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THE PRIVATE OFFERING EXEMPTION UNDER THE FEDERAL SECURITIES ACT—A STUDY IN ADMINISTRATIVE AND JUDICIAL CONTRACTION

by

Julian M. Meer*

THE Federal Securities Act of 1933, as amended, has been law for some thirty-two years. A whole generation of corporate attorneys has been educated and licensed and has reached mature middle age since the act became law; and it would be a true “old timer” who could remember what it was like to formulate a syndication of securities without the act’s requirements being the centerpiece of his timetable and agenda.

For all of the act’s accumulation of history and acceptance, the problems of application and interpretation have increased rather than decreased as the years have passed. Designed to cure many of the excesses of promotional activity and manipulation which culminated in the 1929 stock market crash, the act has seen the annual dollar volume of registered securities grow from $4.8 billion during the Commission’s fiscal year ended June 30, 1936, to $19.4 billion during the fiscal year ended June 30, 1965. The total value of stocks listed on exchanges has increased from $74.7 billion as of December 31, 1936, to $506.8 billion at December 30, 1964.

The investment banking industry, after bitterly fighting the passage of the act, readily adapted to its provisions. The traditional pattern of securities underwritings was soon modified to minimize the additional risks occasioned by the civil liability provisions of the act, and insofar as the act applies to the normal firm-commitment underwriting method of public securities distribution, compliance with the act has become a routine part of corporate legal practice. Many of the now-established procedural techniques have developed through

* Attorney at Law, Dallas, Texas; B.B.A., LL.B., University of Texas; LL.M., Southern Methodist University; formerly Supervising Attorney, Securities and Exchange Commission.

1 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1964) (hereinafter cited either as the “Securities Act” or the “1933 Act”).


4 Id. at 167.

5 National Ass’n of Sec. Dealers, Inc., 19 S.E.C. 424, 431-36 (1945). For discussions of changes in investment banking procedures which followed the adoption of the act, see 1 Loss, Securities Regulation 159-78 (2d ed. 1961).
an interplay of ingenuity between the corporate bar of the larger financial centers and the staff of the Securities and Exchange Commission. The drafters of the original act contemplated a registration statement consisting of detailed answers to an elaborate questionnaire, which would be summarized into a compact readable prospectus delivered to each prospective securities purchaser prior to purchase. Certain issuers developed the technique of answering the registration form items by cross-references to the prospectus, and in 1945 with the adoption of the first “form S-1,” the Commission codified this practice. The heart of the registration statement on form S-1 is the prospectus which includes, in addition to the textual description of the issuer, its history, business, management, use of proceeds and description of the securities being registered; a balance sheet; at least a five-year statement of earnings; supplementary profit and loss information; footnotes to the financial statements; and a description of the underwriting and distributing arrangements.

The need for numerous copies to facilitate the examination process and the development of the “red-herring” or preliminary prospectus, now virtually mandatory, has resulted in costs of registration including printing and legal and accounting fees of at least $25,000 for even a small issue of securities. Meanwhile, the regulation A exemption procedure (which permits the sale under its requirements by an issuer of up $300,000 of securities in a twelve-months period) has evolved from a simple letter of notification procedure to substantially a complete registration process with costs approximating that of full registration. That procedure has for the most part become too cumbersome and expensive for small financings in an enterprise’s early years.

As a result, the economic need for reliance on the private-offering exemption by small and moderate sized business concerns has increased rather than diminished through the years. Nevertheless, due to an increasingly large body of court and administrative law, re-
liance upon the exemption has become ever more risky. Much of the administrative-law aspects depend upon the attitudes of those members of the SEC staff who are responsible for issuing interpretive opinions and conducting Commission proceedings, both administrative and judicial. The scope of the exemption is then a combination of the practical and the theoretical. The determination of whether the lawyer has in fact correctly advised his client as to the exemption's availability (or whether the client has correctly availed himself of the exemption without benefit of attorney's advice—all too frequently the case) may depend upon whether the availability is ever challenged, and, if so, in what forum.

The heart of the securities act is section 5 which makes it unlawful to use the mails or interstate commerce to offer securities for sale unless a registration statement has been filed and to consummate any sales unless the registration statement has become effective, and which requires that all written offers be made by means of, or be accompanied or preceded by, a prospectus which meets the appropriate requirements. The prospectus requirement of the securities act has become increasingly important and is the requirement most frequently overlooked by the client who would like to register his securities once and for all. Almost every corporate lawyer has received from a client the suggestion: "While we're at it, why don't we register all of my stock, so I'll be free to sell it as and when I want."

In truth, however, the effectiveness of a prospectus is a fleeting thing—perhaps good for as little as ninety days or less, of doubtful validity after nine months, and certainly past history after the lapse of sixteen months from the date of the audited financial statements in the prospectus. Also, under section 6(a) of the act, a registra-

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11 "[E]ven today, after more than thirty years, there is a kind of continuous tug of war between Commission and bar as to whether new, borderline situations belong on one side or the other of the all-important boundary." Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340, 1348 (1966). Graham L. Sterling stated in a panel discussion before the Corporation, Banking and Business Law Section of the American Bar Association at the 1959 annual meeting, "Without stopping to trace the developments in the administrative and judicial interpretation of the exemption, I think I can safely state there is still such an exemption, even though it is but a shadow of its former self," Sterling, Possible Solution To Problems in the Private Placement of Convertible Securities and Warrants Under the Federal Securities Act, 15 Bus. Law 145, 147 (1959).

12 1933 Act § 5.

13 With respect to certain deferred offerings, the SEC has required an undertaking to file a post-effective amendment prior to any public offering commenced more than ninety days after the effective date of the registration statement. Practicing Law Institute, S.E.C. Problems of Controlling Stockholders and in Underwritings (1962) 203-12 (hereinafter cited as "P.L.I. Controlling Stockholders"). See also statement by W. McNeil Kennedy in Symposium on Current Problems of Securities Underwriters and Dealers, 18 Bus. Law 27, 71 (1962).

14 Section 10(a)(1) provides that a prospectus used more than nine months after the effective date must contain information not over sixteen months old. Rule 427 requires that
tion statement is deemed effective only as to securities specified therein “as proposed to be offered.” The Commission normally will not permit a “shelf registration” of securities for which there is no present intention to offer. The registration statement has thus evolved into the fulfillment of the requirements for a particular transaction or series of transactions rather than for the registration of the security itself. However, difficulties arise because only the issuer can register its securities. There is no way that a securities owner, who does not contractually provide in advance for the issuer to prepare and file a registration statement upon assurances of reimbursement of the costs, can require the registration of the securities. Thus, the right that a purchaser of securities in a non-registered offering has subsequently to resell the securities within the next two or three years will depend in large part upon the arrangements he makes with the seller at the time he acquires his securities. This will be discussed below under the “investment-letter” practice.

This article will discuss primarily the legal problems of an issuer who sells securities in reliance on the non-public offering exemption. To a lesser extent it will consider the legal status of the owner of non-registered securities originally acquired from an issuer or a controlling person in reliance upon the non-public offering exemption who later wants to sell. References will be made to the more important published judicial and administrative decisions and to law review and other papers on the section 4(1) and 4(2) exemptions.

I. STATUTORY PROVISIONS RELEVANT TO PRIVATE-OFFERING EXEMPTIONS

A. Definitions

Section 5 of the Securities Act, considered out of context, appears to cover under regulatory provisions all offers and sales of securities which involve use of the mails or instruments of transportation or communication in interstate commerce. Section 4, however, exempts transactions by everyone other than an issuer, underwriter, or dealer;
dealer transactions except those within forty to ninety days after a public offering of the security; and day-to-day brokerage transactions. Any discussion of the section 4 exemptions must, therefore, start with the statutory definitions of the terms "issuer," "underwriter," and "dealer." Section 2 (4) defines the term "issuer" to mean "every person who issues or proposes to issue any security." Not particularly profound for a general definition, the section is more specific with respect to less ordinary types of securities such as equipment trust certificates, fractional mineral interests and others not here material. The definition of the word "dealer" to mean "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person" conforms with the usual understanding of the term in the securities business.

The definition of the term "underwriter," however, makes that term a word of art under the act. The definition is fundamental in considering what transactions are exempt from the registration and prospectus requirements of the act pursuant to section 4. The term is defined in section 2 (11) of the act as follows:

The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. . . . As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

B. The Exemptions

Section 4, insofar as is relevant to the scope of this paper, provides as follows: "Sec. 4. The provisions of Section 5 shall not apply to—(1) transactions by any person other than an issuer, underwriter or dealer. (2) transactions by an issuer not involving any public offering. . . ." The exemption in clause (1) is the basis on which general

19 A dealer, whether or not he participated in the distribution, must deliver a prospectus for such period of time with respect to any securities sold under a registration statement; ninety days if the issuer has not previously had an effective registration statement, and forty days if it has.

