SEC Rule 146--The Private Placement Exemption

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Note: SEC Rule 146—The Private Placement Exemption

On April 23, 1974, the Securities and Exchange Commission (SEC) formally announced the adoption of Rule 146 under the Securities Act of 1933, the Rule to become effective June 10, 1974.¹ Section 5 of the 1933 Act prohibits the use of interstate commerce or the mail for the sale of securities unless the issuer has filed an effective registration statement with the SEC.² An exception to this registration requirement is provided in section 4(2), which exempts sales by an issuer that do not involve a public offering. Rule 146 governs transactions based on section 4(2) of the Securities Act of 1933—³ the private placement exemption.

The registration of securities pursuant to the 1933 Act can be a painstaking and expensive process and also precludes certain economic benefits to be derived from sales outside of the process.⁴ Consequently, the private placement exemption has been used to sell a substantial amount of securities since 1933.⁵ Because section 4(2) does not define exactly what kind of transaction constitutes a private offering, there have been numerous administrative and judicial interpretations of the concept. As a result of the confusion generated by these interpretations, the Commission came to the conclusion that a more objective set of standards ought to be promulgated.⁶ In November of 1972, the SEC published its first proposed Rule 146, the stated purpose of which was to provide a “safe harbour” for issuers seeking

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⁴ Issuers are subject to a considerable amount of expense, delay and unwanted public exposure as a result of registration under the 1933 Act. However, the issuer may also seek a private placement because he is able to arrange more flexible terms with the offeree, obtain a firm commitment and avoid the costs of underwriting. 1 L. Loss, SECURITIES REGULATION 681–96 (2d ed. 1961) [hereinafter cited as 1 Loss].
⁵ The exact figures are not available, but Commissioner Owens estimated that the dollar volume of securities privately placed exceeded that of those offered to the public through registration under the 1933 Act. Address by Hugh F. Owens, Commissioner, Securities and Exchange Commission, A Look at the Private Offering Exemption as it Approaches its Fourteenth Birthday, 152 BNA SEC. & L. REP., G-1 (May 17, 1972) [hereinafter cited as Owens].
to accomplish a private placement. If an issuer complied with all the conditions of this Rule, the transaction would be deemed a private placement. As the proposal was to be non-exclusive, private placement exemptions could also be achieved outside of the Rule’s “safe harbour.”

In connection with the publication, the Commission invited comment concerning the proposed Rule. As a result of comments from members of the securities bar, the Commission published a revised proposed Rule 146 in October of 1973. Again, a period of commentary ensued. Although the Rule as finally issued reflects changes based upon the commentary of various critics, certain basic principles have remained intact throughout the development of the Rule.

This Note will examine the development of SEC Rule 146 as reflected in the provisions of each of the proposed Rules, discuss the Rule as finally issued, and present a portion of the securities bar’s opinion of the Rule as expressed by commentary directed to the SEC. This analysis is intended to provide insight into the “legislative” history of the Rule by showing which issues and problems were brought to the attention of the Commission.

I. LEGISLATIVE HISTORY OF THE 1933 ACT

The Congressional purpose in enacting the 1933 Act was to protect the public by providing a continuous system of disclosures concerning securities offered for sale. The Act’s drafters modeled it upon the English Companies Act, which was based essentially on registration and disclosure. This approach differs from that of state “blue sky” laws in that the latter focus on evaluating the soundness of each particular issue. Congress believed that the disclosure of significant facts about an issuer would be a sufficient protection for the public while providing an efficient system of raising investment capital.

The 1933 Act thus requires the issuer to submit to the SEC a registration statement which contains significant information

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7. Id.
11. See 1 Loss, supra note 4, at 30-106.
about the issuer.\textsuperscript{13} Once this statement has been filed, the issuer may make offers to sell the security.\textsuperscript{14} However, no sale may be consummated until the SEC has actually approved the registration statement.\textsuperscript{15} When the statement is made available to the public, written offers of the security must be accompanied by a prospectus which contains information similar to that on file with the Commission. A prospectus must also be distributed to the purchaser when a sale is made.\textsuperscript{16}

The 1933 Act also contains sanctions to make the registration and disclosure requirements effective. Both the issuer and the underwriters are responsible for statements made in the registration statement and prospectus. Issuers and underwriters are likewise held liable for false and misleading statements concerning the issue. There are also sanctions against the sale of a security in the absence of registration when no exemption is available. In addition, purchasers may seek rescission under section 12(1) of the Act when securities are sold in violation of the statute.\textsuperscript{17}

In enacting the 1933 Act, Congress recognized that in some instances registration is unnecessary; the scope of the registration requirement is therefore limited to public offerings of securities. The House report of the bill emphasized that "[t]he sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government."\textsuperscript{18} One of the drafters of the statute recalls that "[t]he careful application of the act to securities transactions where there is no practical need for its application or where the public benefits are too remote."\textsuperscript{19}

In providing for those instances in which the requirement of a registration statement would pro-

\textsuperscript{18} H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).
\textsuperscript{19} See Landis, supra note 10, at 31.
duce unneeded protection for the investing public, Congress drafted section 4(2) exempting transactions not involving "any person other than an issuer, underwriter, or dealer." Section 2(11) of the 1933 Act defines an underwriter as someone who acquires stock "with a view to . . . distribution." One who acquires stock with the idea of later selling it is considered to be acquiring the stock with a view to distribution, and one who acquires stock as part of the distribution process is by definition engaging in a public offering. Therefore, the private offering exemption requires that the stock not be subsequently introduced into the stream of commerce.

II. EARLY ADMINISTRATIVE INTERPRETATIONS

As noted above, section 4(2) exempts from the registration requirement those "transactions by an issuer not involving any public offering." The Commission first attempted to interpret this statutory language by defining the elements of a private offering in a 1935 SEC Release. Prior to 1935, administrative folklore had suggested that an offering to an insubstantial number of persons—25 or fewer—would qualify as a private placement. In its Release, the Commission took note of this view, but stated that numbers alone were not controlling, indicating that the facts of each transaction must be examined to determine whether a private placement had been effected. The Commission then listed four factors which were to be considered in characterizing a private placement. The first factor involved the number of offerees, their relationship to each other, and their relationship to the offeror. The Commission emphasized that the number of persons to whom a security was offered was significant, rather than the number of persons who ultimately purchased the security. The Commission also stated that the word "offering," for this purpose, should include preliminary negotiations. With respect to the relationship of offerees to each

22. See 1 Loss, supra note 4.
24. The release did not specifically rebut the idea that 25 was the key number, but it did imply that this was one of the things to be taken into account.
25. The Commission was obviously forced to retreat from this position when Congress amended the 1933 Act to exclude preliminary negotiations from the definition of offer. 15 U.S.C. § 77b (1970).
other, an offer to the general public rather than to a particular group or class was more likely to involve a public offering. The Commission also discussed the relationship between issuer and offeree, perhaps the most significant element in light of later developments. Persons with "special knowledge" of the issuer such as "high executive employees" were cited as examples of offerees to whom a private offering would be appropriate.

The second factor was the number of units sold. The Commission reasoned that the fewer the number of units sold, the less likely that they would pass into the hands of the general public. The third factor was the size of the offering. It was thought that the size of an offering was an indication as to whether the issue might later be distributed in a public offering by the issuer. The fourth factor was the manner of the offering. The Commission emphasized that "direct negotiations" between issuer and offeree were indicative of a private placement.

These four factors have been frequently cited by courts dealing with the private placement exemption. The definitive analysis of the exemption, however, was offered by the United States Supreme Court in SEC v. Ralston Purina Co. This case involved an offering by a company to a large group of "key" employees. The company selected as an offeree any employee who was "an individual who is eligible for promotion, . . . who is sympathetic to management . . . and who is ambitious . . ." In discussing whether the private placement exemption should be available to the company, the Court examined the purpose of the registration required by the 1933 Act. Inasmuch as the goal of the Act was to provide "full disclosure,"

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26. The courts and the SEC have continued to take this factor into account. See, e.g., Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959); Campbell v. Degenther, 97 F. Supp. 975 (W.D. Pa. 1961).
27. The Supreme Court alluded to these characteristics specifically in SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
28. But see S. Goldberg, Private Placements and Restricted Securities § 2.2 (1973) for the proposition that these two factors are not good predictors as to the validity of a private offering.
32. Id. at 122.
33. Id. at 122-23.
the Court determined that the protection of the Act was not intended to extend to persons who could "fend for themselves" without such disclosure. Thus the availability of the exemption turned upon whether the offerees had "access to the kind of information which registration would disclose." As an example of such offerees, the Court cited "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." Pointing out that the size of the offering was irrelevant as long as the knowledge requirements were met, the Court held that in this case the issuer had not met the aforementioned standard.

After Ralston Purina, federal courts considered a number of cases dealing with the private offering exemption. Most courts formally adopted the access to information test as set forth by the Supreme Court, explicitly rejecting reliance on the number of offerees as a critical factor. Other courts cited Ralston Purina, but continued to employ the four factors set forth by the Commission in 1935. Even the opinions which relied on Ralston Purina, however, interpreted different phrases from the opinion as being of critical importance. Some courts focused on the words "fend for themselves," emphasizing the investment experience of the offerees, while others emphasized the information actually made available to the offerees, while others discussed the offerees in terms of their ability to elicit relevant information from the issuer.

Notwithstanding this confusion as to the specific standard to be applied, all courts agreed that the burden was upon the

34. Id. at 125.
35. Id. at 127.
36. Id. at 125.
37. Id.
38. E.g., Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959).
42. See SEC v. Tax Service, Inc., 357 F.2d 143 (4th Cir. 1966); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959).
issuer to establish the elements of the private placement exemption.44 Because of this burden and the fact patterns present in many cases, much of the language which appears in these cases can be classified as dicta.45 Generally, however, the cases in which courts held against the issuer involved large issues, a substantial number of offerees, and offerees who had not been provided with adequate information about the issuer.46

A final necessary element in private placements, one not alluded to in Ralston Purina, was the requirement that the offerees, in addition to meeting the access to information test, purchase the securities with an appropriate investment intent. In order to dispel the specter of a distribution and to establish investment intent, certain instruments became used as a matter of convention. For example, issuers placed a legend on the stock indicating that its circulation was restricted; stop-transfer instructions were then given to transfer agents with reference to this restriction. More often, however, issuers simply obtained an investment letter from purchasers. This document, signed by the purchaser, indicated that he was purchasing the security with the sole intent of holding it for a period of time as an investment.47 As a practical matter, however, these letters were regarded as mere formalities by all parties involved.48

The decision in SEC v. Cromwell-Collier Publishing Co.49 cast doubt on the effectiveness of these devices. Cromwell involved a disciplinary action against a brokerage firm that had sold securities in a private placement, obtaining letters of investment intent. Because the securities were soon circulating in the stream of commerce, the Commission, as well as the Second Circuit, took a dim view of the issuer's reliance on investment letters.50 The effect of the Cromwell holding was to require issuers to go beyond the formalities of an investment letter in establishing substantial investment intent.

