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FEDERAL AND STATE SECURITIES LAWS AND THE CLOSELY HELD CORPORATION

William R. Jackson, Jr.*

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INTRODUCTION

Assume you are secretary, a member of the board of directors and general counsel to LCE, a small, closely-held corporation. One of its chemist has discovered a new chemical compound which, if successful, could triple LCE's earnings. It is estimated that at least \$600,000 is needed to finance the project, and the financial analyst reports that the only feasible way to raise the capital is through the issuance of bonds.¹ The president, who owns

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1. The term "security" is defined in section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1971), as *inter alia* "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, or certificate of interest or participation in any profit sharing agreement."

75% of the stock, thinks that if he mentions the project to 40 of his close friends and relatives from all over the country, at least 25 will agree to invest an aggregate of \$600,000. He proposes to tell each of them that LCE's chief competitor has been working on a similar project, but if LCE begins work now it will be able to introduce the compound 6 months before any competitor and thereby substantially dominate the market. The president, after obtaining the authority from the board of directors, directs you to prepare the appropriate documentation for issuance of the bonds.

If the corporation were to issue the bonds without complying with the federal and state securities laws,² LCE, the president and the board of directors might be civilly liable to the purchasers for either rescission of the sale, or damages. There is also the possibility of criminal liability if non-compliance is wilful. In addition, you as counsel might be held liable for malpractice.

This article deals with the provisions of the Securities Act of 1933,³ the Securities Exchange Act of 1934,⁴ and the state securities laws, commonly referred to as the "blue sky laws."

The '33 Act is designed to provide full and fair disclosure of the character of securities sold or offered for sale through the mails and in interstate and foreign commerce. Section 5 of the '33 Act, *inter alia*, makes it unlawful for any person to use any means of interstate commerce to *offer* securities unless a registration statement is filed or to *sell* securities unless a registration statement is in effect.⁵ A registration statement contains information, including financial statements, necessary for an investor to make an informed investment decision regarding the securities. The Securities and Exchange Commission does not pass on the merits of the securities, it only passes on whether the issuer of the securities has fully disclosed the information required in the registration statement. There are three periods relevant to the registration process: the pre-filing period;⁶ the waiting period;⁷ and the post-effective period.⁸ The three periods are determinative of the type of securities distribution activity an issuer may engage in.⁹

The preparation of a registration statement is burdensome and costly,¹⁰

2. For a general discussion of the securities laws, see: L. LOSS, *SECURITIES REGULATION*, (2nd ed. 1961), [hereinafter cited as LOSS]; PRACTICING LAW INSTITUTE, *BASIC SEC PRACTICE* (1971); G. ROBINSON, *GOING PUBLIC* (2nd ed. 1971).

3. 15 U.S.C. § 77a to 77aa (1971) [Hereinafter cited as '33 Act.]

4. 15 U.S.C. § 78a to 78jj (1971) [Hereinafter cited as '34 Act.]

5. Section 5 of the '33 Act. A registration statement is filed with the Securities and Exchange Commission [hereinafter cited as S.E.C.].

6. The pre-filing period is the time before the registration statement has been filed.

7. The waiting period is the time after filing of the registration statement and before it becomes effective.

8. The post-effective period is the time after the registration statement becomes effective.

9. A good discussion of this process is contained in Ruder, *Federal Restrictions on the Sale of Securities*, 67 NW. U.L. REV. SUPP. 1 (1972).

10. One of the cost factors may be the underwriting fees incurred if the issuer uses an underwriter to sell the securities. The underwriter will either sell on a "firm commitment" or "best efforts" basis. Under a firm commitment basis the underwriter will actually purchase the securities from the issuer thereby shifting the risk of loss to the underwriter. Under a best efforts basis, the underwriter does not buy the securities but merely agrees to use his best efforts as agent in selling the securities. The method used will depend on how well established the issuer is. Underwriting fees and other costs may make it more advantageous for a small business to sell its own securities, especially when the offering is small.

and usually several drafts are required before it becomes effective. Further, some investors may not need a registration statement to provide them with relevant information. Because of this, Congress has provided specific exemptions from the registration requirement of section 5 of the '33 Act. Section 4 exempts certain transactions and section 3 exempts certain securities. This article will discuss the private offering exemption of section 4(2),¹¹ the intrastate exemption of section 3(a)(11)¹² and the Regulation A exemption of section 3(b).¹³

In order to provide more objective standards for the determination of the availability of an exemption, the SEC is issuing a series of rules, popularly called the "140 series." Rule 144 applies to the non-underwriter or non-dealer exemption of section 4(1), which is discussed below as it relates to the private offering exemption. Proposed rule 146 applies to the private offering exemption of section 4(2) and Rule 147 applies to the intrastate exemption of section 3(a)(11).

If there is an offer or sale of securities in violation of section 5, the person making such offer or sale may be civilly liable under section 12 of the '33 Act. A purchaser's remedy under this section is rescission of the sale with interest, or damages if the purchaser no longer holds the securities.¹⁴ If such violation is wilful, the seller may be subject to criminal proceedings under section 20 of the '33 Act.¹⁵

Notwithstanding compliance with, or exemption from, the registration requirements of section 5, liability is still possible under various fraud provisions of the securities laws. Section 17 of the '33 Act makes unlawful fraudulent interstate sales of securities, and Rule 10b-5 of the '34 Act makes it unlawful, *inter alia*, to defraud anyone in the sale or purchase of securities. There is an overlap between section 17 and Rule 10b-5 with respect to fraudulent sales of securities. Only Rule 10b-5 will be discussed in this article.¹⁶

An offering of securities must also comply with the blue sky laws of each state in which securities are offered. Compliance with these laws will be discussed in light of the Uniform Securities Act.¹⁷

I. PRIVATE OFFERING EXEMPTION

Section 4(2) of the '33 Act provides an exemption for all transactions:

. . . by an issuer not involving any public offering.¹⁸

This non-public or private offering¹⁹ exemption is limited to persons who

11. See text accompanying note 18, *infra*.

12. See text accompanying note 124, *infra*.

13. See text accompanying note 170, *infra*.

14. Section 12 of the '33 Act.

15. For a discussion on criminal prosecutions see Mathews, *Criminal Prosecutions under the Federal Securities Laws and Related Statutes*, 39 GEO. WASH. L. REV. 901 (1971).

16. See text accompanying note 214, *infra*.

17. See text accompanying note 225, *infra*.

18. Section 4(2) of '33 Act.

19. This is sometimes called private placement exemption. For a more detailed discussion in this area see S. GOLDBERG, *PRIVATE PLACEMENT AND RESTRICTED SECURITIES* (1972); Orick, *Nonpublic Offering of Corporate Securities*, 21 U. PITT. L. REV. 1 (1959).

possess or have access to the information which would be contained in a registration statement and therefore do not need the protection of the Act. The leading case in this area is *SEC v. Ralston Purina*.²⁰ Ralston Purina offered treasury stock to an estimated 500 employees who were classified as "key employees," relying on the private offering exemption. The list of "key employees" included artists, bakeshop foremen, clerical assistants, stenographers and veterinarians. The SEC sued to enjoin the offering because the securities were not registered under the '33 Act. The SEC contended that the private offering exemption was not available because of the large number of offerees. The court reasoned that the availability of the exemption depended upon whether the offerees needed the protections of the Act or could "fend for themselves." Since it was not shown that the employees had access to the type of information which registration would have given them, the court held that the private offering exemption was not available.

Whether an offering is private or public is a question of fact²¹ to be resolved by the surrounding circumstances.²² The factors to be considered include: access to information, relationships of parties, sophistication of the purchaser, number of offerees and investment intent.

A. *Judicial and Administrative Interpretations*

1. *Access to information*

In order to qualify for this exemption, all of the purchasers must either possess or have access to information about the issuer similar to that which would be contained in a registration statement.²³ If there is one purchaser who does not have access or possession, the exemption will not be available and the issuer may be liable²⁴ to all of the purchasers, including those who actually had access. In *Bryant v. Uland*,²⁵ the plaintiff sued to have a sale rescinded because all of the investors did not have access to the necessary information. The defense moved to dismiss on the grounds that the plaintiff had no standing since he was an experienced businessman with access to relevant information. In refusing the defendant's motion the court held that even though the plaintiff was an experienced businessman, the exemption was not available because not all of the investors were sophisticated and adequately informed.

The type of information available is important; crucial questions must be answered with specific, rather than general, information. For example, in *SEC v. Royal Hawaiian Management Corporation*²⁶ the defendants, in-

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

21. SEC Release No. 33-4552 (Nov. 6, 1952).

22. *U.S. v. Custer Channel Wing Corporation*, 247 F. Supp. 481 (D. Md. 1965), *aff'd* 376 F.2d 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967).

23. *Custer Channel Wing Corporation*, 376 F.2d 675 (4th Cir. 1967). The court found that most of the individual purchasers did not possess more than the slightest information about the financial affairs of Channel Wing and therefore did not have the requisite information. The exemption was held to be not available.