20 1933 Act §§ 2 (4), 2 (11), 2 (12).

21 1933 Act § 2 (12).

22 That someone could be an underwriter without any contractual relationship with the seller and without receiving any of the proceeds or other compensation was early determined in SEC v. Chinese Consol. Benevolent Ass'n, Inc., 120 F.2d 738 (2d Cir. 1941).
open-market trading is exempt from registration under the act and
governs the status under the act of subsequent transactions by persons
who have purchased securities from an issuer in a transaction which
purports to be exempt under clause (2). This, as we shall see, relates
back to the definition of the term “underwriter” above, and gives rise
to the problem related to the concept of holding for investment pur-
poses discussed below. The term “distribution” in the definition of
“underwriter” in section 2(11) is in practice considered substantially
synonymous with the term “public offering” in section 4(2). The
definition also governs the rights of persons who are deemed to be
in control of the issuer to sell securities of the issuer without regis-
tration.46

II. POSSIBLE CHALLENGES TO RELIANCE UPON EXEMPTION

Section 12(1) provides:

[Any person who] ... offers or sells a security in violation of section
5 ... shall be liable to the person purchasing such security from him,
who may sue either at law or in equity in any court of competent
jurisdiction, to recover the consideration paid for such security with
interest thereon, less the amount of any income received thereon, upon
the tender of such security, or for damages if he no longer owns the
security.”47

Section 24 provides: “Any person who willfully violates any of the
provisions of this subchapter ... shall upon conviction be fined not
more than $5,000 or imprisoned not more than five years, or both.”48

The determination of whether a seller may rely upon the private
offering exemption in any given sale of securities is initially one for the
seller and its counsel. There is no statutory procedure whereby the
SEC may give a ruling which will afford absolute protection to the
seller from either civil or criminal liability for a sale without regis-
tration. The risk on the seller is increased by the well-established prin-
ciple that the burden of proving an exemption from the registration
provisions of the act is on the party claiming the benefit of such

46 H.R. REP. No. 1838, 73d Cong., 2d Sess. (1934); 1 Loss, op. cit. supra note 5, at
511; Orrick, Some Interpretative Problems Respecting the Registration Requirements Under
47 For a comprehensive discussion of the problems of controlling stockholders and persons
who have purchased securities under investment restrictions, see Flanagan, supra note 17;
P.L.I., CONTROLLING STOCKHOLDERS. Good discussions of the rights of controlling stock-
holders to dispose of securities are presented in Sommer, Who's "In Control"?—S.E.C., 21
Bus. Law 559, 583-86 (1966); Frank, Sale of Securities by "Controlling Persons" Under
the Federal Securities Act, 14 Harv. L. Rev. 137 (1962). See also Comment, 78 Harv.
L. Rev. 1535-50 (1965).
48 1933 Act § 12(1).
49 1933 Act § 24.
exemption. However, the Commission has from its earliest history made available both in its regional offices and in its central office in Washington interpretive advice on the application of the act to specific fact situations. With respect to most exemptions, including the section 4 exemptions, upon presentation of a written request for an opinion setting forth applicable facts and analysis by counsel for the seller, counsel for the Division of Corporation Finance will transmit a so-called ‘no-action’ letter stating that the staff would not recommend that the Commission take any action if the prospective seller proceeds accordingly with the sale. Such letter customarily concludes with the caveat that it is not binding on the Commission or upon the courts but is merely an expression of opinion of Commission’s counsel. The no-action letter is, however, as a practical matter, reasonable assurance that the SEC will not institute proceedings for an injunction under section 20(b) of the act or make a criminal reference to the Department of Justice. Such opinion is also practical protection against future adverse action by the Commission in the event that the seller for a subsequent transaction files a registration statement or reports under one of the acts administered by the Commission.

The question of whether the exemption was properly relied upon may subsequently be raised in either informal or formal administrative action by the SEC or the following possible litigation: an injunctive suit by the Commission to prevent future unregistered sales in violation of the act; a civil suit by a purchaser who becomes disenchanted with his purchase (usually by reason of disappointment in the economic results); or a criminal action under section 24 of the act. In general, it can be stated that, no criminal proceeding will be brought for failure to register, absent a showing of fraud or flagrant disregard of the act. Likewise, the Commission is not apt to institute injunctive proceedings unless there has been an offering of substantial size or one involving a substantial number of offerees.

If the issuer files a registration statement under the act within three years after a transaction has been effected without registration, the prior transaction will be reviewed by the staff. In fact, generally-applicable registration forms under the act include a question requiring the registrant (1) to furnish information as to all securities sold by the registrant within the past three years which were not

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registered under the act; (2) to indicate the section of the act or rule of the Commission under which exemption from registration was claimed; and (3) to state briefly the facts relied upon to make the exemption available.\textsuperscript{29} If the registrant has had transactions of substantial scope in reliance upon the private-offering exemption, the disclosure of the transactions in the registration statement and prospectus poses a dilemma. If the staff of the Commission does not agree that the exemption was applicable, it will require that a contingent liability for possible claims under section 12(1) be recognized in the financial statements in the prospectus. There have been several stop-order opinions in part based upon the failure to show such contingent liability.\textsuperscript{30} However, in such cases there were other very material misrepresentations or omissions of material facts, and it cannot be determined that a stop-order would be issued merely because of failure to register prior transactions.

A similar requirement for the justification of prior sales without registration is provided in the form of notification under regulation A. As mentioned earlier, this is a somewhat abbreviated form of registration to permit the sale of up to $300,000 of securities by an issuer in any one year or a sale by a controlling stockholder not to exceed $100,000 in any one year provided that not over $300,000 in sales may be made by the issuer and all controlling stockholders during any year.\textsuperscript{31} If the staff concludes that the exemption was not in fact available on a prior transaction within a year, the amount of such sale is charged against the amount of securities which may be offered. Similar problems as to contingent liabilities and the possibility of a suspension order exist here as in full registration statements.\textsuperscript{32}

The same requirement for the justification of sales of securities without registration is provided in the form for registration of shares under the Securities Exchange Act in connection with the listing of securities on a national securities exchange and with the registration of equity securities under section 12(g) of the Exchange Act by companies having assets of over $1,000,000 and having outstanding a class of equity securities held by more than 500 holders of record.\textsuperscript{33} Substantially the same explanations are requested in the forms of periodic reports which have to be filed by companies whose securities are registered under section 12 of the Exchange Act and by those

\textsuperscript{29} 1933 Act, form S-1, item 26; form S-2, item 16; form S-3, item 15; form S-11, item 30; form N-5, item 32. CCH Fed. Sec. L. Rep. \textsuperscript{\$} 8245.

\textsuperscript{30} See cases discussed in text accompanying notes 114-18 infra.


\textsuperscript{32} See note 118 infra. and accompanying text.

\textsuperscript{33} Form 10, item 17 of 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-jj (1964) (hereinafter cited as the "1934 Act").
issuers who are required to file periodic reports under section 15(d) of the Exchange Act by reason of a prior registration statement filed under the Securities Act. A violation of section 5 revealed in periodic reports or in an investigation by the SEC can result in an order from the Commission suspending trading in the issuer's securities.

Transactions effected in reliance upon exemption from registration under the Securities Act by a broker-dealer who is registered as such under section 15 of the Exchange Act may also come before the SEC for review. Violations of the securities act by such broker-dealer are grounds for disciplinary action, which may lead to suspension or revocation of registration or of membership in a registered securities association. A number of the Commission's disciplinary orders against dealers have included, among other violations, the participation by such dealer in sales transactions which the Commission found were not exempt from registration as non-public offerings. Here again, for the most part, violations of the registration provisions were accompanied by other grounds for disciplinary action such as fraud and unreasonable sales spreads or discounts.