44. E.g., Repass v. Rees, 174 F. Supp. 898 (D. Colo. 1959). This is also part of the holding in Ralston Purina.
45. Comment letter to SEC from Carl Schneider and Charles Zall, 228 Sec. L. REP. F-1 (Nov. 21, 1973) [hereinafter cited as Schneider and Zall].
46. Id.
47. See S. Goldberg, supra note 28, at §§ 2.5-2.6.
48. Id. at § 2.5(d).
50. See Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959).
III. LATER INTERPRETATIONS AND USE OF THE EXEMPTION

In a 1962 SEC Release, the Commission sought to clarify the private placement concepts developed after Ralston Purina.\textsuperscript{51} It reaffirmed the approach suggested in its 1935 Release, emphasizing the facts surrounding each transaction with respect to the "nature, scope, size, type and manner of the offering."\textsuperscript{52} The Commission placed special emphasis on the offerees' access to relevant facts concerning an offering; information voluntarily submitted by the issuer was considered insufficient to meet this aspect of the knowledge requirement.\textsuperscript{53}

Despite the restrictive judicial and administrative interpretations given section 4(2), the private placement remained a viable exemption. Institutional investors, such as insurance companies, continued to purchase securities under the exemption, thus accounting for a large segment of securities sold privately.\textsuperscript{54} Institutional investors are unique, however, in that they usually meet the requirement that the private placement offeree purchase with a genuine investment intent. Whereas a private individual might be tempted to sell, the institutional investor normally has the resources required to retain the investment and therefore rarely disposes of a security acquired in a private placement. Moreover, institutional investors are sophisticated, are usually able to fend for themselves, and possess enough economic power to gain access to relevant investment information.\textsuperscript{55}

Private placement sales also continued to be made in a variety of non-institutional situations. First, private individuals were often the source of venture capital, used to get a newly organized entity on its feet, or at least to defray costs until the registration process could be completed. Normally, these financing arrangements involved smaller amounts of money than did institutional investments.\textsuperscript{56} Second, private placement financing involved sales of stock to employees, often by smaller corporations prior to going public.\textsuperscript{57} Finally, issuers attempted to

\textsuperscript{52} Id.
\textsuperscript{53} Id.
\textsuperscript{54} See Richardson, The Private Placement Method of Financing, 45 CH. B. REC. 328 (1964).
\textsuperscript{55} Id. at 331.
\textsuperscript{56} H. Bloomenthal & S. Wing, Securities Law 4-65, 4-66 (1973).
\textsuperscript{57} R. Mundheim, A. Fleischer, & J. Schupper, Fourth Annual Institute on Securities Regulation 13 (1973) [hereinafter cited as Mundheim].
use the private placement exemption for exchanges of stock in connection with corporate acquisitions, the acquiring corporation exchanging its newly issued stock for stock held by individual shareholders of the acquired corporation. 68

The case of SEC v. Continental Tobacco Co., 59 however, led some commentators to question the continued viability of the private placement exemption, even with regard to institutional investors. 60 Continental Tobacco involved the marketing of securities of a company that manufactured a new type of low tar and nicotine cigarette. The offering of the securities included presentations using high pressure sales techniques and dramatic filmstrips. The offerees were a diverse group of people, not all of whom could be characterized as sophisticated investors, selected from the general public in a casual manner. 61 On appeal from the denial of an injunction sought by the SEC, the Fifth Circuit Court of Appeals reversed and granted the injunction, stimulating fears that the private placement exemption was to be severely circumscribed. 62 In addition to discussing the Ralston Purina opinion, the court noted that the four factors which the SEC had established in 1935 as being relevant to the validity of a private placement had been relied upon in judicial opinions on a regular basis. The court concluded that, therefore, the ultimate test was whether the offerees “had a relationship with Continental giving access to the kind of information that registration would have disclosed.” 63 In particular, the court referred to a previous Fifth Circuit opinion, Hill York Corp. v. American International Franchises, Inc., where the following language was contained in a footnote:

[The exemption is available] where the number of offerees is so limited that they may constitute a class of persons having such a privileged relationship with the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection. . . . 64

58. Id. at 22.
59. 463 F.2d 137 (5th Cir. 1972).
61. One of the offerees was a dentist who in turn distributed offering brochures in his waiting room. MUNDHEIM, supra note 57, at 50.
62. Id. at 57.
63. 436 F.2d at 158 (emphasis added).
64. 448 F.2d 660, 668 n.6 (5th Cir. 1971). See Orrick, Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under the Federal Securities Act, 21 U. Pitt. L. Rev. 1, 6-10 (1959), recognizing that the knowledge requirement could be met by voluntary presentation of information to the offeree; the quoted language about position and access relates only to cases where this is not feasible.
In Continental Tobacco, the offerees had been issued a brochure about the company accompanied by the company's unaudited financial statement. However, the court held the information insufficient because there was no relationship between the offerees and the issuer that could have provided access to further information.

The court's language in Continental Tobacco may be viewed as dicta because the facts involved clearly favored the issuance of the injunction. The high pressure salesmanship together with the inadequacy of the information provided by the issuer could easily have been the basis for the finding of a public offering without reference to the need for a "special relationship" between the offerees and the issuer. What proved most disquieting to the securities bar, however, was the fact that the court's opinion appeared to rely heavily on the brief prepared by the Commission staff. The Commission's brief argued the position that the relationship of the offeree to the issuer should be essentially that of an "insider"—one who occupied a privileged status vis-a-vis the offeror. In support of this position, the Commission observed that both the offeror's attempt to provide registration type documents to the offeree and the fact that the offeree was represented by legal counsel actually weighed against the offeror because they more clearly indicated that the offeree did not possess the requisite "insider" status. If the SEC were to adhere to this "insider" standard, it would bring into question the validity of a private offering to even sophisticated institutional investors. Although enjoying the economic power to demand significant information from the issuer, such investors would not enjoy the close, day-to-day relationship with the issuer that a corporate insider would. One commentator speculated that a rigorous application of this standard would invalidate 99 percent of all private placements.

In response to the furor that Continental Tobacco evoked, SEC Commissioner Owens attempted to lessen the securities bar's anxiety over the new "insider" standard. In May of 1972 he addressed a meeting of the National Association of Securities Dealers and made the following observations:

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66. Id. at B-5.
67. Id. at B-6.
68. Id. at B-7.
69. Owens, supra note 5.
Some commentators have suggested (and I believe there is merit in their suggestions) that this language could be read to mean that a permissible private placee must have a position with the company similar to that of an insider in the 10b-5 sense. If such an interpretation were to prevail, it could lead to such a narrowing of the exemption that even an institutional investor could not qualify. This is certainly not a conclusion I can support; in fact, I do not believe it was intended by the Commission.  

Commissioner Owens then offered his interpretation of the standards to be derived from the case:

(1) the offerees must be shown to have access to material information concerning the issuer and (2) the access criteria cannot be met by merely providing, gratuitously, a promotional prospectus purporting to afford instant access and by having each offeree and purchaser sign a letter saying he has received and read such document.

Commissioner Owens suggested that a more objective or “bright line” standard be developed.

While the Commissioner's statements may have been reassuring, his position was merely that of a single member of the Commission. Therefore, practitioners retained an uncertainty as to the exact scope of the private placement exemption. As a result of the uncertainty that then distinguished this area of securities regulation, the Commission promulgated the first proposed Rule 146 in 1972.  

IV. ANALYSIS OF RULE 146

The statement accompanying the proposed Rule 146 outlined the Commission's basic goals. First, the offeree in a private placement should have access to the same kind of information that would be disclosed in a 1933 Act registration statement. Second, the offeree, or a representative acting in his behalf, should be capable of evaluating the risks of the investment and making an informed decision. As an incident of such capability, the offeree should be able to bear the economic risk of the investment. Third, the manner of the offering should be consistent with the concept of a non-public offering. Fourth, the allowable number of purchasers should be small enough to limit the issue's distribution.

70. Id. at G-2.
71. Id.
73. Id., 37 Fed. Reg. at 26138. The Commission, noting the Rule was experimental, welcomed comments relating to the Rule's effectiveness in private placements.
In what was to become a rather tortuous period of promul-
gation of the Rule, the Commission issued its first proposed Rule
in November of 1972 and invited comments from members of
the securities bar and other interested persons. The response
to this invitation was a series of letters praising the general con-
cept of an objective test, but finding fault with the specific pro-
visions of the proposal. The following year, in October, 1973,
the Commission issued a second proposed Rule reflecting
changes based on some of the criticisms of the first proposal,
but retaining the basic concepts of the first proposed Rule.
Finally, on April 23, 1974, the Commission issued Rule 146, to
become effective on June 10, 1974.

A. APPLICATION AND SCOPE OF THE RULE

During the evolution of Rule 146, its general parameters
have not been greatly modified by the Commission. The Rule
is non-exclusive; thus the private placement exemption still
exists outside of its operation. As the Rule is to operate pro-
spectively only, no placements effected prior to its promulga-
tion come under its provisions. The Rule is applicable only to
issuers; all others must register issues or seek other exemptions.
Even though it may satisfy the requirements of the Rule, how-
ever, an issuer is still subject to the civil and anti-fraud provi-
sions of the 1933 Act as well as the obligations of state law.

The proposed scope and application of the Rule did generate
substantial adverse reaction on the part of commentators. With
regard to the proposed scope of the Rule, some commentators
were concerned that the conditions of the Rule might be used
as de facto standards in the application of the section 4(2)
exemption outside of the Rule. It was therefore suggested

77. Id., Operation, 39 Fed. Reg. at 15266. See also Second Proposed
SEC Rule 146, Operation, 38 Fed. Reg. 28951, 28956 (1973); First Proposed
79. Letter from Peter Platt, Donald Slichter, Norman Zilbur, Loyd
Dinkelspiel Jr., Bruce Mann & David Nelson to Neal S. McCoy, Division
of Corporate Finance, SEC, February 7, 1973, p. 7 [hereinafter cited as
Platt, et al.]; Letter from Sullivan & Cromwell to Neal S. McCoy, Division
of Corporate Finance, SEC, January 26, 1973, p. 2 [hereinafter cited as
that the Rule contain an express statement to the effect that its conditions would not become the exclusive guide for determining the validity of an exemption under section 4(2).80

Some commentators also felt that the rule should be available to sellers other than issuers.81 Representatives of insurance interests, for example, desired that the Rule be made available to institutional investors making secondary distributions.82 Institutional investors generally invest in large amounts of debt securities, and occasionally need to sell blocks of these securities for purposes of liquidity or to meet the demands of state law. Although an outlet for such sales is provided by SEC Rule 144,83 the burdens imposed by that Rule render it an impractical alternative.84 Similarly, some observers suggested that the Rule be made available to affiliates of the issuer. This would provide an outlet to holders of securities acquired in a business combination. In support of this application of the Rule, the burdens of Rule 144 were again noted,85 and an analogy was drawn to Rule 145,86 which has been broadened to include the issuance of securities effected in reliance on section 4(2).