24. *Custer Channel Wing Corporation*, note 22 *supra*.

25. *Bryant v. Uland*, 327 F. Supp. 439 (S.D. Tex. 1971). The defendants subsequently lost because they failed to carry their burden of proving that all of the investors did not need the protections of the Act.

26. [66-67 Transfer Binder] CCH FED. SEC. L. REP. ¶91,982 (1967).

cluding the corporation, its president, and the promoter of the issue, were selling equity interests in a land syndication project. The only information available was contained in advertising and general brochures which the defendants circulated. The SEC charged the defendants with failure to register the issue, a violation of section 5 of the '33 Act. The defenses included reliance on the private offering exemption. The court held that the exemption was not available because the defendants failed to prove that the offerees had sufficient information. The brochures lacked, the court said, solid information about the background, resources, interest and commitments of the issuer, all of which were necessary to an intelligent decision.

The issuer will not lose the exemption if the offeree has access to information but does not take advantage of it. In *Bowers v. Columbia General Corporation*,²⁷ the plaintiffs moved for a preliminary injunction in their suit to rescind the sale under section 12 of the '33 Act. The plaintiffs alleged, *inter alia*, that they did not have, at the time of negotiation, the same amount of information that would have been contained in a registration statement. The trial court agreed that the plaintiffs probably did not have sufficient information, but said that the inquiry could not end on that question. The court noted that although they may not have had actual knowledge, they did have access to the information. In denying the plaintiff's motion the court reasoned that if a sophisticated investor has access (as a matter of practical business reality) and does not choose to take full advantage of such information, the availability of section 4(2) would not be precluded.

2. Relationships

a. Between Offeree and Issuer

The relationship between the offeree and the issuer is significant. If the offerees are executive officers of the issuer they may have knowledge of or access to the financial status and other information concerning the issuer.²⁸ In *Garfield v. Strain*,²⁹ the plaintiff sued to collect the final payment of a fractional interest in a test oil well³⁰ sold to the defendant. Defendant alleged that the transaction involved a sale of securities and since the securities were not registered under the '33 Act he was entitled to rescind the sale under section 12. The court found that the securities were exempt from registration under section 4(2). In discussing the grounds for the exemption, the court noted the close relationship between plaintiff and defendant arising out of a prior transaction and subsequent personal visits. The court reasoned that this type of relationship facilitated access to vital information.

Familiarity with the issuer's publications or products does not connote familiarity with the issuer's financial status. In *SEC v. Tax Services*,³¹ offers were extended exclusively to purchasers and subscribers to the issuer's service and to members of the county bar. The court held, in denying the

27. [71-72 Transfer Binder] CCH FED. SEC. L. REP. ¶93,450 (1971).

28. Ralston Purina, note 20 *supra*.

29. 320 F.2d 116 (10th Cir. 1963).

30. The test showed the well to be dry.

31. 357 F.2d 143 (4th Cir. 1966).

exemption, that these relationships were no guarantee that the offerees had access to information.³²

b. *Between Offerees*

Relationships between the offerees, and their knowledge of each other must also be considered. The relationship must lend itself to the free flow of information, thereby eliminating the necessity for a registration statement. If an offering is being made to a diverse, unrelated group, it would have the appearance of being public.³³ In *U.S. v. Hill*,³⁴ there were two types of purchasers: the "direct" purchasers (those buying from defendant), and the "indirect" purchasers (those buying from the direct purchasers). In considering the availability of the exemption, the district court said the focus of the issue is not merely on the direct purchasers but on the entire group. Furthermore, the court reasoned that there must be a relationship between members of the group and the issuer which demonstrates that the group has access to corporate information. Noting that the group was not "a cohesive unit under any standards" the court held that there was no access and denied the exemption. The *Hill* decision should be compared with *Woodward v. Wright*³⁵ where the offering was characterized as a "closely knit arrangement among friends and acquaintances" and held to be a private offering. The court noted that the contract was consummated on a personal basis, and because of mutual reliance, the protections of the Act were not needed.

The relationship may supplement the knowledge which the purchaser already has, thereby giving him complete and full information. In *Paine, Webber, Jackson & Curtis*,³⁶ there were purchasers who did not appear to have the capability of utilizing the available information to the maximum benefit. The SEC issued a no-action letter³⁷ upon the representation that these investors would be continuously advised by other investors closely related to the company.

Transactions tend to become public when the promoters begin to bring in a diverse group of uninformed friends, neighbors and associates.³⁸ It is here that the possibility of insufficient knowledge, lack of discussion opportunities and loss of information exchange is most likely to occur.

32. The relationship between the issuer and offeree must provide for the exchange of information necessary to the offeree. The court in *SEC v. Continental Tobacco, Inc.*, 463 F.2d 137, 158 (5th Cir. 1972) in reversing the district court emphasized that Continental Tobacco failed to prove that the offerees had a relationship with the issuer which gave them access to the kind of information a registration statement would disclose. (When asked whether he had any relationship with the issuer other than that of shareholder, one purchaser replied, "I smoke (the product), is that a relationship?") The purchasers, the court said, did not have an actual opportunity to inspect the company's records to verify statements made to them as inducements for the purchase.

33. SEC Release No. 33-4552 (Nov. 6, 1962).

34. *U.S. v. Hill*, 298 F. Supp. 1221, 1227 (D. Conn. 1969).

35. *Woodward v. Wright*, 266 F.2d 108, 115 (10 Cir. 1951), see also *Campbell v. Degenther*, 97 F. Supp. 975 (W.D. Penn. 1951). But note, these two cases are oil and gas financing cases which the court in *Woodward* characterized as in a "strange world of their own".

36. [71-72 Transfer Binder] CCH FED. SEC. L. REP. ¶78,437 (1971).

37. A no-action letter is a letter from the SEC staff indicating that they will recommend that no action be taken if the proposed transaction is undertaken.

38. SEC Release No. 33-4552 (Nov. 6, 1962).

3. *Sophistication*

The sale must be made to a sophisticated investor. The investor must be able to analyze the information concerning the offering and make an informed, intelligent decision. The sophistication of an investor, however, does not eliminate his need for the information which would be contained in a registration statement. Sophistication is no substitute for access to vital information. For instance, in *Hill York Corporation v. American International Franchises*³⁹ the plaintiffs sued under section 12 to rescind their purchase of securities in a franchise operation. The defense claimed that the private offering exemption was available and further asserted that since the plaintiffs were all sophisticated, they did not need the protection of the Act. The court, in denying the exemption, cited the "abundant evidence" which showed a lack of information and said sophistication was useless if the plaintiffs did not possess the information.

A purchaser's sophistication does not have to be in the area of securities transactions. In *Bowers v. Columbia*⁴⁰ the plaintiffs claimed that they were not sophisticated investors and signed affidavits stating that they had never studied prospectuses or any other detailed financial statements for the purpose of investing in a company. In finding for the defendants, the court said that the focus was not on experience in securities transactions but whether the plaintiffs knew what information to look for and how to interpret it.

4. *Number of Offerees*

The number of offerees refers to the number of persons offered the securities rather than the number of persons ultimately accepting the offer.⁴¹

The Supreme Court has expressly stated there is no warrant for superimposing a limit on the number of offerees as a matter of statutory interpretation.⁴² Generally, the larger the number of offerees, the greater the likelihood the offering will be considered public.⁴³ The Court in *Ralston Purina*⁴⁴ indicated in dictum that even a sale to one person would not necessarily be exempt because the question of protection is a triable fact. Conversely, there was a no-action letter recommended for an offering to 35 persons who were partners, retired partners, or close friends because it was shown that the investors either had knowledge or access to information concerning the issuer.⁴⁵ The number of persons to whom the offering is ex-

39. *Hill York Corporation v. American International Franchise Inc.*, 448 F.2d 680 (5th Cir. 1971).

40. *Bowers v. Columbia General Corporation* ('71-72 Transfer Binder) CCH FED. SEC. L. REP. ¶93,450 (1971).

41. A. Orrick, *Administration of Securities Laws*, 42 MINN. LAW REV. 25, 34 (1957-58); but see proposed rule 146 at note 98, *infra*, for change from offeree to purchaser.

42. *Ralston Purina*, note 20 *supra*.

43. *Hill York* (dictum), note 39 *supra*.

44. *Ralston Purina*, note 20 *supra*, at 125 footnote 11; see also *Meadow Brook National Bank v. Levine*, ('64-66 Transfer Binder) CCH FED. SEC. L. REP. ¶91,496 (1971), the Court held even though the sale in question was to one person, the availability of the section 4(2) exemption is a fact question to be determined at trial.