III. SOURCES OF PRECEDENT FOR THE EXEMPTION REQUIREMENTS

The development of legal precedents relating to private offering exemptions is a typical case history showing the evolution of administrative law. The law has developed through a number of sources, including, in addition to court opinions, opinions of counsel for the seller or buyer in day-to-day transactions, both informal private interpretations and formal administrative decisions by the SEC and its staff, and law review articles and legal periodicals. While private opinions of counsel do not immediately establish a body of legal authority, nevertheless, by the extent to which various members of the financial bar have reflected their views in legal institutes, law review articles and other legal writings, a body of authority has been established. No one source has contributed as much to the establishment of citable precedent as Professor Loss's comprehensive treat-

34 1934 Act, form 8-K, item 7; form 10-K, item 2.
35 Since the 1934 act was amended in 1964, the Commission has the authority to suspend trading in over-the-counter as well as listed securities. 1934 Act §§ 15(c)(1), 19(a)(4).
36 1934 Act §§ 15(a), (b).
38 See cases in text accompanying notes 105-113 infra.
ise on securities regulation. His original text was based upon his extensive experience in writing and reviewing interpretive opinions while on the staff of the SEC. Subsequent citations of the treatise as authority in judicial opinions have elevated many conjectures and personal judgments to the status of judicial authority citable as such in later cases.

Likewise, the greatest volume of administrative interpretations by the staff of the SEC consists of informal correspondence, either in response to requests for interpretive letters or in comments upon registration statements, regulation A offering circulars, and notifications and periodic reports filed with the Commission. Occasionally, a problem of such importance will arise that the Commission will publish a release setting forth an interpretation by the Commission or its counsel—and there have been several of these with respect to the private offering exemptions. Ordinarily, however, SEC interpretations are not available as a source of authority for general guidance except to the extent that various staff members from time to time have participated in legal institutes and bar association programs and have published papers in legal periodicals. Formal administrative decisions and interpretive releases and decisions in contested cases, including stop-order decisions and broker-dealer disciplinary decisions, are an important source of legal precedent.

These informal and administrative sources of precedent may ultimately become judicial precedent by reason of litigation resulting from legal actions instituted by the SEC, appeals from administrative decisions of the SEC to the United States courts of appeal, and cases among private litigants. The private offering exemption is one of the few to have been the subject of a comprehensive opinion by the United States Supreme Court. Since the Court's interpretation of the private-offering exemption with respect to stock offerings to employees in S.E.C. v. Ralston-Purina Co., the trickle of judicial decisions has expanded to a moderately heavy stream, particularly those by federal district courts. Some of the decisions have held offerings of such limited scope to be non-exempt making reliance on the

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40 Loss, Securities Regulation (1961) (three volumes, hereinafter cited as "Loss" with appropriate volume number).
private-offering exemption in any transaction a calculated business risk at best."43

IV. ELEMENTS OF THE EXEMPTION

As Professor Loss states in his treatise, the few words, *transaction by an issuer not involving any public offering,* "support a substantial gloss."44 To encapsulate the history of the requirements of the exemption, an offering by an issuer to qualify as a non-public offering must meet two basic tests:45

1. The group of persons to whom the offering is made available must be limited in number and must have some sort of relationship to the issuer either by prior association or by bargaining ability so as to be able to obtain comprehensive information about the issuer. In the early history of the exemption, the SEC placed considerable emphasis on the necessity of a relatively small number of offerees, it being generally considered that an offering to not more than twenty-five persons would ordinarily not be a public offering. Later history has highlighted the need of the offerees for protection and access to information of the kind available in a registration statement.

2. The persons who have purchased the securities in such non-public offering must acquire the securities as ultimate purchasers, not as conduits to other beneficial owners or subsequent purchasers. Each original purchaser's conduct and state of mind must not make him an "underwriter" as defined in section 2(11), i.e., the exemption will be lost if his purchase was "with a view to . . . distribution [of the] . . . security."46


44 I Loss 653. The various state blue sky laws have tried to avoid the problems of interpretation by spelling out specific limits. Thus, § 402(b)(9) of the Uniform Securities Act, CCH Blue Sky L. Rep. ¶ 4912, provides an exemption for an offering to not more than ten persons in the state during any period of twelve consecutive months if no commissions are paid for solicitations and the seller reasonably believes that all buyers are buying for investment, with authority in the administrator to increase or decrease the number of offerees. In this Symposium, see Wolens, Hidden Gold in the Blue Sky Laws, 20 Sw. L.J. 578, 579 (1966). See also Loss & Cowett, State Securities Regulation 81-83, 366-77 (1918), and as to the Texas Securities Act, Bromberg, Texas Exemptions for Small Offerings of Corporate Securities—The Prohibition on Advertisements, 20 Sw. L.J. 299 (1966); Bromberg, Texas Exemptions for Small Offerings of Corporate Securities, 18 Sw. L.J. 537 (1964); Meer, The Texas Securities Act—1957 Model; Facelift or Forward Look?, 36 Texas L. Rev. 429 (1958), updated in Meer, A New Look at the Texas Securities Act, 45 Texas L. Rev. 600 (1965).


In the earlier cases the SEC was busy hammering out in the courts and in its own administrative opinions basic principles. In an early opinion interpreting the intrastate offering exemption, the Commission held that the exemption requirements had to be met as of the time of completion of the ultimate distribution and not merely upon the closing of the sale by the issuer to three investment banking firms that redistributed an issue to residents outside the state of incorporation of the issuer.\(^4\) It took the persuasive powers of the best legal talent the Commission could muster to convince the Court of Appeals of the Ninth Circuit in 1938 that an offering to 530 persons, all of whom were stockholders of two corporations, was a public offering when the offering was not open to the general public.\(^4\)

Admitted abuses in what were patently artificial claims of the availability of the exemption to financings of extensive scope frequently have resulted in both Commission and court decisions of a sweeping nature, furnishing language quotable in subsequent cases where the claim to the exemption was bona fide.\(^4\)

**V. Number and Character of Offerees**

A General Counsel’s opinion published in 1935 was the only complete exposition by the SEC of its interpretation of the exemption until 1962.\(^5\) The gist of that interpretation was that the determination of whether a particular transaction involves a public offering depends not on any one factor but on all of the surrounding circumstances, including the following: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of offering. The interpretation pointed out that the basis on which the offerees are selected is of greatest importance and indicated that where the offerees are chosen from the general public at random, the offering may be found to be a public offering even though only a small number of offerees is involved. The opinion also suggested

\(^{1043}\) (1964). The various questions posed by the exemption, public vs. private, investment vs. distribution, shelf registrations, convertible securities, warrants, employee offerings and related problems are pithily outlined in Cohen, supra note 11, at 1348-50.

\(^{47}\) Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 170 (1935). See also Oklahoma-Texas Trust, 2 S.E.C. 764, 769 (1937), aff’d, 100 F.2d 888 (10th Cir. 1939).

\(^{48}\) S.E.C. v. Sunbeam Goldmines Co., 95 F.2d 699 (9th Cir. 1938). See also Merger Mines Corp. v. Grismer, 137 F.2d 335 (9th Cir. 1943).


that an issue in small units or an issue of substantial size is more apt to be a public offering than an issue of small size and a relatively small number of units, and indicated that the sale of the issue through the machinery of public distribution, such as securities brokers and sellers, was more indicative of a public offering. The opinion referred to, and apparently concurred with, an interpretation made by the Federal Trade Commission during its administration of the act that an offering to not more than twenty-five persons would ordinarily not be a public offering. The figure of twenty-five offerees was generally used as a reasonably reliable rule of thumb for a valid exemption. It is elementary, but nevertheless important to emphasize, that the rule of thumb referred to the number of offerees and not the number of actual purchasers.