Despite the adverse reaction87 the Commission rejected suggestions to expand the coverage of Rule 146.88 Its position is

Robert Routier, American Life Insurance Association to Neal S. McCoy, Division of Corporate Finance, SEC, January 29, 1973, p. 2 [hereinafter cited as ALIA]. Letters on file in University of Minnesota Law Library. It is possible that previous experience with Commission practices inspired the fear that section 4(2) would be absorbed by the Rule.


Sullivan & Cromwell, supra note 79, at 4.


Id. Promulgated under the 1933 Act, this rule sets the standards for the determination of whether a seller is engaged in a securities distribution.

ALIA, supra note 79, at 6 n.1; Shearman & Sterling, supra note 80, at 2. Because of the nature of the securities purchased and the usual investment intent of institutional investors, moreover, public distributions are unlikely to occur. Sullivan & Cromwell, supra note 79, at 4.

Id. The rule extends the registration requirements of the 1933 Act to securities issued in the context of certain corporate reorganizations.

Aetna, supra note 82, at 1-2.

supportable in light of the potential and availability of Rule 144. If the conditions of Rule 144 are difficult to meet, the difficulty reflects Commission policy on the resale of restricted securities. The provisions of Rule 146 were developed to deal with the initial placement of securities; the Rule could not be expected to adequately cover the dangers of public distribution in a resale situation.

B. Specific Provisions of Rule 146

1. Conditions to be Met—146 (b)

Both the proposed and final versions of section (b) require that all the conditions of Rule 146 be met in order that it apply. Thus, each section of the Rule represents a condition of its application, and a failure to comply with any provision, regardless of how insignificant, could take a transaction out of the exemption offered by the Rule. In the development of the Rule, this basic concept changed very little.

Most commentators were critical of this concept, arguing that an insignificant error by the issuer could result in a windfall for a purchaser in a deal which had gone sour. Such an error could also interfere with the investment plans of innocent purchasers who had relied on the issuer's assurances that the transaction qualified as a private placement. One observer therefore proposed that where the failure to meet a particular condition of the Rule was an innocent and immaterial error, the exemption would be allowed. The issuer would be subject to

89. Section (a) of the Rule is devoted exclusively to the definition of terms; these definitions will be discussed in connection with the applicable substantive provisions.


91. In reference to conditions to be met, the second proposed Rule gave special emphasis to the word "all" by underlining it, but this underlining was later dropped in the Rule as issued. The second proposed Rule also added a reference to a preliminary note suggesting factors in the determination of whether a series of transactions is to be integrated for purposes of meeting the conditions of the Rule. Second Proposed SEC Rule 146, Preliminary Note no. 3, 38 Fed. Reg. 28951, 28956-57 (1973).

Under the "safe harbour" provision in the Rule as issued, all sales made within more than six months of a given transaction are not integrated with that sale for the purposes of meeting the conditions of the Rule. SEC Rule 146(b) (1), 39 Fed. Reg. 15261, 15267 (1974).

92. Schneider & Zall, supra note 45, at F-2.
some kind of sanction for failing to comply with the Rule, but the sanction would be commensurate with the magnitude of the error and would result in neither the rescission of the transaction nor the loss of the exemption. Those commentators who represented the purchaser's viewpoint suggested that purchasers be protected by a provision which would assume that the issuer had complied with all terms of the Rule. Such a provision would allow a transaction to stand with regard to purchases even where the offering was otherwise defective. In other words, the provision would effect a partial rescission.

Although the Commission rejected these suggestions, certain changes that were made during the development of the Rule served to mitigate the harshness of the section. One example of such a change is the introduction of the "safe harbour" provision in the final version of the Rule. Another example is the reference to "integration" in defining the scope of an offering; this concept serves to establish some boundaries for application of the Rule. Moreover, qualifying phrases have been inserted throughout the Rule to allow some leeway in interpreting its various requirements; frequent reference is also made to "reasonableness" in defining the Rule's standard of compliance. Thus, the use of such phrases and the ambiguity of the conditions themselves suggest that in practice the defense of an innocent and immaterial error may be available to the issuer. However, the Commission has not explicitly declared whether or not such a defense will be recognized.

93. Id.
94. ALIA, supra note 79, at 3; Aetna, supra note 82, at 2-3.
95. The commentators suggested another solution for innocent purchasers through the application of a type of integration concept whereby defective transactions would be distinguished. Letter from O'Melveny & Myers to Neal S. McCoy, Division of Corporate Finance, SEC, January 26, 1973, p. 5 [hereinafter cited as O'Melveny & Myers]; Letter from Cravath, Swaine & Moore to Neal S. McCoy, Division of Corporate Finance, SEC, January 29, 1973, p. 3 [hereinafter cited as Cravath, et al.]. Letters on file in University of Minnesota Law Library; ALIA, supra note 79, at 3; Shearman & Sterling, supra note 80, at 10; Platt, et al., supra note 79, at 6.
97. Id., § (d), 39 Fed. Reg. at 15267. See also id., Synopsis of the Provisions, Rule 146(d), 39 Fed. Reg. at 15263-64. For example, section (d), stating the standards for offeree qualification and requiring the issuer to make a reasonable inquiry as to this qualification, contains a provision allowing the issuer to save the transaction by rescission where he later discovers that the offeree was not qualified.
2. Limitation on the Manner of Offering—146 (c)

Section (c) deals with one of the key concepts of the Rule—the non-public manner in which offers and sales are to be consummated. Throughout the development of Rule 146, from the two proposed Rules to the Rule as finally issued, the essence of this requirement has remained intact.\textsuperscript{99} Notwithstanding its retention, however, the limitation on the manner of offering did not go uncriticized, especially its apparent requirement of face to face bargaining and its prohibition of seminar and promotional meetings.

a. Face to Face Bargaining

The first proposed Rule required that securities be sold in the context of a "negotiated transaction."\textsuperscript{100} A negotiated transaction was defined as one in which there was direct communication between the issuer, or any person acting in his behalf, and the purchaser or his investment representative.\textsuperscript{101} Many observers were disturbed by the use of the term "negotiated transaction" and by its implications; the requirement of actual negotiation would preclude take-it-or-leave-it deals in which the issuer merely stated its terms rather than negotiating them with the offeree. They thought it unreasonable to assume that an issuer could not offer securities without having previously established its terms; as a practical matter, sales are often made on this basis.\textsuperscript{102} The requirement that there be direct communication was also a source of concern because many deals are made in which a single lead purchaser, usually one of the larger institutional investors, actually conducts the negotiation with the issuer as to the terms of the offering. Although other investors later join in the transaction, they discuss neither the terms of the deal nor anything else with the issuer. Thus, the requirements of negotiation and direct communication would clearly interfere with well established practices.\textsuperscript{103} Moreover, many in-

\textsuperscript{99} Id. § (c), 39 Fed. Reg. at 15267; Second Proposed SEC Rule 146(c), 38 Fed. Reg. 28951, 28957 (1973); First Proposed SEC Rule 146(c), 37 Fed. Reg. 26137, 26140 (1972).
\textsuperscript{100} First Proposed Rule 146(c), 37 Fed. Reg. 26137, 26140 (1972).
\textsuperscript{101} Id., § (a) (3), 37 Fed. Reg. at 26140.
\textsuperscript{103} Sullivan & Cromwell, supra note 79, at 8.
\textsuperscript{104} Cravath, et al., supra note 95, at 1-2.
stitutional investors thought that they were sophisticated enough to decide for themselves just exactly how much communication or negotiation was necessary.\textsuperscript{105}

In response to these criticisms, the Commission substituted the term "direct communication" for that of "negotiated transaction" in the second proposed Rule. This change essentially required that the offeree or his representative have the opportunity to elicit information about the issuer and to ask questions of the issuer, or any person acting on his behalf, concerning the terms of the transaction.\textsuperscript{106} In the Rule as issued, the term "direct communication" has been dropped altogether. However, the notion that the offeree should be given the opportunity to solicit information from the issuer has been shifted to section (e), which deals with the kind of information that the issuer must provide to the offeree.\textsuperscript{107} Since this notion calls only for the opportunity to communicate with the issuer,\textsuperscript{108} it presumably does not make communication mandatory. Moreover, the deletion of the "negotiated transaction" language apparently obviates concern over take-it-or-leave-it deals.

b. Mass Advertising

In the first proposed Rule, the use of mass media, seminar and promotional meetings, letters, or circulars was prohibited unless such activity was a part of a "negotiated transaction."\textsuperscript{109} Commentators reacted adversely to this prohibition.\textsuperscript{110} It was thought that the prohibition of seminar meetings would discourage sophisticated investors from discussing a possible sale of securities among themselves. It was also pointed out that seminar meetings would allow the issuer to sound out potential offerees as to their ability to meet the suitability requirements of the

\textsuperscript{105} ALIA, supra note 79, at 4. As the mechanics of closing a transaction are often handled by counsel, some commentators thought that this provision could require the purchaser or representative to be actually present at the closing. Letter from Gibson, Dunn & Crutcher, to Neal S. McCoy, Division of Corporate Finance, SEC, January 17, 1973, p. 17 [hereinafter cited as Gibson, et al.]. Letter on file in University of Minnesota Law Library.


\textsuperscript{108} Id., 39 Fed. Reg. at 15267.

\textsuperscript{109} First Proposed SEC Rule 146(c), 37 Fed. Reg. 26137, 26140 (1972).

\textsuperscript{110} Aetna, supra note 82, at 5; Sullivan & Cromwell, supra note 79, at 9; Platt, et al., supra note 79, at 3-4; Shearman & Sterling, supra note 80, at 7.
Rule. Such meetings could be used, in turn, as a forum for offerees to ask questions in order to fulfill their need for information about the issuer. In general, it was thought that seminar meetings performed valuable functions, other than the actual negotiation of a sale, which might possibly be prohibited by this proposed condition.

The critics also argued that written communications designed to determine the suitability of a potential offeree were foreclosed by the language of the section. They suggested that the area of written communications be generally clarified because, conceivably, it would be impossible for the issuer to determine if a person was a suitable offeree without inadvertently violating the terms of the Rule. Finally, critics noted that the section could be interpreted to exclude the presence of a purchaser's attorney or family friend who possessed considerable investment expertise but who did not meet all the requirements of qualification as a representative of the offeree.