45. *General Alloy Company*, ('70-71 Transfer Binder) CCH FED. SEC. L. REP. ¶78,134 (1971).

tended is relevant only to the question of whether the offerees had the requisite association with, and knowledge of, the issuer. If the number of offerees is small and their positions allow access, the issue is more likely to be private than where the number is large and the offerees' positions do not allow access.⁴⁶

5. *Investment Intent*

The purchaser must hold the security for investment and not for distribution. The theory is that if the investor sells immediately after purchase, the statute's purpose may be circumvented, because the subsequent investor might not have the requisite information upon which to base his investment decision. Investment representations are of probative value⁴⁷ in determining that a purchase was made for investment and not for distribution, but a mere statement by an initial purchaser, made at the time he acquired the securities, that he is not acquiring for distribution would not be conclusive.⁴⁸

Two ways issuers attempt to establish investment intent are by (1) requiring a non-distribution letter⁴⁹ from the investor and (2) imprinting on the securities a legend restricting resales, both of which are discussed below.⁵⁰ These steps alone, however, are not enough to prove investment intent.⁵¹ The SEC in *In Re Crowell-Collier*⁵² said an issuer cannot accept at face value an investment representation and disclaim the responsibility for investigation and consideration of the facts and surrounding circumstances.

Another factor which may be of considerable importance is the past investment and trading practices of the purchaser.⁵³ These along with the character and scope of the purchaser's business might prove inconsistent with the purchase of large blocks of securities for investment. The fact that a purchaser keeps the securities in an "investment account"⁵⁴ rather than a "trading account" will raise no legal justification for assuming the security is being held for investment.

The intention at the time of purchase ordinarily can be ascertained only by weighing evidentiary factors,⁵⁵ and acts will be of greater significance than statements. Self-serving statements that a particular purchase was made for investment will carry little weight in the face of inconsistent con-

46. One must be cautious if many offerees claim positions that afford protection. In *Martin Yale Industries Inc.* ('71-72 Transfer Binder) CCH FED. SEC. L. REP. ¶78,673 (1971) there were 2 stock plans; one with 27 key employees and the other with 19. The Commissioner, because of the number and positions of the offerees, refused to issue a no-action letter, although it was alleged in the letter of inquiry that all offerees either had access to detailed information or were in charge of an important department.

47. *Crowell-Collier Publishing Company*, SEC Release No. 33-3825 (August 12, 1951).

48. SEC Release No. 33-603 (December 16, 1935).

49. See footnote 67 *infra* for example of investment letter.

50. See footnote 62 *infra* for example of legend.

51. *U.S. v. Custer Channel Wing Corporation*, 376 F.2d 675 (4th Cir. 1967); *see also* SEC Release No. 33-4552 (Nov. 6, 1962).

52. *In re Crowell-Collier Publishing Company*, SEC Release No. 33-3825 (August 12, 1951).

53. SEC Release No. 33-4552 (Nov. 6, 1962).

54. *Id.*

55. *Id.*

crete facts and circumstances.⁵⁶

The size and number of securities offered is another factor. An offering of securities which are convertible into smaller units may indicate that the issuer recognized the possibility if not probability of a public distribution.⁵⁷

6. *Integration*

What may appear to be a separate offering may be considered part of a series of a larger integrated offering. An issuer or underwriter may not segregate into parts a series of related transactions which compose a public offering in order to establish that a particular part is entitled to an exemption.⁵⁸ If a part of an issue which is eligible for an exemption is integrated into a larger issue, the whole issue will have to qualify in order to keep the exemption. Moreover, if the initially exempt part loses its exemption because the other part does not qualify, then those securities which were sold pursuant to such exemption would have been sold in violation of section 5.

Close proximity of time, similar form of consideration and similar use of proceeds may cause offerings to be integrated into one scheme of financing.⁵⁹ The SEC⁶⁰ has said that the following factors are relevant to the question of integration: (1) are the offerings part of a single plan of financing? (2) do the offerings involve issuance of the same class of security? (3) are the offerings made at or about the same time? (4) is the same type of consideration to be received? and (5) are the offerings made for the same general purpose?

7. *Coming to rest*

An offering is complete when all the securities have been distributed. When securities are in the hands of the ultimate purchaser the distribution is said to have come to rest. This concept is important because the final person in the distribution process is considered the purchaser in determining an exemption. The issue is a factual one that will take into account all of the surrounding circumstances. For instance, quick commencement of trading and prompt resale of a portion of the offering would raise a serious question of whether an offering has come to rest.⁶¹

8. *Precautions against unauthorized resale*

a. *Legends*

A legend is a statement placed on securities informing purchasers of restrictions on resale.⁶² As indicated above legends should not be relied upon

56. *Id.*

57. *Id.*

58. SEC Release No. 33-3825 (Aug. 12, 1951).

59. Property Investment, Incorporated ('72-73 Transfer Binder) CCH FED. SEC. L. REP. ¶79,123 (1972).

60. SEC Release No. 33-4434 (Dec. 6, 1961).

61. SEC Release No. 33-4386 (July 12, 1961); see also Brooklyn Manhattan Transit Corporation I.S.E.C. 147 (1935).

62. An example of such a legend is as follows:

to assure an exemption. This however, does not mean that they should not be used. The use of legends in many cases has proved to be an effective means of preventing distributions in violation of the Act.⁶³ The legend calls attention to material facts which assist in the protection of public investors.⁶⁴ The SEC has stated that it will regard the presence or absence of appropriate legends as a factor in determining whether the circumstances surrounding the offering are consistent with the exemption.⁶⁵

b. Non-distribution Letters

Non-distribution letters⁶⁶ are statements by the purchaser that the securities are being purchased for investment and not for distribution.⁶⁷ Even though they are not conclusive evidence of investment intent, it is wise to request a non-distribution letter from a purchaser. These letters should state, using the language of section 2(11), that the buyers do not intend to redistribute.

c. Stop Transfer Instructions

An issuer must keep a record of the ownership of its stock through the use of a stock transfer book. An outside stock transfer agent may be used, (as with a publicly held company), or an officer of the issuer, or the issuer's attorney may perform the duties of the stock transfer agent. One method to prevent unwanted sales of restricted securities is for the issuer to instruct the transfer agent not to transfer ownership of the securities without the

"The securities represented by this certificate have not been registered under the Securities Act of 1933. These securities may not be offered, sold, transferred, pledged or hypothecated in the absence of registration, or the availability of an exemption from registration, under the Securities Act of 1933. Furthermore, no offer, sale, transfer, pledge or hypothecation is to take place without the prior written approval of counsel of the issuer being affixed to this certificate. The stock transfer agent has been ordered to effectuate transfer of this certificate only in accordance with the above instructions." S. GOLDBERG, PRIVATE PLACEMENT AND RESTRICTED SECURITIES § 26(6)(1).

63. SEC Release No. 33-5121 (Dec. 30, 1970).

64. This is important, the SEC in Release No. 34-5226 (Jan. 10, 1972) stated that failure to inform purchasers of the restrictions of the securities would be a violation of Rule 10b-5 of the '34 Act, see note 221, *infra*.

65. SEC Release No. 33-5121 (Dec. 30, 1970).

66. Also called an investment letter.

67. An example of such a non-distribution letter is as follows:

"Gentlemen:

In connection with my purchase of _____ shares of the _____ Dollars (\$_____) par value of common stock of _____ [name of corporation], I represent to you that I am acquiring such shares for investment for my own account and not with a view to resell or otherwise transfer such shares, and that I do not intend to resell or otherwise dispose of all or any part of such shares unless and until I determine at some future date that changed circumstances, not now being contemplated, make such disposition advisable. In such event, I will subsequently register my securities under the Securities Act of 1933 unless an exemption from such registration is available. Before resales are made, an opinion of counsel satisfactory to the corporation, or a no-action letter, will be furnished stating that the sale may be made without violating the Securities Act.

I confirm my understanding and agreement that _____ [name of corporation] is selling its capital stock to me under the Securities Act of 1933 in reliance on the foregoing representation and agreement.

Dated _____, 19____

[Signature of purchaser]

issuer's consent. In the case where the officer or attorney performs such functions a notation should be made in the transfer ledger concerning such restrictions. By proper use of stock transfer instructions the issuer can practically assure that the private purchaser will not be able to resell the securities and thereby jeopardize the private placement. The issuer is put in the position where it can withhold consent to transfer until it is assured by its attorney that a resale would not cause the loss of the exemption.

9. *Resale of Restricted Securities*

When a purchaser of a private placement contemplates resale of his restricted securities there is a question as to whether he will be deemed an underwriter within the definition of section 2(11) of the '33 Act. If he is an underwriter he may be liable under section 12 if he sells without an effective registration statement. The issuer is also concerned with this question because it may lose its section 4(2) exemption if the private purchaser is deemed to be an underwriter.⁶⁸ This is so because the securities might be considered to be in a public distribution. If a registration statement is not in effect the private purchaser will usually try to resell pursuant to the section 4(1)⁶⁹ exemption which is available for a "transaction by any person other than an issuer, underwriter, or dealer." Thus, if a private purchaser is deemed to be an underwriter and the 4(1) exemption is not available to him, the issuer may also lose its exemption under 4(2).

