A LOOK AT THE PRIVATE OFFERING EXEMPTION AS IT APPROACHES ITS FORTIETH BIRTHDAY

Address by

Hugh F. Owens
Commissioner
Securities and Exchange Commission
Washington, D. C.

Before
Annual Meeting of District No. 4
(Kansas, Missouri, Nebraska, Oklahoma)
National Association of Securities Dealers

Kansas City, Missouri
May 16, 1972

A LOOK AT THE PRIVATE OFFERING EXEMPTION AS IT APPROACHES ITS FORTIETH BIRTHDAY

Next year will mark the fortieth anniversary of the adoption of the Securities Act of 1933. Of all of the pieces of legislation arising out of the depression, this statute has surely been one of the most successful in accomplishing the ends for which it was passed. The statute itself has been changed very little over the years, even though the public markets and the types of offerings being made in those markets have changed considerably. Perhaps the most striking change that has transpired is in the dollar volume of new corporate security issues. In the period of 1935-39, the value of such offerings was approximately 2.7 billion dollars; in the period of 1970-71, it had expanded to somewhat over 42 billion dollars. This phenomenal growth has been created not only by the requirements of our growing economy, but also by the efficiency of the mechanisms that have been developed for raising capital through the sale of securities to the public.

Despite the changes that have occurred in the past 39 years, I do not believe that the Securities Act of 1933 must be restructured to any significant degree to meet the needs of today. It continues to be a remarkably effective piece of legislation. It is useful, however, to review periodically the interpretive glosses that have been added to the key provisions of the Act by the courts and by the Commission to assure that these provisions are continuing to work in the public interest and for the protection of investors. One such review, of which you are all aware, has just been completed, and its results are manifested in Rule 144 which became effective on April 15 of this year. The purpose of Rule 144 is to make clear the standards applicable to the exemption provided by Section 4(1) of the Act for transactions by persons other than issuers, underwriters or dealers. A number of persons have suggested that the Commission's rule making efforts should not stop at this point and that an attempt should be also made to clarify the standards applicable to the exemption provided by Section 4(2) for transactions by an issuer not involving a public offering.

The Commission's staff has just begun to determine whether this project is a feasible one. It would be helpful, of course, to have available data on the volume of securities issued in private placements in order to know the extent of the activity that would be affected by any rule or interpretation that the Commission may issue. Unfortunately, no reliable statistical information exists. One commentator, however, has speculated that, during the period from 1942 through 1965, the dollar volume of securities privately placed exceeded that of those offered to the public by means of registration under the Securities Act of 1933. I hope that the new amendment to Form 10-K requiring disclosure of the securities sold in reliance on Section 4(2) and, indirectly, the information as to resales of such securities to be provided on new Form 144 will give us a better statistical picture of the private placement market, at least in terms of reporting companies.

Whatever the present-day statistics may show, however, it is undoubtedly true that the volume of private placements has grown tremendously since 1933, and probably in an amount corresponding to the increase in securities offerings generally. In view of this change in the volume of private placements over the years, it is not surprising to find that the criteria for determining the availability of the private placement exemption have also changed and evolved.

The legislative history of Section 4(2), although vague and somewhat general, has set the policy guidelines for the later interpretations of the provision. Congress recognized that, under certain carefully limited circumstances, it might be unnecessary for an issuer to make available through the registration process all the information material to an intelligent evaluation of securities because certain persons in certain circumstances already have access to such information through other channels. Concerning the exemption in general, a 1933 report of the House of Representatives stated that "The Act carefully exempts from its application certain types of securities transactions where there is no practical need for its application or where the public benefits are too remote." In addition to this broad policy statement, the report stated that the private offering exemption "exempts transactions to permit an issuer to make a specific or isolated sale to a specific person."

Since this legislative history delineates only the periphery of the exemption, reference must be had to 40 years of Commission and judicial interpretation for a more definite analysis of the criteria which have developed in determining the applicability of the Section 4(2) exemption to specific factual situations. The Commission's construction of the private offering exemption began in 1935 with an opinion by the SEC's General Counsel wherein he advanced the proposition that "the determination whether a particular transaction involves a public offering is a question of fact dependent on all surrounding circumstances." Although the opinion carefully avoided any specific definition of the clause "not involving any public offering," it did set forth various criteria relative to such a determination. Great emphasis was placed on the number of offerees; other material factors were said to be the offerees' relationship to each other and to the issuer, the number of units offered, the size of the offering and the manner of offering. As to the relationship between the offerees and the issuer and each other, the opinion stated that such a relationship, if it exists, is relevant to the question of whether a substantial number of offerees would have special knowledge concerning the issuer. I mention this factor especially because it formed the basis for the later Ralston Purina test.