Although both the second proposed Rule and the Rule as issued contain proscriptions of general advertising as in the first proposed Rule, they permit written communications and meetings which are directed to offerees and their representatives who meet the standards of section (d), those who are considered to be sufficiently sophisticated and knowledgeable. The Rule as issued adds the requirement that written communications be for the purpose of providing information about the issuer in compliance with the terms of section (e). These changes give the issuer greater latitude in selecting the form of communication with offerees, but do not lessen the requirement that the offerees or their representatives be "suitable" before these devices may be employed. Therefore, the problem of determining such suitability without the use of these devices remains.

Thus, the Commission has apparently abandoned its effort to assure intimacy between the issuer and offerees by requiring "negotiated transactions," but it has retained strict controls on the use of promotional devices. That the Commission con-

tinues to limit seminar meetings to qualified offerees is probably an attempt to prevent promotional meetings such as those in Continental Tobacco, where diverse groups of unsophisticated investors were subjected to high pressure sales pitches.\textsuperscript{117}

3. Nature of the Offerees—\textit{146 (d)}

Section (d) of Rule 146 requires that the issuer have reasonable grounds to believe that the offeree or his representative has sufficient knowledge and experience in business affairs to evaluate the risks of the investment and make an informed investment decision. Where an offeree is advised by a representative, moreover, the issuer must have reasonable ground to believe that the offeree is able to bear the economic risk of the investment.\textsuperscript{118}

Throughout the evolution of the Rule, critical comments were made with regard to the three basic elements of the section: the qualifications of the offeree, the qualifications of his representative, and the offeree’s ability to bear the economic risk of the investment. The Commission made changes which partially acknowledged these criticisms, but retained the substantive requirements of the section.

a. The Qualifications of the Offeree

Commentators pointed out that this section should apply to purchasers rather than offerees.\textsuperscript{119} The emphasis on offerees was considered inconsistent with the test specified in section (e), which limits to 35 the number of purchasers under the Rule.\textsuperscript{120} Not only was this emphasis a mere holdover from the traditional view that there should be a numerical limit on the number of offerees,\textsuperscript{121} but it could make the validity of an exemption turn upon the question of the suitability of an offeree who eventually failed to purchase any stock.\textsuperscript{122} Were the emphasis on purchasers, an issuer could “save” an exemption by not selling to

\textsuperscript{117} SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).
\textsuperscript{118} SEC Rule 146(d) (1) (ii), 39 Fed. Reg. 15261, 15267.
\textsuperscript{119} Letter from Louis Loss to Neal S. McCoy, Division of Corporate Finance, SEC, January 12, 1973 [hereinafter cited as Loss]. Letter on file in University of Minnesota Law Library; Sullivan & Cromwell, supra note 79, at 9-10; Cravath, et al., supra note 95, at 2; Dewey, et al., supra note 79, at 3; O’Melveny & Myers, supra note 95, at 4; Shearman & Sterling, supra note 80, at 7-8.
\textsuperscript{120} Loss, supra note 119; Cravath, et al., supra note 95, at 2.
\textsuperscript{121} Loss, supra note 119.
\textsuperscript{122} Id.; O’Melveny & Meyers, supra note 95, at 4.
an offeree who proved to be unsuitable.\textsuperscript{123} The critics also noted several practical considerations which supported an emphasis upon purchasers. First, in many cases the less serious offerees would be reluctant to supply the issuer with the information necessary to ascertain their sophistication.\textsuperscript{124} Second, investment advisors often select purchasers from among their clients only after a deal has been made.\textsuperscript{125} In effect, the argument was that the issuer ought to be accorded a degree of flexibility in making offers, given the rather broad statutory definition of the term “offer” and the practical difficulty in separating the process of determining the qualifications of the offerees from that of discussing the terms of the transaction.\textsuperscript{126} Third, were the term “purchaser” the touchstone, indiscriminate public offerings would continue to be prohibited by the other provisions of the Rule relating to the manner of the offering and the limitations on disposition.\textsuperscript{127}

As a final practical consideration, the critics thought that the standards for determining the degree of offeree sophistication were too vague\textsuperscript{128} and therefore urged the Commission to delineate the factors to be considered in making this decision.\textsuperscript{129} Representatives of the insurance industry suggested that certain categories of offerees, such as institutional investors, automatically qualify.\textsuperscript{130} It was also suggested that the issuer be allowed to rely on written representations by the offerees that they possessed the necessary investment expertise.\textsuperscript{131} In addition to eliminating the offeree emphasis, the somewhat technical criticism was offered that the phrase “issuer and any person acting in his behalf” be changed to read “issuer or any person acting in his behalf.” This change to the disjunctive presumably would allow the issuer to delegate the investigation of offerees to an agent so the issuer would not be responsible for having direct knowledge of each offeree.\textsuperscript{132}

\begin{itemize}
\item \textsuperscript{123} Cravath, \textit{et al.}, supra note 95, at 2; Loss, \textit{supra} note 119.
\item \textsuperscript{124} Shearman & Sterling, \textit{supra} note 80, at 7-8.
\item \textsuperscript{125} \textit{Id}. This is similar to the problems seen in the requirement of direct communication as it affects lead purchasers. \textit{See} note 103 \textit{supra} and accompanying text.
\item \textsuperscript{126} Sullivan & Cromwell, \textit{supra} note 79, at 9.
\item \textsuperscript{127} Loss, \textit{supra} note 119.
\item \textsuperscript{128} Cravath, \textit{et al.}, \textit{supra} note 95, at 2; ALIA, \textit{supra} note 79, at 4.
\item \textsuperscript{129} Merrill Lynch, \textit{et al.}, \textit{supra} note 102, at 2.
\item \textsuperscript{130} ALIA, \textit{supra} note 79, at 4.
\item \textsuperscript{131} Platt, \textit{et al.}, \textit{supra} note 79, at 4. Some observers suggested that purchasers should be able to rely upon the issuer’s representations that all other purchasers and offerees met this requirement. Dewey, \textit{et al.}, \textit{supra} note 79, at 4.
\item \textsuperscript{132} Cravath, \textit{et al.}, \textit{supra} note 95, at 2.
\end{itemize}
In the second proposed Rule and in the Rule as issued, the substance of the suitability of the offeree requirement has remained unaltered. The second proposed Rule did add a clause which allowed an issuer to save the exemption by withdrawing the offer to a person who was shown by inquiry subsequent to the offer to be an unsuitable offeree. In the synopsis accompanying the proposed Rule, the Commission noted that it remained necessary for the issuer to demonstrate that it had made a reasonable inquiry prior to making the offer, thus emphasizing that the Rule continued to apply to offerees and not purchasers.

In the Rule as issued, the structure of the section was changed for the avowed purpose of making the sequence of events clearer: the issuer must inquire as to qualifications of the offeree—that is, the offeree's business sophistication and ability to bear the economic risk—immediately prior to the offer and prior to the sale. The saving clause that had been included in the second proposed Rule was omitted because the new structure of the section implies that an issuer can save the exemption by rescinding either after an offer or a sale, provided reasonable inquiry is made before each. Although the language of the Rule as issued does not explicitly allow issuer rescission to save the exemption, the Commission's comments should comfort those critics who feared that the exemption would be destroyed by offers to persons who turned out to be unqualified. Thus, the Rule retains the requirement that reasonable inquiry be made; however, one may infer that if the issuer makes a good faith attempt to comply with the section, the exemption for an entire offering will not be jeopardized by a few defective transactions, provided rescission is accomplished with regard to such transactions. At least with respect to this section, the result of the Commission's interpretation comes close to the partial rescission as to defective transactions proposed by some commentators with respect to the Rule as a whole. Moreover, this interpretation to some extent meets the criticism

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138. See note 95 supra.
that the section should apply to purchasers rather than offeres.\textsuperscript{139}

b. The Qualification of the Offeree's Representative

The second basic element of section (d) of the Rule relates to the qualifications of the offeree's representative. In the first proposed Rule, if the offeree alone could not meet the section's sophistication requirements, an offer could still be made if the offeree was represented by an "investment representative."\textsuperscript{140} An "investment representative" was defined in section (a) as one who had knowledge and experience in business affairs, was authorized to act as agent for the purchaser, and was independent of the issuer.\textsuperscript{141}

This investment advisor concept was severely criticized. First, the critics noted a disparity between section (d), which contained the basic terms governing the suitability of the offeree and his representative, and section (a), which contained the definition of investment representative. Section (d) stated that the issuer need have only \textit{reasonable grounds} to believe the representative met the required qualifications, whereas section (a) stated these qualifications in absolute terms. The critics feared that the exemption might be lost where the investment representative did not satisfy the conditions of section (a), even though the issuer had reasonable grounds to believe that the representative was qualified. They therefore suggested that section (a) be changed to define an investment representative as one who the issuer had reasonable grounds to believe met certain requirements.\textsuperscript{142}

Second, the critics thought the Rule should not require that the investment representative be one who acted as agent for the purchaser in completing the transaction. They suggested that the investment representative be allowed to play only an

\textsuperscript{139} Since the Rule states that the issuer must make an inquiry as to either the sophistication or the risk-bearing capacity of the offeree before making an offer, it cuts down the amount of inquiry which must be made before an offer. Therefore, the heaviest burden falls on the issuer in making inquiry as to purchasers. The Rule still applies to the issuer and its agent, and none of the other suggestions as to reliance on written statements by issuer or offeree were adopted. No categories of offeres could automatically qualify, and the Commission has not defined the standards to be used by the issuer in defining business sophistication. SEC Rule 146(d), 39 Fed. Reg. 15261, 15267 (1974).

\textsuperscript{140} First Proposed SEC Rule 146(d) (1), 37 Fed. Reg. 26137, 26140 (1972).

\textsuperscript{141} Id., 37 Fed. Reg. at 26140.

\textsuperscript{142} Shearman & Sterling, \textit{supra} note 80, at 8; O'Melveny & Myers, \textit{supra} note 95, at 2.
advisory role, with the offeree making the final decision whether to purchase. Once the investment representative had revealed the risks of the investment and generally given the offeree the benefit of his expertise, the purpose of the representation was fulfilled.143 Third, the critics suggested that specific types of persons, such as lawyers, accountants, stockbrokers and investment bankers, be automatically qualified to act as investment representatives. If different types of representatives could work together, moreover, different persons could give advice within the particular area of their expertise.144 With joint representation, the liability as well as the responsibility could be divided, thus encouraging qualified specialists, who otherwise would be wary of taking full responsibility for the transaction,145 to contribute their expertise.

