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PRIVATE PLACEMENT RULES 146 AND 240—SAFE HARBOR?

ROBERT A. KESSLER

I. INTRODUCTION

Section 5 of the Securities Act of 1933 (1933 Act) in effect requires registration of all securities. Sections 3 and 4 provide various exemptions from the registration requirement. One such exemption—the private placement exemption—is found in section 4(2) which exempts from registration, not the securities themselves, but "transactions by an issuer not involving any public offering." With its customary clarity, the statute not only fails to further delineate the scope of the exemption, but even fails to define its obverse, the "public offering."

For over forty years the determination of when this vaguely-worded exemption was available was left to ad hoc administrative and judicial interpretations which, in turn, created even greater uncertainty. In response the Securities and Exchange Commission (SEC) promulgated rule 146 which became effective June 10, 1974 and represents the

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2. Id. § 77c.

3. Id. § 77d.

4. Id. §77d(2) (emphasis added).

5. The first paragraph of preliminary note 3 to rule 146, 17 C.F.R. § 230.146 (1975), recognizes that the indefiniteness of such terms as "public offering" has led to uncertainties with respect to the availability of the exemption, while the third paragraph of that note confesses: "The term 'offering' is not defined in the rule. The determination as to whether offers, offers to sell, offers for sale, or sales of securities are part of an offering (i.e., are deemed to be 'integrated') depends on the particular facts and circumstances."

A definition of terms is a necessity if rule 146 is to achieve its aim of certainty. And, reluctant as the SEC may be to concede it, a workable definition must be in terms of arbitrary mathematical limits, for only quantitative or durational boundaries will solve the problem of "integration" (i.e., when does an offering under the rule begin and end). A quantitative definition likewise is required to define the desired outer perimeters of the exemption. The SEC has wrestled long enough with the definitional problem to have realized this. See SEC v. Sunbeam Gold Mines Co., 95 F.2d 699 (9th Cir. 1938). Fortunately, the SEC recognized the need for a quantitative, mechanical test in adopting the thirty-five purchaser limit of rule 146(g).


This is, of course, not the first article on this important rule. While some securities lawyers, especially those representing large reporting companies under the 1934 Act, undoubtedly feel it
SEC's third attempt to provide "objective standards upon which responsible businessmen may rely in raising capital under claim of the section 4(2) exemption . . ." On May 7, 1975, the rule was amended to decrease burdens on issuers in complying with the Rule. Unfortunately, the amendments accomplish this only to a very limited extent, and, ironically, in the case of small issuers, may even increase the dangers of relying on the rule.

represents some improvement over prior uncertainty, comment on the rule has been generally unfavorable. See, e.g., Kinderman, The Private Offering Exemption: An Examination of its Availability Under and Outside Rule 146, 30 Bus. Law. 921 (1975); Kripke, SEC Rule 146: A 'Major Blunder,' 172 N.Y.L.J., July 5, 1974, at 1, col. 3 [hereinafter cited as Kripke]; Rosenfeld, Rule 146 Leaves Private Offering Waters Still Muddied, 2 Sec. Reg. L.J. 195, 212-13 (1974) [hereinafter cited as Rosenfeld]. Even a member of the SEC staff (Mr. Lybecker) admits that "[r]ule 146 is not entirely without thorns and soft, subjective conditions." Alberg & Lybecker, New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities, 74 Colum. L. Rev. 622, 643 (1974) [hereinafter cited as Alberg & Lybecker]. Their final words on the rule are: "Accordingly, although it may remain risky and relatively expensive for many small businesses to use the nonpublic offering route to raise needed capital, many medium to large-sized businesses should find transactions structured to comply with rule 146 a relatively safe and not unreasonably expensive method of raising capital." Id. at 643. See also Arthur, Rule 146 Under the Securities Act of 1933: A Significant Codification, 56 Chi. B. Rec. 94 (1974); Green & Wittner, Private Placements of Securities Under Rule 146, 21 Prac. Law 9 (1975); Rosenfeld, supra; Schwartz, Rule 146: The Private Offering Exemption—Historical Perspective and Analysis, 35 Ohio St. L.J. 738 (1974); Note, SEC Rule 146—The Private Placement Exemption, 58 Minn. L. Rev. 1125 (1974).


9. Preliminary note 3 to rule 146, 17 C.F.R. § 230.146 (1975). The adopting release repeats this purpose several times: "The Rule is designed to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed to be 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." Rule 146 Adopting Release, supra note 7, ¶ 2710, at 2907-2. "The Commission believes that a rule creating greater certainty in the application of the Section 4(2) exemption is in the public interest . . ." Id. at 2907-3. "The Rule is designed to protect investors while at the same time providing more objective standards in order to curtail uncertainty to the extent feasible." Id. It should be noted, however, that the rule was also designed "to deter reliance on [the exemption when the offering is] to persons who need the protections afforded by the registration process." Preliminary note 3 to rule 146 supra. This ambivalence of purpose is characteristic of the "cosmic tension" of the competing concerns of the safety of the issuer and protection of the investor which continue to pervade the SEC exemption process. See text accompanying notes 18 & 81 infra for a manifestation of SEC concern for investor protection.


11. Id.
There is no express statutory provision exempting the initial issuance of stock to the organizers of even the closest of close corporations. Until recently, exemption from registration of such transactions was available only through section 4(2)'s vague nonpublic offering exemption. Then, shortly before the adoption of rule 146, the SEC, pursuant to section 3(b) of the Act, proposed rule 240, entitled "Exemption of Certain Limited Offers and Sales by Closely Held Issuers." Rule 240 became effective, in amended form, on March 15, 1975.

Together, rules 146 and 240 represent the SEC's attempt to provide a "safe harbor" for businessmen relying on the private placement exemption of section 4(2) of the Act. It is the purpose of this Article to assess

12. Over and above the general rules on private placements, the SEC offered additional guidance to small businessmen regarding their eligibility for exemption. But this, if anything, was more vague than the general exemption rules. Thus, SEC Securities Act Release No. 4552 (Nov. 6, 1962), 1 CCH Fed. Sec. L. Rep. ¶ 2774, stated: "The sale of stock to promoters who take the initiative in founding or organizing the business would come within the exemption. On the other hand, the transaction tends to become public when the promoters begin to bring in a diverse group of uninformed friends, neighbors and associates."

13. 15 U.S.C. § 77c(b) (1970). This section allows the SEC to exempt securities if it finds that enforcement of the Act "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering" where "the aggregate amount at which such issue is offered to the public" does not exceed $500,000. Id. Rule 240, 17 C.F.R. § 230.240 (1975), technically was promulgated under this section which exempts the securities themselves, in contrast to § 4(2) which exempts the issuing transaction only. However, the original release to the proposed version of rule 240 makes it clear that the exemption is "for the issuer transaction only, not for the securities themselves." SEC Securities Act Release No. 5499 (June 3, 1974), [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,804. Furthermore, rule 240(g) states that securities acquired under it "shall be deemed to have the same status as if they had been acquired in a transaction pursuant to section 4(2) of the Act," i.e., the exemption applies only to the transaction; the shares themselves are not exempt. It is therefore clear that rule 240 is merely a special type of private placement exemption.


16. Section 3(a)(11) of the Act also provides an exemption for "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within . . . such State or Territory." 15 U.S.C. § 77c(a)(11) (1970). The circumstances under which this exemption is available have been considerably clarified by the promulgation of rule 147, 17 C.F.R. § 230.147 (1975), adopted in SEC Securities Act Release No. 5450 (Jan. 7, 1974), 1 CCH Fed. Sec. L. Rep. ¶ 2340. See note 89 infra. However, rule 147 can be a trap for the unwary. For example, since this exemption is destroyed not only by sales and resales to nonresidents of the issuer's state but also by offers to such non-residents, even the "closest" of businesses in commuter states cannot safely utilize section 3(a)(11) or the congruent rule 147. For example, a New York businessman who resides in New Jersey cannot safely approach a fellow New Jersey resident to invest in his New York business under the exemption. Therefore, knowledgeable businessmen rarely rely exclusively on rule 147 as their sole justification for failure to register.
these rules and examine how well their purposes have been achieved.

Unfortunately, one must conclude that both rules are a great disappointment since they impose too many burdens and do not lessen the uncertainties which have so long plagued the subject.

The principle reason for the failure of these rules is the SEC's failure to recognize and distinguish among the widely different types of transactions subsumed under the "nonpublic" offering.

There are at least three types of "private placements" currently in use. The first involves an offering to a limited number of people, frequently strangers, and typically to raise money for a new venture, e.g., the exploitation of a new invention. It is at least "quasi-public," since often the only feature distinguishing it from a genuinely public one is that it is not made to an undifferentiated public, but is made to fewer, "selected" people through a "chain letter" approach. This is the type most fraught with dangers to the investor, and therefore it is arguably the least deserving of exemption from registration. Secondly, there is an offering, frequently of debt securities, to a large or small (depending on the amount to be raised, which may run into millions of dollars) group of institutional investors, typically banks or insurance companies, by seasoned businesses in need of expansion capital. Where large amounts of capital are needed, participation may be fractionalized among the lenders to spread the risk and profit. A typical example would be a public utility raising money for a new power plant. In this type of placement, the investors, ordinarily all sizeable corporations whose decisions are guided by financial experts, have little need for the protections of the Securities Act. They are well able to take care of themselves, no matter how large or small their investment, or how many investors are included in the group. Finally, there is the small business formation involving no more than a handful of people who purchase a limited partnership interest, or stock in a close corporation, or perhaps lend their money. All of the participants are at least acquainted with one another, and frequently are related. Although, typically, all expect to have a more or less active part in the operation of the business, sometimes a "silent partner" will be willing to risk his money in reliance on the business acumen of the others. Typically, too, any subsequent transfer of the "securities" will be merely a vehicle to accomplish a transfer of the entire business to new

Reliance on this exemption is further discouraged by state statutes such as the New York Registration of Intra-State Offerings Law, N.Y. Gen. Bus. Law § 359-ff (McKinney Supp. 1974), which imposes additional blue sky burdens on issuers relying on the federal intrastate exemption unless a state exemption is available. See note 164 infra.

In view of the foregoing pitfalls, even the small businessman seeking financing will normally place primary emphasis on the non-public nature of the transaction, rather than on the intrastate offering exemption.
owners. While small business participants are frequently unsophisticated, both the initial formation of the business and any "bulk transfer" of it will ordinarily be guided by attorneys who are in a position to insure that their clients are adequately protected, not only by full disclosure of pertinent information, but also by the terms of the securities evidencing their investment participation. The federal law, undoubtedly, was not intended to cover this third type of transaction, which is frequently exempt even under state law. Thus, although the peculiar design of the statute—the all-encompassing registration requirement of section 5, coupled with the exemptions of sections 3 and 4—contributes to the failings of the private placement rules, the primary fault rests with the SEC's failure to distinguish among these different types of private placements.

II. BACKGROUND OF RULE 146

Initially, one might well ask why it took so long for the SEC to come up with these "objective criteria" so that issuers could readily determine when they could safely rely on the exemption. A safe guess is that the SEC probably feared that mechanical tests would leave a loophole through which clever securities lawyers could distribute securities to the public without registration and thus impede the investor protection (through the full disclosure) which registration is designed to insure. In any event, there was great confusion as a result of the SEC's failure to exercise its rule-making power in this area.

There was an early rule of thumb that an offer to no more than twenty-five persons was not a "public offering." But it was never


18. Although the anti-fraud provisions have a broader application, the registration and statutory prospectus requirements apply only to issuers, underwriters and, to a limited extent, dealers, and persons in certain relationships to the three. Therefore, in order to hold private sellers liable, the SEC ordinarily has been forced to show that they were somehow "underwriters." The statutory definition of an "underwriter" includes a person who purchases from the issuer (or a person in a "control" relationship with the issuer) "with a view to...distribution." Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1970). Although the convoluted statute does not say so, presumably a "distribution" is the equivalent of a "public offering," at least if it is a large-scale distribution; otherwise one person could purchase an entire issue in a "non-public offering" and immediately resell it without registration. The courts have accepted this reasoning and as a result the SEC has been able to force registration in such situations, despite a claim of exemption by the security-holders. See, e.g., Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959); In re Ira Haupt & Co., 23 S.E.C. 589 (1946). See generally I. Loss, Securities Regulation 551 (2d ed. 1961) [hereinafter cited as Loss]. Conversely, if one purchased with an intent to invest and not "with a view to distribution," it was not treated as a "public offering."

given official status as a rule, and it was, in effect, repudiated by the only Supreme Court decision\(^{20}\) which has ruled on section 4(2).

