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By H. David Heumann*

Is SEC Rule 146 Too Subjective to Provide the Needed Predictability In Private Offerings?

I. INTRODUCTION

Section five of the Securities Act of 1933 ("1933 Act") requires that all issuers of securities must register with the Securities Exchange Commission ("SEC"), except where the Act provides a specific exemption from the registration requirements. A primary objective of the 1933 Act is to provide investors with material information regarding publicly offered securities. To accomplish this purpose, section 5 of the Act requires that a registration statement setting forth the relevant information be filed with the SEC before offering securities to the public; however, there are exemptions from these registration requirements. One such exemption

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1. Section 5 of the 1933 Act actually applies only where an instrument of interstate commerce is used to sell a security. As a practical matter it is nearly impossible to sell securities without using the mails, telephones, etc., and thus fall outside the jurisdiction of the Act.

2. The Securities Exchange Commission ("SEC") is concerned solely with whether there has been adequate disclosure of material facts relating to the securities being offered for sale, and not with the fairness of the price and terms of the offering.

3. For further basic information concerning the 1933 Act and the registration of securities, the reader should see R. Jennings & H. Marsa, Securities Regulation (3d ed. 1972) which describes the registration process as follows:

To facilitate the registration of securities by different types of issuing companies, the Commission has prepared special registration forms which vary in their disclosure requirements to provide disclosure of the essential facts pertinent in a given type of offering while at the same time minimizing the burden and expense of compliance with the law. In general, the registration forms call for disclosure of information such as (1) a description of the registrant's properties and business, (2) a description of the significant provisions of the security to be offered for sale and its relationship to the registrant's other capital securities, (3) information about the management of
is found in section 4(2), which states that section 5 shall not apply to "transactions by an issuer not involving any public offering."

Exactly what characteristics make up a non-public offering of securities is not revealed by the 1933 Act; therefore, this definitional task has fallen to the courts. Unfortunately, the various judicial decisions construing this test have not clarified the meaning of "non-public," but have only increased the confusion in this area. Recognizing this failure by the SEC and the courts to pro-

the registrant, and (4) financial statements certified by independent public accountants. . . .

Id. at 35-36.

4. Although the 1933 Act itself offered no guidance in the interpretation of section 42(2), the House Report did explain that "[t]he Act carefully exempts from its application certain . . . securities transactions where there is no practical need for its application or where the public benefits are too remote." H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933) (emphasis added). The words "where the public benefits are too remote" imply that the exemption includes offerings where the number of buyers is so limited (i.e., where the offering is more private than public) that the costs of registration cannot be justified.

5. The author assumes in this article that the reader is quite familiar with the case law leading up to Rule 146. See Appendix for Rule 146. While a knowledge of the pre-Rule 146 case law is necessary to a full understanding of the Rule, which is to a great extent a codification of existing law, discussion of these cases has been omitted since many articles have already adequately covered this area. See, e.g., Alberg & Lybecker, New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities, 74 COLUM. L. REV. 622 (1974); Kalokathis, The Private Offering under Rule 144 and Proposed Rule 146: New Armor for an Old Warrior, 77 DICK. L. REV. 585 (1973); McDermott, The Private Offering Exemption, 59 IOWA L. REV. 525 (1974); Note, SEC Rule 146—The Private Placement Exemption, 58 MINN. L. REV. 1125 (1974); 48 WASH. L. REV. 922 (1973).

Two cases, however, are so vital to the context behind Rule 146 that a succinct review of them is in order. The seminal case in the private offering area is SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953), where the Court established the basic criteria for testing the applicability of section 4(2). The test propounded was whether the offerees need the protection afforded by the Act as evidenced by whether the offerees have access to the same kind of information that registration would disclose and whether they are able to fend for themselves. Note 59 infra. Thus, the Court gave birth to the now accepted notion that offerees should be financially "sophisticated." To determine the question of sophistication in subsequent cases, the courts looked to the totality of circumstances surrounding the transaction, particularly the attributes of the offeree. It should not be surprising that this ad hoc approach resulted in different courts stressing different factors.

A relatively recent case illustrating a strict view of the access requirement is SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972). The court stated: "[t]he record does not establish that each offeree had a relationship with the issuer giving access to the kind of information that registration would have disclosed." Id. at 160.
vide an objective or predictable criterion for applying the non-public offering exemption, former SEC Chairman William Casey stated in 1972: "For 40 years there has been great uncertainty as to what constitutes a private offering." 8

The courts’ failure to establish standards upon which conscientious businessmen could rely in seeking to raise capital via private offerings was the chief impetus for SEC Rule 146, which is an attempt to establish discernable guidelines for issuers. In promulgating Rule 146, the SEC explicitly stated:

The Commission believes that a rule creating greater certainty in the application of the Section 4(2) exemption is in the public interest for two reasons. First, such a rule should deter reliance on that exemption for offerings of securities to persons who are unable to fend for themselves in terms of obtaining and evaluating information about the issuer and in certain situations, of assuming the risk of investment. These persons need the protections afforded by the registration process. Second, such a rule should reduce uncertainty to the extent feasible and provide more objective standards upon which responsible businessmen may rely in raising capital in a manner that complies with the requirements of the Act. 7

The purpose of this article is not simply to describe the various provisions of the Rule. Instead, it will focus on the ambiguity and subjectivity of the provisions of Rule 146 in an effort to ascertain whether that Rule in fact fulfilled the SEC’s expressed purpose of providing greater certainty in determining when the private offering exemption is applicable. 8 A secondary purpose of the article will be to explore whether the uncertainties inherent in Rule 146 are especially oppressive to small investors and businessmen.

Thus, at least the Fifth Circuit had come to require of offerees a sort of "privileged relationship" with the issuer. Apparently only "insiders" safely fell within the exemption.


8. Even though Rule 146 became effective on June 10, 1974, an analysis of the Rule is still pertinent because the SEC has declared it does not consider the Rule impervious to alteration or even abandonment:

It should be recognized that the Rule is intended to be in the nature of an experiment and that the Commission will observe its operation to determine whether it is consistent with the objectives of the Act. If experience with the proposed Rule indicates that it is not operating for the protection of investors or in the public interest, it will be rescinded or appropriately amended.

Because the following analysis centers around the notion of certainty, it is appropriate to begin with a brief elucidation of why predictability is crucial in the private placement market. The primary rationale for the private offering is that it allows venture capital to be raised with limited expense and minimal investor harm. The vast importance of the private offering as a money-raising mechanism is mirrored in the fact that in the mid-1960s over half the new corporate offerings utilized the non-public offering exemption.\(^9\) The SEC is also cognizant of the financing potential of private offerings for smaller firms, and accordingly has stated:

\[\ldots\] The lack of objective standards in the private placement area may be hindering the raising of capital by new businesses that are not sufficiently seasoned to attract investment banking firms willing to underwrite public offerings of their securities.\(^10\)

The conclusion seems warranted that to the extent the application of the non-public offering exemption is clouded, small issuers, in particular, will feel the pinch. The newer, smaller issuers normally present the greatest potential for risk and, therefore, courts will be especially harsh in construing the exemption's application to such "risky" enterprises. Another irony is that small issuers, seeking relatively small amounts of capital, may be forced to go to those investors—small investors—least likely to qualify as possessing the degree of sophistication called for by the Rule.\(^11\)

From a practical standpoint, all issuers should be greatly concerned about the potentially immense civil liabilities which might confront them if an after-the-fact decision is made that the section 4(2) exemption does not apply to an offering they effected. More specifically, section 12(1) of the 1933 Act provides a private right of action to any purchaser of an unregistered, non-exempt security. The issuer's only defense is that an exemption from registration applies. Thus, if an issuer mistakenly sells to even one buyer not meeting the standards of sophistication, etc., the entire exemption could be lost.