The turning-point in the history of the numbers criterion was the only section 4 case to come before the United States Supreme Court, S.E.C. v. Ralston-Purina Co., decided in 1953. The case commenced with an action by the Commission to enjoin the Ralston-Purina Company from continuing its practice of offering and selling shares of stock to its employees without filing a registration statement under the act. At the time of the case, the company had over 7,000 employees. Between 1947 and 1952, the company received more than $2 million from sales of stock to its employees in annual stock offerings to more than 400 employees who while being designated as "key employees," actually included comparatively minor employees with salaries as low as $2,400. Both the district court and the court of appeals held against the Commission. The Supreme Court rejected the contention of the Commission that the large number of employees to whom the offering was open was determinative of a public offering without the consideration of any other facts, but it reversed and rendered for the Commission, stating:

The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private-offering exemption is in light of the statutory purpose. Since exempt transactions are those

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32 1 Loss 616; See Corporation Trust Co. v. Logan, 52 F. Supp. 999 (D. Del. 1943) which held that an open-end voting trust necessarily involved a public offering no matter how small the number of persons for whom the trust was created. The classic statement is contained in Nash v. Lynde (1929) A.C. 158, quoted in S.E.C. v. Ralston Purina Co., 346 U.S. 119, 125 n.11 (1953).
as to which "there is no practical need for [the bill's] application," the applicability of Section 4(1) should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."54

While the case would appear to result in a diminishing significance of the numbers test as an upper-quantity limit rather than a lower-quantity limit,5 subsequent decisions by the SEC in stop-order and broker-dealer disciplinary decisions and in its latest interpretative release published in 196256 and recent federal court opinions have not made that distinction.57 Thus, it is risky to rely on any numerical rule of thumb unless the kind of offerees qualifies under the general language of the Ralston-Purina case.58 The general views of the Commission can be gleaned from the following paragraph from the release:

Traditionally the second clause of Section 4(1) [now Section 4(2)] has been regarded as providing an exemption from registration for bank loans, private placements of securities with institutions, and the promotion of a business venture by a few closely related persons. However, an increasing tendency to rely upon the exemption for offerings of speculative issues to unrelated and uninformed persons prompts this statement to point out the limitations in its availability.59

The interpretation gives a green light to private placements with institutional investors such as insurance companies, banks, and pension trusts. The placements usually involve the sale of debt securities which may or may not be convertible into or be accompanied by warrants to purchase common stock.60 Where such placements involve

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54 Id. at 124-25. In United States v. Crosby, 294 F.2d 928 (2d Cir. 1961), the court, in overruling the contention that the term "public offering" was so amorphous as to make the criminal statute unconstitutionally vague, stated: "... the judicial gloss placed on this legislation by the Supreme Court in Securities and Exchange Commission v. Ralston Purina Co. ... two years before the acts here charged, cured any defect which might have existed."


56 The Supreme Court also was particularly concerned about the employer-employee relationship, stating, "The obvious opportunities for pressure and imposition make it advisable that they [employees] be entitled to compliance with Section 5." See Victor & Bedrick, Private Offering: Hazards for the Unwary, 45 Va. L. Rev. 869 (1959).

57 See note 56 supra.

as many as eighty or ninety officers, the Commission has acquiesced in the availability of the section 4(2) exemption, either by transmitting no-action letters or by raising no question in connection with later registration statements. Certainly the offerees are able to "fend for themselves," as demonstrated by the fact that they often obtain from the issuer even more information than the SEC requires in a registration statement. Where a new business is being started or an existing business is being expanded with proceeds from the sale of securities to investors outside the immediate promoter group, and where such securities do not appeal to the institutional investor, a cautious approach is warranted both as to numbers and type of offerees. The twenty-five offeree rule of thumb may be followed on a calculated business-risk basis, but the hazards must be realized. Where the offerees are individual investors—and especially where an investment banker participates in the placement—the number of offerees as well as the number of actual purchasers should be kept to the absolute minimum; the size of the units should be as large as possible; the offerees should be persons well known to the management of the issuer or to the investment banker; and they certainly should be sophisticated investors who are represented by their own counsel."

VI. THE HOLDING-FOR-INVESTMENT REQUIREMENT

The second condition precedent for the non-public offering exemption, that the entire offering come to rest as an investment in the hands of the purchasing group, has also become difficult to establish. Any purchaser who does not have the requisite investment intent (as demonstrated by sales within a relatively short period of time) may be an "underwriter" as defined in section 2(11), thus voiding not only his own possible exemption under section 4(1) when he sells but also, ab initio, the exemption under section 4(2) for the original sale. Of course, the intent of an original purchaser from the issuer is a subjective concept. At least in theory a purchaser may have a good-faith intent to hold for an indefinite period of time and shortly thereafter may change his mind without destroying the exemption. But the length of time the purchaser has actually held the securities is evidentiary as to his actual intent. This time element of the exemption also had an early-established rule of thumb which was generally accepted as being one year. It was based on an opinion of the General Counsel issued in 1938 in which he stated, "it is

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61 Loss 663, 689-96; Orrick, supra note 51 at 33.
my opinion that if they [the securities] were retained for a period as long as a year that fact would be sufficient, if not contradicted by other evidence, to create a strong inference that they had been purchased for investment. The opinion went on to state such inference was rebuttable and, "for example, would fail in the face of evidence of a pre-arranged scheme to effect a distribution at the end of the year."

In an effort to help establish objective evidence of the purchaser's intent, the financial bar developed the technique of requiring each purchaser, either in the purchase contract itself or in a separate written instrument, to make a written representation or covenant that he was acquiring the securities for investment and not with a view to distribution. Such covenant, whether set forth in the purchase agreement or in a separate letter, came to be known as an "investment letter." The investment letter was originally a one- or two-sentence statement substantially in the words of section 2(11) to the effect that the purchaser was acquiring for investment and not with a view to distribution. The letter has since expanded into a collection of long elaborate clauses. As Professor Loss states in his treatise, "In fact, some law firms seem to be quite fond of their own peculiar formulas, which in recent years have sometimes become as elaborate as a paragraph in a trust indenture." It also became the practice to require that a legend incorporating by reference the investment agreement be placed on the stock certificate itself and to have the transfer agent note a stop-transfer on the stock ledger.

The elaboration of the contents of the investment letter was an outgrowth of efforts to meet the language of the Commission and the courts in the several cases resulting from the sale by Crowell-Collier Publishing Company of approximately $3 million of convertible debentures in August, 1955, and an additional $1 million in May, 1956, in reliance on the private-offering exemption. The debentures, which in form were sold to twenty-seven purchasers in 1955 and to twenty-two purchasers in 1956 pursuant to investment letters,


A typical legend is as follows: "The shares represented by this certificate have not been registered under the Securities Act of 1933. The shares have been acquired for investment and may not be sold or transferred in the absence of an effective registration thereof under that Act, or an opinion from counsel satisfactory to the Company that such registration is not required." See Israels, supra note 64, at 869; Israels, Problems Incident to Use of Stop-Transfer Procedures and the Securities Act of 1933—Addendum to Uniform Commercial Code—Article 8, 17 RUTGERS L. REV. 158 (1962); PRACTICING LAW INSTITUTE, op. cit. supra note 59 at 22-23.
ended up, partly as stock, in the hands of at least eighty-nine persons or firms within ten months. It appeared that the investment letter requirement was treated as a mere formality. The Commission, denying the exemption upon an investigation, outlined the various types of holdings which in its opinion did not meet its concept of the requisite holding for investment. The Crowell-Collier matter and subsequent cases has resulted in a holding-period requirement varying from two to as many as five years. Early attempts by a substantial number of purchasers to sell or at least to obtain clearance for sale may result in a taint of the entire transaction, correctible, if at all, only by a registration statement. A lawyer practicing in the field of securities regulation is met almost daily with the question: "How long do I have to hold my securities in order to comply with my letter?" The immediate answer might be that the mere asking of the question is objective evidence negativing the intent to hold for investment. An attorney in one of the Commission's regional offices was heard to have expressed the view that what is required is an intent to put the securities in a safe-deposit box and throw away the key.

Seemingly the SEC attempts to insure that any time there has been a sale by an issuer or its controlling stockholders of a substantial quantity of securities in reliance on the section 4 exemption, the seller will effectively provide for the registration of those securities at some time shortly prior to the time that such securities are sold into the general public market. If prior to such registration a substantial quantity of the securities finds its way into the open market, the

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An exemption under the provisions of Section 4(1) is available only when the transactions do not involve a public offering and is not gained by the formality of obtaining 'investment representations'. Holding for the six months capital gains period of the tax statutes, holding in an 'investment account' rather than a 'trading account,' holding for a deferred sale, holding for a market rise, holding for sale if the market does not rise, or holding for a year, does not afford a statutory basis for an exemption and therefore does not provide an adequate basis on which counsel may give opinions or business men rely in selling securities without registration.


67 In U.S. v. Sherwood, 175 F. Supp. 480 (S.D.N.Y. 1959) in a criminal contempt proceeding, where the government had the burden of proving a distribution in violation of the act beyond reasonable doubt, the court stated that a two-year holding period was "an insuperable obstacle" to finding an intent to distribute. Form S-14, a special form provided for resales of securities by controlling persons of an acquired corporation in a rule 133 transaction, requires an undertaking to keep the registration statement up to date for two years. See Voelkner, supra note 63 at 13. In Friedman v. Chemical New York Trust Co., 153 N.Y.L.J. 14, CCH Fed. Sec. L. Rep. ¶ 91,519 (1965), 133 N.Y.L.J. 14, the New York trial court held that holding stock for five years before attempting to sell was at least prima facie proof that the stock was acquired for investment purposes, and should be deemed conclusive evidence absent evidence to the contrary. See also P.L.I., WHEN CORPORATIONS Go Public at 19-20; P.L.I. CONTROLLING STOCKHOLDERS at 30.