Finally, the commentators impugned the requirement that the investment representative be "independent" of the issuer as too vague and restrictive; they suggested that the required degree of independence be spelled out in greater detail and in more familiar terms, such as "affiliate."146 They argued that, as a practical matter, investment advisors and brokers frequently have ties with the issuer, both in private placement transactions and in transactions involving registered securities.147 An investment representative who has an on-going relationship with the issuer may be able to do a more competent job in representing the offeree than one who is involved on a one shot basis. Furthermore, some offerees are reluctant to enter a transaction if they are the ones who must provide the representative's fee. Rather than be required to maintain complete independence, therefore, the investment representative should be required to disclose the extent of any relationship he has with the issuer.148

143. Aetna, supra note 82, at 3; Sullivan & Cromwell, supra note 79, at 7.
144. Schneider & Zall, supra note 45, at F-3.
145. Id. The extent of the investment representative's liability was considered ambiguous. Given the amount of discretion granted them by the Rule, there was some fear of a strict accountability for the economic success of the investment.
146. Shearman & Sterling, supra note 80, at 3-4; Platt, et al., supra note 79, at 2.
147. Sullivan & Cromwell, supra note 79, at 8; Dewey, et al., supra note 79, at 2; Shearman & Sterling, supra note 80, at 3; O'Melveny & Myers, supra note 95, at 3.
For example, counsel for the purchasers in some private placements are chosen by the issuer, who also pays the fees. Investment bankers arranging a deal for an issuer would probably be reluctant to turn a potential offeree over to a competitor acting as counsel.
148. Shearman & Sterling, supra note 80, at 3-4.
The Commission attempted to meet some of these criticisms in the second proposed Rule. To indicate more clearly the role of the representative vis-a-vis the offeree, the Commission changed the term "investment representative" to "offeree representative." To define with greater specificity the role of the representative vis-a-vis the issuer, the Commission stated that the offeree representative could not be an "affiliate, associate, or employee" of the issuer, unless the offeree was a member of the representative's immediate family or a relative living in his home or a trust or corporation in which he owned 100 percent of the beneficial interest.

In an apparent retreat from the requirement that the representative act as an actual agent in the sale itself, the Commission required only that before each purchase the offeree acknowledge the representative as an agent for the purposes of evaluating the risks of the transaction. As a final change, the Commission required the representative to disclose in writing to the offeree any existing or contemplated relationship with the issuer as well as any previous relationship with the issuer within the prior two years.

Rule 146 as finally issued has gone even further in responding to the suggestions of the critics. The offeree representative is now defined as one who has knowledge and experience in business affairs and who was capable of evaluating the risks of the investment, but no qualifying "reason to believe" phrase was added in the definitional section. In an apparent retreat from the requirement that the representative act as an actual agent in the sale itself, the Commission required only that before each purchase the offeree acknowledge the representative as an agent for the purposes of evaluating the risks of the transaction. As a final change, the Commission required the representative to disclose in writing to the offeree any existing or contemplated relationship with the issuer as well as any previous relationship with the issuer within the prior two years.

It is now clear that there may be more than one offeree representative and that each may supply specialized expertise, since the Rule requires that the representative have "such knowledge and experience in financial and business matters that he, either alone, or together with other offeree representatives or the offeree, is capable of evaluating the merits and risks of the prospective investment." This provision indicates, moreover, that the offeree need not alone provide the expertise, but may qualify in conjunction with the rep-
representative. In regard to the liability of the representative, the Rule simply adds in a note following the section that offeree representatives should be aware of the liabilities imposed on broker-dealers under the Securities Exchange Act of 1934 and the Investment Advisors Act of 1940. In regard to his relationship with the issuer, the Rule states that the offeree representative may 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 . . . ," unless the offeree is a relative no further removed than first cousin, or a trust or corporation in which the representative owns all of the beneficial or equitable interest. This provision differs from the second proposed Rule in that the term "associate" is dropped and is replaced by the reference to officer or director and the ownership of 10 percent of the issuer's equity stock. In addition, where the offeree representative occupies insider status, the Rule no longer requires that the relative live in the same home as the offeree representative if the relative is a first cousin or closer.

Under the Rule as issued, the offeree representative must disclose to the offeree any material relationship with the issuer which exists, is contemplated, or has existed within the previous two years. A material relationship is defined as one which a reasonable investor would consider significant. Notwithstanding this disclosure, however, the Commission cautions that the offeree representative is not relieved of the duty to act in the interests of the offeree. As in the second proposed Rule, the offeree representative must be acknowledged prior to each transaction as the representative of the offeree for purposes of evaluating the risks of the investment.

In the evolution of section (d) the most significant changes have occurred in its second basic element—the qualifications of the offeree representative—especially with respect to his relationship with the issuer. The first proposed Rule required simply that the offeree representative be independent of the issuer.

158. Id., § (a) (1) (i), 39 Fed. Reg. at 15266.
162. Note 2 following the section points out that this requirement expressly disallows blanket acknowledgements. Id., § (a) (1) (Note 2), 39 Fed. Reg. at 15267.
The second proposed Rule stated which relationships were disallowed and required disclosure of others. The Rule as issued adopts the basic language of the second proposed Rule with certain refinements, such as the emphasis upon disclosure of “material” relationships. Perhaps these changes reflect the Commission’s acknowledgement that fees of the offeree representative may be paid by the issuer; however, the Commission has not addressed itself to this issue although it has had the opportunity to do so. Moreover, despite the note which makes reference to statutes governing broker-dealer and investment advisor liability, the Commission has done little to clarify the extent of the offeree representative’s liability to the offeree. And, although it is now clear that a single offeree representative need not alone meet the business expertise requirement, the issuer is still not given specific guidelines as to how the offeree representative may meet the sophistication requirement of the rule. The Commission has evidently rejected the suggestions that certain categories of persons automatically qualify for this role.

c. Offeree’s Ability to Bear Economic Risk

The final basic element of section (d) is the requirement that the offeree be able to bear the economic risk of the investment. In the first proposed Rule the issuer was required to ascertain whether the offeree could bear the risk of the investment.\(^{163}\) In the second proposed Rule and in the Rule as issued this economic risk test has been made applicable only to offerees who require the services of an offeree representative.\(^{164}\)

The retention of this test in any form has been the subject of adverse comment. Most critics have seen this requirement as a departure from existing law, foreign to the disclosure philosophy of the 1933 Act, and beyond the rule-making authority of the Commission.\(^{165}\) They have pointed out that the traditional goal of federal security regulation has been the disclosure of relevant information about the issue to potential investors, leaving the decision of whether to invest with the purchaser.\(^{166}\) As the requirement can be viewed as creating a presumption in favor of wealthy investors, the less well-heeled investors may


\(^{165.}\) Sullivan & Cromwell, supra note 79, at 10, Cravath, et al., supra note 95, at 2; Platt, et al., supra note 79, at 4-5.

\(^{166.}\) Platt, et al., supra note 79, at 4.
be prevented from taking advantage of private placement opportunities. It was also initially feared that the requirement would specifically prohibit the original founders or promoters of a venture from taking part in the initial offering. However, the limitation to offerees who require the services of an offeree representative to meet the sophistication requirement should obviate this concern since promoters will usually be able to meet the requirement of business knowledge and experience.

In response to the first proposed Rule, commentators complained of the lack of standards to ascertain whether an offeree could bear the economic risk. To rectify this omission, in its synopsis of the second proposed Rule and the Rule as issued, the Commission deemed as important the considerations "whether the offeree could afford to hold unregistered securities for an indefinite period, and whether, at the time of the investment, he could afford a complete loss." Nonetheless, many commentators urged still more objective standards, such as the net worth of the investor or the investor's gross income for tax purposes. They also considered as relevant whether the securities were acquired for cash or other liquid assets or whether other property was exchanged. Presumably, investors suffer a more immediate economic setback from a loss of liquid assets. The final and overall problem posited with regard to the economic risk element of section (d) was that it is subject to a "hindsight" evaluation. The judgment of the issuer is likely to be evaluated only after the investment has gone sour, when the economic condition of the investors inevitably looks less optimistic than when the

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167. Id.
168. The commentators have also mentioned some practical problems with regard to ascertaining the ability of offerees to bear the economic risk. Offerees may not be willing to disclose the kind of information necessary to make an informed judgement on this point. Sullivan & Cromwell, supra note 79, at 10. Trustees may be unwilling and perhaps prohibited from disclosing this kind of information about a trust estate. At any rate, in the case of a trust it is argued that the beneficiaries of the trust actually bear the risk, not the trust itself, and that this rule does not call for information about them personally. Shearman & Sterling, supra note 80, at 9.
169. Sullivan & Cromwell, supra note 79, at 10; Cravath, et al., supra note 95, at 2; Dewey, et al., supra note 79, at 4; Shearman & Sterling, supra note 80, at 8-9.
172. Shearman & Sterling, supra note 80, at 8-9.
transaction was originally entered into.\textsuperscript{173}

\textbf{d. Section (d) in Perspective}

Overall, the Commission has retained the basic requirements of section (d) throughout the evolution of Rule 146. These requirements are intended to further the goals of protecting the issuer by assuring the exercise of business sophistication, either the issuer's own or its representative's, and by insulating inexperienced investors from economic disaster.

The section's emphasis on business knowledge and experience is analogous to the standard set forth in \textit{Ralston Purina}, where the Court determined that offerees should be able to "fend for themselves"\textsuperscript{174}; this emphasis is therefore consistent with prevalent judicial opinion and clearly should be an essential part of any rule designed to implement the private placement exemption. The requirement that the offeree be able to bear the economic risk is probably inconsistent with the objectives of the 1933 Act as originally conceived; however, it is not entirely unprecedented in federal securities regulation generally. The Investment Advisors Act of 1940 provides that persons who rely on the advice of an investment advisor registered pursuant to the Act be able to bear the economic risk of their investment.\textsuperscript{175} The rules of the NASD also require that broker-dealers be cognizant of their clients' capabilities to bear the economic risks of their investments.\textsuperscript{176} And finally, the requirement is analogous to the fiduciary obligation of trustees not to make improvident investments on behalf of their clients.\textsuperscript{177} In sum, the provisions of section (d) work toward the same goal, that of keeping inexperienced, small investors out of the private placement market. Given that the protection secured by registration under the 1933 Act is not available in such a market, this seems an appropriate objective.

\textbf{4. Access to or Furnishing of Information—146 (e)}

Section (e) of Rule 146 deals with the kind of information that must be made available to the offeree or his representative.

\textsuperscript{173} Platt, et al., \textit{supra} note 79, at 5; Shearman & Sterling, \textit{supra} note 80, at 9.
\textsuperscript{176} See NASD Rules.
\textsuperscript{177} See \textit{note 175 supra}.
The conditions of this section are satisfied where the offeree or his representative has "access" to the relevant information called for, or where the issuer provides such information. The section has generated several points of controversy: who must receive the information, where must the information be supplied, what constitutes access, and what kind of information is required.

a. Who Must Receive the Information

The first proposed Rule stated that during the process of negotiation the offeree or his representative must either have the same kind of information, to the extent that it is available, that a 1933 Act registration statement would make available or that he at least must have access to such information. In either case the offeree or his representative should have access to sufficient additional data about the issuer to verify the accuracy of that already in his possession. Critics of this requirement contended that its provisions should apply only to actual purchasers, not to offerees who have rejected offers or offerees from whom offers have been withdrawn. It was thought that "casual" investors might use the occasion of an offer to pry unnecessarily into the affairs of the issuer without possessing any serious intention of investing in the issue.