Since the issuer will have to pay rescission damages where it mistakenly invoked the private offering exemption, there will exist a temptation on the part of buyers of securities to contest the applicability of the exemption whenever the deal has gone sour. And, it should be clear that the more ambiguous the test for the non-

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11. One reason small issuers may often have to seek small investors is that many institutional investors are uninterested in making anything other than large investments.
public offering exemption—that is, Rule 146—the more potential ammunition there is for recalcitrant buyers.\footnote{12}

This article will show that many of Rule 146’s provisions are broad or open to interpretation. Since Rule 146 adopts such confusing concepts as “sophistication” and “access” from the case law, courts may be compelled to look to past decisions for help in defining these terms. Yet a return trip to the morass of the case law is not the means to achieve greater safety or certainty. Which of the diverse cases should be honored for their guidance? The most recent? Those with the strictest tests?

Given the importance of predictability to private offering issuers, the next question becomes what degree of subjectivity, and therefore uncertainty, is embodied in Rule 146.

\section*{II. ANALYSIS}

This section of the article will analyze the language of the provisions of Rule 146\footnote{13} and will highlight the flexible nature of

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\begin{itemize}
  \item Given the recent step-up in litigation in the securities law area, issuers should find the possibility of private suits a particularly alarming prospect.
  \item The Preliminary Notes to Rule 146 establish the “ground rules” with respect to when the Rule is applicable. These Preliminary Notes present no blatant ambiguities and, therefore, they will not be discussed separately. Rather, they will be mentioned at appropriate points in discussion of the text of Rule 146.
  \item Preliminary Note 2, however, will be treated here since it is equally applicable to all of the text. It declares that “[n]othing in this rule obviates the need for compliance with any applicable state law relating to the offer and sale of securities.” This straightforward statement confirms that the Federal Government has no intention of preempting state securities law. Since Rule 146 is more liberal than most state private offering exemptions, there may be instances where a private distribution of securities would have to be registered under the blue sky laws of certain states, even though no registration would be required by federal law.
  \item Nebraska’s blue sky law offers an apt illustration. The Nebraska statute provides an exemption from registration under the Nebraska Securities Act only where no more than ten offers to sell securities are made to Nebraska citizens in a twelve month period. In counting whether ten offers have been made, Nebraska does exempt offers to certain institutions. Ne. Rev. Stat. § 8-1111(8) (Reissue 1970). Nevertheless, Nebraska’s ten offerees rule is clearly more stringent than Rule 146.
  \item It could be argued that the states should revise their private offering provisions to conform with Rule 146 so that the usefulness of the SEC’s Rule will be maximized. Specifically, a harmonizing of state rules with Rule 146 would lessen the challenge offered by multi-state registration, which is presently a time-consuming and expensive proc-
\end{itemize}
that language. The journey through the Rule's provisions will be chronological, covering definitions, conditions to be met, limitations on manner of offering, sophistication, access, business combinations, number of purchasers, and limitations on disposition.

A. Definitions—146(a)

The ambiguities in Rule 146 begin to surface at its outset. In subsection (a) (1) "offeree representative" is defined as follows:

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

(i) is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer;\(^{14}\)

\[\ldots\]

(ii) has 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;

(iii) is acknowledged by the offeree, in writing, during the course of the transaction,\(^{15}\) to be his offeree representative in connection with evaluating the merits and risks of the prospective investment; and

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

The major ambiguity in the definition of investment representative is found in the requirement that such a person have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective

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investment. In short, the offeree representative must have investment sophistication. As will be developed in the analysis of the sophistication requirement in 146(d), this is a very imprecise standard, and courts have, predictably, differed in their interpretations of it. It follows that since the SEC has offered no explanation of the sophistication concept in Rule 146, the private offering exemption will continue to bedevil conscientious businessmen and their attorneys.

Another factor causing the elusive sophistication test to be oppressive is the requirement in section 146 (a) (i) that the issuer make reasonable inquiry and have reasonable grounds to believe that the offeree’s representative is financially sophisticated. Thus,

16. See notes 30-44 and accompanying text infra. In addition to further refinement of the sophistication concept, the treatment of 146(d) includes further discussion of the offeree representative provision.


Some of the difficulties which stand in the way of defining “sophistication” are suggested by the following:

The “fending for themselves” standard, which is synonymous with “sophistication,” has proved no less confusing.... Apart from institutional investors, however, one cannot be sure of what the phrase actually means, since it has been used in two different senses. On the one hand, it has been stated that no one is per se sophisticated without access to the information. As used in this sense, the term simply means that access is a prerequisite to sophistication, and an independent inquiry of sophistication would be unnecessary. On the other hand, it has been stated that sophistication is not a substitute for access and that one must be shown to have access and be sophisticated. In this sense, the phrase has significance independent of the offering and even of the access requirement. It implies that an individual deciding to partake in a private offering, by virtue of his education, business acumen and prior investment experience, etc., will arguably be able to understand and evaluate the information, enabling him to make an informed investment decision. Hence, the issuer would have to prove that the offeree had “access,” and in addition, that he could “fend for himself.” In either situation, however, the overriding consideration is whether there exists the elusive relationship which would justify relying on the exemption in the first instance. (Footnotes omitted.)

even assuming that the issuer satisfies the vague "reasonable inquiry" criterion, it must reach the correct conclusion from the information it has garnered. Specifically, if it is determined, after the private placement has been accomplished, that the offeree representative in fact was not able to evaluate the risks, it would appear that the exemption would vanish. The harsh consequence might be that the whole offering would violate section 5 of the 1933 Act, as suggested by section (b) of Rule 146.

B. Conditions to be Met—146(b)

The first paragraph of this section declares that all the provisions of Rule 146 must be met before the exemption is available. It follows that if the issuer fails to conform to any of the conditions, irrespective of their insignificance, the protection of Rule 146 will be lost. Arguably, such a rigid requirement will result in increased litigation, because buyers of stock which has plummeted in value will be tempted to bring an action for rescission against the issuer, claiming the Rule had not been satisfied in every respect.

The harshness of this cumulative aspect of the Rule's provisions would be ameliorated if the various criteria imposed by the Rule were concrete or objective. It is a cruel hoax to tell issuers that the "good news" is that all they need do to comply with the Rule is strictly meet all its requirements, but the "bad news" is that how one meets those requirements is a puzzle.

It is this all or nothing aspect of Rule 146 which makes it potentially grossly unfair. In order to alleviate this dilemma,

18. The incorporation of the "reasonable inquiry" test assures even greater subjectivity in the interpretation of this provision. Does a reasonable inquiry involve questioning by the issuer of the offeree representative's business associates, or does it merely involve having the offeree representative fill out a form?

19. Preliminary Note 3 to Rule 146 also emphasizes that:

In order to obtain the protection of the rule, all its conditions must be satisfied and the issuer claiming the availability of the rule has the burden of establishing, in an appropriate forum, that it has satisfied them. The burden of proof applies with respect to each offeree as well as each purchaser.


20. Since the entire private offering would then be in violation of the 1933 Act, the issuer would be at least potentially liable civilly to every purchaser! Query whether such "punishment" really fits the "crime."

21. Admittedly, it is possible that courts would overlook a minor breach of Rule 146 in deciding whether the offering qualified as non-public under the section 4(2) case law. Even though the issuer attempted to comply with Rule 146, that does not constitute an election on its
one commentator has suggested that the SEC should establish a "substantial compliance" test which would allow the exemption to be applicable in cases where the failure to meet a particular provision of the Rule was both innocent and immaterial. Given the illusory nature of many of the required conditions of the Rule, this suggestion would be a legitimate method of injecting a measure of fairness into the application of Rule 146. It should be noticed, however, that such measures are really only aimed at treating the symptoms rather than combatting the virus of Rule 146. More specifically, what is needed is a major overhaul of Rule 146 with the purpose of providing greater certainty as to the Rule's application.

A laudible step toward greater objectivity is manifested in subsection (b) (1):

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

This "safe harbour" provision protects issuers who have not part—the courts are free to follow case law in testing for the offering. Even assuming an offering would qualify under section 4(2) law, that does not diminish the fact that Rule 146 would have failed to provide greater certainty in applying the non-public offering exemption, since it would end up tested by case law, which is exactly what Rule 146 was created to avoid.