68 See Israels, supra note 64; See Wood, supra note 46, at 1017.
Commission, to say the least, will be greatly concerned. Any subsequent registration statement for the issuer or its controlling stockholders will be closely scrutinized for possible contingent liability disclosures, and court or administrative proceedings may very well result.\(^9\)

The purchaser desiring to resell at sometime short of the minimum safe-holding period has one possible out. If he can establish that his desire or need to sell is caused by a change of circumstances not foreseeable at the time of his purchase, such sale may not be inconsistent with his investment covenant, and he might even be able to get a no-action letter from Commission counsel.\(^9\) Ordinarily, a change in circumstance must be a personal one to the holder rather than a change in the business fortunes of the issuer which are deemed normal business risks.\(^7\) For some reason, the purchase of a house, which would appear to be a normal event in the life of an investor, has generally been accepted as a valid change in circumstances.\(^9\) Unusual sickness or business adversities not attributable to the stock market are other possible valid changes in circumstance. The need to sell the security to pay a related bank loan will not be such a change of circumstance; in fact, the necessity of a loan to make the purchase weakens the entire investment representation.\(^9\) There have been some statements by Commission staff that a pledge may itself be a sale in violation of the investment covenant.\(^9\)

VII. Position of the Holder of Investment-Restricted Securities

Under present administrative attitudes, the purchaser of securities sold under the private offering exemption is the orphan of the regulatory scheme. Controlling stockholders of the issuer have the power to cause the issuer to register their securities. Controlling stockholders

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\(^7\) In SEC Securities Act Release No. 4552, op. cit. supra note 41, the interpretation states as follows with respect to change in circumstances: "An unforeseen change of circumstances since the date of purchase may be a basis for an opinion that the proposed resale is not inconsistent with an investment representation."


\(^9\) See Orrick, supra note 71; Victor & Bedrick, supra note 58, at 874.

\(^9\) See Mulford, Private Placements and Interstate Offerings of Securities, 13 Bus. Law 297-302 (1958). In Release 4552, the Commission stated, "Possible inability of the purchaser to pay off loans incurred in connection with the purchase of the stock would ordinarily not be deemed an unforeseeable change of circumstances. Further, in the case of securities pledged for a loan, the pledgee should not assume that he is free to distribute without registration." S.E.C. v. Guild Films Co., Inc. 279 F.2d 481 (2d Cir. 1960), cert. denied, Santa Monica Bank v. S.E.C., 364 U.S. 819 (1960).

\(^9\) I Loss 672; Mulford, supra note 73, at 259, Orrick, supra note 23, at 372.
also have available a procedure to sell a small quantity of securities without registration (assuming such securities are not subject to investment restrictions). Rule 154, adopted under section 4(4) of the act, is available to their broker so that there is no "underwriter" in the transaction and the sale is exempt under section 4(1). If their company merges into another company or effects a sale of assets for securities of another company, the transaction will probably be exempt from registration under rule 133. While as controlling stockholders of a constituent corporation, they will be underwriters if they acquire the new securities in the acquiring corporation with a view to distribution, rule 133(d) permits each such controlling stockholder to sell in any six-month period the amount not deemed to be a distribution (the same quantity as provided in rule 154). However, the average holder of investment-letter stock may not be able to sell under the section 4(1) exemption until the amorphous time period necessary to establish the investment intent has elapsed, unless he can establish a change in personal circumstances that will enable him to get the requisite opinion of counsel or a no-action letter. Then too, he is always subject to the hazard that his co-purchasers may already have destroyed the exemption by having sold such quantity that a distribution has already occurred. If there have been no resales until after one year from the time the issuer or controlling persons effected the original sales transaction, the original seller may well argue that he is protected by the one-year statute of limitations in section 13, but this does not protect the statutory underwriter.

Section 4(4) exempts: "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders." Under rule 154, the term is defined to include "transactions by a broker acting as agent for the account of any person controlling, controlled by, or under common control with, the issuer . . ." where the broker performs only the usual broker's functions and is not aware that the transactions are part of a distribution. The rule indicates that a distribution shall not be deemed to be involved where, in an over-the-counter security, transactions effected by the same person over the past six months did not exceed one per cent of the outstanding shares or units of the class or in the case of a listed stock not in excess of the lesser of one per cent or the largest aggregate volume of trading during any one of the preceding four calendar weeks. Limitations on the rule are outlined in SEC Securities Act Release No. 4669 (1964), CCH Fed. Sec. L. Rep. § 2920. See P.L.I., Controlling Stockholders, §§ 47-68; Sommer, Who's in Control?-S.E.C., 21 Bus. Law 359, 388-91 (1966); Hill, Rule 154 Under the Securities Act of 1933 and Related Problems—A Proposed Solution, 20 Bus. Law 335 (1965).

Rule 133 provides that for the purposes of § 5 of the act, no offer for sale or sale, as involved in the submission to vote of stockholders of a statutory merger or consolidation or a proposal for transfer of assets for securities in a tax-free reorganization where the vote of a required favorable majority, will bind all stockholders except to the extent of dissenting stockholders, being entitled to appraisal rights.

See Voelkner, supra note 63, at 1-18.

Section 13 provides no action shall be maintained "to enforce a liability created under section 12(1) unless brought within one year after the violation upon which it is based."
The question as to when the limitations period as to the issuer starts to run when there are sales which have tainted the entire issue is another one of those fascinating exercises in fine-spun theory with which the Securities Act abounds. In deciding from what point in time a registrant should show a contingent liability in the financial statements in its prospectus, the staff of the Commission takes the position that the violation does not occur until the time a distribution is effected by the original purchaser(s), rather than at the time of the issue of such unregistered securities. Thus, a contingent liability must be reflected for at least one year thereafter.

There is some support among the financial bar and the staff of the SEC that a rule 133 transaction does not make investment letter stock freely tradeable and that the investment-restriction attaches to the securities of the new corporation acquired in a rule 133 transaction.80 It would seem to this writer that a merger of the issuer into another company or the sale of its assets to another would be an obvious change in circumstance not readily foreseeable at the time of the purchase. Perhaps the wise course for any holder of investment-letter securities who is not part of management or a sponsor of a plan of amalgamation would be to vote against the plan, and even assert his appraisal rights, if any.81

In order for a purchaser in a private offering exemption transaction to protect his right to sell, the purchase contract should provide that the issuer will register the securities at the request of the holders of a certain amount of securities. Such an agreement is usually required in private placements with institutional investors, particularly if the securities involved are debt securities which are convertible into stock or are accompanied by stock-purchase warrants.82 While it is arguable that the inclusion of a registration covenant in the purchase agreement is evidence of a lack of investment intent, if no sales are made by the original purchasers until the securities are registered, the transaction between the issuer and the initial purchasers would appear not to require registration, since it would be a preliminary agreement between an issuer and any underwriter and, therefore, not an offer or sale within the definition of section 2 (3).83

Once the issuer agrees to register, other problems may be encoun-

81 P.L.I., Controlling Stockholders, at 39.
82 See P.L.I., When Corporations Go Public, at 20.
83 “The terms defined in this paragraph ["sale," "sell," "offer to sell," "offer for sale," or "offer"] . . . shall not include preliminary . . . agreements between an issuer . . . and any underwriter . . . .” 1933 Act § 2 (3).
PRIVATE OFFERING EXEMPTION

tered. Registration of outstanding stock held by a number of individual security holders for sale into the open market without the benefit of a firm-commitment underwriting arrangement is fraught with difficulty. This was demonstrated by the Hazel Bishop stop-order case, where the Commission delineated the problems created by an attempted registration for sale by a number of purchasers in an uncoordinated distribution.

While a procedure for permitting the registration statement to become effective ultimately was negotiated with the Commission, for a while it looked like the answer was, "You can't get there from here." The most satisfactory solution to the resale problem is, of course, a firm-commitment secondary underwriting.

The investment-holding requirement is applicable to institutional investors as well as private individuals. For example, rule 155 concerning convertible securities was adopted by the Commission in February, 1962 (over two years after its original submission for comment in accordance with the requirements of the Administrative Procedure Act). The rule provides in part as follows:

The phrase "transactions by an issuer not involving any public offering" in Section 4(2) of the Act shall not include (1) any public offering of a convertible security (which at the time of such offering is immediately convertible into another security of the same issuer) by or on behalf of any person or persons who purchased the convertible security directly or indirectly from an issuer as part of a non-public offering of such security, or (2) any public offering by or on behalf of any such person or persons of the security acquired on conversion of a convertible security, unless the security so acquired was acquired under such circumstances that such person or persons are not underwriters within the meaning of Section 2(11) of the Act.