In response to this criticism, the Commission added a note in the second proposed Rule declaring that information need not be supplied to an offeree who indicates during the course of the transaction that he is no longer interested in purchasing stock. The Rule as issued retains this note and creates the additional qualification that further information need not be provided to any offeree or offeree representative to whom the issuer or any person acting in his behalf has decided not to sell securities, except in cases where the undertaking was based on written materials submitted to the offeree or his representative pursuant to section (c)(3). These provisions should obviate fears that information will be demanded frivolously. However,
the Commission has remained firm in the requirement that section (e) applies to offerees and not just purchasers.

b. When the Information Must be Supplied

The qualifying phrase in the first proposed Rule that information should be provided "to the extent that it is available" drew immediate comment. In the second proposed Rule and the Rule as issued this phrase was partially clarified by the substitution of the requirement that information be provided if it can be generated without "unreasonable effort or expense." Although the requirement has been somewhat clarified, the question of what represents unreasonable expense or effort remains.

c. What Constitutes Access

The statement in the first proposed Rule that the information requirement could be satisfied by those offerees or representatives who had "access" to the relevant information stirred some commentary. The existing law concerning what constituted access was unclear, and this provision seemed only to compound the confusion. Some commentators noted that if access meant offerees could come in and examine corporate books and records at will, issuers could justifiably rebel. It was suggested, for example, that the Rule make it clear that the right to monitor the issuer's operation was limited to the physical inspection of premises and the right to ask questions. Representatives of insurance companies complained at having to comply formally with any aspect of this section; because of their economic leverage they could obtain whatever information they desired at their convenience.

The second proposed Rule added a note which required that the access to information spring from economic bargaining

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184. Aetna, supra note 82, at 4; Sullivan & Cromwell, supra note 79, at 11; O'Melveny & Myers, supra note 95, at 5.
186. Moreover, the critics asked how "access" was to be proved. Letter from Real Estate Securities and Syndication Institute of the National Association of Real Estate Boards to Neal S. McCoy, Division of Corporate Finance, SEC, January 31, 1974, pp. 1-2 [hereinafter cited as Real Estate Board]. Letter on file in University of Minnesota Law Library.
188. Id.
189. Aetna, supra note 82, at 5.
power or an employment relationship with the issuer.\textsuperscript{190} The Rule as issued contains a similar note, adding "family relationship" as a means of gaining access.\textsuperscript{191} The inclusion of this note raises the additional question of how much economic bargaining power is necessary. Institutional investors such as insurance companies will probably satisfy the standard; however, it can be asserted that given the appropriate financial and economic circumstances even a modest investor will be in a commanding position vis-a-vis the issuer.

d. What Kind of Information is Required

As noted above, the first proposed Rule intended that the information be made available which would appear in a 1933 Act registration statement.\textsuperscript{192} The commentators thought that a requirement of all the technical information normally found in a registration statement required by the 1933 Act was unduly burdensome and that compliance with this section would entail the same effort and expense as actual registration.\textsuperscript{193} Therefore one commentator suggested that the requirement be defined in terms of information material to making an investment decision.\textsuperscript{194} Others suggested that an issuer who registered under the Securities Exchange Act of 1934, with the concomitant duty to file the necessary reports, should automatically qualify.\textsuperscript{195}

In the second proposed Rule the Commission altered its approach and required the information normally contemplated by Schedule A of the 1933 Act.\textsuperscript{196} Where the offeree or his representative did not have access to this information and the issuer thus was compelled to supply it, the Commission delineated more specific standards. If the issuer was registered under the 1934 Act, it could submit an annual 10-K report along with other documents required by that Act, a brief description of the secu-

\textsuperscript{190} Second Proposed SEC Rule 146(e) (1) (i) (Note), 38 Fed. Reg. 28951, 28957 (1973).

\textsuperscript{191} SEC Rule 146(e) (Note), 39 Fed. Reg. 15261, 15267 (1974). Moreover, in the Rule as issued the note has been placed at the beginning of the section, perhaps indicating an added emphasis.

\textsuperscript{192} First Proposed SEC Rule 146(e) (1), 37 Fed. Reg. 26137, 26140 (1972).

\textsuperscript{193} Gibson, et al., supra note 105, at 10-11.

\textsuperscript{194} Id. See also Real Estate Board, supra note 186, at 2.

\textsuperscript{195} Cravath, et al., supra note 79, at 2; Platt, et al., supra note 79, at 5.

rities being offered, a statement as to the intended use of the proceeds from the offering, and a recital of any adverse changes in its affairs not reflected in reported documents. If the issuer was not registered pursuant to the 1934 Act, it could submit Schedule A information. If audited financial statements were not available, the issuer could use Schedule A financial statements. If the issuer would be required to submit S-2 statements were it to register securities under the 1933 Act, such statements could also be used, even though unaudited. As with the first proposed Rule, observers found these information requirements too demanding. The Schedule A requirements were inappropriate because they called for more detailed information than was necessary. The observers suggested instead that the section require “substantially” the same information required by Schedule A, thereby allowing the issuer to omit nonessential data.

The basic requirement of the Rule as issued is that the offeree or his representative have access to or be provided with Schedule A type information, with the structure of the Rule having been changed to reflect this either/or nature of the requirement. Again, where the information requirement is to be satisfied by the issuer’s production of information for the offeree, the Commission has provided more detailed standards. If the issuer registers under the 1934 Act, the following information should be provided:

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

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198. Schneider & Zall, supra note 45, at F-4.


200. Id., § (e) (1) (a), 39 Fed. Reg. at 15267. There must also be provided the various material information mentioned in the proposed Rules.
If the issuer is not registered under the 1934 Act, essentially the same requirements are retained as were present in the second proposed Rule.\footnote{201} The Rule as issued also specifies that exhibits, normally filed as part of the registration process of the 1933 or 1934 Act, need not actually be distributed to offerees if the exhibits are available to them on request.\footnote{202}

An added feature of the Rule as promulgated is that the issuer must allow the offeree or his representative “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 . . .”\footnote{203} This language is considered a substitute for the term “direct communication” which was deleted from section (c) governing the manner of the offering.\footnote{204} The issuer must also divulge to the offeree whether it or any of its affiliates has any relationship with the offeree representative, past, present or future, and whether it has received any compensation as a result of such relationship.\footnote{205}

e. Section (e) in Perspective

The overall effect of section (e) as it has developed and been finally issued is to provide a significant departure from the traditional information requirements under existing law, at least as seen by the court in Continental Tobacco. The holding in that case implied that the information requirement could be met only by an offeree who enjoyed access to relevant information by virtue of insider status.\footnote{206} The rule, on the other hand, suggests that information can be provided to offerees who do not otherwise have access to it, but by defining access in terms of insider status or economic bargaining power, the Commission may have used the access concept in a more restricted sense than would many courts outside the Fifth Circuit.

In terms of the kinds of information which may be provided under the Rule, the Commission has for the most part provided express standards, but the Rule is still subject to the criticism that the cost of providing such information is prohibitive and may exclude small issuers from a Rule 146 private placement. With respect to the expense of providing information, the Rule

\footnotesize{
\begin{itemize}
\item \footnote{201} Id., 39 Fed. Reg. at 15267.
\item \footnote{202} Id., § (e) (1) (c), 39 Fed. Reg. at 15288.
\item \footnote{203} Id., § (e) (2), 39 Fed. Reg. at 15268.
\item \footnote{204} Id., Synopsis of the Provisions, Rule 146(c), 39 Fed. Reg. at 15263.
\item \footnote{205} Id., § (e) (3), 39 Fed. Reg. at 15268.
\item \footnote{206} SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).
\end{itemize}
}
still does not state with any clarity what is meant by "unreasonable expense" nor what alternatives are available should it be determined that the production of Schedule A type information is unreasonably expensive.

5. Business Combinations—146 (f)

In response to criticism that the first proposed Rule did not apply to business combinations, section (f) was added in the second proposed Rule. In this section, substantially retained in the Rule as issued, the Commission attempted to provide for situations where the offeree representative is an officer or director of an acquired company. Such a person can be an offeree representative for stockholders of the acquired company if certain disclosures are made and if he possesses the requisite expertise. Stockholders may choose their own offeree representative, and it then becomes the responsibility of either the issuer or the acquired corporation to pay the reasonable costs of the representation. Except for these specific provisions the same requirements apply to offers made in the business acquisition context as apply generally.

Solicitations made to stockholders of the acquired corporation for the purpose of offering to act as their offeree representative are not considered offers within the broader meaning of the Rule, provided certain conditions are met. The officer or director is generally required to make disclosures as to the nature of the transaction and his interest therein. This disclosure requirement highlights the purpose of the section, which is to see that the corporate offeree representative does not take advantage of his position to induce stockholders to enter a transaction contrary to their best interests. Although the disclosure requirement parallels that of section (d), relating to the nature of the offeree, section (e) does not contain any provision akin to the economic ability to bear the risk test of section (d).

Following the publication of the second proposed Rule, commentators drew the Commission's attention to two basic problem areas. First, under this section it is possible for a single dissi-
dent stockholder to frustrate the transaction by refusing to "sophisticate" himself through the voluntary selection of an offeree representative, since the decision remains with the unsophisticated offeree whether to qualify for the exemption by utilizing the services of such a representative. Even where the unsophisticated offeree chooses not to qualify, however, the acquisition can take place if the securities are registered, but registration is time consuming, costly, and perhaps disadvantageous from a tax standpoint. Ironically, after a registration, the acquisition can proceed even though a dissident shareholder is no more informed about the deal than he was before—the 1933 Act does not require offerees to understand the prospectus submitted to them. Moreover, state corporation law generally recognizes that a dissenting shareholder has dissent and appraisal rights in "fundamental" or "organic" corporate actions such as acquisitions. Such rights should provide the dissatisfied shareholder with an adequate avenue for legitimate expression of his dissent.

The second basic problem with the application of section (f) is that the management of the acquired company may not meet the sophistication requirements of an offeree representative. Arguing that there should be a limit upon the paternalism of federal securities law, Carl Schneider urged that where shareholders have sufficient faith in the management of their corporation, even though it is not financially sophisticated, they should be able to rely upon the judgment of that management. Schneider noted that the Commission's position regarding the sophistication requirement's fulfillment by alternative means might be self-defeating. To bring in an outside representative for all the shareholders might prove costly and time consuming since a representative must acquaint himself with the situation; to avoid the sophistication problem entirely by completing a registration might be fruitless since those who receive the information by definition cannot understand it. Schneider therefore recommended that the sophistication requirement be waived with regard to the management of the acquired corporation in

213. Schneider, et al., supra note 92, at F-6.
214. Id., at F-5.
its role of offeree representative.\textsuperscript{216}

In the Rule as issued, the Commission appears to have been unmoved by these two basic criticisms.\textsuperscript{216} It is still possible for a single dissenting shareholder to defeat a merger by refusing to accept the services of an offeree representative in order to meet the sophistication requirements of the Rule. In the commentary accompanying the Rule, the Commission conceded that the protections offered to the dissident shareholder by state corporation laws may be adequate, but stood firm in its view that the requirements of federal securities law were paramount, even where these requirements would serve to defeat merger or reorganization attempts.\textsuperscript{217} Moreover, the Commission made no special provision for the qualification of the acquired corporation's management as an offeree representative in terms of meeting the business sophistication standard.