22. Letter from Carl Schneider and Charles Zall to SEC, (Nov. 21, 1973). This plan would still allow a sanction against the issuer for less than full compliance with Rule 146, but would ensure that the "punishment would fit the crime." Id.

23. Ironically, the ambiguity in the provisions of Rule 146 may present courts with the flexibility to allow minor, inadvertent failures to comply without the loss of the exemption. It should be emphasized, however, that since the language of Rule 146(b) militates in favor of total compliance, issuers cannot rely on such judicial mending.

24. Such a tentative alternative is sketched in Section III, infra.

25. Rule 146 as a whole is often referred to as a "safe harbour." This is because Preliminary Note 1 states that Rule 146, far from presenting a mandatory standard for the applicability of the private offering exemption, offers a "safe harbour" for those issuers complying with its requirements. Apparently, the SEC felt obliged to underscore the non-exclusive nature of the Rule in that the Commission had received letters expressing concern that the earlier Proposed Rule had not been
offered for sale or sold similar securities within a six month period on either side of the transaction in question.26

But if there have been similar securities offered less than six months prior to or subsequent to any offer or sale pursuant to Rule 146, then Preliminary Note 3 becomes apposite. A portion of it directs the reader to SEC Release 33-4552 which gives factors indicating whether offers and sales should be regarded as a part of a larger offering and thus should be integrated. The integration concept is of paramount importance since all offers, offers to sell, offers for sale, or sales which are part of an offering must meet all of the conditions of Rule 146 for the Rule to be available.

C. Limitation on Manner of Offering—146(c)

It has long been an accepted tenet that mass advertising campaigns are not consonant with the notion of a “non-public” offering of securities. The SEC has incorporated this general rule in 146(c)(1), which states:

   (c) Limitations on Manner of Offering. Neither the issuer nor any person acting on its behalf shall offer, offer to sell, offer for sale, or sell the securities by means of any form of general solicitation or general advertising, including but not limited to, the following:

   (1) Any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over television or radio; ....


If, then, it is felt that an issuer may not qualify under Rule 146, an attempt may also be made to satisfy the criteria established by current administrative and judicial interpretations. It should be recognized, however, that in such circumstances an attempt to qualify outside the Rule is likely to fail. Since Rule 146 largely represents a codification of existing case law, it is unlikely that the relevant judicial decisions would afford relief to the issuer in situations where the Rule would not. Further, section 4(2) compliance would be guided by interpretations in effect “at the time of the transaction,” and courts will, as a practical matter almost certainly adopt the provisions of Rule 146, which went into effect June 10, 1974, as their shibboleth, in deference to the SEC's acknowledged expertise in securities law. That is, the detailed checklist, provided in the form of Rule 146, will understandably be viewed by judges as a welcome map charting troublesome waters.

26. If there were offers or sales of similar securities, then the factors defining integration, found in Preliminary Note 3, would be relevant.
One rationale for prohibiting general advertising of securities for sale by the issuer is that since there is no numerical limitation on offerees under Rule 146, without a limit on advertising the issuer might be able to solicit such a large quantity of offers that it could selectively accept certain offers. Nevertheless, it is difficult to perceive what harm could follow from such a selective process given the framework of Rule 146, which requires all purchasers to be financially sophisticated and able to obtain material information. Section 146(c)(1) at least contains no patent ambiguities in its prescription of general sales efforts (other than the usual issue of how many offers constitute a "general" solicitation).

In the SEC's initial effort, Proposed Rule 146, the Commission entirely banned the use of promotional meetings. Qualified use of seminars and meetings is now allowed by 146(c)(2). This subsection provides that offerees who are financially sophisticated, or who are able to bear the economic risks, and are accompanied by their sophisticated representatives, may attend meetings or seminars where restricted securities are offered. Allowing group sessions, at least under the SEC's restrictions, is a wise policy, for sophisticated investors may be bolder in questioning the issuer when there is strength in numbers, and the entire group would be forced to reflect upon the views of the least enthusiastic members of the group. However, there may be some problem in ascertaining precisely what is a "meeting" or "seminar" for purposes of Rule 146(c)(2). Conceivably, any group consisting of more than one offeree would constitute a meeting. Yet, if "bandwagon fever" was what the framers of this provision were endeavoring to prevent, a group of two or three persons was probably not envisioned as comprising a meeting. A prudent issuer, confronted with a situation where more than one offeree is present, would take care to have a record made of exactly what ensued. The issuer must likewise be cognizant of the identity of everyone at any meetings. If, for example, an unsophisticated offeree were to show up at a scheduled meeting without a sophisticated representative, presumably a violation of Rule 146 would have occurred. Surprisingly, the requirements of subsection (c)(2) are not satisfied by the issuer's reasonable belief as to the qualifications of those present. Instead that section sets down an absolute requirement that no meetings shall take place with unqualified persons present.

28. The SEC was rightly concerned that such promotional gatherings might provide a forum for high pressure factors by the issuer. For an interesting illustration of these techniques see Kalokathis, supra note 5, at 591-92.
This is just one more illustration of an overly harsh result flowing from noncompliance with a Rule 146 provision which is latently ambiguous: the sophistication requirement which section (c) invokes is a nightmare for lawyers wishing to pinpoint the meaning of that concept.

Section 146(c)(3) provides for use of letters, circulars, notices or or other written communications distributed only to offerees (and their representatives) who satisfy the sophistication requirement of subsection (d).29

D. Nature of Offerees—146(d)

The nature of the offeree has always been a central concern in private offerings. It would, therefore, seem to be extremely important that such a provision be easy to interpret. Nonetheless, even a cursory reading of the applicable section, 146(d), will unearth legal terms and concepts ripe with ambiguity.30 For example, "reasonable grounds," "offers," "financial sophistication," "financial security," "reasonable inquiry," and "offeree representative" are all terms or concepts which raise major, if not insuperable, obstacles to a predictable interpretation of 146(d).

Even before offers to sell securities in a private placement are made, the "issuer and any person acting on its behalf" shall have "reasonable grounds" to believe that all offerees were sophisticated or able to fend for themselves.31 By employing this "reasonable grounds" test, the SEC has created an area where a wide range of conduct may or may not fulfill the requirement. The term "reasonable" cries out for facts to supply the context in which

29. Section (c)(3) previously required letters, circulars, notices, or other written communications to include a promise to provide section (e)(1) information on request. SEC Release No. 5487, 39 Fed. Reg. 15,263 (1974). A recent SEC Release No. 5585, 40 Fed. Reg. 21,709 (1975), deleted this requirement for (c)(3). This represents an improvement, for what constitutes (e)(1) information is not crystal clear. See notes 49-50 and accompanying text infra. The purpose of this recent release was "to provide more objective standards for determining whether offers or sales of securities by an insurer would be deemed ... within ... Section 4(2) of the Act ... ." While every little bit helps, the Commission did not face the most critical ambiguities plaguing Rule 146. Conspicuously absent from the SEC's amendments was any mention of the subjectivity in the language relating to the notion of sophistication. And, the amendments considered only minimally the access notion.

30. See Rule 146(d), Appendix.

31. By using the phrase "issuer and any person acting on its behalf" the SEC has presumably eradicated any possibility of the issuer delegating the duty of ascertaining reasonable grounds. Id. (emphasis added).
RULE 146

reasonableness will be determined, and that in turn gives courts
great discretion in resolving this question of fact. While such a
factual-legal test may work well in the courtroom, it wreaks havoc
on conscientious issuers who are required to know what activities
satisfy the standard in advance of a judicial determination.

