acquired shall be deemed to have been acquired at the same time as the securities surrendered for conversion. . . .

116. Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957).

117. *Id.* at 7-8.

Commission and the bar—became known as the two-security and the package approaches. The two-security approach advanced by the Commission viewed the convertible security as comprising two distinct components: the conversion privilege and the underlying security.[118] However, the holder could only hold one security at any one time. The conversion privilege was considered to be a continuing offer to the debt holder to convert to an equity holder. But one could not hold simultaneously in both capacities. While conceding that the act of conversion would be exempt under Section 3(a)(9),[119] it did not follow that the security acquired through conversion would meet the investment intent requirement by reference to the holding period of the underlying security. Indeed, it would be virtually impossible to escape the status of an underwriter unless the security acquired upon conversion were held for a sufficient period of time—a highly improbable practice—undermining the basic character of the convertible security.

The financial bar advanced the package theory.[120] Under this approach the purchaser of a convertible security was deemed to have acquired a package with a series of rights which were not necessarily independent. Therefore, if a private purchaser held the package for a sufficient period of time to establish investment intent, he should be free to resell any part of the package without becoming an underwriter. Moreover, the theory continued, Section 3(a)(9) exempted the security obtained upon conversion. Unfortunately for the lovers of metaphysics, the above debate has now ended[121] with the result desired by the financial bar being embodied in Rule 144(d)(4)(B).

Dividends, Splits, Recapitalizations

In view of the concessions granted to convertible securities, it should follow a fortiori that, with respect to securities acquired

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118. Loss, *supra* note 1, at 677.

119. Securities Act of 1933 § 3(a)(9), 15 U.S.C. § 77c(a)(9) (1970) provides:

> (a) . . . the provisions of this title shall not apply to . . .
> (9) Any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange . . .

120. Loss, *supra* note 1, at 676.

121. During earlier rounds of this debate, the financial bar found itself in the loser's corner. Under Rule 155 (rescinded by SEC Securities Act Release No. 5223 (Jan. 11, 1972)), the two-security approach was adopted over the package theory. SEC Securities Act Release No. 4162 (Dec. 2, 1959) embodies the Commission's former attitude:

> It has been generally understood that a conversion is an exchange within the meaning of section 3(a)(9), with the result that the actual transaction of conversion is exempt if the other conditions of the section are satisfied. It is clear, however, that there is nothing in the intrinsic nature of securities issued in a transaction falling within section 3(a)(9) which justifies consideration of such securities as permanently exempt from registration without regard to any other factors.
>
> A security which is immediately convertible consists of the

through dividends, splits, and recapitalizations, the holding period should begin on the acquisition date of the primary security. And the rule so provides.[122]

Contingent Stock

In cases in which stock is being issued as contingent payment of the purchase price of an equity interest in a business, the holding period begins on the date that the issuer was committed to issue the securities subject only to conditions other than the payment of further consideration for such securities.[123]

Pledged Securities

The treatment accorded to securities pledged as collateral and thereafter publicly sold to liquidate the loan is the product of compromise. Without exempting the resale, the rule allows the pledgee to tack the pledgor's holding period onto his.[124]

The classic case is *SEC v. Guild Films Co.*[125] in which a bank accepted as collateral certain securities containing legends announcing its restricted character. The pledged stock was originally acquired by the pledgor through transactions not involving any public offering. Thereafter it was publicly sold to liquidate the loan despite the warning by the Commission that such sales would impose underwriter status upon the bank. In upholding the SEC's position, the Second Circuit deemed irrelevant the bank's contention that it acted in good faith. Thus, the stage was set for a series of maneuvers by the banks to soften the effect of the

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convertible security and a right to acquire the underlying security, thus involving a continuous offering by the issuer of the underlying security. A purchaser of the convertible security acquires it and the right and no more. If he offers to sell the convertible security, he offers to sell the right, thus transferring the issuer's offer of the underlying security, originally limited to the persons to whom the convertible security was initially offered, into an offer to all persons to whom the convertible security is now offered. The issuer's offer of the underlying security terminates upon exercise or expiration of the right. At any one time a person can own only one security or the other; he can never own both. Consequently, it cannot be said that a purchaser of the convertible security includes a simultaneous purchase of the underlying security. In the case of a debenture convertible into an equity security, the purchaser remains a creditor until he chooses to become an owner of the equity security; the two interests never merge. The transaction of conversion is an exchange for value and, therefore, a sale under the Securities Act and under accepted commercial practice and understanding.

122. SEC Rule 144(d)(4)(A), 17 C.F.R. § 230.144(d)(4)(A) (1972).
123. *Id.* at (d)(4)(C), 17 C.F.R. § 230.144(d)(4)(C).
124. *Id.* at (d)(4)(D), 17 C.F.R. § 230.144(d)(4)(D).
125. 279 F.2d 485 (2d Cir. 1960).

Guild Films case. One such assault occurred during the rule-making process leading to Rule 154, but the SEC stood firm, citing the authority of the *Guild Films* case.[126] However, the inflexibility of the Commission's position soon drew fire from other quarters. Professor Loss called for a return to the concept of the bona fide pledge;[127] the Wheat Report agreed,[128] but apparently not entirely.[129] All other conditions of Rule 144 must be met before the pledgee is free to sell. There is, however, limited relief embodied in the tacking prerogatives which allow tacking between pledgee and pledgor after default of the obligation secured by the pledge.[130] But a strand of fungibility remains. Sales by the pledgee shall be aggregated with those sales by the pledgor for the purpose of determining whether the amount of securities sold falls within the one per cent allowable.[131]

This latter rule concerning aggregation raises a baffling question. Suppose that a portion of stock acquired privately and held for over two years is pledged and a portion retained. Thereafter default occurs. It appears that the bank and the pledgor are free to sell provided both sales are aggregated and the amounts do not exceed the percentage limitations. However, can it be said that the dual sales activity detracts from the requirement that the pledge be bona fide? Without more evidence the answer is difficult and generally the bank should be able to justify its own immediate sales activity to cover its financial position. Moreover, it seems incongruous that the rule would permit dual sales activity of unregistered stock (within limits, of course). Even if the bank is acting in good faith, the fact that a defaulting pledgor is allowed Rule 144 privileges strains credulity.[132] It is enough that the bank be given a qualified respite; Rule 144 should not provide a refuge for such sales by a defaulting pledgor.