There are two methods for determining whether a private purchaser is an underwriter. First, there are the relevant judicial and administrative interpretations in effect at the time of resale.⁷⁰ Second, resales can be made pursuant to Rule 144⁷¹ which in effect creates certain safe harbors in which a private purchaser may resell without fear of falling outside of the section 4(1) exemption.

a. *Judicial and Administrative Interpretations for Resale*

Resales in compliance with the administrative and judicial interpretations of the act are primarily for those acquiring securities before the effective date of Rule 144. Although Rule 144 is not an exclusive method of resale for securities purchased after its effective date, the SEC has let it be known that it will be difficult to establish an exemption under section 4(1) if the private purchaser does not sell in compliance with Rule 144.⁷²

The two primary judicially and administratively developed tests are the "holding period" and "change in circumstances." Although there is no set time period for holding securities before resale, the shorter the period before resale, the stronger the inference of an intent to resell at the time of purchase.⁷³ Certainly an investment intent does not exist if, at the time

68. Section 2(11) definition of underwriter, *see also*, SEC Release No. 33-5223 at 5 (Jan. 11, 1972).

69. Section 4(1) of the '33 Act.

70. The administrative and judicial interpretation test is becoming of limited use.

71. 17 CFR § 230.144 (1973).

72. SEC Release No. 33-5223 (Jan. 11, 1972).

73. *Loss*, at 666.

of acquisition, the purchaser merely intended to hold the securities for the six month capital gains period.

The SEC has considered the length of holding meaningful when considered in conjunction with other closely related factors, such as the type of security, the characteristics of the issuer,⁷⁴ and the financial condition of the purchaser.

For securities purchased subsequent to the adoption of Rule 144, the SEC has taken the view that the length of the holding period will be considered, but will not in itself establish the availability of an exemption.⁷⁵

If the holding period does not establish investment intent, there must be a valid change in the circumstances which require the sale. A valid change in circumstances must generally be the occurrence of some unanticipated event, which substantially affects either the personal business or the financial affairs of the purchaser.⁷⁶ Things that could or should have been foreseen or expected do not qualify. In the absence of other persuasive factors, the occurrence or non-occurrence of an event in the affairs of the company, or within the industry or economy is not the type of emergency or hardship which comes within the change in circumstances test.⁷⁷ Even a change in circumstances due to a change in personal finances may not be enough. A claim based on a need for immediate cash due to legal fees, and a general business recession have been considered too vague to permit the SEC to issue a no-action letter.⁷⁸

This concept is no longer operative for securities purchased after the adoption of Rule 144.

b. Rule 144

Rule 144⁷⁹ is designed to give more objective standards for private purchasers who desire to sell under the section 4(1) exemption. A detailed discussion of Rule 144 is not within the scope of this article.

A private purchaser may request an issuer to conform to certain information requirements in Rule 144 so that he may sell within its safe harbor. In fact, the SEC has suggested that purchasers negotiate with an issuer for a contractual right to registration or compliance with Rule 144 in order to facilitate resales of restricted securities.⁸⁰

Rule 144 is a prospective rule, applicable only to securities acquired after April 15, 1972.⁸¹ Those purchasers who have securities acquired prior to that date have the option of complying with either the rule or the judicial and administrative interpretations in effect at the time of resale.⁸² All of the conditions of the rule must be met.

74. Orrick, *Non Public Offering of Corporate Securities*, 21 U. PITT. L. REV. 1, 19 (1959).

75. SEC Release No. 33-5223 (Jan. 11, 1972).

76. Orrick, *supra* note 74 at 16.

77. *Id.*

78. Pakco Inc. ('70-71 Transfer Binder) CCH FED. SEC. LAW REP. ¶78,117 (1971).

79. 17 C.F.R. 230, Section 144 (1973) [hereinafter cited as Rule 144].

80. SEC Release No. 33-5223 (Jan. 11, 1972).

81. SEC Release No. 33-5223 at 12 (Jan. 11, 1972).

82. *Id.*

The rule has three basic requirements: (1) current public information, (2) holding period, and (3) a limitation on the amount of securities sold pursuant to the rule.⁸³

Current public information concerning the issuer must be available.⁸⁴ If the issuer has been subject to the reporting requirements of section 13 or section 15 of the '34 Act for 90 days and is current with its filings, then the information provided pursuant to such sections will satisfy this requirement.⁸⁵ For small issuers which are not likely to be subject to such sections, this information requirement will be satisfied if there is publicly available specific information⁸⁶ regarding such issuer.

The holding period requirement is to assure that sellers are not acting as conduits for the issuer to circumvent the registration requirements of the '33 Act. The securities must have been beneficially owned for at least 2 years prior to sale.⁸⁷ If purchased, the securities must have been paid for at least 2 years prior to the sale.⁸⁸ The holding period begins from the date of purchase.⁸⁹ If acquired by gift⁹⁰ or from an estate⁹¹ the holding period is carried over from the prior owner.⁹²

The securities to be sold are limited to such an amount as will not disrupt the trading market.⁹³ The amount of securities eligible to be sold under the rule depends on: (1) who is selling them and,⁹⁴ (2) whether they are traded on a stock exchange.⁹⁵ A private purchaser who sells pursuant to the rule must provide the SEC with certain information regarding such sales.⁹⁶

c. Rule 237

Non-controlling persons may sell securities pursuant to the exemption provided by Rule 237⁹⁷ which is promulgated under section 3(b) of the '33 Act. This rule permits a limited amount of securities to be sold without

83. SEC Release No. 33-5223 at 5 (Jan. 11, 1972).

84. Rule 144(c)(1).

85. Rule 144(c)(2).

86. The following information is required: (1) the exact name of the issuer and its predecessor (if any); (2) the address of its principal executive officer; (3) the state of incorporation (if incorporated); (4) the exact title and class of the security; (5) the par or stated value of security; (6) the number of shares or total amount of securities outstanding as of issuer's most recent fiscal year; (7) the name and address of transfer agent, if any; (8) the nature of the issuer's business; (9) the nature of products or services offered; (10) the nature and extent of issuer's facilities; and (11) who the quotation benefits.

87. Rule 144(d).

88. This is the general rule. There are provisions for promissory notes, other obligations or installment contracts, short sales, puts or other options. Rule 144(d)(2).

89. Rule 144(d)(1).

90. Rule 144(d)(4)(v).

91. Rule 144(d)(4)(vii). There is no holding period requirement if the estate is not an affiliate of the issuer or if the securities are sold by a beneficiary of the estate who is not such an affiliate.

92. Other types of acquisition would include stock dividends, splits, recapitalizations, conversions, contingent issuances and pledged securities.

93. Preliminary Note Rule 144.

94. There are exceptions if sale is below specified dollar amount.

95. See Rule 144(e)(3)(vii).

96. Rule 144(h).

97. 17 C.F.R. § 230.237 (1973).

registration and without compliance with Rule 144. In order to qualify for the exemption the issuer must be a domestic company actively and continuously engaged in business as a going concern for at least 5 years. Further, the seller must have beneficially owned the securities for at least 5 years prior to the sale, and the sale must be made in a negotiated transaction.

The total amount of securities sold under the rule cannot exceed the lesser of 1% of the securities of the class outstanding or \$50,000 in aggregate proceeds. The amount of gross proceeds is reduced by the gross amount of securities sold under the section 3(b) exemption or pursuant to Rule 144.

B. Proposed Rule 146

Proposed Rule 146⁹⁸ determines when offers or sales of securities by an issuer are deemed to be "transaction not involving any public offering" within the meaning of section 4(2) of the '33 Act and thus exempted from the registration requirements of section 5. It, therefore, creates a private placement safe harbor for the issuer.⁹⁹

All of the conditions of the proposed rule must be met if it is to apply.¹⁰⁰ The rule would not be the exclusive means by which private offerings could be established; those complying with the administrative and judicial interpretations in effect at the time of a transaction may also qualify.¹⁰¹ If a transaction does not satisfy all of the conditions of the proposed rule there will be no inference raised as to whether or not the exemption is otherwise available.¹⁰² The proposed rule would only be available to issuers of securities and would not be available to affiliates of issuers or to other persons.¹⁰³ The rule does not relieve issuers from complying with state statutes.¹⁰⁴

There are six requirements which relate to the following items, (1) the manner of the offerings, (2) the nature of offerees, (3) the access to or furnishing of information to the offerees, (4) the number of purchasers, (5) the disposition of securities, and (6) the reports of sales.¹⁰⁵

The proposed rule prohibits offers or sales of securities by any means of general advertising.¹⁰⁶ This prohibition does not mean that there cannot be meetings or written communications, but rather that advertisements are restricted to qualified offerees and must satisfy the direct communication re-

98. Proposed rule 146 was adopted on April 23, 1974 (after the date of the writing of this article) in SEC Release No. 33-5487 to become effective June 10, 1974. There were several changes in the rule as adopted; however, such changes do not affect the discussion of the rule in the text accompanying note 98, *infra*. Of course, reference should be made to the rule as adopted prior to issuing securities in a private offering.