That 1953 decision, \textit{SEC v. Ralston Purina Co.},\(^{21}\) became the most important guide to availability of the private placement exemption. The narrow holding of the case was plain enough: the issuer has the burden of proving an exemption;\(^{22}\) and it failed to do so where the stock, though purportedly offered only to "key employees" who themselves took the initiative in seeking to buy it, actually was sold to employees with widely diverse duties and salaries.\(^{23}\)

Despite the brevity of the opinion, the Court, as is frequently the case, said too much. At one point it stated:

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."\(^{24}\)

At the end of the opinion, however, the Court stated:

The focus of inquiry should be on the need of the offerees for the protections afforded by registration. 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.\(^{25}\)

The first statement appears sufficiently straightforward: if all the offerees are able "to fend for themselves" the offering is exempt. However, the concept of being able to fend for oneself is not defined. It could be equivalent to having access to the information which registration would disclose, but it seems to encompass a broader concept. It suggests sophistication, and perhaps even more importantly, suggests it as an alternative to access.

On the other hand, it is not completely clear that the Court regarded access alone as sufficient to protect the exemption. The 1933 Act does presuppose that access to information which registration would disclose makes an investor able to fend for himself;\(^{26}\) and so it would


\(^{21}\) Id.

\(^{22}\) Id. at 126-27.

\(^{23}\) Id. at 121, 126.

\(^{24}\) Id. at 124-25 (emphasis added) (footnote omitted).

\(^{25}\) Id. at 127 (emphasis added).

\(^{26}\) Registration is designed merely to guarantee full disclosure. It is assumed that, equipped with such disclosure, the investor will be able "to fend for himself." The SEC summarized the
follow that access alone should have been regarded as sufficient. However, the holding could be viewed as analogous to that of a common law cause of action in fraud and deceit where, although nonreliance defeats the action, reliance alone is not sufficient to make one out. In any event, the ambiguous relationship of the two tests left room for expansive lower court and SEC interpretations.

Moreover, the access test itself was left open to later interpretation because the Court formulated the access test not by defining access, but by condemning lack of access (to information registration would disclose). Although the Court may have intended to require access to information registration would disclose, the manner in which the test was phrased did not preclude lower courts from interpreting that some other form of access is required. In short, the meaning of access was left to the lower courts and SEC to define.

The most sensible reconciliation of the two statements would have been to allow the exemption where the investor either had access to the information which registration would disclose or was otherwise able to fend for himself. In fact, mere access to information which registration would disclose should have assured exemption to prevent the anomaly of a private placee getting greater protection than he would have gotten had the securities been registered. However, the lower federal courts chose to create just such an anomaly and the SEC has chosen to perpetuate it in rule 146.

The U.S. Court of Appeals for the Second Circuit, in *Gilligan, Will & Co. v. SEC*, interpreted the *Ralston Purina* case as follows:

> "The purpose of registration is to provide disclosure of these and other important facts so investors may make a realistic appraisal of the merits of the securities and thus exercise an informed judgment in determining whether to purchase them. Assuming proper disclosure, the Commission cannot deny registration or otherwise bar the securities from public sale whether or not the price or other terms of the securities are fair or the issuing company offers reasonable prospects of success. These are factors which the investor must assess for himself in the light of the disclosures provided; and if the facts have been fully and correctly stated, the investor assumes whatever risks may be involved in the purchase of the securities." The Work of the Securities and Exchange Commission 2-3 (1967) (italics deleted).


27. The pre-rule cases are collected in Annot., 6 A.L.R. Fed. 536 (1971).


29. 267 F.2d 461 (2d Cir. 1959).
The Court . . . defined the standard to be applied in determining whether an issue is a public offering. It held that the governing fact is whether the persons to whom the offering is made are in such a position with respect to the issuer that they either actually have such information as a registration would have disclosed, or have access to such information. . . . The stipulation of facts here expressly states that the purchasers "were not supplied with material information of the scope and character contemplated by the Securities Act nor were the purchasers in such a relation to the issuer as to have access to such information concerning the company and its affairs."[30]

Since there appears to have been little doubt as to all four purchasers' sophistication and ability to fend (one was a broker, one the wife of another broker and the remaining two were friends of that broker), the court's requirement of either actual knowledge of or access to information which registration would disclose was an implicit rejection of sophistication as an alternative test.

In United States v. Custer Channel Wing Corp.,[31] the U.S. Court of Appeals for the Fourth Circuit went even further:

Appellants argue that the District Court erred in finding that the individual purchasers were not able "to fend for themselves," noting that they were "sophisticated investors" and "businessmen of mature experience." But "sophistication is not a substitute for "access to the kind of information which registration would disclose." . . . Schedule A of the Securities Act . . . lists 32 categories of information that should be included in a registration statement. This type of information is designed to protect the investor by furnishing him with detailed knowledge of the company and its affairs to make possible an informed investment decision. A purchaser of unregistered stock must be shown to have been in a position to acquire similar information about the issuer.[32]

The court not only rejected the Ralston Purina sophistication test as insufficient, but imposed a new requirement that purchasers must take for investment. While justifiable on policy grounds of preventing a two-step public distribution, the investment requirement was an obvious expansion of the Ralston Purina tests.

More recently, the Tenth Circuit, in Lively v. Hirschfeld,[33] construed the Supreme Court decision as requiring both sophistication (and exceptional sophistication at that) and access (and "regular access" to information well beyond that which registration would give). The court said:

After the Ralston Purina case the emphasis in the decisions has been placed on the particular capabilities and information had by particular persons, buyers, plaintiffs, or offerees. The Ralston Purina case requires this examination of the individuals solicited to determine the nature of the offer, that is, to determine whether there was a public need for registration. Thus the question has become whether there is a "need" for

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30. Id. at 466 (emphasis added).
32. Id. at 678 (footnote omitted) (emphasis added).
33. 440 F.2d 631 (10th Cir. 1971).
registration as to the individuals or group concerned, and the "public" or "private" categories are not particularly descriptive. The "need" requirement is strict. 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. When applied to the record in the case before us, the offerees are not such persons of unusual business experience and skill, they did not have the degree of access to the type of data as would meet the standard. There was, as indicated above, the cross-examination of a plaintiff which showed him to be a person of some experience in business, and there were general references to other buyers and offerees. This cannot suffice under the decisions. The proof as to the particular buyer who testified was not sufficient to meet the requirements as to him, even if he could be considered alone. The testimony as to all other offerees was woefully short of the requirement. The standard must apply to all the offerees if the Ralston Purina case is to be meaningfully applied, and if the artificial classification of "plaintiffs" and the accidental classification of "buyers" is to be prevented from determining the nature of the offer in a private action such as this.34

As implied earlier, a conjunctive interpretation of the two Ralston Purina statements seems unwarranted.35 Furthermore, the adjectival glosses of these cases36 obviously go beyond even the broadest permissible construction of Ralston Purina and impose additional requirements for availability of the exemption.

The case which caused the greatest concern among members of the securities bar was the Fifth Circuit decision, SEC v. Continental Tobacco Co.37 While the decision was not as unfavorable as securities lawyers had feared from reading the SEC's brief, it clearly did impose further burdens on issuers seeking to make a non-public offering.

The offerors in Continental Tobacco prepared a prospectus and required purchasers to sign a statement that they not only had received the prospectus, but had read it, and, further, had investigated the business and financial statements of the issuer by questioning the issuer's officers and counsel. The statement concluded: "I do not desire any further information or data concerning your company."38 The defendants failed to prove that all investors had received the prospectus and signed the agreement. The court could have decided the case on that basis, since, as it held, the Ralston Purina tests apply to all offerees. However, it chose not to use that ground. Instead it stated:

As pointed out by the Commission, "Even if it were assumed that Continental's prospectus provided those offerees to whom it was disseminated with all the informa-

34. Id. at 632-33 (emphasis added).
35. See text accompanying notes 25-28 supra.
37. 463 F. 2d 137 (5th Cir. 1972).
38. Id. at 146 n.1.
tion that registration would disclose, this would not suffice to establish the requisite relationship of those offerees to the company"... [The] mere disclosure of the same information that would be contained in a registration statement does not assure exemption...

In Lively v. Hirschfeld, ... the Tenth Circuit held that under the standard of Ralston Purina the issuer must ultimately prove that as to all offerees there was a lack of public need for registration and the protections of the Act. Continental did not affirmatively prove that all offerees of its securities had received both written and oral information concerning Continental, that all offerees of its securities had access to any additional information which they might have required or requested, and that all offerees of its securities had personal contacts with the officers of Continental.39

Thus, Continental Tobacco expanded Ralston Purina's second test—access to information registration would disclose—by requiring "any additional information which [the offerees] might have required or requested," and "personal contacts [between the offerees and the] officers." More importantly, a vague new requirement, "relationship" with the issuer, was imposed.

This new relationship requirement is traceable to a relationship factor in Ralston Purina. At this point, it should be emphasized that "factors" and "requirements" are not the same thing. Factors are balanced against each other: the absence of one factor may be outweighed by the presence of another. Requirements, however, are mandatory: each requirement must be satisfied. The relationship factor was implicated in the Ralston Purina Court's discussion of the inability of widely varied employees to fend for themselves:

The exemption, as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within § 4(1) [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. Absent such a showing of special circumstances, employees are just as much members of the investing "public" as any of their neighbors in the community.40

The Supreme Court was not imposing an additional requirement of particular relationship, but merely was conceding that some employee offerings could constitute private offerings. The most reasonable interpretation of its statement is that proof of a certain insider relationship may substitute for proof of actual access and thereby demonstrate that the offerees meet the standard of being able to fend for themselves. Clearly, Ralston Purina treated relationship to the issuer as an alternative factor, as opposed to an added requirement. Following the trend of the other lower court decisions, however, the Continental
Tobacco case converted it from a disjunctive factor to a conjunctive requirement.

Ultimately, the new relationship requirement is traceable to an early opinion of the SEC's general counsel in which he declined to give an opinion as to whether a proposed offering of $1,768,000 of preferred stock to twenty-five offerees was exempt, but set forth four factors which the SEC would use in determining the availability of the exemption: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of offering. After Ralston Purina the SEC issued a release which purported to downplay the significance of the first factor, but actually restated all four factors.

Most of the SEC "factors" and the judicial glosses on Ralston Purina found their way into new rule 146, and, in the process, were transmuted into requirements.

III. THE ONEROUS RULE 146

Paragraphs (c), (d), (e) and (g) of rule 146 set forth the general conditions for eligibility of the private placement exemption. These
concern the manner of offering, the nature of the offerees, the offeree's

(ii) That the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment.” Id. § 230.146(d) (italics deleted).

45. “(e) Access to or Furnishing of Information.

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

(1) Either

(i) Each offeree shall have access during the course of the transaction and prior to the sale to the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense; or

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

(a) In the case of an issuer that is subject to the reporting requirements of Section 13 or 15(d)
of the Securities Exchange Act of 1934:

(1) The information contained in the annual report required to be filed under the Exchange Act or a registration statement on Form S-1 under the Act or on Form 10 under the Exchange Act, whichever filing is the most recent required to be filed, and the information contained in any definitive proxy statement required to be filed pursuant to Section 14 of the Exchange Act and in any reports or documents required to be filed by the issuer pursuant to Section 13(a) or 15(d) of the Exchange Act, since the filing of such annual report or registration statement, and

(2) A brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs which are not disclosed in the documents furnished;

(b) In the case of all other issuers, the information that would be required to be included in a registration statement filed under the Act on the form which the issuer would be entitled to use, provided, however, that:

A. the issuer may omit details or employ condensation of information if, under the circumstances, the omitted information is not material or the condensation of information does not render the statements made misleading.

NOTE: The issuer would have the burden of proof to show that, under the circumstances, the omitted information is not material and that any condensation does not render the statements made misleading.

B. if the issuer does not have the audited financial statements required by such form and cannot obtain them without unreasonable effort or expense, such financial statements may be furnished on an unaudited basis, provided that if such unaudited financial statements are not available and cannot be obtained without unreasonable effort or expense, the financial statements required by Regulation A under the Act may be furnished.

C. if the financial schedules required by Part II of the registration statement have not been prepared, they need not be furnished.

(c) Notwithstanding paragraph (e)(1)(ii)(a) and (b) of this section exhibits required to be filed with the Commission as part of a registration statement or report need not be furnished to each offeree or offeree representative if the contents of the exhibits are identified and such exhibits are available pursuant to paragraph (e)(2) of this section; and
access to or the offeror's furnishing of information, and the number of

(2) The issuer shall make available, during the course of the transaction and prior to sale, to each offeree or his offeree representative(s) or both, the opportunity to ask questions of, and receive answers from, the issuer or any person acting on its behalf concerning the terms and conditions of the offering and to obtain any additional information, to the extent the issuer possesses such information or can acquire it without unreasonable effort or expense, necessary to verify the accuracy of the information obtained pursuant to paragraph (e)(1) of this section; and

(3) The issuer or any person acting on its behalf shall disclose to each offeree, in writing, prior to sale:

(i) Any material relationship between his offeree representative(s) or its affiliates and the issuer or its affiliates, which then exists or mutually is understood to be contemplated or which has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship;

(ii) That a purchaser of the securities must bear the economic risk of the investment for an indefinite period of time because the securities have not been registered under the Act and, therefore, cannot be sold unless they are subsequently registered under the Act or an exemption from such registration is available; and

(iii) The limitations on disposition of the securities set forth in paragraph (h)(2), (3), and (4) of this section.