A particularly harsh aspect of this requirement is that the
reasonable grounds must exist before the issuer makes an offer,
regardless of whether a purchase results. To establish such reason-
able grounds the issuer would be, in most cases, forced to communi-
cate with the potential offeree. This places the issuer in the
tenuous position of endeavoring to ascertain detailed personal
financial information while remaining sufficiently aloof so that
the prospective investor's interest is not aroused to the extent
that the issuer's actions constitute an offer. It is true that the
SEC has greatly limited this danger by providing that an in-
quiry to verify a belief of reasonable grounds is not an offer. But
the exact meaning of this statement is not clear, and issuers still
must be careful so that their communications are all related to the
verification process.

It is a crucial fact that the issuer has the burden of proving
that reasonable grounds existed. Accordingly, a prudent issuer
should keep records of all persons contacted as prospective offerees
so that evidence would be available later if proof is required that
reasonable grounds were relied upon. Another oppressive phase
of the reasonable grounds requirement is that where it is found
that reasonable grounds did not exist for making an offer, the Rule
146 exemption may be rendered totally invalid, even though the
offeree never became a purchaser.32

The concept in Rule 146 most likely to cause consternation is
the sophistication requirement. Section 146(d) (1) (k) enunciates
the Commission's test for offeree sophistication as: possession of
"such knowledge and experience in financial and business matters
that he is capable of evaluating the merits and risks of the pro-
spective investment." Since the knowledge and experience needed
to satisfy this condition depend on the particular prospective in-
vestment, this complex test requires an examination of the offeree's
background as well as a conclusion that such background has prop-
erly prepared the offeree to tackle skillfully the investment at

32. In its Synopsis of the Provisions of Rule 146, the SEC has provided
that when an offeree or even a purchaser is unqualified, the whole
exemption will not be wiped out so long as reasonable grounds ex-
isted. But what if the judgment of the issuer on that score was
hand. The potential inconvenience and cost to the issuer caused by the necessity of investigating and evaluating is tremendous, because the sophistication of each offeree must be established or the exemption could be destroyed with respect to every purchaser. The sophistication criterion presents a question of fact, thus making it so maze-like that some issuers might be deterred from attempting to comply with Rule 146.

Perhaps the words of Rule 146(d)(1)(i), setting out the requirement of sophistication, are meant to induce issuers to look to case law in deducing what comprises financial sophistication. If so, Rule 146 has done nothing to lift issuers out of the quandary left by the case law, which offers diverse and uncertain views of the concept of sophistication.

If the offeree is not sophisticated, he must be rich, or at least "able to bear the economic risk of the investment." Rather than define such a nebulous phrase, the SEC has chosen merely to provide the hapless issuer with two important considerations:

33. The inclusion of several variables in the sophistication formula augments the potential for misjudgments by issuers. For example, even if the investment proposal is a relatively simple one, can the offeree ever be deemed sophisticated under the test if he never has dealt in the particular type of investment offered? Is experience in the stock market the same as experience in option trading? Or, if the investment is a complex one, must the offeree have experience with equally complicated transactions?

Another twist might involve an offeree with both education and experience in the specific type of investment to be analyzed, but with a record of constantly losing money on such investments. Must the issuer go so far as to try to analyze the previous transactions of the prospective offeree to see if the past failures were simply bad luck?

It is also worth noting that in the negotiation stages, when the offeree is enthusiastic, he may try to impress the issuer with his sophistication in financial concerns. Yet, after the investment has proved disappointing, the purchaser may change his tone, if not his tune. This possibility underscores the need for issuers to procure outside evidence pertaining to the purchaser's background.

34. It is a salient consideration that sophistication has taken on the status of a legal concept.

[T]he more deeply we get involved in an analysis of concepts in operation, a number of questions arise that cast doubts on how far they can actually advance us towards making law objective and knowable, towards relieving judges of the burden of detailed inquiry and choice.

W. BISHIN & C. STONE, LAW, LANGUAGE, AND ETHICS 170 (1972).

35. For example, must each offeree possess "exceptional" or "unusual business experience and skill," as required by Lively v. Hirschfield, 440 F.2d 631, 633 (10th Cir. 1971)? For an outstanding article which portrays the intangibility of the sophistication concept as developed by case law, see Proposed SEC Rule 146: The Quest for Objectivity, supra note 17, at 887 & nn.89-95 (1973).

1. Whether the offeree could afford to hold unregistered securities for an indefinite period, and;

2. Whether, at the time of the investment, he could afford a complete loss.

An examination of these two factors reveals that the “able to fend” test is tantamount to the suitability standard relating to stockbrokers. A legitimate criticism of such a suitability standard can be constructed on the grounds that traditionally the 1933 Act has been concerned only with fair disclosure, not with the merits of particular securities. Since the purchaser's financial information would not need to be supplied under the 1933 Act for registered securities, the argument is made that it should not be required for unregistered securities.

Even assuming that it is appropriate to include a suitability test in a private placement exemption, the particular test incorporated in Rule 146 is open to serious attack. Specifically, what do the words “bear” and “economic risk” denote? Does “bear” mean that if all were lost the investor would not need to change his lifestyle in the slightest? Or does it mean only that bankruptcy would not be necessary? Given the second consideration, namely, that the investor be able to afford a complete loss, “economic risk” apparently means the possible loss of the total investment. Yet, it is possible that the term “economic risk” may require using a scale of probabilities to determine the likelihood of losing various percentages of the investment.

Ascertaining the offeree's ability to bear the risk would seem to necessitate, at a minimum, inspection of the offeree's net worth. For a multitude of reasons, however, offerees may be reticent in revealing an exact net worth, not to mention its composition. Thus, this requirement could cause some investors to forego buying privately offered securities.

Assuming arguendo that all offerees would voluntarily divulge any financial information the issuer requested, how is the issuer to evaluate that information? Would an uninflated net worth

37. It is ironic that in endeavoring to explain the “able to bear” language the Commission introduced further ambiguity through use of the words “could afford” in both of the considerations. (Emphasis added).
38. See 17 C.F.R. § 240.15610-3 (1972).
39. Not only does the suitability requirement arguably exceed the rule-making authority of the SEC, but such a requirement may also discriminate against the poor. Read strictly, the requirement might make private offering securities available only to the rich. SEC Rule 146—The Private Placement Exemption, supra note 5, at 1150-51.
40. Id.
41. It should be recognized at the outset of a search for a proper criterion
of $250,000 be sufficient in all cases? Use of such a flat figure would of course provide certitude, but unfortunately would have no correlation to the size of the economic risk. Accordingly, the best proposal would be to require an offeree to have a net worth at least equal to a specified multiple of the proposed investment.

Before actually selling a security in a private offering, the issuer must, according to 146(d)(2), have reasonable grounds to believe, after making a "reasonable inquiry," that the purchaser is "rich" and sophisticated (or at least has a sophisticated representative). The SEC has in effect stated that reasonable grounds cannot exist before an investigation has occurred. While the "reasonable inquiry" test can be viewed as a clarification of the "reasonable grounds" standard, it can also be seen as another snag in the path of the issuer. Issuers must not only resolve at what point their sleuthing has matured into a "reasonable inquiry," but they must also conclude on the basis of the information procured whether "reasonable grounds" exist. Because the issuer bears the burden of proving reasonable inquiry, tangible evidence should be carefully maintained.

If the offeree is not financially sophisticated, the issuer may not sell to him unless there is an offeree representative with the requisite sophistication. Although the Commission in promulgating the test for offeree representative sophistication used the same words as for offeree sophistication, it is possible to infer that the test will not be treated the same in both situations. Specifically, courts might expect a higher level of financial expertise from an avowed expert (i.e., the representative of the offeree). In light of the "education and experience" portion of the test, it is not necessarily safe to assume that lawyers are per se qualified financial analysts, because many lawyers do not have a background in, and do not in their practice normally deal with, financial problems. One solution to the problem of determining offeree representative sophistication might be to adopt a class of persons, such as registered stockbrokers, who are deemed per se qualified.42

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42. Alberg & Lybecker, supra note 5, at 637. This article also points out that

[1] It is unclear whether the issuer may recommend an offeree representative to the offeree, whether the offeree representa-
It is noteworthy that as a whole, section 146(d) operates to prevent small, inexperienced investors from participating in private offerings, yet one of the original reasons behind private offerings was to allow small businesses to raise relatively small amounts of capital from friends, business acquaintances, etc. The thrust of Rule 146(d) is to make it easier for institutional investors to be active in the private placement market, but much more difficult for the small investor to be so.