Proposed Rule 146, SEC Release No. 33-5430 (Oct. 10, 1973).

99. Proposed Rule 146 is somewhat of a codification of the administrative and judicial interpretations of the section 4(2) exemption.

100. Proposed Rule 146(b).

101. SEC Release No. 33-5430 (Oct. 10, 1973) General Notes.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. Proposed Rule 146(c); Proposed Rule hereinafter cited as "P. Rule."

quirement¹⁰⁷ in the proposed rule.

The proposed rule requires that the issuer be certain that the offeree or his offeree representative¹⁰⁸ meets two conditions. First, the offeree or his representative must have knowledge and experience in financial matters and be capable of evaluating the risks of the prospective investment. Second, the offeree must be able to bear the economic risk.¹⁰⁹ Although stated in terms of an offer, the rule will still be available if after an offer is made it turns out that one or both of the above two conditions were not met, provided that there was no sale to such offeree.¹¹⁰

The proposed rule requires that the information required by Schedule A¹¹¹ of the '33 Act be available to an offeree or his representative.¹¹² It should be available either through access, if the offeree has the type of relationship that will lend itself to such access, or by having been furnished by the issuer or its agent.¹¹³ In addition, there must be an opportunity to obtain any other information.¹¹⁴ The information need not be furnished to any offeree who at any time indicates that he is no longer interested in purchasing the securities. Before the sale of securities the issuer must inform each purchaser in writing of the restrictions on resale and warn him that he must be able to bear the economic risk for an indefinite period.¹¹⁵

No more than 35 persons¹¹⁶ can purchase the same or a similar class of securities from the issuer in any consecutive 12 months period.¹¹⁷ In computing the number of persons, each beneficial owner of an equity interest in any corporation or other entity that is organized for the specific purpose of acquiring the securities offered is considered a person.¹¹⁸ The following people are not to be included in computing the number of purchasers: (1) any person who purchases or agrees in writing to purchase for cash \$150,000 or more in securities; (2) any director or executive officer of the issuer; (3) any 100% owned parent or subsidiary of the issuer; (4) any bank which has loans to the issuer evidenced by debt securities; (5) any past or present employees who purchase securities pursuant to an approved shareholder plan (up to 35 in a consecutive 12 month period); and (6) any purchaser in a business combination.¹¹⁹

Reasonable care must be taken to assure that purchasers are not under-

107. "Direct communication" means the offeree or his representative have the opportunity for questions, P. Rule 146(a)(2).

108. Offeree representative is defined as a person not an affiliate, associate, or employee (except certain relatives) who is sophisticated in business matters, is acknowledged to be the representative and has disclosed any relationship, to the offeree, which he may have with the issuer.

109. P. Rule 146(d).

110. P. Rule 146(d)(3).

111. Schedule A specifies the information to be contained in a registration statement, section 7 of the '33 Act.

112. P. Rule 146(e).

113. P. Rule 146(e)(1).

114. P. Rule 146(e)(2).

115. P. Rule 146(e)(3).

116. For purposes of this paragraph, the term "person" includes certain relatives, trusts and corporations, P. Rule 146(g)(1).

117. P. Rule 146(g)(2). The Rule as adopted abandoned the 12 men.

118. P. Rule 146(g)(3).

119. P. Rule 146(g)(3)(ii). But see the Rule as adopted.

writers. The proposed rule suggests that the issuer: (1) make a reasonable inquiry to determine whether the purchaser is an underwriter; (2) place a legend on the certificate or other document stating that the securities are not registered and resale is restricted; (3) issue stop transfer instructions if there is a transfer agent, or note on the transfer ledger the restriction, if the issuer transfers its own securities, and (4) procure a non-distribution letter from the purchaser.¹²⁰

Reports of sales of securities sold pursuant to Rule 146 are required to be filed in Washington within 45 days of the end of any quarter of the fiscal year in which sales are made in reliance on the rule.¹²¹ Reports need not be filed if the total amount of securities sold within a 12 month period does not exceed \$500,000, or if they are sold to specified persons.¹²²

C. Controlling Person

The definitional sections of the '33 Act expand the definition of issuer to include controlling persons.¹²³ In other words, the controlling person is functionally treated as an issuer. This makes the private offering exemption of section 4(2) available to the controlling person. This should be contrasted with the non-controlling person who can engage in a secondary offering, under the exemption of section 4(1) for sales by persons other than underwriters, issuers, or dealers.

II. INTRASTATE EXEMPTION

Section 3(a)(11) of the '33 Act exempts from registration

. . . any 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, or if a corporation, incorporated by and doing business within such State or Territory.

This is purely an exemption for local businesses. It is designed for financing which will be consummated in their entirety within the state or territory¹²⁴ in which the issuer is located.¹²⁵ Congress apparently believed that a company whose operations are restricted to one area should be able to register its securities with a federal agency. In theory, the investors will be protected by both their proximity to the issuer and state regulations.¹²⁶

The intrastate exemption¹²⁷ will be analyzed by looking at the judicial and administrative interpretations of the exemption and Rule 147¹²⁸ which provides a safe harbor for sales made under such exemption.

120. P. Rule 146(h).

121. P. Rule 146(i).

122. *Id.*

123. Section 2(11) of the '33 Act.

124. Since the District of Columbia is neither a state nor territory this exemption is not available there. L. LOSS, *SECURITIES REGULATION*, at 602 (2nd ed. 1961).

125. SEC Release No. 33-1459, (May 29, 1937).

126. See Blue Sky Law section starting with note 227, *infra*, and accompanying text.

127. The intrastate exemption is also available for controlling persons.

128. Rule 147 discussed *infra*, at text accompanying note 144.

A. *Judicial and Administrative Interpretations*

The offeror of the security must be a resident of the state or territory. If the issuer is a corporation, it must be incorporated in the state or territory.¹²⁹ At the time of completion of the distribution the securities must be found in the hands of investors resident within the state.¹³⁰

The intrastate exemption is not available where stock is issued¹³¹ or listed¹³² in the name of a resident and then transferred to a non-resident. In *SEC v. Hillsborough Investment Corporation*,¹³³ the defendant, relying on an intrastate exemption sold securities to non-residents. This was done by direct sales and by issuing securities to residents who, after 30 days transferred such securities to non-residents. The SEC sued to enjoin the sale stating that the exemption was not available. The defense argued, first, that a single sale to a non-resident would not render the exemption unavailable, and second, that there was no sale to non-residents if the securities were issued to residents and transferred 30 days later. The court found against the defendant on both grounds and enjoined the sale. The court said that the legislative history and subsequent rulings showed that the entire issue must be sold to residents. In regards to the transfer arrangement, the court said that ultimate distribution has not occurred until the second transfer and the procedure was in reality a sale to a non-resident.

A single offer of part of the issue to a non-resident will render the exemption unavailable for the entire issue,¹³⁴ including securities already sold to residents.¹³⁵

In view of the local character of the section 3(a)(11) exemption, the requirement that the issuer be doing business within the state of issuance can only be satisfied by the performance of substantial operational activities.¹³⁶ The doing business requirement will not be met merely by the performance of certain functions in the state such as bookkeeping, maintaining stock records, or similar activities.¹³⁷ However, the issuer's business need not be confined to the state. There may be some interstate activity,¹³⁸ but if all activities of the business are out of state, there can be no exemption. If the proceeds are to be used principally on a project located out of state, there can be no exemption even if sales are restricted to residents of the state.¹³⁹

Securities may be resold to residents at any time without breaking the exemption if the second purchaser fulfills the same condition of residence

129. SEC Release No. 33-4434 (Dec. 6, 1961).

130. SEC Release No. 33-201 (July 20, 1939).

131. *Belhumeur v. Dawson* ('64-66 Transfer Binder) CCH FED. SEC. L. REP. ¶91,418 (D.C. Mont. 1964).

132. *SEC v. Los Angeles Trust Deed & Mortgage*, 186 F. Supp. 830, 870, *modified* 285 F.2d 162, (9th Cir.), *cert. denied* 366 U.S. 919 (1960).

133. *SEC v. Hillsborough Investment Corporation*, 173 F. Supp. 86 (D.N.H. 1958), *aff'd* 276 F.2d 665 (1st Cir. 1960).

134. SEC Release No. 33-4434 (Dec. 6, 1961).

135. *Hillsborough Investment Corporation v. SEC*, 276 F.2d 665, 667 (1st Cir. 1960).

136. SEC Release No. 33-4434 (Dec. 6, 1961).

137. *Chapman v. Dunn*, 414 F.2d 153, 157 (6th Cir. 1969).