NOTE: Information need not be provided and opportunity to obtain additional information need not be continued to be provided to any offeree or offeree representative who, during the course of the transaction, indicates that he is not interested in purchasing the securities offered, or to whom the issuer or any person acting on its behalf has determined not to sell the securities.” Id. § 230.146(e) (italics deleted).

46. “(g) Number of Purchasers.

(1) The issuer shall have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that there are no more than thirty-five purchasers of the securities of the issuer from the issuer in any offering pursuant to the rule.

NOTE: See paragraph (b)(1) of this section, the note thereto and the Preliminary Notes as to what may or may not constitute an offering pursuant to the rule.

(2) For purposes of computing the number of purchasers for paragraph (g)(1) of this section only:

(i) The following purchasers shall be excluded:

(a) Any relative or spouse of a purchaser and any relative of such spouse, who has the same home as such purchaser; and

(b) Any trust or estate in which a purchaser or any of the persons related to him as specified in paragraph (g)(2)(i)(a) or (c) of this section collectively have 100 percent of the beneficial interest (excluding contingent interests);

(c) Any corporation or other organization of which a purchaser or any of the persons related to him as specified in paragraph (g)(2)(i)(a) or (b) of this section collectively are the beneficial owners of all the equity securities (excluding directors' qualifying shares) or equity interest; and

(d) Any person who purchases or agrees in writing to purchase for cash in a single payment or installments, securities of the issuer in the aggregate amount of $150,000 or more.

NOTE: The issuer has to satisfy all the other provisions of the rule with respect to all purchasers whether or not they are included in computing the number of purchasers under Subdivision (g)(2)(i).

(ii) There shall be counted as one purchaser any corporation, partnership, association, joint stock company, trust or unincorporated organization, except that if such entity was organized for the specific purpose of acquiring the securities offered, each beneficial owner of equity interests or equity securities in such entity shall count as a separate purchaser.

NOTE: See Preliminary Note 5 as to other persons who are considered to be purchasers.” Id. § 230.146(g) (italics deleted).
purchasers, respectively. Paragraph (h)\textsuperscript{47} imposes duties on the issuer to prevent disposition of the securities by the purchaser. Paragraph (b) states that all of the conditions of the rule must be met to secure its protection. Paragraph (f)\textsuperscript{48} deals with the special problem of business combinations, and paragraph (a) contains definitions.

47. "(h) Limitations on Disposition. The issuer and any person acting on its behalf shall exercise reasonable care to assure that the purchasers of the securities in the offering are not underwriters within the meaning of section 2(11) of the Act. Such reasonable care shall include, but not necessarily be limited to, the following:

(1) Making reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons;

(2) Placing a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities;

(3) Issuing stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, making a notation in the appropriate records of the issuer; and

(4) Obtaining from the purchaser a signed written agreement that the securities will not be sold without registration under the Act or exemption therefrom.

NOTE: Paragraph (h)(4) of this section does not apply to business combinations as described in paragraph (f) of this section. Notwithstanding the absence of a written agreement, the securities are restricted and may not be [resold] without registration under the Act or an exemption therefrom. The issuer for its own protection should consider, however, obtaining such written agreement even in business combinations." Id. § 230.146(h) (italics deleted).

48. "(f) Business Combinations.

(1) The term 'business combination' shall mean any transaction of the type specified in paragraph (a) of Rule 145 under the Act and any transaction involving the acquisition by one issuer, in exchange solely for all or a part of its own or its parent's voting stock, or stock of another issuer if, immediately after the acquisition, the acquiring issuer has control of the other issuer (whether or not it had control before the acquisition).

(2) All the conditions of this rule except paragraph (d) and paragraph (h)(4) of this section shall apply to business combinations.

NOTE: Notwithstanding the absence of a written agreement pursuant to paragraph (h)(4), any securities acquired in an offering pursuant to paragraph (f) are restricted and may not be resold without registration under the Act or an exemption therefrom.

(3) For purposes of paragraph (f) only, the issuer and any person acting on its behalf, after making reasonable inquiry, shall have reasonable grounds to believe, and shall believe, at the time that any plan for a business combination is submitted to security holders for their approval, or in the case of an exchange, immediately prior to the sale, that each offeree either alone or with his offeree representative(s) has such knowledge and experience in financial and business matters that he is or they are capable of evaluating the merits and risks of the prospective investment.

(4) In addition to information required by paragraphs (e) and (f)(2), the issuer shall provide, in writing, to each offeree at the time the plan is submitted to security holders, or in the case of an exchange, during the course of the transaction and prior to the sale, information about any terms or arrangements of the proposed transaction relating to any security holder that are not identical to those relating to all other security holders." Id. § 230.146(f) (italics deleted).

This revised version of paragraph (f) of the rule extends the benefits of rule 146 to business combinations affected by an exchange of the acquiring corporation's stock for that of the acquired corporation (a type "B" reorganization under Int. Rev. Code of 1954, § 368). While this change
Paragraph (c), which regulates the manner of the offering, imposes a general ban on "any form of general solicitation or general advertising," and gives specific examples of interdicted publicity activities.\textsuperscript{49} Since an appeal to an undifferentiated public is obviously antithetical to a private offering, there can be no serious objection to this portion of the rule.\textsuperscript{50}

Paragraph (d),\textsuperscript{51} captioned "Nature of Offerees," defines the class of offerees and the class of purchasers capable of fend for themselves. A capable offeree is one who the issuer and any person acting on its behalf shall have reasonable grounds to believe and shall believe \textit{immediately prior to making an offer} either . . . has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or . . . can bear the economic risk of the investment.\textsuperscript{52}

Thus, capable offerees are those whom the issuer and anyone acting on his behalf reasonably believe to be sufficiently sophisticated or wealthy enough to withstand a total loss on the investment. A capable purchaser is one who \textit{immediately prior to making a sale}, the issuer and any person acting on its behalf, after making reasonable inquiry, shall have reasonable grounds to believe and shall believe either (1) . . . has the requisite knowledge and experience, or (2) [in conjunction

\textsuperscript{49} See note 43 supra for text of rule 146(c).
\textsuperscript{50} This amended form of the rule deletes part of the original subdivision (c)(3) which required the issuer to supply on request the information required by subdivision (e)(1) to every person with whom written communication had been made with regard to the offering. Since every offeree still must meet either the sophistication or wealth tests of subdivision (d), and still must have access to or be furnished with the information required under subdivision (e), the only effects of the amendment appear to be to excuse the issuer from repeating needlessly the offeree's rights each time an interested offeree is contacted in writing, and to eliminate the sending of unwanted information to an offeree who after an initial expression of interest and request for information decides not to pursue the matter further. Since each offeree, or his representative, must meet the sophistication test of subdivision (d), perhaps no reminder of his rights is necessary. A requirement that the issuer give the offeree a general outline of his rights at the time of the initial communication, however, might have been useful. In any event, the deletion of the undertaking requirement does make the issuer's burden lighter, but not significantly so, when the remaining requirements of the rule are considered.
\textsuperscript{51} See note 44 supra for text of rule 146(d).
\textsuperscript{52} Rule 146 Adopting Release, supra note 7, at 2907-7 (emphasis added).
with an offeree representative has] the requisite knowledge and experience and . . . is a person who is able to bear the economic risk of the investment.53

Thus, capable purchasers include those offerees whom the issuer and any person acting on its behalf reasonably believe to be sufficiently sophisticated; or reasonably believe to be sufficiently wealthy and, in conjunction with an "offeree representative,"54 sufficiently sophisticated. It is important to note that wealth alone is not sufficient to satisfy the definition of a purchaser under the rule.

Paragraph (e), in accordance with the Lively55 and Continental Tobacco56 cases, goes beyond Ralston Purina57 by onerously requiring access to or actual furnishing of information beyond that which registration would disclose. Paragraph (e)(2) provides:

The issuer shall make available, during the course of the transaction and prior to sale, to each offeree or his offeree representative(s) or both, the opportunity to ask questions of, and receive answers from, the issuer or any person acting on its behalf concerning the terms and conditions of the offering and to obtain any additional information, to the extent the issuer possesses such information or can acquire it without unreasonable effort or expense, necessary to verify the accuracy of the information obtained pursuant to paragraph (e)(1) of this section . . . .58

Whether viewed as an access or an information-furnishing requirement, it should be noted that paragraph (e)(2) must be complied with even if the offeree has available all the information which registration would disclose. In addition, rule 146(e) adopts a variation of the special relationship test of Continental Tobacco and the precursor SEC release.59

Access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate the merits and risks of the prospective investment.60

The accompanying release explains that the term "access" is used in the rule in the same sense that it has been used "by courts and the Commission in the past—to refer to the offeree's position with respect

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53. Id. (emphasis added).
54. See note 109 infra for a definition of offeree representative.
57. See text accompanying notes 25-28 supra.
58. 17 C.F.R. § 230.146(e)(2) (1975) (emphasis added). See note 45 supra for full text of rule 146(e).
59. See text accompanying note 39 supra; note 41 supra and accompanying text.
60. 17 C.F.R. § 230.146(e) (1975); see note 45 supra.
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to the issuer.”61 However, the same release also states that “the Commission is of the view that an offeree need not be an insider such as an officer or director of the issuer in order to have access to information.”62 Theoretically, then, the SEC has rejected Continental Tobacco’s “insider” special relationship test. Practically, however, the rejection is meaningless since in applying only to those employees, family members and wealthy people who already have enough clout to compel the issuer to give them the same information as registration would disclose,63 the access requirement protects only those who do not even need its protection. In creating this situation the release and note do little to reduce “uncertainty” or provide “more objective standards.”64

Because the determination of who possesses this requisite power relationship can be made only after the fact, the only safe alternative for an issuer appears to be to furnish the information and not rely on “access” as a substitute. This means, as a practical matter, that the issuer must prepare a registration statement.65 In fact, since the issuer

62. Id. at 2907-3.
63. This is consistent with Ralston Purina which held, to use the new language, that ordinary employees did not have the requisite relationship. See text accompanying note 23 supra. Thus, only top level employees (query exactly which) will meet the requirement.
64. Compare Rosenfeld, supra note 7, with Kripke, supra note 7. “In considering the access concept, it is helpful to note that the Commission, in defining access, has retreated from its position in SEC v. Continental Tobacco Co., where the Commission argued that only an insider could have access. The concept as it exists under Rule 146 makes it clear and perhaps relatively easy for an institution or venture capital firm to possess sufficient economic bargaining power to be an access offeree.” Rosenfeld 206 (italics deleted) (footnote omitted). “This new concept of ‘clout’ merely compounds but does not solve the difficulties of the access concept. How does anyone have any bargaining power with an issuer except to be able to say that if the issuer does not tell him what he wants to know, he will not make the investment? In that sense everyone has clout, and no one has special clout, with the possible rare exceptions of major suppliers and customers, and perhaps some limited number of the largest institutional investors whose participation is so necessary in major financial deals that they have special clout. Thus this change in itself takes us nowhere.

“But the Commission adds as an alternative to access under the Rule the furnishing of information equivalent to that on the appropriate registration form. The result, of course, is that the unavoidable requirement of access will be forgotten in all but very rare cases under the Rule and the furnishing of information will be substituted.” Kripke 6, col. 3 (italics deleted).
65. Rule 146(c) requires an issuer not subject to the 1934 Act reporting requirements to furnish each offeree (or his offeree representative), unless the offeree has “access” to the information, with “the same kind of information that is specified in Schedule A.” Schedule A to the 1933 Act, which sets forth the contents of the registration statement, sets forth thirty-two required items, ranging from the name of the issuer to copies of significant documents. It, of course, includes the familiar prospectus. Its preparation is a highly specialized art, the prime function of the highly specialized and expensive securities bar. For guides to the preparation of registration statements see SEC Securities Act Release No. 5278 (July 26, 1972), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,888; SEC Securities Act Release No. 4936 (Dec. 9, 1968), [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,636.
must comply with the additional requirements of paragraph (e)(2), the burden ultimately is greater than registration. Furthermore, because no one can say with certainty how much additional information is enough under paragraph (e)(2), attempted compliance becomes even more risky than a registered offering.

Reporting companies ordinarily can afford the costs of full registration. The economic burden of rule 146 disclosure thus falls most heavily on the smaller issuers. Newly formed businesses will have the highest proportional burden since presumably they will have to prepare at least the mini S-2 registration statement.