Although these two basic problem areas remain unsolved, the Rule as issued does reflect several changes. First, the definition of "business combination" is lifted directly from Rule 145, thereby excluding the "exchange offers" which had been included in the second proposed Rule's definition of "business combination."\textsuperscript{218} The reason given for this change is that exchange offers are voluntary transfers which do not require all the protections provided by this section.\textsuperscript{219} Second, the issuer need no longer obtain an agreement from the offerees that the securities issued will not be resold without a registration or other exemption under the Act. Although such agreements are generally required under section (h),\textsuperscript{220} the Commission sees the requirement as too burdensome in this context.\textsuperscript{221} The Rule makes it clear, however, that the stock is still restricted in the absence of such agreements, and the other restrictions imposed by section (h), designed to inhibit further distribution of the stock, are still in effect.\textsuperscript{222} Finally, the second proposed Rule contained a statement that solicitations to stockholders for purposes

\textsuperscript{215} Id., at F-6.
\textsuperscript{220} Id., §§ (f) (2), (h) (4), 39 Fed. Reg. at 15268.
\textsuperscript{221} Id., Synopsis of the Provisions, Rule 146(f), 39 Fed. Reg. at 15264.
\textsuperscript{222} Id., § (f) (2) (Note), 39 Fed. Reg. at 15268. Inasmuch as such agreements are generally regarded as mere formalities, this change is likely of little significance.
of becoming their offeree representative under this section would not be considered "offers" within the Rule. The Commission has decided that this is implicit in the Rule as issued and therefore has omitted the specific statement to that effect.\textsuperscript{223}

As a final comment upon section (f), perhaps the Commission would have been well-advised to heed the advice of its critics. Because the application of Rule 146 to business combinations may be frustrated by recalcitrant unsophisticated shareholders, the utility of this section is sharply limited. A look at the realities of the corporate merger process tends to suggest that the Commission is misguided in its balancing of considerations.

6. \textit{Limitation on the Number of Purchasers—146 (g)}

Section (g) involves the limit on the number of purchasers who may purchase securities under the Rule. In the development of this section, the main areas of controversy have been the scope of the limitation on the number of purchasers and the definition of a "person" for purposes of compliance with the limitation.

\begin{itemize}
\item \textbf{a. The Number of Purchasers}

The first proposed Rule stated that under the Rule no more than 35 persons could purchase securities from an issuer during a consecutive 12-month period.\textsuperscript{224} This represented a significant departure from existing law as well as from other provisions of the Rule in that emphasis was shifted from offerees to purchasers. Nonetheless, the purchaser orientation was retained in the second proposed Rule and in the Rule as issued.\textsuperscript{225}

Many critics of the first proposed Rule considered as inappropriate the method of computing the 12-month period for measuring the number of purchasers. In the interest of certainty on the part of the purchaser, they thought that the 12-month period should be measured up to the time of sale to the particular purchaser so that the purchaser could investigate to determine how many sales had previously taken place. With a "roll-

\textsuperscript{223} Id., Synopsis of the Provisions, Rule 146(f), 39 Fed. Reg. at 15264.
In any event, it was suggested that the purchaser be able to rely on the written representation of the issuer that it would sell to only 35 persons. Other critics rejected the 12-month period in toto, suggesting instead an integration approach. Under this approach, sales which are related in some manner would be applied to such offerings regardless of the time period involved. The sales related to the financing of a particular project undertaken by the issuer, for example, could be considered a single offering in which no more than 35 purchasers could take part. In support of their integration approach, the critics pointed out that a rolling 12-month period could lead to a continuous offering in which sales were carefully spaced to include no more than 35 purchasers in any given year but which actually related to the same purpose. Finally, some critics suggested that the numerical limitation ought to be calculated separately for each class of security. Since the quality of an offering often depends on its classification—for example, a debt offering involves different risks and expectations than those in a common stock offering—the limitation should be counted separately. As a practical matter, moreover, corporations frequently issue different classes of securities for different projects.

The second proposed Rule retained the limit of 35 purchasers within any 12-month period, but the Commission adopted the suggestion that 35 purchasers be allowed for each separate class of stock issued. The proposal also made the limitation applicable to sales made outside the Rule pursuant to the general private placement exemption of section 4(2) of the 1933 Act. As a result, observers immediately cited this extension as an

228. Cravath, et al., supra note 95, at 3; Dewey, et al., supra note 79, at 8; Gibson, et al., supra note 105, at 9; O'Melveny & Myers, supra note 95, at 5; Shearman & Sterling, supra note 80, at 11.
229. Another basis suggested for an offering distinction was that of whether the sales involved cash or non-cash transactions. Non-cash offerings are likely to be issued to promoters or shareholders in an acquisition; cash offerings are likely to be used for different reasons, involving a different class of purchasers. Platt, et al., supra note 79, at 5-6.
230. Shearman & Sterling, supra note 80, at 11.
231. Sullivan & Cromwell, supra note 79, at 14; ALIA, supra note 79, at 8; Dewey, et al., supra note 79, at 8.
233. Id.
infringement upon the application of the existing private placement exemption and therefore as a violation of the notion that the Rule was to be non-exclusive. They thought the issuer should be protected from the arbitrariness of the limitation because, despite any precautions, a hidden 36th purchaser could emerge to destroy the exemption.

In the Rule as issued, there may be no more than 35 persons purchasing securities per any “offering” made pursuant to the Rule—a rejection of the 12-month rolling period in favor of the integration concept suggested by so many critics. Although nowhere in the Rule itself is the term “offering” defined, Preliminary Note 3 suggests some factors relevant to the number of sales considered as part of the same offering. These factors are:

(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.

Section (b) (1) provides the aforementioned “safe harbour” provision regarding sales made prior to or later than six months of any particular sale within the Rule. This “safe harbour,” along with the integration concept, should help allay fears that a remote 36th purchaser will materialize to destroy the exemption. Moreover, since the Rule as issued states the 35-person limit in terms of purchases made in an offering under the Rule, it would appear to exclude sales to purchasers in an offering pursuant to the section 4(2) exemption, unlike the previous proposed Rules.

b. The Definition of Person

In the development of Rule 146, a source of continuing controversy has been the question of what persons are to be counted in determining compliance with the 35-person limitation. Section (a) of the first proposed Rule defined “person,” for the purposes of section (g), to exclude from separate enumeration rela-

235. Schneider & Zall, supra note 45, at f-7 to -8.
236. For example, options and warrants issued in the previous 12-month period could be exercised at a time which would kill the exemption. Id.
238. Id., § (g) (1) (Note), 39 Fed. Reg. at 15268.
tives of a purchaser who lived in the same household and trusts, corporations or other associations in which the purchaser held 100 percent of the beneficial interest.\textsuperscript{242} In contrast, business associations formed for the express purpose of acquiring securities offered under this exemption were not to be counted as a single person; rather, the individual members of such associations were to be counted separately for purposes of determining the 35-purchaser figure.\textsuperscript{243}

Commentary abounded. Many critics thought the Commission was too strict in excluding from enumeration only those trusts and corporations wholly owned by a person purchasing under the Rule. They suggested the section be liberalized to exclude from separate enumeration any corporation or trust where the purchaser was a majority owner or primary beneficiary.\textsuperscript{244} It was argued that the majority owner or primary beneficiary would be the one to make controlling decisions, or at least would be the primary risk bearer, and thus should be treated as one with the institution.\textsuperscript{245} Observers also suggested that family members who live in separate households be counted as a single person for purposes of the section.\textsuperscript{246} Many trusts in a position to invest have as beneficiaries extended families, the members of which do not live under the same roof; the exemption would be quickly exhausted in a purchase by a trust representing a large family.\textsuperscript{247}

Some critics argued for single-person treatment in cases where an investment decision is made by an investment advisor or trustee who has sole discretion to purchase for a number of different investors.\textsuperscript{248} They pointed out that this argument represented a position taken by the Commission in at least one no-action letter and hence could be considered as part of the common law interpretation of the section 4(2) exemption.\textsuperscript{249} This approach would allow account managers for insurance com-

\textsuperscript{242} First Proposed SEC Rule 146(a) (1) (i) (a), 37 Fed. Reg. 26137, 26140 (1972).
\textsuperscript{243} Id., $ (a) (1) (i) (b), 37 Fed. Reg. at 26140. Purchasers for cash of more than $250,000 of securities were completely excepted. Id., (f), 37 Fed. Reg. at 26141.
\textsuperscript{244} Aetna, supra note 82, at 4.
\textsuperscript{245} Shearman & Sterling, supra note 80, at 1-2.
\textsuperscript{246} Id. at 2.
\textsuperscript{247} Id.
\textsuperscript{248} Aetna, supra note 82, at 4-5; Gibson, et al., supra note 105, at 14.
\textsuperscript{249} Sullivan & Cromwell, supra note 79, at 6-7, citing Letter from Baldwin Bane, Director of Division of Corporate Finance, SEC to Bankers Trust Co., March 5, 1946.
panies and managers of trust accounts to participate in an offering without quickly dissipating the exemption.\textsuperscript{250} Absent this approach, investment advisors would be put in the position of having to choose among clients to determine who would be allowed to participate in a particular issue.\textsuperscript{251} If only one person actually made the decision, it was considered appropriate that it be counted as a sale to one person.