138. Loss, at 601.

139. *SEC v. McDonald Investment Co.*, 343 F. Supp. 343 (D. Minn. 1972), where the money was used to make loans out of state.

as the original purchaser. The question is: Can the securities be safely resold out of state? After the securities have come to rest they may be resold to non-residents without disqualifying the exemption.¹⁴⁰ The crucial question, therefore, is whether the securities have come to rest. The fact that the securities are resold to a non-resident a short time after purchase, although not conclusive, would support an inference that the original offering had not come to rest¹⁴¹ and that the resale constituted a part of the primary distribution.¹⁴²

It is customary for issuers who sell in reliance on the intrastate exemption to obtain written assurances that the purchases are not made with a view to resale to non-residents. Further, issuers may place legends on the securities and to issue stop transfer instructions.

B. Rule 147¹⁴³

The SEC has promulgated¹⁴⁴ Rule 147¹⁴⁵ which is intended to provide more objective standards for those issuers who wish to comply with the conditions of the intrastate exemption.¹⁴⁶ It defines and clarifies certain terms of the exemption.¹⁴⁷

The rule does not establish exclusive standards for complying with section 3(a)(11).¹⁴⁸ Persons may claim this exemption without complying with the rule if they satisfy the conditions set forth in relevant administrative and judicial interpretations in effect at the time of the transaction.¹⁴⁹ The rule is available only to issuers of securities and not to other persons, such as controlling persons.¹⁵⁰ In order for such other persons to qualify for the exemption, they must satisfy the relevant administrative and judicial interpretations.¹⁵¹

The rule defines terms in the act, prescribes limitations on resale, and provides precautions against interstate distributions. All of the conditions must be met in order for an offering to come within the section 3(a)(11) exemption by reason of the operation of the rule.¹⁵² It is further required that all of the securities of an issue be sold pursuant to the conditions of the rule in order for the rule to be applicable.

Rule 147 automatically excludes from integration with an intrastate offering sales made pursuant to (1) a registration statement, (2) the private placement exemption, or (3) any of the other exemptions under section 3.

140. SEC Release No. 33-4434 (Dec. 6, 1961).

141. SEC Release No. 33-1459 (May 29, 1937).

142. *Id.* See also text accompanying note 61.

143. This rule became effective March 1, 1974.

144. SEC Release No. 33-5349 (Jan. 8, 1973).

145. The rule shall not be available to any person with respect to any offering which, although in technical compliance with the rule, is part of a plan or scheme by such person to make interstate offers or sales of securities, SEC Release No. 5450 (Jan. 7, 1974).

146. Introductory note Rule 147.

147. SEC Release No. 33-5349 (Jan. 8, 1973).

148. *Id.*

149. Rule 147 preliminary Note 3.

150. *Id.*

151. *Id.*

152. *Id.*

Such non-integrated offers or sales must, however, be made 6 months prior to the first offer or sale and 6 months subsequent to the last offer or sale pursuant to the exemption.¹⁵³ Any security not satisfying these conditions will be tested for integration¹⁵⁴ by the traditional methods.¹⁵⁵

A corporate issuer is considered a resident if it is incorporated in or organized under the law of the state.¹⁵⁶ A partnership which is not organized under any state law will be a resident if its principal office is located within the state.¹⁵⁷ An individual offeror would be considered a resident if his principal residence is located within such state.¹⁵⁸

An issuer would be considered as doing business within a state or territory if it: (1) derives at least 80% of its gross revenues,¹⁵⁹ on a consolidated basis, from operations¹⁶⁰ within the state or territory;¹⁶¹ (2) has at least 80% of its assets in such state or territory at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue;¹⁶² (3) intends to use and uses at least 80% of the net proceeds from sales pursuant to Rule 147 in connection with operations within the state;¹⁶³ and (4) has its principal office within the state.¹⁶⁴

An individual offeree is considered a resident of the state in which his principal residence is located.¹⁶⁵ An offeree which is a corporation, partnership, or other business organization is deemed to be a resident of the state if its principal office is within such state at the time of purchase or sale.¹⁶⁶ During the distribution of the securities and for nine months thereafter, resales of securities issued pursuant to the rule are limited to persons resident within the state of issuance.¹⁶⁷

As precautions against interstate distribution, the rule prescribes four mandatory requirements in connection with an offer of any security: (1) a legend must be placed on the securities indicating that the securities cannot be resold to a non-resident for nine months after the end of the distribution; (2) stop transfer instructions must be issued to the transfer agent or a notation must be placed in the appropriate records if there is no transfer agent; (3) a written representation of residence¹⁶⁸ must be obtained from each

153. Rule 147(b)(2).

154. See general introduction to Rule 147.

155. Rule 147(b)(2), preliminary Note 3.

156. Rule 147(c)(1)(i).

157. Rule 147(c)(1)(ii).

158. Rule 147(c)(1)(iii).

159. If first offer of any part of an issue is made during the first six months of the fiscal year, then determined from the most recent fiscal year; if first offer is made during the second six month period of fiscal year then determined by either first six months of current fiscal year or from 12 month period ending with the beginning of the current six month period. Rule 147(c)(2)(i).

160. Operation of business, of real property or rendering of services.

161. This provision does not apply to any issuer who has not had gross revenues exceeding \$5,000 for his most recent 12 month period. Rule 147(c)(2)(B).

162. Rule 147(c)(ii).

163. Rule 147(c)(iii).

164. Rule 147(c)(iv).

165. Rule 147(d)(2).

166. Rule 147(d)(1).

167. Rule 147(e).

168. Rule 147(f)(1).

purchaser; and (4) the restrictions on resale must be disclosed to the offeree in writing.¹⁶⁹

III. REGULATION A

Regulation A, which consists of rules 251-263¹⁷⁰ promulgated under 3(b), is an exemption from the registration requirements of section 5 of the '33 Act.¹⁷¹ This exemption requires that an offering circular and a letter of notification be filed. Regulation A is designed to help issuers¹⁷² who wish to make a small offering by allowing them a method of registration which is shorter and requires less information than ordinary registration.¹⁷³ The registration papers are filed in a regional office rather than in the national office.¹⁷⁴ Regulation A is the only exemption which permits interstate public offerings. It is available for the securities of most¹⁷⁵ U.S. issuers. One of the principal problems with Regulation A is in determining whether an issuer qualifies. There are many rules and an issuer must be careful that it meets all the requirements, some of the more important of which are discussed in this section.

Regulation A scrutinizes the past activities of the issuer¹⁷⁶ and certain related parties in order to determine, *inter alia*, if any such persons have violated any federal securities law. If so, the exemption may not be available.

There are limitations on the amount of securities that can be sold under Regulation A. The amount will vary depending on the status of the person seeking to use the exemption. In determining compliance with the limitation, securities sold during any 12 month period are aggregated.¹⁷⁷ An issuer¹⁷⁸ and its affiliates, in general, can offer or sell up to \$500,000 of securities.¹⁷⁹ A group of individuals other than issuers or affiliates, in general, can offer or sell up to \$300,000,¹⁸⁰ but the limitation for each mem-

169. Rule 147(f)(3).

170. 17 C.F.R. § 230.251 to 230.263 (1973).

171. Section 3(b) of the '33 Act.

172. Regulation A is available for a controlling person, Rule 252(a)(2).

173. See schedule 1-A under Regulation A as compared to S-1 under regular registration. But one should not get the idea that Regulation A is easy to file.

174. 17 C.F.R. § 230.255(c) (1972). (Rules hereinafter cited by Regulation number only.).

175. Excluded are securities consisting of fractional undivided interests in oil or gas rights, or securities of any registered investment company. 252(b).

176. The issuer, its predecessor or affiliate must not have within the last five years: (1) filed a registration statement which is or was the subject of any refusal order under the suspension rule; (2) been subject to any order or pending procedure under the suspension rule; (3) been convicted of any crime or offense involving the purchase or sale of securities; (4) been subject to any temporary or permanent order restraining or enjoining him from engaging in any conduct in connection with a purchase or sale of securities. In addition, the issuer must not be subject to a U.S. Post Office fraud order. 252(a)(i).

Predecessor is defined as (1) a person, the major portion of whose assets have been acquired directly or indirectly by the issuer or (2) a person from which the issuer acquired directly or, indirectly the major portion of its assets. 251.

Affiliate is defined as a person controlling, controlled by or under common control with such issuer. 251.

177. 254(a)(1).

178. Also an estate of a decedent can sell up to \$500,000. An estate has to sell within 2 years after the death of decedent, 254(a)(1)(i).