There is an exception from these access and information-furnishing requirements for issuers required to report under the 1934 Act. There is also an ameliorative provision for non-reporting issuers. The latter

Rosenfeld combines the "substantial employee time and money to explain the terms of an offering or verify information obtained or furnished" (Rosenfeld, supra note 7, at 207) with the cost of the offeree representative and concludes that "f[or] most small issues, as well as most small issuers, the conditions and requirements set forth in the Rule will cause legal, accounting, and the issuer's internal expenses to be too large." Id. at 212. See also Alberg & Lybecker, supra note 7, at 643. See generally SEC Reg. S-X, 17 C.F.R. § 210.1-01 et seq. (1975), which sets forth the SEC accounting requirements.

66. Issuers required to report under section 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(d) (1970), are those who have already had a registered public offering under section 5 of the Securities Act of 1933, id. § 77(e), or who have registered under section 12 of the 1934 Act. Id. § 781(a). Section 12(b) covers securities listed on a stock exchange. Id. § 781(b). Section 12(g) requires registration by issuers who have total assets exceeding $1,000,000 and a class of unexempt equity security held of record by 500 or more persons. Id. § 781(g).

67. They will not have to pay the underwriter's spread, and may save some printing costs. They also will not have to pay the statutory registration fee, Securities Act of 1933 § 6(b), id. § 77f(b), but this is a relatively minor expense. Significant legal and accounting fees will undoubtedly be incurred. The excuse from furnishing audited financial statements where the issuer "cannot obtain them without unreasonable effort or expense" is discussed at note 70 infra. Unaudited financials are, of course, less expensive than audited ones, and would normally have to be prepared, anyhow, for tax purposes. See rule 1-02(d), 17 C.F.R. § 210.1-02(d) (1975), for a definition of audit.

68. 17 C.F.R. § 230.146(e)(1)(ii)(b) (1975). Form S-2, although requiring fewer items than the more frequently used S-1 form, requires that all financial statements be certified. See rule 1-02, 17 C.F.R. § 210.1-02(f) (1975), for a definition of certified. Unless this requirement is excused, furnishing the information which form S-2 would disclose will probably cost the issuer as much or more than furnishing the S-1 information. Form S-3 is provided for promotional-stage issuers in mineral exploration, development or exploitation (other than oil or gas). Very small new ventures, needing less than $100,000, will, fortunately, be able to rely on rule 240, rather than rule 146, thus avoiding problems under paragraph (e). See text accompanying notes 136-164 infra for a discussion of rule 240.

69. 17 C.F.R. § 230.146(e)(1)(ii)(c) (1975); see note 45 supra.

70. The addition of subdivision (e)(1)(ii)(a)(2) regarding the information requirement for issuers not subject to the reporting requirements of the 1934 Act is perhaps the most important of the rule 146 amendments. Non-reporting issuers—smaller, expanding businesses—are perhaps the most important ones to encourage in the present state of the economy, and should certainly be the peculiar concern of any private placement rule. The amended rule continues the basic requirement that the information furnished to offerees be the same as that in a registration statement, but makes it clear
eases the burden on non-reporting issuers somewhat by excusing them from furnishing certain financial statements. However, the new permission for non-reporting issuers to condense or omit certain registration statement items does not ease the burden and is a trap for the unwary.

Paragraph (g) modifies the SEC's pre-Ralston Purina rule of thumb as to the number of permissible offerees (twenty-five) by increasing the number to thirty-five and by making it applicable to purchasers instead of offerees, which is a step in the right direction. The thirty-five need not include the purchaser's spouse, relatives living in the same home, trusts, estates and corporations in which they have the entire interest, or purchasers of $150,000 worth of securities. However, a recent change in the note to subdivision (g)(2)(i) makes it clear that all of the sophistication, information, etc., requirements apply to all purchasers even though they need not be counted in the thirty-five investor maximum.

Prior to the amendment of the rule, the purchaser maximum was absolute. Although the issuer was (and still is) required to take precautions against re-transfers, including making a "reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons," the SEC concedes that "the issuer, even if it had exercised good faith and reasonable care in determining how many purchasers there were, would lose the Rule if the issuer had sold securities to thirty-five persons and one of the purchasers had deceived the issuer and had in fact purchased the securities for other accounts." In order to forestall such a loss of the exemption, the amendment deletes the absolute maximum of thirty-five purchasers and provides instead that "[t]he issuer shall have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that the financial schedules called for in part II of the registration statement need not be furnished to an offeree if the issuer has not prepared such schedules. It also relaxes the requirements as to financial statements by allowing an issuer to substitute regulation A financial statements (see Form 1-A, Schedule I, Item 11, P-H Sec. Reg. Guide ¶ 4102) for the audited and unaudited financial statements in the form required by a registration statement where the ordinary required financials are not available without "unreasonable effort or expense." Again, the problem inheres in the vagueness of the excuse. Lastly, the amending release makes it clear that a reg. A offering circular will not suffice.

Non-reporting issuers will normally have to comply with this information section of the rule. Accordingly, the amendment, except for the uncertain relaxation as to financials, does little to lessen the burden of providing each offeree, in effect, with a registration statement.

71. See text accompanying note 130 infra.
72. See text accompanying notes 19 & 41 supra.
74. Id. § 230.146(h)(1).
that there are no more than thirty-five purchasers . . . ." 76 This language, hopefully, will be interpreted in light of its purpose of providing greater protection to the issuer. However, on its face it introduces the same uncertain standards ("reasonable grounds to believe," "reasonable inquiry") that are characteristic of the rule as a whole and represent one of its principal defects. 77

Paragraph (h) requires the issuer and any person acting on its behalf to exercise "reasonable care" to assure that the purchasers are not "underwriters," 78 and sets forth the minimum that the issuer must do to meet its obligation of preventing a distribution. The release explains the requirement:

[The issuer and any person acting on its behalf must take reasonable care to assure that the purchasers are not underwriters. Such reasonable care shall include but is not necessarily limited to (1) making reasonable inquiry to determine if the purchaser is purchasing for his own account or on behalf of others; (2) placing a legend on the certificates or other documents evidencing the securities indicating that they were not registered and setting forth or referring to the restrictions on transferability and sale; (3) issuing stop transfer instructions to the restrictions [sic] on transferability and appropriate notation in the issuer's records if the issuer transfers its own securities; and (4) except as provided in subparagraph (f)(2), obtaining a written agreement from the purchaser that the securities will not be resold without registration or exemption therefrom. The Commission believes that these limitations are necessary in order to protect the public from a deferred distribution. They are also in the self interest of the issuer. 79

The SEC, from its earliest days, 80 has been legitimately concerned that an exempt transaction will somehow be converted into a public distribution without the investor protection which registration gives. Its bête noir has always been the one or two purchasers who take an entire issue under an exemption and then divide their unregistered securities into smaller parcels which they sell to the gullible public without any of the disclosures required for registered offerings (and frequently by means of the fraudulent practices the Act was designed to prevent). An obvious way to forestall the danger is to prevent the second step. This led to the pre-rule requirement that all original purchasers in a private placement could take only for investment. 81 Thus was born the "investment letter" under which the initial purchaser in effect agreed that he would not sell.

Such a letter obviously should not prevent the SEC from stopping

76. 17 C.F.R. § 230.146(g)(1) (1975).
77. See text accompanying notes 115 & 129 infra.
78. See note 47 supra.
80. See In Re Unity Gold Corp., 3 S.E.C. 618 (1938).
the distribution where the signers have no intention of abiding by it. Accordingly, the SEC has ruled:

Counsel and their issuer and underwriter clients cannot base a claim to exemption from registration under the Securities Act upon the mere acceptance at face value of representations by purchasers that they take for investment and disclaim responsibility for investigation and consideration of all relevant facts and circumstances pertinent to a determination that the transactions do not involve a public offering. A representation by a purchaser that he is taking for "investment" when in fact he concurrently is dividing a participation among others or reselling a portion of a commitment to others is worthless. Issuers, underwriters or counsel cannot claim that a transaction does not involve a public offering if they do not know the identity and number of initial offerees or purchasers or whether such purchasers offer and sell to others. Moreover, even though all of the original purchasers sincerely agreed not to transfer their shares, an offering to a large number of initial purchasers should not, as a policy matter, be automatically exempt; otherwise an offering could be made to everyone in the country, provided he agreed to sign, and there would probably never be another registered offering. The Continental Tobacco case went further, however, and held that even conclusive evidence that the purchase was for the purpose of investment would not, standing alone, be sufficient to sustain a private offering exemption, even where the number of offerees was quite limited.

Rule 146, in effect, follows the Continental Tobacco case by requiring three devices that previously had been merely recommended: agreement not to distribute, formerly called an "investment letter;" a legend on the share certificates restricting transfer; and a stop transfer order to the transfer agent. Furthermore, compliance with these three required devices does not assure exemption, even where the number of investors is limited, because the SEC additionally requires that the issuer make "reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons. Moreover, even these four safeguards are insufficient

83. Such an absolute prohibition on transfer generally would be unenforceable. 8 W. Fletcher, Cyclopedia of Private Corporations § 4205 (perm. ed. 1966).
84. SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); see text accompanying notes 37-39 supra.
85. 17 C.F.R § 230.146(h) (1975).
under rule 146, since it states that the reasonable care required by the issuer to assure that the purchasers are not underwriters “shall include, but not necessarily be limited to” these safeguards. And in addition to these rule 146(h) requirements, the issuer must also fulfill the rule 146 (e) requirement that it inform each offeree in writing that the securities are restricted and may not be resold unless registered or exempted from registration. 88

There can be no objection to requiring the issuer to take reasonable steps to insure that the original purchasers do not convert the private placement into a public offering, provided that the “reasonable steps” are specified. However, in imposing non-distribution requirements beyond the three standard precautions, rule 146 is more restrictive than other recent rules. 89 Whether such restrictiveness is warranted is questionable, especially in light of the over-all restrictiveness of the rule.

Sufficient protections against wide-scale public distributions are provided by the limitation on the number of initial purchasers, coupled with the legend, stop transfer and agreement not to resell requirements, especially since these requirements are effectively enforceable against the original purchasers.

In the first place, few people are likely to purchase legended securities. Secondly, the original purchasers are unlikely to attempt such a sale unless they have complied with the quantity limitations and

88. 17 C.F.R. § 230.146 (e)(3)(ii)-(iii) (1975). See note 45 supra. There is nothing objectionable about this requirement, except its conjunction with so many others.

89. E.g., the intrastate exemption rule, rule 147, 17 C.F.R. § 230.147 (1975), provides in pertinent part:

“(f) Precautions Against Interstate Offers and Sales.
(1) The issuer shall, in connection with any securities sold by it pursuant to this rule:
(i) Place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the limitations on resale contained in paragraph (e);

(ii) Issue stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities make a notation in the appropriate records of the issuer; and

(iii) Obtain a written representation from each purchaser as to his residence.

(2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are part of the same issue that are presented for transfer during the time period specified in paragraph (e), take the steps required by paragraphs (f)(1)(i) and (ii).

(3) The issuer shall, in connection with any offers, offers to sell, offers for sale or sales by it pursuant to this rule, disclose, in writing, the limitations on resale contained in paragraph (e) and the provisions of paragraphs (f)(1)(i) and (ii) and paragraph (f)(2).” (italics deleted).

It is, to say the least, incongruous to require, as rule 146 does, more safeguards against redistribution in an offering limited to thirty-five purchasers than one in which the initial purchasers theoretically may number thousands, or in some cases, millions.
holding period requirements of either rule 237 or 144, which make a public offering a practical impossibility.

Rule 237(a) excludes sales through brokers from its "Exemption of certain securities owned for five years." Since a wide scale distribution is effectively impossible without the assistance of a broker, and since the SEC has control over brokers anyway an illicit public distribution under rule 237 is difficult to transact.

Rule 144 regulates distribution of restricted securities, such as rule 146 securities, and defines "[p]ersons deemed not to be engaged in a distribution and therefore not underwriters" as those who comply with the various conditions imposed by the rule. By implication, failure to comply with rule 144 will make the original purchaser an underwriter and hence subject to the civil and criminal penalties of the Act if he sells in violation of the rule. Obviously, this should deter original purchasers of rule 146 securities from engaging in a wide-scale public distribution of the securities.

Lastly, an improper resale not only might make the seller an underwriter, but might even destroy the exempt status of the original issuance, making the issuer guilty of violating the Act. Therefore, few issuers are likely to allow transfer of rule 146 securities without proof of compliance with either rule 237 or rule 144.