Although the first proposed Rule exempted cash purchases of greater than $250,000, that threshold was considered by many to be too high.\textsuperscript{252} The Commission apparently selected this figure because it represented a typical purchase by an institutional investor,\textsuperscript{253} but some commentators felt that it should be lowered to $100,000.\textsuperscript{254} Moreover, as securities are frequently sold in "roll over" transactions which involve an exchange of outstanding securities for a new issue, commentators saw little reason to limit this exception to cash transactions. Exchanges of other property for securities are also commonly effected, particularly in the context of corporate acquisitions. It was thus thought that purchasers should be able to aggregate their purchases within a 12-month period until they reached the $250,000 level. Quite often a firm commitment is made to purchase this amount with different "takedowns" or actual sales over a period of time. For example, in the financing of construction projects, sales often take place as the work progresses.\textsuperscript{255}

In the second proposed Rule, most of the basic reforms suggested by the commentators were rejected; however, some changes were made. The definition of "person" was incorporated in this section instead of being placed in the definitional section, section (a).\textsuperscript{256} However, this change of location reflected no concomitant change in substance. The second proposed Rule did spell out with greater specificity the types of organizations that could be considered single persons for purposes of the Rule, provided, of course, that they were not formed

\textsuperscript{250} Shearman & Sterling, supra note 80, at 1-2; ALIA: supra note 79, at 7.
\textsuperscript{251} Shearman & Sterling, supra note 80, at 1-2.
\textsuperscript{252} Aetna, supra note 82, at 3; Cravath, et al., supra note 95, at 3-4.
\textsuperscript{253} O'Melveny & Myers, supra note 95, at 5.
\textsuperscript{254} Aetna, supra note 82, at 3; Sullivan & Cromwell, supra note 79, at 14; Gibson, et al., supra note 105, at 5.
\textsuperscript{255} Sullivan & Cromwell, supra note 79, at 15; Cravath, et al., supra note 95, at 4; Dewey, et al., supra note 79, at 6; Gibson, et al., supra note 105, at 5.
for the specific purpose of investing in the securities offered: namely, any "corporation, partnership, association, joint stock company, trust or unincorporated organization or other entity that is organized for the specific purpose of acquiring the securities offered." It also excluded from enumeration "any person who purchases or agrees in writing to purchase for cash securities of the issuer in aggregate amount of $150,000 or more, either in a single payment or in installments . . . ." Thus, the suggestions regarding the lowering of the threshold amount for this exception and the views as to the aggregation of a series of "take down" purchases were heeded, but the Rule retained the requirement that the purchases be made in cash. Similarly, the proposal added specific categories of persons who were excepted from enumeration. Among them were directors or officers of the issuer; a 100 percent subsidiary of the issuer and a 100 percent parent of the issuer; a bank which lends money evidenced by a debt security; 35 or fewer persons within a 12-month period who purchase pursuant to a stock option plan; and 35 or fewer persons who purchase within a 12-month period pursuant to a business combination. All these persons were otherwise required to meet the conditions of the Rule.

Finally, the Commission added a note which stated that "[o]ffers or sales to any person, including an investment advisor with or without discretionary authority, acting on behalf of other persons shall be deemed to be offers and sales to such persons." Thus, the Commission expressly rejected the suggestions that discretionary investment advisors be treated as a single purchaser for purposes of the section. With respect to the reference to "offers" in this note, one critic declared it to be inappropriate inasmuch as the section was concerned only with purchasers. It was suggested, moreover, that if an exception was going to be made for banks that make loans evidenced by debt issues, the exception should be extended to other financial institutions that invest in debt securities.

The Rule as issued retains basically these same exemptions and exclusions. However, because of the adoption of the integration concept, the Commission felt justified in dispensing with the series of special exemptions made available in the second

257. Id., § (g) (3) (i), 38 Fed. Reg. at 28958.
258. Id., § (g) (3) (ii) (a), 38 Fed. Reg. at 28959.
259. Id., § (g) (3) (ii), 38 Fed. Reg. at 28959.
260. Id., § (g) (3) (i) (Note), 38 Fed. Reg. at 28959.
261. Schneider & Zall, supra note 45, at F-8.
262. Id.
proposed Rule: directors and officers, bank lenders, subsidiaries and parent companies, employee plans and business combinations.\textsuperscript{264} In Preliminary Note 5, which is referred to in the section, the Commission again states that customers of investment advisors, brokers and bank trust advisors (specifically mentioned for the first time in this context) are to be considered offerees and purchasers regardless of the amount of their investment discretion.\textsuperscript{265} Thus, once again the Commission stands firm on this issue.\textsuperscript{266}

c. Section (g) in Perspective

The evolution of section (g) indicates that the Commission is consistently firm in its basic purpose of placing a limit on the number of purchasers under the Rule. The decision to define this limitation in terms of the number of purchasers rather than offerees benefits the issuer because it relieves it of the difficult task of deciding when an offer has been made for purposes of meeting a limitation on the number of offerees. The limitation on the number of persons who may become involved in a private placement has its origins in existing law, where the widely accepted rule of thumb is that offers can be made to 25 or fewer persons. Although the section 4(2) exemption does not seem to involve a rigid insistence on the exact number as the Rule does, the Rule is more liberal in that the emphasis is on purchasers rather than offerees and that the number allowed is 35 rather than 25.

The decision to substitute the integration concept for the rolling 12-month period is probably a sound one. However, there remains the problem of determining what particular sales may be grouped under the same offering; the relative certainty derived from using the 12-month period of the proposed Rule is sacrificed to the rationality of the integration approach. Finally, the rejection of the notion that an investment advisor should be able to purchase for a number of people and still count as one person is probably correct in light of the possibilities of employing this device as a sham for a widespread distribution.

\textsuperscript{264} Id., Synopsis of the Provisions, Rule 146(g), 39 Fed. Reg. at 15265.
\textsuperscript{265} Id., Preliminary Note no. 5, 39 Fed. Reg. at 15266.
\textsuperscript{266} By placing the observation in a preliminary note, the commission also skirts the criticism that a reference to "offerees" is inappropriate in a section dealing with purchasers.
7. Limitation on Distribution—146 (h)

Section (h) of the proposed Rules and the Rule as finally issued requires basically that the issuer make reasonable inquiry and take reasonable care to assure that purchasers are not "underwriters" and that the securities sold do not undergo further distribution.\textsuperscript{267} The steps taken by the issuer should include, but are not limited to: making inquiries to determine for whose account the securities are being purchased, legending stock certificates, issuing stop-transfer instructions to transfer agents, and obtaining letters from purchasers indicating their investment intent. The Commission has made few changes in this section throughout the development of the Rule,\textsuperscript{268} but the structure of the section has been rearranged slightly and, in the Rule as issued, a reference to section 2(11) of the 1933 Act has been added in order to define the term "underwriter."\textsuperscript{269}

Section (h) has remained fundamentally unchanged in spite of several critical comments. Because in some states it is illegal for insurance companies to agree not to sell securities,\textsuperscript{270} it was suggested that a special exemption for insurance companies be included in the provision. It was also suggested that debt securities be exempted, as they are not often resold and frequently are subject to retirement by the issuer.\textsuperscript{271} Some critics thought there should be more specific guidelines as to what represented a reasonable inquiry on the part of the issuer.\textsuperscript{272} Others wondered whether further measures, not articulated in the Rule, would be required to prevent distribution.\textsuperscript{273} Finally, one commentator observed that this was one section where written assurances of compliance with its conditions should be effective, thus allowing issuer and purchaser alike to rely on the exemption.\textsuperscript{274}

The steps specified in section (h) reflect common practices


\textsuperscript{269} Id., § (h), 39 Fed. Reg. at 15268. The Commission has also noted that the requirement as to letters of investment intent is inapplicable in the business combination context but that securities sold in such a transaction are nevertheless restricted. Id., § (h) (4) (Note), 39 Fed. Reg. at 15268.

\textsuperscript{270} Dewey, et al., supra note 79, at 9; ALIA, supra note 79, at 6.

\textsuperscript{271} Dewey, et al., supra note 79, at 9-10.

\textsuperscript{272} Sullivan & Cromwell, supra note 79, at 15.

\textsuperscript{273} Schneider & Zall, supra note 45, at F-8; Sullivan & Cromwell, supra note 79, at 15.

\textsuperscript{274} Cravath, et al., supra note 95, at 4.
required in the section 4(2) exemption under existing law.\textsuperscript{275} That the Rule requires a greater, yet unspecified, effort on the part of the issuer perhaps indicates that the Commission feels such measures are too often viewed as mere formalities and disregarded outside the Rule. Thus section (h) requires, but does not expressly define, reasonable care, establishing a kind of good faith requirement on the part of the issuer.

8. \textit{Reporting Requirement}

The first and second proposed Rules contained a section which established certain reporting requirements as a condition of compliance with the Rule.\textsuperscript{276} In the Rule as issued, the Commission dropped the reporting requirement section altogether, although it did reserve the right to amend the Rule in the future to include such a provision.\textsuperscript{277} The kinds of information required by the proposed Rules included the identity of the issuer, the securities sold, the identity of all purchasers (including persons satisfying the section (f) requirement), and the names of offeree representatives and other persons acting on behalf of the issuer.\textsuperscript{278}

While the proposed Rules were in circulation, the reporting requirement generated untold animadversion, questioning the very authority of the Commission to require such information.\textsuperscript{279} Not only was the requirement viewed as irrelevant and unnecessary,\textsuperscript{280} but it seemed to defeat a basic purpose of the private placement exemption—the avoidance of the burdensome registration requirements of the 1933 Act. Were the reporting requirement a condition of compliance with the Rule, a violation of a purely administrative mandate would cause the issuer to lose the exemption even though it was otherwise in compliance.\textsuperscript{281} On the practical side, moreover, many investors would object to having information about them registered for public scrutiny; providing for such scrutiny would tend to dis-

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\textsuperscript{279} Schneider & Zall, supra note 45, at F-9.
\textsuperscript{280} Platt, et al., supra note 79, at 6.
\textsuperscript{281} Cravath, et al., supra note 95, at 4-5.
\end{flushleft}
Thus, given the conditions already imposed on the issuer by the Rule, the Commission acted responsibly in rejecting this potentially troublesome condition.

V. CONCLUSION

In promulgating SEC Rule 146, the Commission is attempting to provide objective guidelines for the sale of securities under section 4(2) of the 1933 Act. The need for more objective guidelines has been generated by the confusion resulting from the administrative and judicial opinions which have attempted to define the parameters of the private placement exemption. This uncertainty may be attributed in part to the difficulty in giving substance to the terse abstraction of section 4(2). However, the language in court opinions is frequently overly broad. With respect to cases which hold against finding the exemption, Carl Schneider has made the following observation:

[V]irtually every case holding the exemption unavailable involved a massive public offering without regard to the sophistication or risk bearing capabilities of the offerees and/or fraud and/or a total failure of the issuer to carry the burden of proof that the offering was made in the proper manner.283

Rule 146 has been declared non-exclusive so that, at least theoretically, compliance with the Rule is an alternative to attempting to meet whatever standards are discerned to exist under section 4(2)’s general provisions. There is some concern, however, that the Commission and the courts may tend to apply standards set forth in the Rule to the exemption outside of the Rule as well. On the other hand, there is the danger that in attempting to comply with the terms of the Rule, the issuer might prevent itself from taking advantage of the exemption outside of the Rule. For example, under the Rule an offeree may have access to information only as provided by the issuer, while in the Fifth Circuit, the only way an offeree may have access to information is by virtue of insider status.284 In this situation, the issuer would have to decide whether to attempt to comply with the Rule or with the exemption under existing law. Hopefully the Commission will issue a release which clarifies the terms of the exemption under existing law so that issuers can choose intelligently among complying with the Rule, utilizing existing law, or registering its stock.

282. Schneider & Zall, supra note 45, at F-9.
283. Id. at F-10.