The General Counsel stated with regard to the number of offerees that "The opinion has been previously expressed by this office that an offering of securities to an insubstantial number of persons is a transaction by an issuer not involving any public offering . . . Furthermore, the opinion has been expressed that under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering." The opinion did carefully point out, however, that the determination is essentially a question of fact and that "in no sense is the question to be determined exclusively by the number of prospective offerees."

The next development occurred in 1938 when the Ninth Circuit Court of Appeals in SEC v. Sunbeam Gold Mines Co. adopted another standard which was, in essence, an interpretation of the first factor mentioned in the General Counsel's release. The Court said that, in order to determine the distinction between "public" and "private" in any particular context, "it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction." The criterion which was adopted was to see if there was a "sensible relationship" between the reason for making the offering and the selection of particular offerees.

In 1953, the United States Supreme Court in SEC v. Ralston Purina did away with this "sensible relationship" test. In its place, the Court set down two broad criteria which have since been generally followed by both the Commission and the Federal courts. These criteria are, first, whether offerees need the protection which registration affords and, second, whether they have access to the kind of information that would be available in a registration statement. I should point out that, in adopting these criteria, the Supreme Court expressly disclaimed any numerical tests; it did say, however, that the Commission was not precluded, as an administrative prerogative, from using some numerical standard in deciding when to investigate particular claimed exemptions under Section 4(2). In any event, the two criteria used in this case have been interpreted many times, for the most part consistently, and, for better or worse, generally constitute the present state of the law.

A concise interpretation of the access to information test was attempted by the Second Circuit Court of Appeals in the case of Gilligan, Will & Co. v. SEC in 1959. The Court stated that: "The governing fact is whether the persons to whom the offering is made are in such a position with respect to the issuer that they either actually have such information as a registration statement would have disclosed, or have access to such information." In November of 1962, the Commission sought to further clarify the Ralston Purina criteria and to reaffirm in part the "surrounding circumstances" test formulated in the 1935 General Counsel's release. A release issued by the Commission reaffirmed its position that "whether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of all the surrounding circumstances, including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering." The Commission emphasized that the number of offerees is relevant only to the question of whether they have the requisite association with and knowledge of the issuer which makes the exemption available. Perhaps most importantly, the 1962 release clarified the meaning of the "knowledge-access-needs" criteria with the following statement:

> "The exemption does not become available simply because offerees are voluntarily furnished information about the issuer. Such a construction would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards and sanctions of the Act."

The most recent judicial ruling directly concerning Section 4(2) was handed down last year by the United States District Court for the Southern District of Florida in SEC v. Continental Tobacco Company of South Carolina. In that decision, which is presently being appealed by the Commission to the Fifth Circuit Court of Appeals, the District Court cited Ralston Purina and held that, on the basis of the testimony and evidence adduced, the offers by Continental and the other defendants to at least 38 persons and sales to 35 of such persons during a period from June 1969 to October 1970 were transactions not involving any public offering and, therefore, were exempt from the registration provisions of the Act. The testimony of the purchasers showed that they had received both written and oral information concerning Continental, including in most cases unaudited financial statements, that they had access to any additional information which they requested and that they had personal contacts with the officers of the company. In this situation, the Court found that the offerees "were furnished and/or provided access to the same type and kind of information that would have otherwise been provided in a registration statement . . ." The main thrust of the Commission's argument on appeal is that it was not shown, by the evidence adduced, that each offeree had a relationship to the issuer giving him access to the kind of information that a registration statement would disclose. As to the contention upheld by the District Court that some offerees got a promotional prospectus, our briefs argue that; first, all offerees must be provided such material; second, the prospectus did not meet the requirements of the Act on its face since it did not contain audited financials; and, third, that the mere provision of a prospectus alone cannot establish a Section 4(2) exemption since, even if it conforms with the Act and rules thereunder, it is not subject to staff review or the civil liability sanction of Section 11.

Although I agree with the general position taken by the Commission through its General Counsel in the appeal brief, I do feel that there are certain dicta, as it were, in the brief which may be overly restrictive. The brief states that "Before the statutory protections may be safely eliminated in any case, the issuer must affirmatively demonstrate by 'explicit, exact' evidence that each person to whom unregistered securities were offered was able to 'fend' for himself -- in other words, that each offeree had a relationship to the company tantamount to that of an 'insider' in terms of his ability to know, to understand and to verify for himself all of the relevant facts . . ."