In light of the foregoing it is clear that under ordinary circumstances the legend, stop transfer and agreement not to resell requirements should be sufficient safeguards against redistribution. This reasoning has been adopted by section 227(b) of the proposed ALI Federal Securities Code which provides:

(b) [Limited offering.] (1) A "limited offering" is one in which the following conditions are


91. 17 C.F.R. § 230.144 (1975), adopted in SEC Securities Act Release No. 5223 (Jan. 11, 1972), 1 CCH Fed. Sec. L. Rep. ¶ 78,487. Rule 144(c) has an availability of information requirement which affords private placement purchasers almost as much protection as would be afforded by registration. Issuers required to report under the 1934 Act must keep their filed reports current. Issuers not required to report must make "publicly available" considerable information, including their most recent financial statements. Thus, if all public transfers of private placement securities are under rule 144, ample protection would seem to be afforded the public.

92. See, e.g., Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959); rule 15c2-11. 17 C.F.R. § 240.15c2-11 (1975), under the 1934 Act, restricting the quotations necessary to make a market; SEC Securities Act Release Nos. 5168 & 9239 (July 7, 1971), 2 CCH Fed. Sec. L. Rep. ¶ 22,760, cautioning broker-dealers that they will be held responsible unless they exercise great care to make sure they do not aid a public distribution of unregistered securities. See 3A H. Bloomenthal, Securities and Federal Corporate Law § 12.05 [3], as to rule 15c2-11.

satisfied: (A) the initial buyers of the securities are institutional investors or not more than thirty-five other persons or both; (B) resales of any of the securities . . . three years after the last sale to any of the initial buyers . . . do not result in more than thirty-five owners of those securities (apart from any institutional investors and persons who become owners otherwise than by purchase) at any one time, unless the resales are pursuant to an offering statement, a distribution statement, or an exemption; and (C) the original offeror and all sellers in such resales comply with any rules adopted under paragraph (4). 94

It must be conceded that this proposed code section would ignore both the need for protection of the original purchasers and the *Ralston Purina* tests. That case, therefore, effectively would be overruled. A proposal that the SEC adopt proposed section 227(b) as its rule is not quite as radical as it might appear at first glance, however. First, the *Ralston Purina* Court itself indicated that it was not clear that Congress intended the protective restrictions imposed by that decision. 95 A fortiori there could not have been clear congressional intent to support the embellishments of the subsequent lower court decisions. Second, the “permissiveness” of the proposed section is not without precedent: the intrastate offering exemption of section 3(a)(11) of the 1933 Act, 96 even as interpreted by the SEC, 97 theoretically permits an offering to millions of people without any proof of their sophistication or access to information, provided only that all are residents of the same state as the issuer, resales to non-residents are restricted, and 80% of the proceeds of the offering are to be used in that state. 98 This intrastate offering exemption, in contrast to the private placement exemption, does not turn on a “need . . . for the protections afforded by registration” test. 99

When the burdens of complying with rule 146 are considered, the wisdom of adopting section 227(b), or at least some rule midway between section 227(b) and rule 146, becomes clear, despite the diminished protection to the original purchasers. New rule 240 is

94. ALI Fed. Sec. Code § 227(b) (Rep.’s Rev. of Tent. Drafts Nos. 1-3, 1974). Section 502(b) of the proposed Code makes it unlawful for an offeror or reseller to engage in “general advertising” in a limited offering. The new Code is being prepared under the direction of Louis Loss, the acknowledged dean of securities lawyers, to replace the 1933 and 1934 Acts. See also Victor & Bedrick, Private Offering: Hazards for the Unwary, 45 Va. L. Rev. 869, 882 (1959), suggesting an exemption for offerings to 100 or fewer persons, where an investment agreement is given by the purchaser, and the seller does not have reason to believe that resales will be attempted within two years. 95. 346 U.S. at 122. 96. 15 U.S.C. § 77c (1970). 97. 17 C.F.R. § 230.147 (1975); see note 16 supra. 98. 17 C.F.R. § 230.147 (1975). For prior SEC thinking on the subject see SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH Fed. Sec. L. Rep. ¶ 2270. 99. See text accompanying notes 24-25 & 34 supra. 100. See text accompanying notes 136-164 infra. It is anomalous that SEC reg. A, 17 C.F.R. § 230.251-263 (1975), was not amended when rule 240 was adopted. For example, rule 240 prohibits general advertising (although it does permit unlimited personal solicitation of offerees so long as the number of beneficial owners does not exceed 100 and the amount raised does not
not such a satisfactory midway point. It allows a much larger number of purchasers than proposed section 227(b), but any advantage ensuing from this is offset by the disadvantage of uncertainty as to transferability of shares by the original purchasers. This is antithetical to what is needed.

If U.S. Steel should decide to borrow $3,000,000 in a private placement, it would not have much of a problem complying with rule 146. The corporation would merely approach a few large insurance companies or banks (they will presumably have "such knowledge and experience in financial and business matters that they [would be] capable of evaluating the merits and risks of the prospective investment" and be "able to bear the economic risk of investment"), staple its 1934 Act filings into an offering circular, deliver the package to each offeree, answer any relevant questions, show any other financial reports, allow any examination or audits the offerees might desire, and include language in the loan agreement to prevent assignment of the obligation, etc. as required by paragraph (h) of rule 146. It could even make the offer (accompanied, of course, by the information) to an unlimited number of such sophisticated institutions, provided that it required each purchaser to commit itself to at least a $150,000 participation.101

However, at the other end of the financial spectrum, compliance with rule 146 would be an almost impossible financial burden. For example, if a New Jersey resident decided he wanted to raise even a very small amount of money, say $10,000, for his New York business, and he approached his next door neighbor, a dentist, to invest, he would have to make an initial inquiry to determine whether or not the dentist had the requisite knowledge and experience in business matters,102 and presumably would have to make sure that the dentist exceed $100,000). However, the restrictiveness of this ban on advertising is infinitesimal compared to the requirements imposed on reg. A users. See, e.g., rules 253, 256 & 257, 17 C.F.R. §§ 230.253, 230.256 & 230.257 (1975), requiring an offering circular for all offerings over $50,000 and some offerings under that amount; rule 255, id. § 230.255, requiring the filing of a "notification;" rule 256 (a)(2), id. § 230.256 (a)(2), requiring delivery of the offering circular; rule 258, id. § 230.258, requiring filing of sales materials; rule 260, id. § 230.260, requiring a sales report. This disparity of treatment between rule 240 and reg. A is yet another indication of the need for synchronism in the drafting of the various SEC exemptive rules.

Cf. Coles, An Introduction to Regulation A: Small Business Financing Exemption, 56 Chi. B. Rec. 34 (1974), which cautions that a public offering under reg. A may be preferable to reliance on rule 146 (or rule 147) because "[t]he stringent criteria of [those] exemptions frequently makes them unavailable or makes reliance on them uncertain." Id. This itself is a sad commentary on the draftsman's need for synchronism in the drafting of the various SEC exemptive rules.

102. Dentists as well as doctors are not per se sufficiently sophisticated. See SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).
could stand the loss (query whether he would have to ask the dentist to give him a statement of his net worth, which request would probably not only queer the deal, but might end in the erection of a "spite-fence"), pay the added legal and accounting fees to prepare the mini-registration statement, and give the dentist all the interesting inside information about the business (perhaps, if a partnership were involved, also a similar net worth statement). If the dentist didn't buy, he would have to repeat this procedure with each offeree, making certain, at his peril, that each met all of the sophistication and information requirements. It is no answer to the small businessman's problem that the SEC would probably not bother him. People today are less apt to shrug off a loss as part of the risks of investment. When the security goes sour they suddenly become sophisticated enough to sue, even though they were financially unsophisticated enough to buy. Rule 146 is not exclusive, but if it is not complied with the issuer must rely on either the "administrative and judicial interpretations in effect at the time of the transactions," the uncertainty of which was the very reason for adoption of the rule, or on rule 240. And even if the small businessman is fortunate enough to secure a no-action letter, this will not bar his litigious former friend from recovery.

103. But see Paradise Valley Property, SEC No-action letter (available June 5, 1972), where the offerees did supply their net worth.

104. The SEC cautions: "The courts and the Commission have consistently held that one claiming an exemption under Section 4(2) of the Act has the burden of proving that the exemption is available to him and the Rule does not shift that burden. In addition, it should be pointed out that the burden of proof applies with respect to each offeree and not just to the purchasers of the securities. See Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971). Accordingly, any issuer who relies on the Rule has the burden of establishing that it has satisfied all the conditions of the Rule. Such issuer for its own protection should obtain and retain in its files written evidence that would assist in meeting this evidentiary burden." (italics omitted). Rule 146 Adopting Release, supra note 7.

105. See Repass v. Rees, 174 F. Supp. 898 (D. Colo. 1959), where rescission was granted on the ground that the offering was public, despite the fact that apparently only thirteen persons had purchased and plaintiffs were sophisticated businessmen. See also Henderson v. Hayden, Stone Inc., 461 F.2d 680 (5th Cir. 1971), again involving only thirteen purchasers who were sophisticated businessmen and lawyers. Apparently many rescission claims are settled by the defendants to avoid suit. See Schneider & Zall, Section 12(1) and the Imperfect Exempt Transaction: the Proposed I & I Defense, 28 Bus. Law. 1011, 1013 (1973). See also SEC v. Ralston Purina Co., 346 U.S. at 125 n.11.

106. 17 C.F.R. § 230.146 (1975), Preliminary Note 1. See also Rule 146 Adopting Release, supra note 7.

107. Such No-action letters will be difficult to come by, since the release adopting rule 146 states that "although the staff will continue to consider no action requests relating to Section 4(2) of the Act, such letters will only be issued infrequently and only in the most compelling
The problem is that apparently rule 146 was drawn up with the "almost-public" offering in mind. But fortunately, in the example given, our small businessman can utilize rule 240. If, however, instead of $10,000 he needs over $100,000—a not unlikely prospect in today's inflation—rule 240 will be unavailable and rule 146 will be his only effective alternative.

The judicial decisions were well on the way to destroying the private placement exemption. By largely codifying those decisions rule 146 has done nothing to reverse this unfortunate trend. Unfortunately, too, as will be indicated below, those who can rely on rule 240 will find it too is not a really satisfactory solution to their securities law problems.

IV. UNCERTAINTIES UNDER RULE 146

It could be argued solely on the basis of the difficulties of compliance, that rule 146 fails to achieve its purpose of reducing uncertainty, since so many businessmen will have to forego dependence on it as a justification for their exemption. Even if a draconian law can be "certain" in the sense that its harsh requirements are clear, the new rule fails in its goal.

There are a number of vague provisions in the new rule which seem almost certain to cause interpretive difficulties, litigation, and, worst of all, unanticipated liability. Some are of minor significance. Others, unfortunately, are major.

Some of the more minor ones appear in the definition of a qualified "offeree representative." As indicated above, the sophistication circumstances." Rule 146 Adopting Release, supra note 7. As with rule 144, the Commission will issue interpretive letters to assist persons in complying with the new rule.

The same policy applies to rule 240 transactions. See Rule 240 Adopting Release, supra note 15.


109. Rule 146(a)(1) provides:

"(1) Offeree Representative. The term 'offeree representative' shall mean any person or persons, each of whom the issuer and any person acting on its behalf, after making reasonable inquiry, have reasonable grounds to believe and believe satisfies all of the following conditions:

(i) Is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the offeree is:

(a) Related to such person by blood, marriage or adoption, no more remotely than as first cousin;
(b) Any trust or estate in which such person or any persons related to him as specified in paragraph (a)(1)(i)(a) or (c) of this section collectively have 100 percent of the beneficial interest (excluding contingent interests) or of which any such person serves as trustee, executor, or in any similar capacity; or
(c) Any corporation or other organization in which such person or any persons related to him as specified in paragraph (a)(1)(i)(a) or (b) of this section collectively are the beneficial owners of 100 percent of the equity securities (excluding directors' qualifying shares) or equity interest;
(ii) Has such knowledge and experience in financial and business matters that he, either alone, or
quirement can be satisfied by the offeree's employing a competent offeree representative where the offeree is able to bear the economic risk of investment.\textsuperscript{110} This might be called the "rich widow provision." Generally, the offeree representative is required to be independent of the issuer (which, of course, makes sense), \textit{i.e.}, he should not be an "affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer . . . ."\textsuperscript{111} "Affiliate" is defined in the familiar, but somewhat indefinite language known to all securities lawyers.\textsuperscript{112}

Apart from a few minor exceptions to the independence rule, the requisites for a qualified offeree representative generally are stiff, including a requirement that he disclose in writing any "material relationship" with the issuer.\textsuperscript{113} "Material" is defined in the \textit{Mills-Ute} sense (the test which gives nightmares to defendants' securities lawyers) as "any relationship that a reasonable investor might consider important . . . ."\textsuperscript{114} The courts have been quite generous in finding together with other offeree representatives or the offeree, is capable of evaluating the merits and risks of the prospective investment;

(iii) Is acknowledged by the offeree, in writing, during the course of the transaction, to be his offeree representative in connection with evaluating the merits and risks of the prospective investment; and

(iv) Discloses to the offeree, in writing, prior to the acknowledgment specified in paragraph (a)(1)(iii) of this section, any material relationship between such person or its affiliates and the issuer or its affiliates, which then exists or is mutually understood to be contemplated or which has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

\textbf{NOTE 1:} Persons acting as offeree representatives should consider the applicability of the registration and anti-fraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 and relating to investment advisers under the Investment Advisers Act of 1940.