E. Access to or Furnishing of Information—146(e)

It is instructive to pay heed to the opening note under section (e), which advances the Commission's view of the access concept:

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

This note reveals that the SEC has perpetuated the confusing judicial notion of considering access in terms of special relationships between the issuer and offeree (e.g., family and employment). In addition, the Commission has added to this list those relationships based on economic bargaining power. This latter criterion makes it relatively easy for powerful institutions to meet the access requirement. Simultaneously, the Commission has shut the door

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43. SEC Rule 146—The Private Placement Exemptions, supra note 5, at 1152.

44. Could this lead to a perpetuation of the "rich get richer" phenomenon? Could it stifle individual initiative in the investment field? Such questions perhaps overstate the significance to small investors of the private offering, since in many situations the offering can be made to conform to the parameters of either a Regulation A offering or the intrastate offering exemption. Nevertheless, these offerings will not always be satisfactory. The time and money spent in filing a Regulation A offering can be almost as great as that spent with fully registered offerings. See Glavin & Purcell, Securities Offerings and Regulation A—Requirements and Risks, 13 Bus. Law 303 (1958). The intrastate offering exemption is cast in such rigid terms that in many situations it simply will not be a viable alternative. It will, for example, normally present problems for issuers located in populous areas very close to the state's geographical borders.

45. The addition by the SEC of "bargaining power" to the test of "insider status" employed by Continental Tobacco appears to represent a divergence from the case law.
on smaller, less economically influential investors who will probably not be held to have sufficient bargaining power vis-à-vis the issuer to compel disclosure of all registration-type information. Admittedly, this discussion is speculative, because it is unclear how much bargaining power is necessary to gain access to the material information investors require in order to make informed decisions. Finally, it should be noted that the terms “employment or family relationship” are not entirely unambiguous.

The SEC has propounded a relatively objective test for the type of information to which the offeree must have access. The issuer knows that if it supplies all the information called for in Schedule A it will be safe. The Commission, however, in an apparent attempt to add leniency to this requirement, tacked on the qualifying phrase “to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense.” Asking issuers to second guess what courts will deem to be unreasonable effort or expense is a tough order. Another question left unresolved by the Rule’s access notion is whether the issuer must act affirmatively by supplying the offerees with material information or whether it could await an offeree’s request for information. It would appear, however, that the issuer must at least be willing to open its books to offerees. But this could prove burdensome for the issuer since it might result in a general disruption of the business.

Perhaps because the SEC recognized the inherently imprecise nature of the traditional access notion, it has provided in subparagraph (e)(1)(ii) that issuers may meet the access requirement by furnishing the same kind of information that is specified in Schedule A (to the extent it can be required without unreasonable

46. Greater objectivity could be given the special relationship test by specifying certain relationships which per se possess the requisite bargaining power to gain access. For example, institutions with certain characteristics or voting members of the board of directors might be granted such status.

47. Section (e)(1)(i) is phrased so as to include only offerees. Thus, even if the offeree’s representative has the special relationship necessary for access it will be to no avail.

48. Schedule A is that portion of the 1933 Act which, along with sections 7 and 10, prescribes the contents of the registration statement and prospectus.

49. It has been pointed out that not only is “unreasonable expense” undefined, but it is also unclear what alternatives may be available if Schedule A-type information is in fact unreasonably expensive to produce. SEC Rule 146—The Private Placement Exemptions, supra note 5, at 1158.

expense). This alternative to the traditional access approach has provided greater certainty for issuers, at least those which are reporting companies, because the provisions detailing the type of information required of issuers subject to the reporting requirements of section 13 or 15(d) of the 1934 Securities Exchange Act, though somewhat complicated, are concrete.51

The established, relatively more powerful companies—the reporting companies—have benefited from this increased certainty since they are already required to compile the kind of information necessary to satisfy the disclosure provision [(e) (l) (ii)] of Rule 146. The price for this greater certainty, however, will probably be paid by the smaller, less well-established, non-reporting companies. In order to meet the disclosure requirements, these companies must furnish “the information that would be required to be included in a registration statement filed under the Act on the form which the issuer would be entitled to use.”52 One commentator has observed there may be some risk in determining exactly what information the foregoing test requires, since issuers will not have the guidance normally supplied in a full registration by SEC staff comments.53

Even assuming that the exact information is ascertainable, the really insidious aspect of this provision is that:

[The difficulty of complying with these requirements may vary, depending upon the status of an issuer. For a publicly held company which is subject to the reporting requirements of the Exchange Act, the information which must be furnished can be assembled and supplied probably without expending a great amount of time or expense. However, for the start-up situation or the small, existing privately held issuer, complying with the Rule is, in all likelihood, too expensive and burdensome, since the information would not be readily available.54]

If the disclosure requirements of private offerings under Rule 146 have become as burdensome to small issuers as regular offerings or even Regulation A offerings, then one of the bedrock principles underlying private offerings, namely, that they provide an inexpensive method of issuing securities, has been erased. It is submitted that the situation could be improved if the SEC would draft a special, less detailed disclosure form for non-reporting companies.

Rather than drafting such a disclosure form, however, the SEC

51. Rule 146 (e) (1) (ii) (a) (1)–(2), Appendix.
52. Rule 146 (e) (1) (ii) (b), Appendix.
53. Alberg & Lybecker, supra note 5, at 640.
in a recent release\textsuperscript{55} merely qualified subparagraph (e)(1)(ii)(b), as follows:

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

NOTE: The issuer would have the burden of proof to show that, under the circumstances, the omitted information is not material and that any condensation does not render the statements made misleading.\textsuperscript{56}

The amendment further states that if the issuer can furnish neither audited nor unaudited financial statements "without unreasonable effort or expense, the financial statements required by Regulation A under the Act may be furnished."\textsuperscript{57} These amendments to Rule 146 are an admirable attempt to lessen the burden on issuers, especially small issuers. Arguably, however, they do not go far enough. The SEC should have simply drafted a minimal disclosure form, thus eliminating the need for the ambiguous language "without reasonable effort or expense." Furthermore, since the burden is on issuers to show that any omissions from Schedule A were not material, they may be reluctant to take advantage of the less stringent requirements.

Another weighty provision of 146(e) is found in section (e)(2):

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

It is readily apparent that the words "any additional information, to the extent the issuer possesses such information or can acquire it without unreasonable effort or expense, necessary to verify the . . . information obtained pursuant to subparagraph (e)(1)"\textsuperscript{58} contain a multiplicity of uncertainties. The paramount question is how far must issuers go to appease zealous investors. Must the issuer afford offerees the opportunity of perusing all company correspond-

\textsuperscript{56} Id.
\textsuperscript{57} Id.
\textsuperscript{58} Emphasis was supplied to those terms which are crucial to interpreting the phrase to illustrate the tremendous potential for interpretive nightmares lurking in the provision.
ence? Or must receipts and daily records be produced so that offerees can double-check the issuer's bookkeeping? While these two examples would probably be held "unreasonably expensive," it is clear that much hinges on how strictly the provision is construed. This emphasizes the great latitude available to the judge, and the attendant unpredictability confronting issuers.