The rule contains language to permit the transfer of the convertible security to intermediate holders who themselves do not acquire with a view to distribution. The object of the rule is, of course, to require

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86 1933 Act, rule 155.
87 1933 Act, rule 155.
88 Paragraph (b) of the rule provides:
"The phrase 'transactions by any person other than an . . . underwriter' in Section 4(1) of the Act shall, in the situations covered in paragraph (a), be deemed to include transactions by the initial, and any intermediate, holder of the convertible security or of the underlying security who (1) has not acquired the convertible or underlying security with a view to the distribution of either of them, and (2) is not effecting, is not causing to be effected, and has not arranged for, a public offering of either security within the meaning of and subject to paragraph (a) of this rule."
that the convertible securities, or the securities into which they have been converted, be registered shortly prior to the time that they are sold into the open market. It is important to note that the rule applies to non-public offerings even if registered at the time of the sale to the original purchasers. Much early comment on the rule in its initially proposed form concerned its effect on previous placements and the position of institutional investors who had not provided in the purchase agreements covenants for registration. The rule as finally adopted was made applicable only with respect to convertible securities issued after February 7, 1962, the effective date of the rule.

VIII. SOME ILLUSTRATIVE ADMINISTRATIVE AND JUDICIAL DECISIONS

That the application of the private offering exemption principle enunciated in the Ralston-Purina case is not an exact science can be illustrated by a sampling of the administrative and judicial opinions promulgated since the Supreme Court's opinion.

A. CIVIL SUITS UNDER SECTION 12(1)

Section 12(1) gives the purchaser of a security sold in violation of the registration and prospectus provisions in section 5 a cause of action to recover the consideration paid or a valid defense against a suit brought to enforce an agreement to purchase securities. Several cases, also showing the inclusiveness of the term securities, involve the sale of fractional interests in oil and gas leases or similar property rights and demonstrate how strictly the exemption may be construed with respect to offers to a small number of persons.

In Repass v. Rees, the District Court of Colorado, in a suit to

90 The historical background, position of the SEC and of those in opposition to the rule are extensively discussed in 1 Loss 673-87. See also Orrick, supra note 80, at 15-22. A running debate was carried on in volume 15 of The Business Lawyer. See Sterling, Possible Solutions to Problems in Private Placement of Convertible Securities and Warrants Under the Federal Securities Act 145 (1959); Gadsby, Private Placement of Convertible Securities, at 470 (1960); Comments of Members of Committee on Federal Regulation of Securities, at 493; Fooshee & McCabe, Questions as to SEC's Legislative Authority to Adopt Rule 155, and of its Constitutionality, at 508; Lund, Private Placements and Proposed Rule 155, General Comments, at 516.

91 1933 Act, rule 155(c).

92 374 F.Supp. 898 (D. Colo. 1959). In Lynn v. Caraway, CCH Fed. Sec. L. Rep. 91,664 (W.D. La. 1966), four purchasers of a 1/16th interest in a producing oil and gas lease were awarded a judgment under §12(1) for recovery of the $33,530 purchase price and $3,350 in attorney's fees. It appeared from the opinion that one of the plaintiffs had approached the defendant, a lease broker, seeking an oil and gas investment, and the parties had visited the lease site in person and had made inquiry about the defendant through banks. While the case involved the question whether the defendant, who purchased the entire working interest from one of the other defendants and sold fractions to the plaintiff, was an issuer, the court recognized that in order for the sale of a mineral interest to be the sale of a security by an issuer, there had to be a "subdivision of a portion of the owner's inter-
rescind a purchase of an oil and gas lease interest, while finding that the plaintiffs were experienced businessmen and investors who did not need the protection of the act, held that defendants had not sustained the burden of proving their right to the exemption merely by testifying that they had sold to only nine persons in one tract and four persons in another tract, since it was incumbent upon them to introduce evidence as to how many offers were made to other persons and as to the experience of the buyers other than the plaintiffs.

In *Nicewarner v. Bleavins,* the same court held for the plaintiffs in a suit for the return of moneys paid to purchase a percentage interest in a retained inventor’s royalty, where the record showed only one sale other than to the plaintiffs. In again deciding that the defendants had failed to sustain the burden of proving the exemption, the court stated:

Here, the only evidence is that Bleavins made at least one sale other than to the Nicewarners. There is no evidence as to how many offerees there were, what information they received, or whether they needed the protection afforded by registration. In these circumstances, we are unable to say that Bleavins did not make a public offering. Consequently, Bleavins is liable under Section 12(1).

The Court of Appeals for the Tenth Circuit in *Woodward v. Wright,* while holding that a sale of oil and gas interests to four persons was entitled to the exemption since the purchasers were the type persons able to fend for themselves, nevertheless, held for the plaintiff on the ground that the defendants had made untrue statements of material facts.

In *Garfield v. Strain,* an action involving rescission of a purchase contract on the ground that the transaction concerned the purchase and sale of an unregistered security, the same court found that the defendants had effectively sustained the burden of proving their right to the private-offering exemption in a sale of an undivided one-half interest in an oil and gas lease. There, the number of units offered and sold were “few,” a close relationship existed between buyer and seller, and the transaction was small in size ($10,500); moreover, apparently most important in this case, because of his wide business

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*ext for the purpose of a public offering.* The defendant did not defend the case, and the defense of no public offering was not presented. In *MacClain v. Bules,* 275 F.2d 431 (8th Cir. 1960), a seventy-four year-old wheat farmer who had been in school only through the third grade and his wife were held to be entitled to recover their purchase price in three $10,000 purchases of stock in a Colorado oil company, the court finding plaintiffs had been solicited as part of a general offering in the area.

*244 F. Supp. 261 (D. Colo. 1965).*

*266 F.2d 108 (10th Cir. 1959).*

*320 F.2d 116 (10th Cir. 1963).*
experience in several businesses including the securities market and ownership of oil stocks, the buyer was able to fend for himself and was not in need of the protection of the act. The United States District Court of Minnesota in Collier v. Mikel Drilling Co., involving a sale of oil and gas lease interests to three persons, refused to go outside the record to speculate as to the nature of other transactions involving the same tracts and held for the defendant.

A sophisticated obligor, such as an investment banker, will ordinarily not be permitted to avoid his contract on the ground that it was contemplated that his own obligation involved a sale of unregistered securities. Thus, in Fuller v. Dilbert, an investment banking firm which had guaranteed the purchase of a twenty-seven per cent block of stock brought an action for a declaratory judgment to void a contract on the ground that the contract by its terms contemplated a public distribution in violation of section 5 of the Securities Act. The plaintiff argued that all parties were aware that the purchaser who was the primary obligor could not himself finance the transaction and that it was contemplated that he would designate other investors described as “designees” to take portions of the stock. The court held that the plaintiff could not void the contract on the ground that a public offering might be involved, stating:

Section 12 of the Securities Act which creates civil liability on the part of one who sells stock in violation of Section 5 does not require that a purchaser and his guarantor be permitted to escape their contractual obligations where the violation is brought about by the purchaser’s wrong-doing in which the seller did not participate and of which he was without knowledge. No public interest requires this result. To so hold would supply a built-in defense to a purchaser, who by the very violation of his agreement would at once effectively relieve himself of all his other obligations thereunder. It would virtually destroy the utility of the private offering since any purchaser of investment stock could insure himself against the future by the simple expedient of offering or selling a small slice of his purchase to the public in violation of the Act, thus enabling him unfairly to get rid of an unfavorable agreement.

B. Injunction Suits Brought By SEC

Section 21 (a) of the Securities Act gives the SEC the right to bring an action in any federal district court for an injunction to restrain violations of any provisions of the act.88 The Ralston-Purina case involved such an action brought by the SEC.89 An injunction by its terms enjoins the defendant from using the means of interstate commerce or the mails to sell securities unless registered under the act or exempt from registration. Subsequent sales in violation of the injunction subject the defendant to criminal contempt proceedings.

In U.S. v. Custer-Channel Wing Corp.,90 the defendant corporation and certain officers had been enjoined from selling stock of the company without registration. Three years later, the United States Attorney acting at the instance of the Commission filed an application for contempt proceedings based on the sale of over 1,500,000 shares sold for approximately $400,000 from time to time, to three separate purchase groups and approximately twenty individual buyers, each purchaser signing an investment letter. The court, after summarizing the Ralston-Purina case and the SEC's November 1962 release, held that a public offering in violation of the injunction was involved.