\textbf{NOTE 2:} The acknowledgment required by paragraph (a)(1)(iii) of this section and the disclosure required by paragraph (a)(1)(iv) of this section must be made with specific reference to each prospective investment. Advance blanket acknowledgment, such as for "all securities transactions" or "all private placements", is not sufficient.

\textbf{NOTE 3:} Disclosure of any material relationships between the offeree representative or its affiliates and the issuer or its affiliates does not relieve the offeree representative of its obligation to act in the interest of the offeree." 17 C.F.R. § 230.146(a)(1) (1975) (italics deleted).

\textsuperscript{110} See text accompanying note 52 supra.

\textsuperscript{111} 17 C.F.R. § 230.146(a)(1)(i) (1975), supra note 109.

\textsuperscript{112} Id. § 230.146(a)(3) provides that "[t]he term 'affiliate' of a person means a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with such person." 17 C.F.R. § 230.146(a)(1)(i) (1975), supra note 109.

\textsuperscript{113} Id. § 230.146(a)(1)(iv), supra note 109.

undisclosed information "material" under this and less liberal tests, and it is quite possible that friendship with the issuer's president, membership in the same country club, hiring the same brokerage firm, or perhaps merely knowing an ordinary employee of the issuer, will be considered a "material relationship" under this test. It is obvious that the test is vague, and this is a very charitable characterization.

The significance of this vagueness appears in the requirement that "the issuer and any person acting on its behalf" must, "after making reasonable inquiry, have reasonable grounds to believe and [in fact] believe" that the offeree representative meets all of the enumerated conditions. Thus, if an offeree representative does not make the requisite disclosure to his client, not only is he in trouble, but the issuer may find that it has lost its exemption. This hardly removes uncertainty. Fortunately, most small issuers, at least, can avoid such an occurrence by restricting their offers to persons who themselves meet the sophistication test. Therefore, the deficiency of the term "material," while undesirable, is not fatal here.

Another of the less important deficiencies appears in the exceptions to the general ban on advertising. Seminars and circulars are permitted, but only if the persons solicited thereby meet the sophistication test of the rule. The deficiency here is the incorporation of the extremely vague sophistication test. But here, too, any problem can be avoided by omitting seminars and written communications except those required under the rule. A minor uncertainty in a significant provision is the use of the word "similar" in what the SEC characterizes as the "safe harbor" provision of paragraph (b)(1). That paragraph provides:

(1) For purposes of this rule only, an offering shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six-month period immediately preceding or after the six-month period immediately following any offers, offers for sale or sales pursuant to this rule, Provided, That there are during neither of said six-month periods any offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

116. The term "sophistication" is used here as shorthand for the test imposed by rule 146(d) which allows an offer to the unsophisticated wealthy, but requires sophistication, at least of the offeree's representative, before a sale can be made.
117. But in the context of rule 146(e)(2), the materiality deficiency may well prove to be a trap for the unwary. For a discussion of this serious deficiency see text accompanying note 130 infra.
118. 17 C.F.R. § 230.146(c)(2) (1975), supra note 43.
119. Id. § 230.146(a)(1)(iv), (e), (f)(4).
120. Id. § 230.146(b)(1).
If securities of the same or a similar class are offered within the two
six-month periods, the customary, imprecise integration rules will apply.121

A more serious problem is to establish when the offering period
"pursuant to this rule" begins and ends, since this fixes the limits of the
six-month periods on either side. The rule as adopted does not require
any filing,122 so the determination of when the offering period begins
and ends is a question of fact. The rule (again demonstrating that it
was drafted with the "almost-public" offering in mind) seems to
presuppose a single offer to all of the offerees at the same time,
something which frequently does not occur in a legitimate private
placement in which the issuer must sometimes go from one offeree to
another before his terms are accepted.

The uncertainty might have been resolved by defining "offering" or
"offering pursuant to the rule" in quantitative terms, or by requiring a
filing at the commencement and termination of the offering. Although
the rule, again, engenders uncertainty, the problem can be avoided by
permitting no other offers of any kind within six months of either
extreme of the private placement.

As indicated above, "access" requires that the offeree have a "posi-
tion" (the Continental Tobacco "relationship") with the issuer. "Posi-
tion" "means an employment or family relationship or economic bar-
gaining power that enables the offeree to obtain information from the
issuer in order to evaluate the merits and risks of the prospective

121. A note to rule 146(b)(1) provides: "NOTE: In the event that securities of the same or
similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six
months prior to or subsequent to any offer, offer for sale or sale pursuant to the rule, see
Preliminary Note 3 hereof as to which offers, offers to sell, offers for sale or sales may be deemed
to be part of the offering." (italics deleted). Preliminary Note 3 states: "The term 'offering' is not
defined in the rule. The determination as to whether offers, offers to sell, offers for sale, or sales
of securities are part of an offering (i.e., are deemed to be 'integrated') depends on the particular
Sec. L. Rep.] ¶ 5590. All offers, offers to sell, offers for sale, or sales which are part of an offering must
meet all of the conditions of Rule 146 for the rule to be available. Release 33-4552 indicates that in
determining whether offers and sales should be regarded as a part of a larger offering and thus should
be integrated, the following factors should be considered: (a) whether the offerings are part of a
single plan of financing; (b) whether the offerings involve issuance of the same class of security; (c)
whether the offerings are made at or about the same time; (d) whether the same type of consideration
is to be received; and (e) whether the offerings are made for the same general purpose."

122. As the Commission points out in Rule 146 Adopting Release, supra note 7, at 2907-10, the
proposed version of rule 146(i), found in SEC Securities Act Release No. 5430 (Oct. 10, 1973), [1973
Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,529, required a report of sales. The requirement was
deleted in the rule as adopted because it was felt that it "would unnecessarily increase the difficulty of
complying with the Rule for many small issuers." While this is true, such a requirement could make
for greater certainty, which might outweigh the burden. Compare rule 240(h), 17 C.F.R.
§ 230.240(h) (1975) (Notice of sales requirement), with the proposed version of rule 146(i).
investment. 123 This test is so vague that the only safe course for the issuer is to furnish the information; otherwise the plaintiff's failure to get the information may be viewed by the courts as proof that he didn't have "access" to it. Here the rule is more egregious because it not only does not diminish uncertainty, it creates uncertainty.

Another significantly vague provision is paragraph (h) which deals with the issuer's obligation to guard against re-transfers. The precautions against re-transfer must include, but are "not necessarily . . . limited to," those enumerated in the rule. 124 Certainty requires that the list be exclusive; 125 otherwise an issuer may later find out in court that despite compliance with all of the other detailed provisions of the rule, the exemption was not available after all.

Among the most serious deficiencies of the new rule are the provisions dealing with the nature of the offerees. 126 The issuer and any person acting on its behalf must have reasonable grounds to believe and in fact believe prior to the offer that each offeree either "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment," or "is able to bear the economic risk of the investment." 127 And it must have reasonable grounds to believe and in fact believe prior to the sale that each purchaser has the same knowledge; or, if the purchaser can bear the risk, then he and his offeree representative together must have the requisite knowledge.

How much "knowledge and experience" is necessary? How many stock transactions must a lawyer have handled to possess the requisite knowledge and experience? How wealthy does one have to be to be able to "bear the economic risk?" Even the ability to put up $150,000 does not guarantee that one is able to "bear the economic risk of the investment;" that wealth test 128 applies only to the provision for counting the number of offerees, not to this sophistication provision. Is the son of a living millionaire able to bear the risk? Suppose the offeree has a large salary but also has a large family to support? Is his own assurance that he can take the chance relevant? Does it make a difference whether the issuer is an established company or a new venture? The provision is patently uncertain.

Probably the most significant elements of uncertainty, which render the entire rule inadequate in light of its avowed purpose, are the

123. 17 C.F.R. § 230.146(e) (1975); see note 45 supra.
124. See text accompanying notes 85-88 supra.
125. See, e.g., rule 147 quoted in note 89 supra.
126. 17 C.F.R. § 230.146(d) (1975), supra note 44.
127. Id. § 230.146(d)(1)(i)-(ii).
128. Id. § 230.146(g)(2)(ii)(d); see text accompanying note 73 supra.
indefinite terms "reasonable" and "unreasonable" which appear at least fourteen times in the new rule. One need not be familiar with the two famous "due diligence" cases under the 1933 Act to appreciate the uncertainty inherent in standards such as "reasonable grounds for belief," "reasonable investigation," and the like.

Similar problems are posed in another context by the words "material" and "misleading." The amended version of rule 146(e), which sets forth the information that must be furnished or to which there must be access, allows the issuer to condense the registration statement information or omit details, but only "if, under the circumstances, the omitted information is not material or the condensation of information does not render the statements made misleading." A new note (reinforced by the release) places the burden of proof on the issuer to show that the condensation of information is not misleading and that the omitted information is not material. Even where the plaintiff ostensibly has the burden of proving such a material omission or misstatement the defendant may be found liable, even if the misstatement or omission was in fact innocent. Therefore, only a foolhardy issuer's lawyer would rely on the permission to omit or condense where his client has the burden of proof of non-materiality.

The inevitable conclusion is that the rule fails in its design "to curtail uncertainty to the extent feasible" by "providing more objective standards."  

V. INADEQUACY OF RULE 240

As pointed out above, rule 146 is designed for the "almost-public" offering. No exception is provided for the small business. Most of these businesses will qualify for the intrastate exemption; but the solicitation of even one non-resident will destroy that exemption. It is anomalous that rule 147 theoretically can be used in lieu of rule 146 to exempt from the requirements of registration an offering to millions of people and worth millions of dollars, while an offer by a single individual to another to "go in with him" in the formation of a business would, unless rule 146 were complied with, subject the "offeror" to the liabilities of the Act solely because the person he approached happened to be a non-

133. Since the Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970), and rule 147 permit even a public offering to local residents for a local business, obviously a more limited attempt to secure local investors would also be permitted. See notes 16 & 89 supra.
134. 17 C.F.R. § 230.147(d) (1975).
resident of the state where the business was to be conducted. There are too many out-of-state suburbs for such treatment to make sense. Accordingly, a close corporation exemption was an obvious necessity.

It is clear that the SEC has the power to exempt completely and unconditionally any offering (even a public one) which does not exceed $500,000,\textsuperscript{135} \textit{Ralston Purina} notwithstanding. Recognizing the inadequacy of the basic private placement rule in the small business area, the SEC exercised this power to promulgate rule 240,\textsuperscript{136} addressed to small businesses, including close corporations.

The requirements of rule 240 are basically simple:

1. The total sales of securities by the issuer without registration (\textit{i.e.}, in reliance on the rule and otherwise) within a 12-month period cannot exceed $100,000.
2. There can be no more than 100 beneficial owners, as opposed to offerees.
3. There can be no general advertising and no commissions paid for securing purchasers.
4. Resales of the securities must be restricted (including placing a legend on the certificates).
5. A form (form 240) must be filed with the SEC Regional Office, at least for any sales after the first $100,000.\textsuperscript{137}

Special provisions designate which shareholders shall not be counted in determining the number of beneficial owners and whose securities shall not be counted in determining the $100,000 total. Generally these are ameliorative. For example, a husband and wife living in the same home shall be counted as only one beneficial owner.\textsuperscript{138}

Compared with rule 146, this "Exemption of Certain Limited Offers and Sales by Closely-Held Issuers" is a model of clarity\textsuperscript{139} and, although

\textsuperscript{135} Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1970), provides: "(b) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $500,000." This statute, pursuant to which rule 240 was promulgated, is quoted in Rule 240 Adopting Release, supra note 15, at 84,946.

\textsuperscript{136} See notes 13-15 supra and accompanying text.

\textsuperscript{137} 17 C.F.R. § 230.240 (1975).

\textsuperscript{138} Id. § 230.240(f)(1)(i).