F. Business Combinations—146(f)

A major hurdle is created by section (f) (3), which states that an offeree who needs an offeree representative in order to satisfy the knowledge and experience test, and who refuses to have one, may make the Rule unavailable for the transaction.60

Another dilemma is posed where the management of an acquired company is not deemed to be financially sophisticated.61 In such a case, the management may not act as an offeree representative.62

Only in unusual circumstances would the issuer in a 146(f) transaction be justified in relying on the access notion of 146(e) (1) (ii) to satisfy the Rule's information requirements.63 The average shareholder simply does not possess the bargaining power needed to have access. But this is really a problem of double access, for even if the individual shareholder has access to information of the acquired company there is a further question of whether the company to be acquired has sufficient bargaining power to constitute access with respect to the issuer, i.e., the acquiring corporation.64

G. Number of Purchasers—146(g)

Rule 146(g)(1), as originally drafted, provided that "[t]here shall be no more than thirty-five purchasers of the securities of the issuer from the issuer in any offering pursuant to the rule." Casting the "numbers" test in terms of a concrete number of purchasers represents a rather bold severing of the prior law in the private offering area.65 Through this changing of the test, the

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59. "Virtually all information is 'available' if unlimited time and effort is devoted to compiling it, and thus a court is left with considerable discretion, and an issuer with considerable doubt, as to where to draw the line." Note, Revising the Private Placement Exemption, 82 YALE L.J. 1512, 1520 (1973).
61. SEC Rule 146—The Private Placement Exemption, supra note 5, at 1159.
62. Rule 146(f) (3), Appendix.
63. Rosenfeld, supra note 54, at 211.
64. Id.
65. The landmark Ralston-Purina case stated that "there is no warrant
Commission has transformed a previously murky test into a supremely objective one. The SEC deserves the accolades it has received for this feat. Choosing a particular number, such as thirty-five, necessarily entails a somewhat arbitrary process. But the cogent rationale behind setting a relatively low number (such as thirty-five) is that when there are so few purchasers the expense and time consumed in going through the motions of the registration process outweigh the limited benefits which would accrue.

In an effort to ease the burden on issuers who in good faith believed there were no more than thirty-five purchasers, the SEC recently changed the “there shall be no more than thirty-five purchasers” language to “The issuer shall have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that there are no more than thirty-five purchasers.” This is precisely the kind of change which is needed, for it will help lighten the burden imposed by 146(b) which states that all of the conditions must be met or the Rule will be lost.

A note following subparagraph (g)(1) directs readers to Preliminary Note 3 and section (b)(1) which together state that the “thirty-five purchasers” test is to be construed in conjunction with the integration approach to defining an “offering.” Specifically, section (b)(1) sets up a “safe harbour” for sales made within six months (before or after) any sale within the Rule. This “safe harbour” provision, in conjunction with the given factors of the integration concept, offers sufficient certainty to issuers.

Subparagraph (2) of Rule 146(g) defines certain classes of purchasers which are to be excluded in counting to thirty-five. The most prominent provision is 146(g)(2)(i)(d) which includes “any person who purchases or agrees in writing to purchase for cash in a single payment or installments, securities of the issuer in the aggregate amount of $150,000 or more.” Thus, the Rule sets no numerical limit on the number of institutional investors which can meet this large cash requirement. As has been discussed, these

for superimposing a quantity limit on private offerings as a matter of statutory interpretation.” SEC v. Ralston-Purina Co., 346 U.S. 119, 125 (1953). Of course Rule 146 still indirectly controls the number ofofferees through other sections such as the sophistication and access standards.

68. Under section (b)(1) if two offerings are at least six months apart they will be considered separate under Rule 146.
69. In practice institutional investors often invest more than $150,000 per
institutional investors will not normally experience difficulty in satisfying the sophistication and access criteria. Even the "negotiated transaction" requirement found in the Proposed Rule 146, which proved troublesome for institutional investors, was deleted from Rule 146 as issued in April, 1974. Thus, through this special treatment for $150,000 or more cash purchasers, the Rule has again evidenced favoritism toward large versus small investors.

Section (g)(2)(ii) of the Rule clarifies the term "purchaser" by stating:

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

A note following this section refers to the Rule's Preliminary Note 5, which teaches that clients of an investment advisor, customers of a broker or dealer, or persons of similar relationships shall be considered the "offerees" or "purchasers" regardless of the degree of discretion given to the advisor or broker by the client. If the law were otherwise, a serious loophole would exist; therefore, this provision seems justified.

H. Limitations on Disposition—146(h)

This section sets forth the various steps which issuers must take before selling Rule 146 securities to ensure that the purchasers are not underwriters. Stop transfer instructions and legends are already in common use. Additionally, section (h) requires that the

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71. Preliminary Note 5 states:
Clients of an investment adviser, customers of a broker or dealer, trusts administered by a bank trust department or persons with similar relationships shall be considered to be the "offerees" or "purchasers" for purposes of the rule regardless of the amount of discretion given to the investment adviser, broker or dealer, bank trust department or other person to act on behalf of the client, customer or trust.

72. "Teaches" is probably the most appropriate word in that many lawyers, relying on an earlier SEC no-action letter, had for years been telling clients that where several purchases are made by one investment advisor on behalf of several clients who had given the advisor full discretion in investing, only one purchase had occurred. These lawyers learned that the law had changed with the promulgation of Rule 146. SEC Rule 146—the Private Placement Exemptions, supra note 5, at 1164.
issuer obtain "a written agreement from the purchaser that the securities will not be resold without registration or exemption therefrom," and that issuers make "reasonable inquiry" to determine if the purchaser is purchasing for his own account. By using the words "reasonable inquiry," without supplying guidelines as to their meaning, the Commission has introduced an uncertain test.

It is interesting to note that section (h) states that the reasonable care required of issuers "shall include, but not necessarily, be limited to," the previously enumerated four acts the issuer must perform. This cryptic phrase, apparently intended to create a "good faith" requirement for issuers, is inherently subjective.

III. A SUGGESTED APPROACH

The rationale underlying the private offering exemption is that the money, time, and energy necessary to comply with section 5 of the 1933 Act by filing a registration statement and prospectus is too great when balanced against the attenuated need for such disclosure in small or non-public offerings. Implicit in this core notion is the belief that the raising of venture capital, which in turn fuels economic growth, is an important concern for businessmen which cannot always be subservient to investor protection.

Based on the major ambiguities contained in and created by Rule 146, it could be concluded that the Commission had, in the balancing process, deferred to considerations related to investor protection to such an extent that the certainty provided by the Rule was emasculated to the point where many businessmen, especially the less successful ones, would find the Rule unworkable. Assuming that balancing is necessary, one might reasonably determine that the Federal Securities Code by not providing enough investor protection.

It is possible to reach a compromise between these two approaches and still retain sufficient objectivity to permit all levels

73. Rule 146 (h) (4), Appendix.
74. Id.
75. ALI FEDERAL SECURITIES CODE (Tent. Draft No. 1, 1972). The Code, drafted by Professor Loss, defines a limited offering as "one in which the initial buyers are institutional investors and not more than thirty-five other persons . . ." Id. at 12. Also, general advertising is not permitted. The most noticeable aspect of the Code is that it totally abandoned the sophistication requirement with respect to the 35 purchasers. It is submitted that at least a small degree of investor protection is a necessary element of a fair private offering exemption.
of business to utilize the exemption advantageously. This portion of the article will sketch the direction such an approach should take.

Today there is consensus that certain institutional investors are appropriate purchasers in an exempt offering because they possess financial sophistication and security as well as bargaining power. Accordingly, certain institutions should be excluded in counting the number of offerees and purchasers allowed. The ALI Code's objective definition of institutions can offer the certainty needed as to what is an institution. The Code's definition permits the classes falling within the definition to be expanded or contracted objectively. One such objective standard could be a requirement that the institution have net assets, as shown by their tax returns, at least equal to a certain multiple of the prospective investment. Under such a definition at least some institutions, those presumptively not needing the protection of the registration process, would be per se able to participate in the private placement market.