Donative Transactions

The application of the Rule to acquisitions from gifts, estates or trusts involves an interplay between the "tacking" rules and the "aggregation" rules. In short, tacking from donor to donee is generally allowed, but the effect of this generosity is tempered by certain rules requiring aggregation in specific instances.[133]

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126. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

127. Loss, *supra* note 1, at 645.

128. WHEAT REP., *supra* note 4, at 240.

129. The concept of bona fide pledge as embodied in Rule 144 (d) (4) (D) is accepted only if the other requirements of Rule 144 are met. For example, a bona fide pledge to a non-qualified issuer would not fall within the purview of Rule 144.

130. SEC Rule 144(d) (4) (D), 17 C.F.R. § 230.144(d) (4) (D) (1972).

131. *Id.* at (c) (3) (B); 17 C.F.R. § 230.144(c) (3) (B).

132. This assumes that the consideration obtained by the pledgor from the sale of his unpledged stock, is not being used to fulfill his obligation to the pledgee.

133. SEC Rule 144 (d) (4) (E), (F), (G), 17 C.F.R. § 230.144(d) (4) (E), (F), (G) (1972).

Gifts

If securities are acquired through gift, the donee may tack the donor's holding period onto his.[134] However, for purposes of computing the percentage limitation, the donor's and donee's sales are aggregated.[135]

Trusts

Tacking is permitted between the settlor and the trust itself, and between the trust and beneficiary.[136] It is unclear whether double tacking, *i.e.* from settlor to trust to beneficiary, is allowed. There appears to be no reason that it should be disallowed. As in the case of gifts, aggregation between the parties is required.[137]

Estates

An estate or a beneficiary can adopt the deceased's date of acquisition as its own.[138] Moreover, the two-year holding period requirement is suspended if neither the estate nor the beneficiary is an affiliate of the issuer.[139] This is a major concession and will help to facilitate the expeditious disposition of probate proceedings. However, the suspension of the two-year holding period does not amount to a complete waiver of the other requirements of Rule 144. There is a second major waiver of the amount limitations requirement provided the estate or beneficiary is not an affiliate of the issuer.[140] Thus, in cases involving nonaffiliate status, the concept of change of circumstances seems to have been resurrected for a limited purpose.[141]

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134. *Id.* at (d) (4) (E), 17 C.F.R. § 230.144(d) (4) (E).
135. *Id.* at (e) (3) (C), 17 C.F.R. § 230.144(e) (3) (C).
136. *Id.* at (d) (4) (F), 17 C.F.R. § 230.144(d) (4) (F). Profit sharing trusts are not included in this category; the holding period does not relate back to the date of acquisition of shares by the trust. International Flavors & Fragrances, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,216 (Jan. 3, 1973).
137. SEC Rule 144(e) (3) (D), 17 C.F.R. § 230.144(e) (3) (D).
138. *Id.* at (d) (4) (G), 17 C.F.R. § 230.144(d) (4) (G). An informal ruling holds that options to purchase stock passing to the estate, when exercised, start a new holding period with no tacking allowed. Mircoform Data System, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,916 (July 20, 1972).
139. SEC Rule 144(c) (3) (E), 17 C.F.R. § 230.144(c) (3) (E).
140. *Id.*
141. On the other hand, affiliate status with respect to the issue triggers the aggregation rules. SEC Rule 144(e) (1) (A) & (B), 17 C.F.R. § 230.144(e) (1) (A) & (B) (1972).

V. Conclusion

The Commission's decision to introduce objective criteria to facilitate the practical administration of the private offering exemption has been stimulated no doubt by the flurry of activity surrounding its recently departed Chairman Casey. Now the fate of the private offering rests with Rule 144 and proposed Rule 146. Rule 144, a daring venture by SEC standards, is currently presenting special problems of interpretation to both the Commission and the bar. Its uniqueness no doubt will continue to create administrative burdens.

Proposed Rule 146, on the other hand, being less revolutionary, should not generate as many administrative burdens. It is akin to a restatement of the case law, but it does extend the rationale of several of the basic precedents. If anything, such extension tends to promote the aim of the Securities Act and could only help to improve the integrity of the investment atmosphere. Although Rule 144 was meant to lay to rest the uncertainty surrounding the application of the private offering exemption, ironically the volume of informal rulings issued with respect to this exemption is running extremely high.

While the impetus toward objective standards is welcomed as an administrative respite, the effect of the new rules creates a specific problem which should not be overlooked. The environment which once supported the essential judicial stimulus which caused the law of the non-public offering to grow and develop has become rigid. And those well-developed forces shaping the growth and texture of the non-public offering struggle for survival. In such instances it is usual for petrification to develop and a body of quaint and exhaustively mechanical rules to emerge. Although it cannot be denied that the non-public offering did indeed possess potential to trap the unwary, the new scheme of objective criteria will surely trap those less mechanically inclined.

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