That there is little likelihood that an attempt to effect a widespread distribution of securities by the use of intermediary purchase groups will be successful is amply demonstrated by successful injunction actions. In the Crowell-Collier case, the Commission conducted an investigation under section 19 (b) of the act and published its findings in a release.101 The Commission's statement reflects that the use of investment letters is a useless formality if the transaction involves a substantial distribution to non-institutional investors.102

Injunction cases supporting the SEC in this viewpoint include SEC v. Mono-Kearsarge Consol. Mining Co.,103 involving a sale of a block of 962,000 shares to one person subsequently resold to the general public through nominees, and SEC v. Culpepper104 involving the sale of over 700,000 shares of stock acquired in exchange for assets of a Canadian corporation.

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88 1933 Act § 22(a).
92 This was succinctly put by the present General Counsel of SEC, "Where, however, such letters are regarded as a mere ritual insulating the transactions from the registration requirements, they become worthless." Loomis, supra note 62, at 669.
C. Broker-Dealer Disciplinary Cases

Under section 15 of the Exchange Act, the Commission is given the authority to censure, suspend for a period of not more than twelve months, or revoke the registration of any broker-dealer if it finds that such censure, suspension or revocation is in the public interest and that such broker or dealer has willfully violated any provision of the Securities Act of 1933. The Commission may also suspend such broker or dealer from membership in the National Association of Securities Dealers, Inc. (NASD) under section 15A, which effectively bars such broker or dealer from participating in syndicates with other members or from having any transactions with other members during the period of such suspension. It was in a broker-dealer proceeding against Ira Haupt & Co. that the SEC first held that the broker's exemption in section 4(2) could not be used to effect a distribution for a controlling stockholder. Subsequently, the Commission brought broker-dealer disciplinary proceedings against several broker-dealer firms which had participated in the Crowell-Collier distribution. The only proceeding which was appealed to the courts was Gilligan, Will & Co. There, the Commission suspended Gilligan-Will for a period of five days from membership in the NASD. The Commission overruled the contention that it must decide the case on the basis of the dealer's own transactions, apart from the transactions of others. The Commission noted that a seller, particularly a registered broker-dealer, may not safely rely upon a claim of a private offering exemption when he does not have knowledge of the identity and number of offerees and purchasers and of whether such purchasers intend to offer and sell to others. The statute gives an aggrieved person the right to appeal the order of the Commission to the United States court of appeals for the circuit in which it resides or has its principal place of business, or to the Court of Appeals for the District of Columbia. The Court of Appeals for the Second Circuit upheld the Commission, and the court's opinion sets forth extensive quotable language upholding the Commission's interpretation of what is necessary to hold

\[105\] 1934 Act § 15(a)(1).
\[107\] Ira Haupt & Co., 23 S.E.C. 589 (1946). The broker-dealer was suspended from membership in the NASD for a period of twenty days.
\[108\] 38 S.E.C. 388 (1958). Companion cases were Elliott & Co., 38 S.E.C. 381 (1958), involving the principal broker-dealer handling the "placement" in which the Commission suspended the firm's membership in the NASD for twenty days and Dempsey & Co., 38 S.E.C. 371 (1958) in which the Commission suspended the firm's membership in the NASD for five days. Note, 72 Harv. L. Rev. 784 (1959).

\[109\] 1934 Act § 25(a).
for investment in order to prevent a purchaser in a private offering transaction from being an underwriter.\textsuperscript{119}

\textit{D. F. Bernheimer & Co., Inc.}\textsuperscript{119} involved an offering to twenty-two offerees of $250,000 of convertible debentures of a small sulphur company. The debentures were converted approximately two years later. The purchasers did not execute investment letters. The Commission found that false and misleading statements had been made and that respondent had failed to produce evidence showing that offerees had special knowledge of the issuer and were in a position to fend for themselves; therefore, the exemption was not available. The dealer was suspended from membership in the NASD for six months.

In \textit{Robinette & Co.}\textsuperscript{119} the Commission found that a sale of $100,000 of convertible debentures in a cosmetics company to “at least” ten purchasers, some of whom were already stockholders, was not exempt. The Commission noted that each of five salesmen was told that he could offer the debentures to ten to twenty-five customers, “advice hardly consistent with the concept of a non-public offering,” and that although some of the purchasers were stockholders, they had no special relationship to the issuer and “were not only relatively unsophisticated but . . . woefully lacking in knowledge of the issuer’s affairs.” The Commission concluded, “Under no circumstances could they be considered persons who did not need the protection of the disclosure requirements of the Securities Act.” Here again, however, the Commission also found that false and misleading representations had been made to the purchasers, together with other violations of the 1934 act and rules.

In a consolidated proceeding which involved disciplinary actions against four broker-dealer firms (as well as a stop-order proceeding under the Securities Act and a suspension order proceeding under regulation A)\textsuperscript{119} the Commission found failure by one corporation to disclose contingent liabilities for fraudulent sales of unregistered securities, a failure by another corporation to comply with the terms of the regulation A procedure, and violations of the registration provisions by the participating broker-dealers. Among the transactions found not to have qualified for the private offering exemption were:

\textsuperscript{119} Gilligan, Will & Co. v. S.E.C., 267 F.2d 461 (2d Cir. 1959), cert. denied, 361 U.S. 896.


(1) an offering of 97,000 shares of stock to twenty-one persons, eighteen of whom purchased, where there were subsequent transfers within the existing group of shareholders with one exception;
(2) an offering of $125,000 of convertible debentures to at least thirty-three persons, of whom twenty-six purchased and at least four of whom resold to nine other persons within a few months;
(3) a sale of $35,000 of convertible bonds to sixteen persons out of a total of eighteen offerees;
(4) an issue of 247,500 shares, of which 130,000 shares were issued in a reorganization to officers and directors of a closed corporation, a substantial portion of which was shortly thereafter resold.

The Commission also found the use of false and misleading statements, market manipulations, and excessive mark-ups in selling the securities. The registrations of the various broker-dealer firms involved were revoked.

D. Stop-Order Cases

Under section 8(d) of the securities act if it appears to the Commission at any time that a registration statement includes any untrue statement of material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after appropriate notice and opportunity for a hearing, issue a stop-order suspending the effectiveness of the registration statement. There are a number of SEC decisions finding, as one or more grounds for issuance of a stop-order, the failure to disclose in the prospectus that sales were effected in violation of the act and to provide in the financial statements for the resulting contingent liabilities.

The following cases illustrate fact situations which the Commission held did not qualify for the private offering exemption.

_Hazel Bishop, Inc._114 involved the filing of a registration statement covering over 1,000,000 shares of common stock on behalf of 112 stockholders who proposed to sell their stock from time to time at prices current at the time of sale through brokers on the American Stock Exchange, in the open market, or otherwise. The registrant claimed that previous unregistered sales (562,500 shares) by the registrant to the stockholders on whose behalf the registration statement was filed (most of which were included in the registration statement) were exempt from registration under section 4(1) of the act [section 4(2) under the 1964 amendments] as transactions not involving a public offering. The registrant had relied upon opinions of counsel to that effect. The stock had been issued to and held in the

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names of thirty-two persons who executed investment letters with a legend on the certificates restricting resale, pledge, or hypothecation of the stock. The record revealed that some of the persons held stock for a large number of other persons, some shares being sold for cash without the new owner receiving any document of ownership. Further, even though the registration statement was filed on behalf of 112 selling security holders, the record actually showed at least 150 beneficial owners. There had been a number of sales in the open market in less than a year although the sellers had signed investment letters. The Commission's conclusion is a succinct summary of the effect of such transactions upon a subsequent registration statement:

By virtue of sales of shares in violation of the provisions of Section 5 of the Act, registrant became contingently liable under Section 12(1) of the Act, to purchasers of such shares for rescission or damages. The affirmative claim to an exemption, the omission of facts revealing widespread violations and the failure of the registration statement and the financial statements included therein to disclose the existence of contingent liabilities with respect to such violations rendered it materially misleading.