In addition to institutions, many wealthy individuals have little need for the prospectus required by section 5 of the 1933 Act. Accordingly, to allow such presumably sophisticated individuals to participate, they too would be excluded in counting the number of offerees and purchasers allowed. An objective test for such wealthy individuals would be the one embodied in Rule 146(g) (2) (i) (d), which excludes from the numerical limit on purchasers those who buy, for cash, securities of the issuer amounting to $150,000 or more. Generally, persons who deal in such large amounts of securities are financially sophisticated and can afford to take the risks presented by the investment (as evidenced by payment in cash). It must be recognized, however, that occasionally investments of such magnitude may be made by persons lacking financial sophistication. To ensure that such an investor is not financially

76. The Code defines "institutional investor" as follows:
(a) a bank, insurance company, or registered investment company, or a parent of any such person, except to the extent that the Commission provides otherwise by rule with respect to any such class of persons on the basis of such factors as financial sophistication, net worth, and the amount of assets under investment management, or (b) any other person of a class that the Commission designates by rule on the basis of such factors.

Id. § 242, at 19. The Reporter's Comment to that section advises that "[i]t is simply impossible to make all the necessary discriminations by statute." Id. Thus, it would be incumbent on the SEC to expand or contract the classes of institutional investors included in the definition.

77. For example, a person may have inherited great wealth and yet have no experience in financial matters.
ruined, a requirement that there be a minimum net worth, such as $750,000, should be established. Alternatively, all individuals making purchases over $150,000 could be required to consult with an investment advisor. To keep this requirement objective, a class of investment advisors who are per se qualified should be established.\textsuperscript{78}

Furthermore, "any relative or spouse of a purchaser and any relative of such spouse, who has the same home as such purchaser"\textsuperscript{79} should be excluded from the counting process. This allows a husband and wife who purchase separately for tax or other reasons to be counted as one purchaser. Finally, voting members of the issuer's board of directors should not be counted as purchasers, since it is fair to infer that directors have access to the kind of information that would be included in a prospectus.\textsuperscript{80} The proposed provision should include only full-fledged, voting directors in order to keep issuers from adding directors to evade the registration requirements.

The exclusionary provisions just outlined mostly cater to the large investor. The more difficult, yet critical challenge is to provide for at least limited participation by smaller investors. In this way one of the original reasons for the private offering exemption—to allow small businessmen to raise capital from friends, family, business associates, etc., without undue expense—can be realized. The sophistication/access requirements of Rule 146 present virtual roadblocks to small issuers. Accordingly, these idealistic concepts should be jettisoned in favor of a "number of offerees and purchasers" test. In keeping with the notion that a non-public offering should be a relatively small one, a proper approach might be to allow only twenty purchasers. Further, a limit—perhaps fifty—should be placed on the number of offerees. The purpose of an offeree's test in this approach would be to encourage the issuer to choose offerees carefully. Thus, the issuer would feel constrained to extend initial offers to those most likely to be in a position to accept (i.e., those with available investment funds). In turn, the fact that relatively wealthy people will be approached by the issuer acts as a crude sophistication requirement since it is presumed that those with funds to invest are generally in a better

\textsuperscript{78} As an example, the class of qualified investment advisors could include brokers who had been for the previous five years a member of NASD.

\textsuperscript{79} Rule 146(g) (2) (i) (a), Appendix.

\textsuperscript{80} If directors are not well versed in the company's business, they are probably violating their duty as directors. See Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).
position than most to withstand the risk of loss and are more familiar with money matters.

Irrespective of the partial screening process supplied by these numbers tests, there will still be a group of potential buyers who possess few of the attributes making up sophistication. As a minimum measure of protection, therefore, before any purchase, the issuer should provide all offerees with a letter putting them on notice of the risks of private offerings. Although the exact wording of a satisfactory letter could be developed by the SEC, such a letter should explain that private offering securities are different from most securities because they are not registered and, therefore, it may be more difficult for an investor to ascertain the risks involved since no prospectus will be available. To offset partially that disadvantage the letter should urge investors to take advantage of their opportunity, upon request, to: (1) receive by mail a short circular containing the issuer's latest prepared financial statements including at the least a balance sheet and income statement for the three most recent years (if the business has existed that long);81 (2) have the issuer send a short statement describing the type of business it is engaged in and the proposed use of the proceeds from the private offering; and (3) visit the business site and ask questions of management.82

Even if there are instances where the financial statements would not be meaningful to particular purchasers, those documents could serve as a basis for suit under the anti-fraud provisions of the 1933 Act. In this connection, special notice should be taken of how buyers are protected from fraudulent conduct by the recent, ever-expanding parameters of Rule 10 (b) (5) of Section 10 (b) of the 1934 Securities Exchange Act.83

For purposes of determining what offers are part of an offering, the "safe harbour" provisions and integration factors set out in Rule 146 would seem to provide a clear guideline for issuers. Further, general advertising should continue to be prohibited.

Finally, the limitations on disposition should include: (1) placing legends on certificates, (2) issuing stop transfer instructions, and (3) obtaining from the purchaser a signed written agreement that the securities will not be sold without registration under the Act unless he is exempt from this requirement.

81. The financial statements sent should be audited unless the issuer has no audited statements.
82. If the issuer has decided not to sell to a particular offeree, no duty of disclosure should continue to exist with respect to that offeree.
83. For a background in Rule 10b-5, see R. JENNINGS & H. MARSH, supra note 3.
Appendix
Rule 146


PRELIMINARY NOTES

1. The Commission recognizes that no one rule can adequately cover all legitimate private offers and sales of securities. Transactions by an issuer which do not satisfy all of the conditions of this rule shall not raise any presumption that the exemption provided by section 4(2) of the Act is not available for such transactions. Issuers wanting to rely on that exemption may do so by complying with administrative and judicial interpretations in effect at the time of the transactions. Attempted compliance with this rule does not act as an election; the issuer can also claim the availability of section 4(2) outside the rule.

2. Nothing in this rule obviates the need for compliance with any applicable state law relating to the offer and sale of securities.

3. Section 5 of the Act requires that all securities offered by the use of mails or other channels of interstate commerce be registered with the Commission. Congress, however, provided certain exemptions in the Act from such registration provisions where there was no practical need for registration or where the public benefits of registration were too remote. Among these exemptions is that provided by section 4(2) of the Act for transactions by an issuer not involving any public offering. The courts and the Commission have interpreted the section 4(2) exemption to be available for offerings to persons who have access to the same kind of information that registration would provide and who are able to fend for themselves. The indefiniteness of such terms as "public offering," "access" and "fend for themselves" has led to uncertainties with respect to the availability of the section 4(2) exemption. Rule 146 is designed to provide, to the extent feasible, objective standards upon which responsible businessmen may rely in raising capital under claim of the section 4(2) exemption and also to deter reliance on that exemption for offerings of securities to persons who need the protections afforded by the registration process.

In order to obtain the protection of the rule, all its conditions must be satisfied and the issuer claiming the availability of the rule has the burden of establishing, in an appropriate form, that it has satisfied them. The burden of proof applies with respect to each offeree as well as each purchaser. See "Lively v. Hirschfeld," 440 F.2d 631 (10th Cir. 1971). Broadly speaking, the conditions of the rule relate to limitations on the manner of the offering, the nature of the offerees, access to or furnishing of information, the number of purchasers, and limitations on disposition.

The term "offering" is not defined in the rule. The determination as to whether offers, offers to sell, offers for sale, or sales of securities are part of an offering (i.e., are deemed to be "integrated") depends on the particular facts and circumstances. See Securities Act Release No. 4552 (November 6, 1962) (27 FR 11316). All offers, offers to sell, offers for sale, or sales which are part of an offering must meet all of the conditions of Rule 146 for the rule to be available. Release 33-4552 indicates that in determining whether offers and sales should be regarded as a part of a larger offering and thus should be integrated, the following factors should be considered:

(a) Whether the offerings are part of a single plan of financing;
(b) Whether the offerings involve issuance of the same class of security;
(c) Whether the offerings are made at or about the same time;
(d) Whether the same type of consideration is to be received; and
(e) Whether the offerings are made for the same general purpose.