\textsuperscript{139} Despite its clarity, rule 240 has given rise to certain interpretive questions: e.g., who is a "full-time" employee, and who is a person "who has the same home as such beneficial owner?" There is also the perennial "integration" problem. See, e.g., Interpretive Response, BNA Sec. Reg. & L. Rep. No. 304, at C-2 (May 28, 1975); Interpretive Response, BNA Sec. Reg. & L. Rep. No. 308, at C-1 (June 25, 1975). Fortunately, however, the initial formation of a genuinely
unheralded as such, it represents a much safer harbor than its rule 146 counterpart. In sharp contrast to rule 146, a small business' original issuance of securities under rule 240 is free from the uncertainties caused by the access, information, sophistication and wealth requirements of rule 146. Furthermore, there are no restrictions on the number or qualifications of the offerees, although the rule does use the vague "reasonable grounds to believe" after "reasonable inquiry" language with regard to the number of purchasers.140 Because of the high number of permissible owners (100), a much less serious problem is posed than under rule 146, however.

Fortunately, the SEC was able to provide relative certainty in rule 240 without overburdening the issuer. It is ironic, however, that smaller issuers, whose purchasers need the most protection, are permissively regulated by rule 240, whereas larger, more responsible issuers, whose purchasers need less protection, are subject to the infinitely more burdensome rule 146. For example, it is anomalous that rule 240 permits almost three times as many purchasers as rule 146. Where an offering comes under rule 146 and all its protective provisions, such a strict limitation on the number of purchasers is unnecessary. And where those protections are absent in a rule 240 offering, the 100 purchaser ceiling seems overly generous.

Ultimately, rule 240, like rule 146, seems to have been drafted with an eye toward the almost-public offering, rather than the typical small business offering. This is evidenced in part by the resale provisions.141

Securities issued under rule 240 are treated as though they were issued under rule 146, i.e., only the issuance of the securities, not the securities themselves, is exempt, and resales are restricted.142 The same release

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140. 17 C.F.R. § 230.240(f) (1975). See text accompanying notes 72-76 supra for a discussion of the number of purchasers limitation of rule 146(g).

141. 17 C.F.R. § 230.240(g) (1975).

142. Rule 240 Adopting Release, supra note 15, provides:

"Rule 240(g): Limitation on Resale

"The condition relating to resale has been revised to make clear that the securities acquired pursuant to the rule are unregistered securities and that they are deemed to have the same status as if they were securities acquired in a transaction pursuant to Section 4(2) under the Act.

"The rule requires the issuer to exercise reasonable care to assure that purchasers are not acting as underwriters, which reasonable care includes at least making reasonable inquiry to determine if the purchaser is buying for himself or others, informing the purchaser of the restrictions on resale, and legending of the certificates.

"In connection with such restrictions, the Commission is amending Rule 144 to include within
which adopted rule 240 also amended rule 144(a)(3) to make that rule applicable to resale of rule 240 securities.\textsuperscript{143}

Rule 144(a)(1) defines "an 'affiliate' of an issuer [as] a person that directly, or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer."\textsuperscript{144} Since possession of a small number of shares in a typical close corporation may result in control over the business, any shareholder is likely to be an "affiliate" or "control" person.\textsuperscript{145} Obviously in the smallest of close corporations, those with a single shareholder, the sole shareholder is sure to qualify for this unfortunate characterization, the result of which is that the shareholder-seller is treated like an issuer\textsuperscript{146} and the buyer, especially if he divides the shares when he resells, may be treated like an underwriter.\textsuperscript{147} In such a case, the seller and buyer must comply with the quantity and information requirements of rule 144 or may risk criminal

the definition of 'restricted securities' those securities acquired from the issuer in a transaction in reliance on Rule 240 under the Act or which were issued by an issuer in a transaction in reliance on Rule 240 and were acquired in a transaction or chain of transactions not involving any public offering. Thus, Rule 144 would be available for resales of securities acquired pursuant to Rule 240." (footnote omitted).

143. Rule 144(a)(3) 17 C.F.R. § 230.144(a)(3) (1975), as amended by Rule 240 Adopting Release, supra note 15, defines "restricted securities," resales of which are controlled by the rule, as "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 or from the issuer in a transaction in reliance on Rule 240 under the Act or which were issued by an issuer in a transaction in reliance on Rule 240 and were acquired in a transaction or chain of transactions not involving any public offering."

Technically, transfers of private placement securities by ordinary shareholders should find their exemption under section 4(1) of the Securities Act of 1933, 15 U.S.C. § 77d(1) (1970), which exempts "transactions by any person other than an issuer, underwriter, or dealer." The section 4(2) exemption for private placements technically applies only to "transactions by an issuer not involving any public offering." Id. § 77d(2). However, since a controlling shareholder is treated as an "issuer" under section 15, Id. § 77o, and a shareholder buying from him may become an "underwriter" by virtue of section 2(11), Id. § 77b(11), it is probably accurate to speak of a private placement by a selling shareholder and to apply the issuer tests. The SEC itself seems to recognize this by its reference, in amended rule 144(a)(3), to a "chain of transactions not involving any public offering ...." See 1 Loss, supra note 18, at 642-43.

144. This definition is typical of those found in other SEC Rules. See, e.g., rule 251, 17 C.F.R. § 230.251 (1975).

145. "Control" is not defined in the statute. It generally has been interpreted to mean the power to cause the corporation to file a registration statement, and its presence is a question of fact. Obviously, ownership of a majority of the shares carries control. However, considerably fewer shares may be sufficient, and "group control" is recognized. See generally 1 Loss, supra note 18, at 557; 2 Loss 770-83. Kripke, in The SEC, the Accountants, Some Myths and Some Realities, 45 N.Y.U.L. Rev. 1151, 1163 n.65 (1970), suggests that anyone holding officer status may be deemed to be in control. Even though it has been held that the burden of proof of control is on the plaintiff (Ayers v. Wolfenbarger, 491 F.2d 8, 15 (5th Cir. 1974)), the existence of such control in the average close corporation should not be difficult to establish.


147. Id. § 2(11), 15 U.S.C. § 77b(11).
penalties for violation of the provisions of the Act relating to issuers and underwriters.\textsuperscript{148}

In addition, under rule 144 there is an availability of public information requirement\textsuperscript{149} which will be difficult to meet, a requirement that the shares be held for two years,\textsuperscript{150} and a quantity limit on resales (one percent of the class of securities in any six-month period) which will make the rule impossible for most close corporations to use. The foregoing illustrates that rule 144 is not appropriate for closely-held businesses.

Although rule 240 makes no express reference to it, rule 237\textsuperscript{151} presumably is an available alternative to rule 144 for transfers of securities issued under the small business exemption. While rule 237 increases the required holding period to five years, it compensates for this by dispensing with the onerous current information requirement of rule 144.\textsuperscript{152} However, it limits the securities sold in any one year to \textquotedblleft the lesser of the gross proceeds from the sale of 1 percent of the securities of the class outstanding or $50,000 in aggregate gross proceeds.\textquotedblright\textsuperscript{153} Furthermore, rule 237 is not available to an affiliate of the issuer, as defined in rule 144 to include controlling shareholders. These limitations similarly make rule 237 useless for most close corporations.

A leading commentator, Homer Kripke, characterized the originally proposed rule 240 as \textquotedblleft another disaster,\textquotedblright pointing out that it would not immunize a typical close corporation transaction such as the sale of all the stock of an incorporated pizza parlor by its sole owner to another pizza twirler.\textsuperscript{154} The rule, as adopted, is subject to the same criticism, and this is a fatal defect. Consequently, careful close corporation practitioners will advise their clients to use the sale of assets method of transferring a business, despite possible tax disadvantages.\textsuperscript{155}

The average close corporation practitioner, however, will probably be unaware of even the existence of rule 240. Yet all conditions of the rule must be met for the exemption to be granted. Our hapless selling shareholder will, therefore, be forced to seek refuge in either the uncertain pre-rule 146 private placement case law,\textsuperscript{156} or, as the SEC apparently wants, the inappropriate rule 144.

\textsuperscript{149} See note 91 supra.
\textsuperscript{150} 17 C.F.R. § 230.144(d) (1975).
\textsuperscript{151} See note 90 supra; text accompanying notes 90-92 supra.
\textsuperscript{152} See note 91 supra.
\textsuperscript{153} 17 C.F.R. § 230.237(b) (1975).
\textsuperscript{154} Kripke, supra note 7, at 6, cols. 4-5.
\textsuperscript{156} See text accompanying notes 21-40 supra. There is very little law on the relationship of the Securities Acts to the truly small business. Ayers v. Wolfinbarger, 491 F.2d 8, 16 (5th Cir. 1974), appears to be the first case holding that the sale of stock to a promoter group qualified as
This sale of stock can hardly be the type of transaction that the Securities Act was designed to inhibit. Such restrictions on innocuous transfers represent the principal drafting defect in rule 240.

However, probably the worst feature of rule 240 is the possible "spill over." For example, the clear negative implication of the rule is that all business interests, including those participating in the initial formation of close corporations, are subject to the Securities Act of 1933 unless exempted by the SEC. And although the SEC expressly disclaims exclusivity of rule 146, the rule's standards will undoubtedly influence courts in judging the availability of the private placement exemption. The fact that rule 146 makes no exception from its onerous requirements for the truly close corporation may well suggest to the courts that the only close corporation exemption is to be found in rule 240, and failure to comply is equivalent to a violation. If this occurs, the courts can expect a flood of rescission suits if the business goes sour. This additional risk for the small businessman still courageous enough to have hope in the country's future is antithetical to what is needed in the present state of the economy. Accordingly, despite what were obviously good intentions on the SEC's part, Professor Kripke was correct in characterizing the rule as "another disaster."

If the SEC wants to cover the field, as the proliferation of new rules suggests, what is needed is a single unified rule that brings rules 146 and 240 closer together and offers a blanket exemption (of the securities rather than merely the original issuance transaction) for small

an exempt nonpublic offering. The paucity of cases is probably explained by the previously widespread assumption that the Securities Act had no application to close corporations. But cf. Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa.), modified, 83 F. Supp. 613 (E.D. Pa. 1947), which involved a close corporation and was the first case to impose liability under rule 10b-5 of the Securities Exchange Act of 1934 (the primary purpose of which was "[t]o provide for regulation and control of [securities exchanges and of over-the-counter markets].") 15 U.S.C. § 78(b) (1970)). Until the SEC comes forward with an adequate small business exemption, much more litigation in this area can be expected in this age when business is bad and, according to an SEC Commissioner, the "consumer is king." Address by Commissioner Sommer, The Banking, Corporation and Business Law Section, New York State Bar Association, Jan. 24, 1974, in Emerging Responsibilities of the Securities Lawyer. 171 N.Y.L.J., Jan. 30, 1974, at I. col. 1.

157. The term is borrowed from Alberg & Lybecker, supra note 7, at 653.

158. "The Commission recognizes that no one rule can adequately cover all legitimate private offerings and sales of securities. It is to be emphasized that the Rule does not provide the exclusive means for offering and selling securities in reliance on section 4(2)." Rule 146 Adopting Release, supra note 7, at 2907-11.

159. See Alberg & Lybecker, supra note 7, at 642-43.


161. Kripke, supra note 7, at 6, col. 5.

businesses, or at least an unqualified transaction exemption for all initial and subsequent "offerings" by the original owners of a small business.

VI. HOW SHOULD THE RULES BE CHANGED?

As intimated above, adoption of Federal Securities Code section 227(b) might well be the most satisfactory solution to the entire private placement problem. In a few lines, using simple language, unclouded by the ambiguities and uncertainties of the multitude of present SEC rules designed to handle the matter, it deals effectively with not only the three most common private placement situations, but also with the troublesome problem of re-transfers.

Using the same numerical limit on purchasers (thirty-five) as rule

163. E.g., an asset limitation of $500,000 or less, perhaps based on Int. Rev. Code of 1954, § 1244; or a shareholder limitation of ten based on Int. Rev. Code of 1954, § 1371(a)(1) (the ten shareholder limit is ongoing, i.e., the corporation can never have more than the limit, with certain persons counted as one); or a combination asset/shareholder limitation might be used. Thus, rule 240(f)-(g) could stand, and the issuer and its shareholders could be given a blanket exemption for their shares, provided the other requirements continued to be met. Obviously, the filing and re-transfer restrictions of the rule would be removed. An emphasis on the qualification of the issuer could be accomplished, as in § 1244 of the Int. Rev. Code of 1954, by a limit on the number of authorized shares where a corporation is involved.

164. This would be under sections 2(11), 4(1) and 4(2) of the Act, 15 U.S.C. §§ 77b(11), d(1), d(2) (1970). The New York intrastate exemption, 13 N.Y.C.R.R. § 80.9 (1968), 2 CCH Blue Sky L. Rep. ¶ 35,621, at § 80.9 (1968), promulgated by the New York Attorney General to exempt offerings from the New York Fraudulent Practices Act, N.Y. Gen. Bus. Law § 359-ff (McKinney Supp. 1974), would be a better model than the Uniform Securities Act § 402(b)(9), 7 Uniform Laws Ann. 755 (1970). The New York exemption provides: "Pursuant to section 359-ff, subdivision 3, of the General Business Law of the State of New York, small offerings to a promoter group, small offerings to a related group, as defined in these regulations, offers and sales of any interest or participation in a collective trust fund maintained by a bank which interest or participation is issued in connection with a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, and offerings made to fewer than 10 persons are hereby exempted from the provisions of section 359-ff of the General Business Law. Offerings within the scope of this section are automatically exempted without application." 13 N.Y.C.R.R. § 80.9 (1968), 2 CCH Blue Sky L. Rep. ¶ 35,621, at § 80.9 (1968). The New York exemption includes the following definitions:

"(2) Promoter. All officers, directors, principals or controlling persons of a venture.