Some commentators have suggested (and I believe there is merit in their suggestions) that this language could be read to mean that a permissible private placee must have a position with the company similar to that of an insider in the 10b-5 sense. If such an interpretation were to prevail, it could lead to such a narrowing of the exemption that even an institutional investor could not qualify. This is certainly not a conclusion which I can support; in fact, I do not believe it was intended by the Commission. My interpretation of the Commission's position in this case is that (1) the offerees must be shown to have access to material information concerning the issuer and (2) the access criteria cannot be met by merely providing, gratuitously, a promotional prospectus purporting to afford instant access and by having each offeree and purchaser sign a letter saying he has received and read such document. Based upon the facts in this case, I do not believe the Commission meant to say or should have been saying anything more than this. Certainly, my interpretation is not novel nor does it limit the exemption unduly since it is the same as that expressed in Ralston Purina and in the Commission's 1962 release.

This brief recitation of the history of the private placement exemption illustrates the difficulties experienced by the courts and the Commission in attempting to formulate so-called "bright line" or objective criteria as to the availability of the exemption. It is interesting to note that the drafters of state blue sky laws have apparently not found these difficulties to be insurmountable. The State of California, for example, generally exempts offers to no more than twenty-five persons (and sales to ten of such persons) who have either a pre-existing personal or business relationship with the issuer or, by reason of their business or financial experience, can be reasonably expected to be able to fend for themselves. The California Code specifically provides that those situations which fall outside the definition do not result in any presumption that a public offer has been made, the burden remaining on the person claiming the exemption to show that it was a private offering.

The criteria used by California, if analogized to Federal law, might present two problems. First, the criteria of personal or business relationship is vague; and, second, the criteria of business or financial experience or "financial sophistication" has been held by the courts in interpreting the Federal exemption to be insufficient when standing alone. What I find to be the most interesting part of the California statute is its exclusion of a presumption against a private offering for situations not within its criteria. Perhaps this is a tacit admission of the difficulty in setting down a test precise enough or comprehensive enough to create a presumption, albeit a rebuttable one, that offers not falling within its parameters are public offers.

In all, forty-six states have enacted some form of private offering exemption. Essentially, the state private offering exemptions may be divided into six categories. Four states limit the number of offerees in the state within any consecutive twelve-month period, with the range under such state statutes being from ten to twenty-five offerees. Two states limit the number of purchasers, as opposed to offerees, to fifteen and twenty-five purchasers, respectively. Six states only allow the exemption so long as the holders of securities of the issuer would not exceed a specified number giving effect to the proposed transaction, with the range being five to thirty-five security holders. Four states impose a maximum limit on the number of security holders and limit the amount of capital which may be sought, with the range being ten to twenty-five security holders and $25,000 to $100,000. Four states exempt "isolated transactions" which are commonly defined as sales not in the course of successive and repeated transactions of a similar nature which are, thus, subject to integration with previous or subsequent sales. Twenty-four states and the District of Columbia have adopted, in one form or another, Section 402(b)(9) of the Uniform Securities Act originally promulgated by the National Conference of Commissioners on Uniform State Laws. Essentially, the Uniform private offering exemption exempts offers to not more than ten persons (that number being modified by most states) in a state within any twelve-month period.

In addition to these criteria, any one or more of the following requirements may be found in any of the state private offering exemptions:

(1) each purchaser, prior to sale, must be given adequate information concerning the financial condition of the issuer, its business operations and the intended use of proceeds;

(2) sales made pursuant to the exemption must be made without any public solicitation or advertisement;

(3) purchasers must take for "investment" only; and

(4) no commission or other remuneration may be given in connection with the sales.

These state statutory provisions may provide guidance as to what should be appropriate criteria under the Federal private placement exemption. From the legislative, judicial and administrative development of the Federal exemption which I have outlined, however, it seems clear that any formulation of administrative standards for its application will be a complicated task. It is doubtful that several of the traditional criteria can be, or should be, discarded. In particular, the number of offerees, the type of offerees, the access of the offerees to information and the manner of the offering all appear to be appropriate criteria. We must also, of course, consider new approaches.

One suggestion is that the "know your customer" requirement now applicable to broker-dealer transactions be incorporated into a rule under Section 4(2). Such a rule could incorporate traditional suitability standards and might require that prospective private placees have the financial depth necessary to sustain losses which could result from investing in securities without the benefit of a statutory prospectus. Another suggestion is that, because of the legislative and interpretive history that surrounds Section 4(2), an effort should be made to draft an exemptive rule under Section 3(b), the small offering exemption, which is not similarly encumbered. Such a rule, it is suggested, could provide definite criteria for venture capital private placements, which frequently involve private individuals; and Section 4(2), either with or without benefit of further clarification, would be available primarily for private placements to institutional investors. I see some problems with both of these suggestions, but they certainly deserve consideration. In any event, I doubt that a perfect solution will be found; I think we would all be happy with a workable one.