4. Rule 146 relates to transactions exempted from section 5 by Section 4(2) of the Act. It does not provide an exemption from the anti-fraud provisions of the securities laws or the civil liability provisions of section 12(2) of the Act or other provisions of the securities laws, including the Investment Company Act of 1940.

5. Clients of an investment adviser, customers of a broker or dealer, trusts administered by a bank trust department or persons with similar relationships shall be considered to be the “offerees” or “purchasers” for purposes of the rule regardless of the amount of discretion given to the investment adviser, broker or dealer, bank trust department or other person to act on behalf of the client, customer or trust.

6. The rule is available only to the issuer of the securities and is not available to affiliates or other persons for sales of the issuer's securities.

7. Finally, in view of the objectives of the rule and the purposes and policies underlying the Act, the rule is not available to any issuer with respect to any transactions which, although in technical compliance with the rule, are part of a plan or scheme to evade the registration provisions of the Act. In such cases registration pursuant to the Act is required.

(a) Definitions. The following definitions shall apply for purposes of this rule.

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

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

(a) Related to such person by blood, marriage or adoption, no more remotely than as first cousin;

(b) Any trust or estate in which such person or any persons related to him as specified in paragraph (a)(1)(i)(a) or (c) of this section collectively have 100 percent of the beneficial interest (excluding contingent interests) or of which any such person serves as trustee, executor, or in any similar capacity; or

(c) Any corporation or other organization in which such person or any persons related to him as specified in paragraph (a)(1)(i)(a) or (b) of this section collectively are the beneficial owners of 100 percent of the equity securities (excluding directors' qualifying shares) or equity interest;

(ii) Has such knowledge and experience in financial and business matters that he, either alone, or together with other offeree representatives or the offeree, is capable of evaluating the merits and risks of the prospective investment;

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

(iv) discloses to the offeree, in writing, prior to the acknowledgement specified in paragraph (a)(1)(iii) of this section, any material relationship between such person or its affiliates and the issuer or its affiliates, which then exists or is mutually understood to be contemplated or which has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.
NOTE 1: Persons acting as offeree representatives should consider the applicability of the registration and anti-fraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 and relating to investment advisers under the Investment Advisers Act of 1940.

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

NOTE 3: Disclosure of any material relationships between the offeree representative or its affiliates and the issuer or its affiliates does not relieve the offeree representative of an obligation to act in the interest of the offeree.

(2) Issuer. The definition of the term "issuer" in section 2(4) of the Act shall apply, provided that notwithstanding that definition, in the case of a proceeding under the Bankruptcy Act, the trustee, receiver, or debtor in possession shall be deemed to be the issuer in an offering for purposes of a plan of reorganization or arrangement, if the securities offered are to be issued pursuant to the plan, whether or not other like securities are offered under the plan in exchange for securities of, or claims against, the debtor.

(3) Affiliate. The term "affiliate" of a person means a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with such person.

(4) Material. The term "material" when used to modify "relationship" means any relationship that a reasonable investor might consider important in the making of the decision whether to acknowledge a person as his offeree representative.

(b) Conditions to be met. Transactions by an issuer involving the offer, offer to sell, offer for sale or sale of securities of the issuer that are part of an offering that is made in accordance with all the conditions of this rule shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.

(1) For purposes of this rule only, an offering shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by section 3 or section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, Provided, That there are during neither of said six month periods any offers, offers nor sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

NOTE: In the event that securities of the same or similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six months prior to or subsequent to any offer, offer for sale or sale pursuant to the rule, see Preliminary Note 3 hereof as to which offers, offers to sell, offers for sale or sales may be deemed to be part of the offering.

(c) Limitations on manner of offering. Neither the issuer nor any person acting on its behalf shall offer, offer to sell, offer for sale, or sell the securities by means of any form of general solicitation or general advertising, including but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over television or radio;
(2) Any seminar or meeting, except that if paragraph (d)(1) of this section is satisfied as to each person invited to or attending such seminar or meeting, and, as to persons qualifying only under paragraph (d)(1)(ii) of this section, such persons are accompanied by their offeree representative(s), then such seminar or meeting shall be deemed not to be a form of general solicitation or general advertising; and

(3) Any letter, circular, notice or other written communication, except that if paragraph (d)(1) of this section is satisfied as to each person to whom the communication is directed and the communication contains an undertaking to provide the information specified by paragraph (e)(1) of this section on request, such communication shall be deemed not to be a form of general solicitation or general advertising.

(d) Nature of offerees. The issuer and any person acting on its behalf who offer, offer to sell, offer for sale or sell the securities shall have reasonable grounds to believe and shall believe:

(1) Immediately prior to making any offer, either:
   (i) That the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or
   (ii) That the offeree is a person who is able to bear the economic risk of the investment; and
(2) Immediately prior to making any sale, after making reasonable inquiry, either:
   (i) That the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or
   (ii) That the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment.

(e) Access to or furnishing of information.

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

(1) Either
   (i) Each offeree shall have access during the course of the transaction and prior to the sale to the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense; or
   (ii) Each offeree or his offeree representative(s), or both, shall have been furnished during the course of the transaction and prior to sale, by the issuer or any person acting on its behalf, the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense. This condition shall be deemed to be satisfied as to an offeree if the offeree or his offeree representative is furnished with information, either in the form of documents actually filed with the Commission or otherwise, as follows:
      (a) In the case of an issuer that is subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934:
         (1) The information contained in the annual report required to be filed under the Exchange Act or a registration statement on Form S-1 under the Act or on Form 10 under the Exchange Act, whichever filing is the most
recent required to be filed, and the information contained in any definitive proxy statement required to be filed pursuant to section 14 of the Exchange Act and in any reports or documents required to be filed by the issuer pursuant to section 13(a) or 15(d) of the Exchange Act, since the filing of such annual report or registration statement, and

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

(b) In the case of all other issuers, the information that would be required to be included in a registration statement filed under the Act on the form which the issuer would be entitled to use, Provided, however, That if the issuer does not have the audited financial statements required by such form and cannot obtain them without unreasonable effort or expense, such financial statements may be provided on an unaudited basis;

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

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

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

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

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

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

Note: Information need not be provided and opportunity to obtain additional information need not be continued to be provided to any offeree or offeree representative who, during the course of the transaction, indicates that he is not interested in purchasing the securities offered, or, except in the case of any undertaking made pursuant to paragraph (c) (3), to whom the issuer or any person acting on its behalf has determined not to sell the securities.

(f) Business combinations. (1) The term "business combination" shall mean any transaction of the type specified in paragraph (a) of Rule 145 under the Act.

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

Note: Notwithstanding the absence of a written agreement pursuant to paragraph (h) (4), any securities acquired in an offering pursuant to para-
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(3) For purposes of paragraph (f) only, the issuer and any person acting on believe, and shall believe, at the time that any plan for a business combination is submitted to security holders for their approval, that each offeree either alone or with his offeree representative(s) has such knowledge and experience in financial and business matters that he is or they are capable of evaluating the merits and risks of the prospective investment.

(4) In addition to information by paragraph (e), the issuer shall provide, in writing, to each offeree at the time the plan is submitted to security holders for approval, information about any terms or arrangements of the proposed transaction relating to any security holder that are not identical to those relating to all other security holders.

(4) In addition to information by paragraph (e), the issuer shall provide, in writing, to each offeree at the time the plan is submitted to security holders for approval, information about any terms or arrangements of the proposed transaction relating to any security holder that are not identical to those relating to all other security holders.

(g) Number of purchasers. (1) There shall be no more than thirty-five purchasers of the securities of the issuer from the issuer in any offering pursuant to the rule.

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

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

(i) The following purchasers shall be excluded:

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

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

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

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

Note: The issuer would have to satisfy all the other provisions of the rule with respect to the purchasers specified in subdivision (g) (2) (i).

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

Note: See Preliminary Note 5 as to other persons who are considered to be purchasers.

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

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

(2) Placing a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities;
(3) Issuing stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, making a notation in the appropriate records of the issuer; and

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

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