179. Each affiliate is limited to \$100,000, 254(a)(1)(i).

180. 254(a)(1)(ii).

ber of the group is \$100,000.¹⁸¹

It is important to determine the total amount of the offering before deciding to use Regulation A. If the maximum dollar value of the securities offered is uncertain and there is a chance that it may exceed the limitation, Regulation A should not be used.¹⁸² The value placed on the securities is very important. Securities offered at a price below the market, perhaps to employees or existing security holders, must be valued at market price.¹⁸³

As with other exemptions, an offering will be deemed to continue until the entire issue has been distributed. The timing of a resale will be evidence of whether such a resale should be integrated¹⁸⁴ into a prior distribution. If resold securities are integrated, the resale prices will be aggregated to determine if the limits have been exceeded.¹⁸⁵

A letter of notification on Form 1-A must be filed with the regional office at least 10 days prior to the date of the initial offering. This notification must be signed by the issuer and such other persons for whom the securities are to be offered.¹⁸⁶

A written offering circular containing information specified in Schedule 1 of Form 1-A of the '33 Act must be distributed in order to be in compliance with Regulation A.¹⁸⁷ The offering circular is designed to give the prospective investor an accurate basis to evaluate the risks involved in the proposed venture. All of the information required should be reported fairly and honestly. The true risks of the offering and condition of the business must be disclosed.¹⁸⁸

Failure to include speculative factors applicable to the securities will make a Regulation A registration statement materially defective.¹⁸⁹ The presentation of an optimistic picture of the issuer's prospects without disclosure of significant adverse information may create a picture which as a whole will be materially misleading even though it may be qualified by general concessions.¹⁹⁰ This remains true notwithstanding the fact that a particular representation in another context might not be objectionable.¹⁹¹ Any representation which bears directly on the investment attractiveness such as public demand,¹⁹² inventions, patents, formulas, devices and the like should be reflected in its true perspective.¹⁹³ The identities of the corporations' promoters and the moving force behind the corporations must be disclosed

181. *Id.*

182. If the securities are to be resold, then the value might not be known if the resale price is not available. In *Strategic Automated System International* ('72-73 Transfer Binder) CCH FED. SEC. L. REP. ¶79,298, a no-action letter was refused because of the uncertain price on resale.

183. Loss, at 614.

184. See text accompanying note 58.

185. 254(a)(1).

186. 255.

187. 256(a); The financial statements need not be certified, Schedule I of Form 1-A of the '33 Act.

188. *Jackpot Exploration Corporation*, SEC Release No. 33-5061 (April 22, 1970).

189. *Sports Arenas (Delaware)*, SEC Release No. 33-4153 (Oct. 23, 1959).

190. *General Aeromation, Inc.*, 41 SEC 219, 224 (1962).

191. *Id.*

192. SEC Release No. 33-3907 (March 18, 1958).

193. Galvin & Pincell, *Securities Offerings and Regulation A, Requirements and Risks*. 13 BUS. LAW. 303, 323 (1957-8).

since this information is likely to affect the investor's decision.¹⁹⁴

The offering circular must be concurrently distributed with any written offer to sell the securities.¹⁹⁵ No securities can be sold under Regulation A unless the purchaser is given an offering circular at the time of or prior to confirmation of the sale or payment of all or part of the purchase price.¹⁹⁶

Whenever offerings are continued over any extended period of time, which is frequently the case where the issue is sold by an underwriter on a 'best efforts' basis or offered to employees or stockholders, the issuer and other participants must avoid the use of an offering circular which is stale in any material respects. In any event, Regulation A requires the offering circular to be updated and revised if the offering is not completed within nine months.¹⁹⁷

It is required that no offering circular or other written communication used in connection with any offer contain any language that states or implies that the SEC has in any way: (1) passed on or given approval to the securities; (2) determined that the securities are exempt from registration; or (3) made any findings that the statements contained within the offering circular or other communication are accurate and complete.¹⁹⁸

No offering circular is required for Regulation A offerings which do not exceed \$50,000.¹⁹⁹ The issuer, however, must file a statement containing information (other than financial statements) as required by schedule 1 of Form 1-A.²⁰⁰ Any advertisements, articles or other communication with respect to such issuer shall not contain more than: (1) the name of the issuer; (2) the title of the security; (3) the amount offered; (4) the general type of the issuer's business; (5) the per-unit offering price to the public; (6) a statement of the character and location of the issuer's property; and (7) by whom the order will be filled or where further information may be obtained.²⁰¹

Regulation A²⁰² requires sales of securities to be reported²⁰³ within 30 days after each six month period following the date of issuance of the original offering circular. A final report must be made within six months after the last sale pursuant to the exemption.²⁰⁴ This is required whether the offering is completed or terminated.

A copy of every advertisement, article or communication to be published, every radio and television broadcast, and every letter, circular or

194. Dinky's Inc., ('72-73 Transfer Binder) CCH FED. SEC. L. REP. ¶79,170 (1973).

195. 256(a)(1). The offering circular may be typed.

196. (a) Rule 256(a)(2). (b) When transactions are made on a securities exchange, Regulation A provides that a reasonable number of offering circulars be furnished to the exchange for delivery to anyone requesting them.

197. 256(e); 12 months where offerings under stock purchase savings, stock option or other similar plan for employees.

198. 259; schedule 1 requires this on outside of offering circular, this legend is sometimes called "hymn of hate" or "duty of doubt".

199. 257.

200. This should be filed as an exhibit to the notification.

201. 257.

202. 260.

203. On Form 2-A of the '33 Act.

204. 260.

other communication sent to more than 10 people must be submitted to the regional office five days prior to its use.²⁰⁵

All of the conditions²⁰⁶ of Regulation A are continuous and any subsequent non-compliance will serve as grounds for suspension²⁰⁷ of the exemption.²⁰⁸ The SEC may at any time after filing of a notification enter an order temporarily suspending the exemption.²⁰⁹

Upon suspension, the SEC may allow the issuer to amend its filings. It has allowed filings to be amended upon the showing of good faith and other mitigating circumstances,²¹⁰ but it stresses that a careful and honest preparation is an absolute prerequisite to the exercise of its discretion.²¹¹ A good faith and diligent effort requires more than a showing that a deficiency was not a deliberate intent to deceive or defraud.²¹² When a permanent suspension order is given, the filing can be amended to conform to the requirement of a regular registration.²¹³

IV. RULE 10b-5

"Anyone attempting to present an overall view of the current status of the law of rule 10b-5 may take some encouragement from the fact that he does not have to assume full responsibility for the resulting confusion." Lancey, 25 BUS. LAW. 1355 (1969-70).

The theory behind the Securities Exchange Act of 1934 is equalization of information and bargaining position. The main fraud prophylactic device in the '34 Act is Rule 10b-5²¹⁴ promulgated under section 10(b) which reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

205. 258.

206. These include failure to file any report required by Rule 260.

207. 261(a)(4). This includes an issuer, any of its predecessors, or any affiliated issuer; and any director, officers of either the issuer or its underwriter.

208. The obvious significance of this provision cannot be overemphasized; it is a clear warning that the offering should be closely watched and "chaperoned". Galvin & Pincell, *Securities Offering & Regulation A, Requirements and Risks*, 13 BUS. LAW. 303 (1957-8).

209. 261(a).

210. The SEC is quite serious about this. Release No. 33-3999 (Dec. 4, 1958), said that a free amendment procedure would result in "less than full and accurate disclosure . . . [and] . . . would impose unwarranted administrative burdens . . ." and in Release No. 33-5061 the SEC said it would "impair the required standards . . . and . . . encourage a practice of irresponsible or deliberate submission of inadequate material . . ."

211. General Aeromation, 41 S.E.C. 219 (1962).

212. *Id.*

213. SEC Release No. 33-3999 (Dec. 4, 1958).

214. 17 C.F.R. § 240:10b-5 (1973). For a more developed discussion see A. BROMBERG, *SECURITIES LAW: FRAUD: SEC RULE 10B-5* (1967).

At the time Rule 10b-5 was promulgated, there were provisions against fraud committed by a seller and by a purchaser if the purchaser was a dealer. There were no provisions, however, against fraud committed by a non-dealer purchaser. The rule closes this loophole by making it unlawful for a non-dealer to purchase securities in a fraudulent transaction. The rule also applies to dealer purchasers and all sellers. It is applicable to all securities sold in either primary or secondary transactions in interstate commerce, regardless of the size of the issuer.

The essence of Rule 10b-5 is that an insider who has material inside information or a person who has obtained inside information from an insider²¹⁵ may not take advantage of that information in connection with a purchase or sale of securities by using such information knowing that it is not available to those with whom he is dealing.²¹⁶ Rule 10b-5 is not designed merely to prohibit actual misrepresentation but also to impose affirmative duties of disclosure and fairness upon insiders.²¹⁷ It is a means of neutralizing the advantage one party may have over another because of the differences in the relationships they have with the issuer. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of an uninformed stockholder. It is an attempt to provide some degree of equalization of bargaining position so that the outside shareholder may make an informed judgment in every transaction.²¹⁸ The regulatory objective of equal enjoyment of material information requires the disclosure of basic facts so the outsiders may draw upon their own evaluative expertise²¹⁹ in reaching their own investment decisions.²²⁰

The obligation rests on two principal elements. First, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone. Second, the inherent unfairness invoked where a party takes advantage of such information knowing it is unavailable to those he is dealing with.²²¹ Anyone in possession of material inside information must either disclose it to the investing public, or if he chooses not to disclose,²²² he must abstain from trading in or recommending the securities concerned while the inside information remains undisclosed.²²³

There is no federal statute of limitations; the federal courts will look at the law of the forum state and will borrow the most applicable state statute. Normally a court will either use the time limitation applicable to

215. So-called "tippee."

216. *Radiation Dynamic v. Goldmuntz*, ('72-73 Transfer Binder) CCH FED. SEC. L. REP. ¶93,548.