(3) Related group. A group where a family or long time business or personal relationship exists between one or more of the promoters and each and every member of the group.

(5) Small offering. An offering which seeks to raise no more than $40,000, not including the personal investment of promoters." Id. § 80.1(j), 2 CCH Blue Sky L. Rep. ¶ 35,621, at § 80.1(j) (italics deleted). See also the definitions in rule 240(a), 17 C.F.R. § 230.240(a) (1975).

Both the amounts of money and numbers of persons involved should undoubtedly be higher, and rule 240's term, "owners" (purchasers), is preferable to the uncertain offeree concept. See text accompanying notes 165-178 infra for further discussion of how the rules should be changed.

165. See text accompanying notes 94-100 supra.
146, section 227(b) adequately handles the problem of small business formation and expressly permits typical small business transfers, avoiding the present uncertainties of rule 240 in this regard. The thirty-five purchaser maximum, coupled with a three year limit on fragmentation (but wisely allowing a "bulk transfer" of the original purchaser's participation), may pose policing problems. Nevertheless, it offers a much simpler answer to the "almost-public" offering with which rule 146 seems principally concerned.

By not imposing any number, dollar, or re-transfer limits on sales to institutional purchasers, section 227(b) adequately covers another important private placement area. Omitted are the complex sophistication, access and information requirements of rule 146 and its correlative transfer provision, rule 144. Obviously, from the issuer's point of view, the closer the SEC can come to adopting section 227(b) as a rule the better.

Because section 227(b) does not impose any dollar limit on the size of the offering, section 3(b) of the 1933 Act could not serve as a partial umbrella for a rule adopting it. However, neither section 4(2), nor Ralston Purina's interpretation of section 4(2), mandate any dollar limit on the securities offered under the nonpublic offering exemption. In fact, the Ralston Purina test which equates private placement with lack of need for the protection of the Act can arguably be used to validate section 227(b)'s failure to limit the number of initial institutional investors and re-transfers by them to other such investors.

It is not completely clear whether the SEC has the power under the Act to entirely overrule the Supreme Court's interpretation of the language of section 4(2). Some sections of the 1933 Act expressly empower the Commission to interpret or alter their terms, but section 4 does not contain such an express authorization. Section 19(a) of the Act, under which the Commission purported to act in adopting rule 146, also does not expressly authorize Commission interpretation or amendment. The Ralston Purina case itself gives some, but not

166. Section 19(a) provides: "The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this subchapter. Among other things, the Commission shall have authority, for the purposes of this subchapter, to prescribe the form or forms in which required information shall be set forth . . . ." However, it concludes: "No provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason." 15 U.S.C. § 77s(a) (1970).
unequivocal, support to the Commission's power to vary the tests of that decision.\textsuperscript{167}

But even if the \textit{Ralston Purina} tests cannot be overruled, they are susceptible of more than one interpretation.\textsuperscript{168} There is nothing to prevent a narrow interpretation, which certainly need not include the lower court embellishments. Any apprehension about tampering, at least with these lower court decisions, should be allayed by the concluding language of section 19(a) which protects persons relying on SEC rules prior to their judicial invalidation.\textsuperscript{169}

Even if it were legally possible to dispense completely with the \textit{Ralston Purina} safeguards, from the point of view of investor protection it might be undesirable to do so, at least in the case of the almost-public offering to non-institutional investors. On the other hand, \textit{Ralston Purina} should be given a sensible interpretation which places primacy on its "need for the protections of the Act" test.\textsuperscript{170}

The only valid concern of a private placement rule is the protection of actual purchasers (or transferees from them), rather than offerees who are not harmed if they do not purchase. Thus, although the mode of offering should be controlled (e.g., by a prohibition on general advertising), the portions of rule 146 which attempt to protect offerees rather than actual purchasers should be deleted as in Code section 227(b) and rule 240.

Rule 146 and the judicial decisions it largely codifies are anomalous in affording greater protection to purchasers than they would get from registration itself. A sensible reading of \textit{Ralston Purina} would be to require in the alternative either sophistication, or access to or furnishing of registration-type information. A rule which insures that a purchaser gets the same information he would get on registration should be sufficient to meet the sophistication ("ability to fend-for-himself") test.

The present rule's alternative access requirement for reporting com-

\textsuperscript{167} The Supreme Court stated: "The Commission would have us go one step further and hold that 'an offering to a substantial number of the public' is not exempt under § 4(1) [now §4(2)]. We are advised that 'whatever the special circumstances, the Commission has consistently interpreted the exemption as being inapplicable when a large number of offerees is involved.' But the statute would seem to apply to a 'public offering' whether to few or many. It may well be that offerings to a substantial number of persons would rarely be exempt. Indeed nothing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation." SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (footnote omitted).

\textsuperscript{168} See text accompanying notes 25-28 supra.

\textsuperscript{169} See note 166 supra.

\textsuperscript{170} See text accompanying notes 24 & 25 supra.
panies\textsuperscript{171} is unobjectionable. It is not burdensome on such issuers and gives even greater protection to the purchasers than ordinary registration, since even in a registered offering the purchaser does not always receive a final prospectus (\textit{i.e.}, the principal information which registration offers) until after he has bought the security, and as a memorial to his folly.\textsuperscript{172} The rule could continue to provide the purchaser of a non-reporting company's private placement with greater protection than registration would afford, and yet not overburden the issuer, by requiring the issuer to secure from the purchaser an acknowledgment\textsuperscript{173} that he had timely received sufficient information, or by giving the purchaser a right of rescission for a certain period after availability of the information. Again, of course, exact requirements should be spelled out rather than relying on vague terms such as a "reasonable time."

The present rule concedes in its "access" provision that there can be a substitute for actual information. It also intimates that insiders, family members, and the wealthy are not in as great a need of protection as the average investor. An exception to the actual furnishing of information based on such criteria seems amply justified by the \textit{Ralston Purina} case; however the rule fails to provide one. An amendment to the rule is needed to give these factors, specifically defined, full recognition as alternatives to a duty to prepare the informal registration statement.

Thus, paragraph (d) of the present rule, with its ambiguous sophistication test, should be repealed, since sophistication is not a required complement to information.\textsuperscript{174} It should be replaced with a disjunctive to actual information, enumerating the persons who presumptively have access to such information. The definition of these persons should

\textsuperscript{171} C.F.R. $\S$ 230.146(e)(i)(a)(1)-(2) (1975).


\textsuperscript{173} Vhile on a "hot issue," a purchaser might be pressured into signing, there probably is no more danger to the investor than under a registered offering where the purchaser may commit himself without actually reading the prospectus. Furthermore, this would still offer the investor more protection than he would get under rule 240 under which he is not entitled to any information.

\textsuperscript{174} See, e.g., the interpretation given to \textit{Ralston Purina} by the district court opinion in \textit{United States v. Custer Channel Wing Corp.}, 247 F. Supp. 481, 489 (D. Md. 1965), aff'd, 376 F.2d 675 (4th Cir.), cert. denied, 389 U.S. 850 (1967), which combined sophistication and access by stating the test to be whether the offeree is able to discover the information for himself.
be precise. Rule 147 with its purely mechanical tests could be used as a model. 175 "Insiders" (perhaps as defined in section 16 of the 1934 Act and the implementing SEC rules), relatives, trusts, estates and corporations related to the issuer or insiders (perhaps as defined in the number of purchasers provisions of the present form of rule 146 or in the aggregation provisions of rule 144), "promoters" (perhaps as defined in rule 240), and persons who agree to take significant dollar amounts of the securities offered (perhaps as defined in the number of purchasers provisions of the present form of rule 146), together with persons who represent that their net worth is high enough that they can bear the risk of the investment, should all be exempt from the information-furnishing requirement. And, of course, institutional investors, the concern of proposed ALI Federal Securities Code section 227(b), 176 should be exempt from the information-furnishing requirement under the foregoing proposal for revision of rule 146.

Since the "offeree representative" is necessary only to meet the sophistication test of paragraph (d), the provisions dealing with him can be dropped if the proposed changes in the rule are adopted. This will result in an additional simplification. Obviously, the "wealthy widow" can and should secure professional assistance if she is unable to evaluate for herself the merits and risks of the investment, but the issuer should not be required to make sure that she does so in a private placement, any more than it would in a registered offering.

The offering should be treated as though it were a registered one: the purchaser should have, or be entitled to get, only the information which registration would disclose. As a practical matter, the issuer may have to supply more information in order to make the sale, but this should be left to the purchaser's relative bargaining power. It should not be a condition for the availability of the exemption.

Rule 240 could be substantially retained for the small business. However, with today's inflation, the maximum dollar limit ($100,000) is rather low. On the other hand, the maximum number of owners (100) is probably unnecessarily high. It would make more sense to reverse the rule 146 and rule 240 purchaser limits. The higher limit

175. The only serious deficiency of rule 147 is its incorporation of the same vague integration of offerings criteria which rule 146 also adopts. See Kant, SEC Rule 147—A Further Narrowing of the Intrastate Offering Exemption, 30 Bus. Law. 73 (1974), for a further criticism of the rule.

176. It must be conceded, however, that adoption of Code § 227(b) as the new private placement rule might pose certain dangers to institutional investors, in view of its blanket exemption of them. Although significant institutional and other sizeable investors have enough clout to compel the issuer to make full disclosure to them, a blanket exemption for all institutional investors might enable an issuer in a "hot issue" to coerce such investors, especially the smaller ones, into foregoing the information needed to make a wise investment decision, by threatening to exclude them from participation if they refuse to make an immediate "blind" commitment.
should be available at least for certain specified rule 146 issues and purchasers (e.g., debt securities of reporting companies sold to institutional ("corporate") investors), even if such purchasers are unwilling to take a $150,000 participation.

Clear and unencumbering resale provisions are essential. Rules 144 and 237 should continue to be generally available. However, there should also be a provision for "bulk sales" (re-transfers without fractionalization). As a compromise, the liberal proposed Code section 227(b)(B), which limits retransfers by setting a maximum number of owners during a three year period, would be acceptable. Transferees should not be required, even for a limited time, to meet the sophistication, access, or information received requirements of original purchasers, for this might inhibit unnecessarily certain innocuous transfers (e.g., Kripke's pizza parlor).177

From the above it is clear that many of the provisions of the present rules can still be used. Equally obvious is the need to delete all of the ambiguous language from the provisions which remain. Terms such as "reasonable belief," "reasonable inquiry," and the like should be blue-pencilled. Even if the requirements for the exemption are not relaxed, the issuer should still be told exactly what it must do to comply. Undesirable as such a law might be, a statute making littering a felony (providing "littering" were clearly defined) would still be preferable to one making any "unreasonable conduct" a misdemeanor.

It may also be helpful for the SEC to promulgate a form of investment agreement (formerly "investment letter") and acknowledgment of receipt of information for the issuer's files as acceptable proof of compliance with the rules.178

VII. CONCLUSION

In recent years, the SEC has proven that it can draft clear mechanical tests to replace the vague guidelines and folklore which have plagued the securities laws for so long. Rules 146 and 240 fail to live up to the expectations engendered by these earlier, successful efforts. Not only are the requirements for the private placement and small business exemptions overly burdensome, but, at least in the case of

177. See text accompanying note 154 supra.
178. The "Subscription Agreement and Investment Letter" utilized unsuccessfully by the offerors in the Continental Tobacco case could serve as a model. See SEC v. Continental Tobacco Co., 463 F.2d 137, 146 n.1 (5th Cir. 1972).

Under the present rule the issuer should, of course, obtain from each offeree and each purchaser a separate written acknowledgment of receipt of the necessary information, including all additional information desired. See note 104 supra. A statement by each offeree that he meets the sophistication or wealth requirements of the rule is also desirable, although such self-serving declarations probably will be given little weight.
rule 146, they even fail to achieve the SEC's goal of clarity. Businessmen deserve an easily accessible safe harbor. At least they should be given a clear chart of the shoals and reefs on the approach. Rules 146 and 240 should be changed before they result in the litigation their present form is bound to provoke. Hopefully they will be re-amended to accommodate more successfully the legitimate needs of issuers by giving them a single, certain, integrated guide, based on practical considerations, and covering both initial and subsequent sales of their securities.