Skiatron Electronics & Television Corp.118 concerned the registration of shares of common stock covered by warrants held by a licensee of the registrant's pay TV system. The licensee borrowed 156,000 shares of registrant's stock from its president to pledge as collateral to secure loans for working capital, of which 78,200 shares were sold by the pledgee. The licensee also exercised options to purchase unregistered stock of the registrant to secure other loans and sold and pledged other warrants as collateral for loans. Within two years all warrants had been exercised and all pledged shares sold to the public. The president of the registrant owned 700,000 shares and held options on 30,000 additional shares. During a three-year period he sold 400,000 shares in the open market while he was also purchasing stock by exercising his options. The Commission rejected the claim to exemption under the former section 4(1) as well as under rule 154 and issued a stop order for the registration.118

Ten promoters and fifty-one other persons who were also desig-

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118 The Commission held that rule 154 "provides no exemption for an issuer or a controlling person of an issuer, but merely sets out certain standards as aids in determining when transactions by brokers are [exempt] routine trading transactions." Skiatron Electronics & Television Corp., 40 S.E.C. 216, 249 (1960).
nated promoters, apparently to lend credibility to their informed position, received unregistered stock in Republic Cement Corp.\textsuperscript{117} The Commission found that the fifty-one other persons were not in fact promoters but merely investors. Registrant had issued 10,410 shares for cash at ten dollars a share and 696,570 shares for promotional services. The Commission noted that sales made to residents of Southern California and Texas were consummated in Nevada pursuant to powers of attorney. The Commission stated:

The diverse geographical location of the offerees and the circuitous efforts taken by registrant's officers to avoid local Blue Sky Laws are additional circumstances indicating that there was not involved the type of private offering contemplated by Section 4(1) when applied to a new venture, namely, one made to a small group of informed offerees to finance its organization and preliminary operations.

The suspension order procedures under regulation A are a form of stop-order proceeding. In the filing, the seller must disclose sales made within one year without registration and establish the reason why such sales were exempt from registration. The regulation provides for the issuance of suspension orders which either prevent the filing from becoming effective or suspend the effectiveness if it has already become effective. There are numerous cases in which sales of unregistered stock were found not to be entitled to the private offering exemption and grounds for issuance of suspension orders.\textsuperscript{118}

E. Actions Against Transfer Agents To Compel Transfer

As mentioned earlier, one of the mechanical precautionary techniques to effect practical compliance with the holding-for-investment requirement is stamping a legend on the certificate disclosing the investment instruction and issuing instructions to the transfer agent of the corporation to note a stop-transfer in its stock records.\textsuperscript{119} This is a reasonably effective manner by which the issuer can protect itself against violating the act. In fact, the failure of an issuer who has made a private placement to provide effectively for stop-transfer procedures may be deemed by the SEC to make the issuer a party to a subsequent distribution by the purchaser.\textsuperscript{120}

There have been two recent cases involving actions to allow a

\textsuperscript{117} 38 S.E.C. 19 (1957).


\textsuperscript{119} See text related to note 65 supra.

\textsuperscript{120} SEC Securities Act Release No. 4552, supra note 41; Symposium—Current Problems of Securities Underwriters and Dealers, 18 BUS. LAW 27, 86 (1962); Victor & Bedrick, supra note 58, at 871.
transfer against transfer agents by purchasers of investment-letter stock. In *Kanton v. United States Plastics, Inc.*, the court by summary judgment granted a mandatory injunction to a corporation and its transfer agent ordering them to effect a transfer of stock acquired subject to an investment representation. The plaintiff had purchased 10,000 shares from the corporation at a time when he was the corporation's special counsel for handling financial matters. His relationship with the company terminated, and approximately three years after he had purchased the stock, he obtained both an opinion from another attorney and a concurring no-action letter from the SEC that he was free to dispose of the stock, either publicly or privately, without registration. The transfer agent contended that the no-action letter from the Commission was not binding and that this would not preclude the issuer from exercising its own judgment as to what was necessary to protect itself from violations of the act by reason of the sale of unregistered stock. This case establishes a combination of a three-year holding plus a "change in circumstances" represented by a termination of an attorney-client relationship.

In *Friedman v. Chemical Bank New York Trust Co.*, the New York trial court granted a permanent injunction directing the transfer agent to effect a transfer of securities where the plaintiff who had purchased the securities for investment purposes held the securities for five years and was compelled to sell to meet financial burdens. Plaintiff had obtained a no-action letter from the SEC staff. The opinion stated that the court would not permit the defendant to raise conjectures and suspicion concerning the accuracy of the facts urged in the plaintiff's application for the no-action letter.

In *Prudential Petroleum Corp. v. Rauscher, Pierce Co.*, a corporation had acted as its own transfer agent and had refused to transfer shares. Although such shares were subject to an investment letter, the certificate for them had not been legended. The corporation was in the process of clearing the sale of 200,000 shares under regulation A and put a stop-transfer on all outstanding shares. The corporation was held liable for conversion to a securities dealer. The court held that, there being no restriction on the face of the certificate, a refusal to transfer record ownership resulted in a liability for conversion.

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2. That cessation of an attorney-client relationship between stockholder and issuer might be a valid change of circumstance was suggested by George Duff at the P.L.I. Forum in Problems of Controlling Stockholders. See P.L.I. Controlling Stockholders, at 35.
4. 281 S.W.2d 457 (Tex. Civ. App. 1955) error ref. n.r.e.
IX. Conclusions

It can be seen from the foregoing review of SEC and judicial decisions that reliance on the non-public offering exemption in any financing not involving a private placement with institutional type investors is a hazardous risk. Milton H. Cohen in his very thought-provoking article, "Truth in Securities"—Revisited, which distills insight gained while he was Director of the SEC's Special Study of Securities Markets, presents a program for a coordinated disclosure system which would integrate the disclosure requirements of the Securities Act with those of the Exchange Act. He advocates a distinction in the treatment of those issuers which are subject to the filing requirements of the Exchange Act, which refers to as "continuous registrants," and those issuers which are not continuous registrants.

Mr. Cohen suggests that with respect to non-public offerings of issuers who are not continuous registrants there be a conclusive presumption that an offering "effectively confined to" a designated number of offerees, "25, 50, perhaps even 100" be exempt from registration. However, he stresses the need for an effective provision insuring that any reoffering by the purchasers in such a non-public offering, which would cause the issuer to be a "public company," would result in the purchasers' being deemed underwriters, at least insofar as making any distribution attributable to the issuer. He further suggests that the no-sale rule (rule 133) not be available to the securities of any issuer who is not a continuous registrant. Perhaps the rule should be limited further so that a non-public company would not be permitted to use a rule 133 transaction as a means of going public except pursuant to a registration statement.

It is, of course, obvious that a program coordinating the filing requirements of the 1933 and 1934 acts is a legislative one that by its very nature could not be achieved for several years. Such coordination would be of primary benefit to companies which are continuous registrants and for which it is relatively easy to achieve an effective registration statement. However, there is an economic need for an exemption from registration for a small speculative company in an early stage of its operations whereby it may be permitted to seek risk capital in a "semi-public offering." In the case of a state the size
of Texas, it is possible to achieve such financing through the use of the intrastate offering exemption, although as is set forth in footnote 44, supra, registration under the Texas Securities Act is required if the issuer will have over thirty-five security holders except to the extent that it may thereafter make sales to as many as fifteen persons in a one-year period. In business communities such as the Chicago and New York areas, reliance on the intrastate offering exemption is not generally advisable. An appropriate solution of the dilemma occasioned by the narrow construction of the private offering exemption might be the adoption by the SEC of a new regulation under section 3(b) which would be available on a simple notification basis and use of a very brief offering circular. This could apply to an issue of securities within the $300,000 limitation of that section offered to not over one hundred persons and purchased in amounts of not less than a specified sum, such as $5,000 by not over fifty owners of beneficial interest. Such an exemption, conditioned on an offering to a limited number of actual purchasers and on a disclosure of the terms of the offering to the Commission to prevent fraud, would offer reasonable protection to investors without unduly restricting the access of small business to individual risk-taking investors. While the Small Business Investment Act program has filled the gap to some degree, it is believed that more definitive ground rules are needed on offerings to private investor groups who may be beyond the “few closely related persons” allowed for in the Commission’s interpretation of the scope of the private offering exemption.

129 Section 3(a)(11) exempts from registration: “Any security which is part of an issue offered and sold only to persons resident within a single State... where the issuer... is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State.”


131 See text related to notes 9 and 10 supra. The increased complexity was occasioned in particular by the problems incurred by the SEC during the uranium stock boom of 1955-1956. The major hazard of the use of regulation A is that despite the elaborate nature of the filing, it is still in theory an “exemption” from registration with the burden of establishing the exemption’s existence being on the user. See Weiss, Regulation A Under the Securities Act of 1933—Highway and Byway, 38 N.Y.L.F. 3 (1962).