There are two other, somewhat related, projects currently underway at the Commission which I think would be of interest to you. The first is the implementation of newly adopted Rule 144, which I touched on just briefly at the beginning of my remarks. The principal thrust of the rule is to provide that persons who meet certain objective standards in the sale of restricted securities, which are those acquired from an issuer or affiliate otherwise than in a transaction or chain of transactions involving a public offering, shall be deemed not to be engaged in a distribution and, therefore, not to be underwriters as to such securities.

The main body of securities which the rule affects are quite obviously those which were originally issued under the private offering exemption I have just discussed. The rule does not apply to unregistered securities acquired in a business combination transaction covered by present Rule 133 under the 1933 Act (which the Commission is now considering rescinding); nor does it apply to such securities received as underwriting compensation in connection with a public offering. It does apply to unregistered securities acquired pursuant to a stock bonus or similar plan.

One standard in Rule 144 is that there must be current public information available with respect to the issuer of the securities. The rule itself enunciates the specific requirements necessary for meeting this test. A second standard relates to the period during which the seller must have beneficially held a fully paid interest in the restricted securities. The period of risk established is two years, but the rule places certain quantitative limitations on the amount of restricted securities which may be sold in brokerage transactions even after that period. Another specification is that a notice of sale must be transmitted to the Commission concurrently with placing the sell order with the broker. The new rule explicitly abandons the traditional "change of circumstances" and fungibility doctrines as not being reflective of the purposes of the 1933 Act.

Many questions have arisen regarding the interpretation of Rule 144's provisions and their applicability to particular factual situations. A number of these are being answered in interpretive letters, and consideration is also being given to the issuance of an interpretive release responding to the questions most frequently raised. We are anxious to see how the new rule works in operation, and it is our hope that it will not only be of material assistance to the bar and the investing public, but also will eventually cut down on the workload of the staff.

Another current project at the Commission which may be pertinent to our discussion is the public fact-finding inquiry we are making into the matter of "hot issue" securities. The purpose of this proceeding is to develop a factual basis for determining whether the problems we have come to associate with such "hot issues" should be dealt with by revisions of the Commission's rules or by legislation which would have to be recommended to the Congress. I say that the hot issue hearing is pertinent to the subject of the private offering exemption because it appears that many hot issues are created to enable their promoters to reap large capital gains on stock they originally acquired under that exemption.

The immediacy of the proceeding has increased since the Commission first announced it on October 21, 1971. Articles recently appearing in the financial press are raising questions as to whether a new hot issue security market is presently developing. In recent months there has been a substantial increase in the number of issuers filing registration statements under the Securities Act of 1933 for the first time. For example, for the first eight months of fiscal 1972, ended February 29, 1972, there were 801 first time filings as compared to 441 for the comparable period of fiscal 1971, and for the month of February 1972, 33.9 percent of the registered offerings filed were first time filings as compared to 23.5 percent in February 1971.

The first phase of the hearings has consisted of testimony from representatives of the investment banking industry, small business investment companies, venture capitalists and others. Representatives of the investment banking industry have testified to date on such subjects as artificial impediments to a free market as a cause of hot issues, effects of a limited trading ban on new issues, prospectus disclosure and the due diligence investigation of underwriters. The testimony from the small business investment companies and other venture capitalists has involved a broad examination of the availability and allocation of venture capital as a source of financing for new, emerging businesses. Testimony has compared the type of information obtained by sophisticated venture capitalists both prior to and after investment with the disclosure public investors receive through prospectuses and periodic reports.

The second and third phases of the hearings will consist of an in-depth analysis of the disclosure provided in registration statements and reports and the distribution and aftermarket activity of the securities of ten or twelve companies whose securities were hot issues during the period June 1, 1968 through June 20, 1969.

In closing today, I should like to leave you with one thought. I have discussed some rather complex legal problems confronting my Commission because these problems and the way that they are being resolved are of obvious importance to the members of this audience. I hope, however, that you will derive from my remarks more than simply an understanding of the legal technicalities involved and that you will also take away with you an appreciation of the efforts the Commission is making to improve the state of the law in these areas -- to make it more comprehensive and more equitable to those issuers and brokers whom it regulates. We are convinced that we can accomplish this goal without diminishing in the least the protections afforded by these laws to the investing public whom we serve; in fact, we believe that an increase in those protections will be an inherent part of the changes we are contemplating and striving to effect.