217. *Closely Held Corporations*, ILLINOIS INSTITUTE FOR CONTINUING LEGAL EDUCATION, § 14.3 (1971).

218. *Speed v. Transamerica Corporation*, 99 F. Supp. 801 (1951), *modified* 235 F.2d 369 (1955).

219. An insider is under no duty to the ordinary investor to give him the benefit of his superior financial analysis. *Loss* at 1463.

220. *U.S. v. Texas Gulf Sulphur*, 446 F.2d 1301 (1971).

221. *Cady Roberts*, 40 S.E.C. 907 (1961).

222. He may choose not to disclose information to protect a corporate confidence.

223. *U.S. v. Texas Gulf Sulphur*, *supra*, note 222.

the general fraud statute or the blue sky fraud statute. The blue sky limitation will be used when its wording is similar to the federal statute. The time when the claim arises and the period of limitations starts to run is either upon actual discovery of the fraud or at the time a reasonably prudent person would have discovered the fraud.²²⁴

V. STATE SECURITIES LAWS-BLUE SKY LAW

State securities laws²²⁵ are designed to insure that the necessary facts are available so an investor can make an informed investment decision.²²⁶ All states²²⁷ have passed legislation regulating the offering for sale and the sale of securities.²²⁸ These laws are called blue sky laws because of the purpose of preventing speculative schemes which have no more basis than so many feet of blue sky.²²⁹ Blue sky laws are specifically allowed by the '33 Act²³⁰ and have been held to be a constitutional regulation of business by the U.S. Supreme Court.²³¹ These laws constitute a system of regulation separate and independent from the federal securities laws. They, therefore, must be complied with in addition to the federal securities laws before any offer or sale of securities. Like the federal statutes there are exemptions but certain conditions must be fulfilled before they can be used. An exemption from the federal statutes does not automatically give an exemption from the state statutes.

Most blue sky laws go beyond the full disclosure philosophy²³² of the federal securities laws and grant to the state administrator, charged with enforcing such laws, the discretion to determine which securities may be publicly sold in his state.²³³ This concept allows state administrators to make an official evaluation regarding the degree of risk in the proposed offering and prohibit businesses from offering their securities publicly if the risks to investors are considered too high.²³⁴

The Uniform Securities Act²³⁵ was designed to minimize the existing diversity of legal requirements for state securities regulations.²³⁶ It was drafted at the request of the National Conference of Commissioners of Uniform State laws. It prohibits fraudulent practices in the purchase and sale of securities and requires the registration of broker-dealers, investment ad-

224. *Hoffert v. Hinkle and Company*, ('72-73 Transfer Binder) CCH FED. SEC. L. REP. ¶93,655.

225. For a more detailed discussion of Blue Sky see L. LOSS & E. COWETT, *BLUE SKY LAW* (1958); and J. MOFSKY, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS* (1971).

226. R. Corley, *Blue Sky Takes Many Forms*, 8 AMER. BUS. L.J. 53 (1970-71). (1970-71).

227. And the District of Columbia and Puerto Rico.

228. 1 CCH BLUE SKY REP. 701.

229. *Hall v. Greiger-Jones Corporation*, 242 U.S. 539 (1917).

230. § 18 of '33 Act.

231. *Hall v. Greiger-Jones Corporation*, 242 U.S. 539 (1917).

232. Mofsky, *Adverse Consequences of Blue Sky Regulation of Public Offering Expenses*, 72 WIS. L. REV. 1010 (1972).

233. *Id.*

234. *Id.*

235. The UNIFORM SECURITIES ACT hereinafter cited as U.S.A. The Act together with the unofficial comments of the draftsmen appears as an appendix in L. LOSS & E. COWETT ON *Blue Sky Law* (1958); it is also in 1 CCH BLUE SKY REP. 701.

236. L. LOSS, & E. COWETT ON *BLUE SKY LAW* (1958).

visors, and securities.²³⁷ It has been adopted with modifications, by 31 jurisdictions.²³⁸ The following discussion will be based on the Uniform Securities Act.

The Uniform Securities Act is in four parts. The first three parts represent the three basic blue sky philosophies: (1) the fraud approach;²³⁹ (2) the registration of broker-dealers, agents and investment advisors approach;²⁴⁰ and (3) the registration of securities approach. Part four contains the general provisions²⁴¹ essential in varying degrees under any of the three basic philosophies.²⁴² The first three parts are designed to stand alone or in combination with each other.²⁴³

The theory is that it is impractical to expect complete uniformity among states with basically different regulatory philosophies, but that there is some likelihood of achieving a substantial degree of uniformity among those states which follow a particular philosophy.²⁴⁴ In this regard when dealing with an offering which will be made in two or more states it is important that each state law be consulted.

Under the registration of securities approach all securities, except those exempted, must be registered under the act. The act allows for registration by three methods:²⁴⁵ notification, coordination and qualification.

Registration by notification is available to a certain class of securities. These securities are issued by a corporation which has been in continuous operation for a number of years, has had a favorable earnings record, and has not defaulted on security obligations in the past.²⁴⁶ The procedure for registration by notification requires only the filing of certain documents.²⁴⁷

Securities for which a registration statement has been filed under the Federal Securities Act of '33 in connection with the same offering of the same securities may be registered by coordination.²⁴⁸ This exemption is not available if the securities have not been registered under the '33 Act. The reg-

237. Official Prefatory Note U.S.A.

238. 1 CCH BLUE SKY REP. ¶4901, this includes District of Columbia and Puerto Rico.

239. The Uniform Securities Act contains two antifraud provisions. The first provision is in substantially the same language as Rule 10b-5 of the '34 Act and prohibits fraud in the purchase or sale of securities. The second provision is modeled after a similar provision in the Investment Advisors Act of 1940, and prohibits fraud on the part of any investment advisor. There are no exemptions from these provisions.

240. The Uniform Securities Act requires the annual registration of all broker-dealers, agents and investment advisors.

241. This includes definitions, exemptions, judicial review, investigating, injunctive and criminal provisions.

242. L. LOSS & E. COWETT, BLUE SKY LAW 236 (1958).

243. *Id.*

244. Florida and North Dakota also allow registration by announcement. This method will not be discussed.

245. U.S.A. § 302.

246. The documents include: (1) a statement showing eligibility for registration by this method; (2) the issuer's name, address, form of business, and date of organization; (3) a description of the security; and (4) certain other required information.

247. U.S.A. § 303(a).

248. Along with future amendments, three copies of the prospectus filed with the Securities and Exchange Commission, articles of incorporation and by-laws of the issuer, agreements with and among underwriters, copies of instruments governing the issuance of the security and copies of the security itself.

istration must be accompanied by certain documents²⁴⁹ filed with the SEC. The State Security Administrator may require any additional information that has been filed with the SEC pursuant to federal registration.²⁵⁰

Registration by qualification may be used for the registering of any security and is required of all securities not entitled to registration by notification or coordination.²⁵¹ This procedure requires the filing of a prescribed form. The statements, exhibits and documents required to be filed go into much greater detail than any of the other forms of blue sky registration.²⁵² The Administrator may under this procedure, require a prospectus or any part thereof to be furnished to offerees.²⁵³

Certain offerings may be exempt from registration. The Uniform Securities Act, like the federal act, provides for both exempt securities and exempt transactions.

249. U.S.A. § 303(b). A registration by this method will become effective automatically at the moment the federal registration becomes effective if all above conditions are met. To become effective there must not be a stop order in effect, the registration statement must have been on file 10 days and a statement of maximum and minimum offering prices and maximum underwriting commissions and discounts must have been on file for two business days. U.S.A. § 303(c).

250. U.S.A. § 304.

251. Questions are asked in regard to: issuer, any significant subsidiary, any director or officer of issuer, beneficial owners of more than 10% of stock, promoters, anyone on whose behalf part of the distribution is being offered, capitalization and long term debt, kind and amount of securities, estimated cash proceeds, stock options and material contracts. Also required to be filed are copies of prospectuses, pamphlets and other literature to be used with the offering, signed opinions of counsel as to legality of security, written consent of any professional who makes statements, and balance sheets.

252. U.S.A. § 304(d). The registration statement is effective when the Administrator so orders it to be effective. U.S.A. § 304(c).