Fordham University
School of Law
New York, NY

14 September 1981

File No. S7-891

George A. Fitzsimmons, Esq., Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Dear Mr. Fitzsimmons:

This letter is in response to your request for comments on proposed Regulation D as set forth in Release No. 6339.

Obviously, the new integrated set of Rules represents a significant improvement over the previous "hodge-podge". I do, however, find some problems with them. For one thing, I never understood why Rule 242, which generally requires that information be made available to the unsophisticated ("non-accredited" purchasers) contained a limit of 35 such purchasers, while Rule 240, which had no information requirement, allowed 100 purchasers, and this anomaly has been continued in new Rules 504 and 505. I also find note 30 to the release disquieting. (I would think it better to specifically limit the number of even accredited purchasers rather than reintroduce the uncertainties as to the number of permitted offerees that the note suggests.) I also find note 27 puzzling.

Furthermore, I do not understand why if "bad people" can't use Rule 505 they were not also in the current draft precluded from using the more liberal (except for the dollar limit) Rule 504. You, of course, requested comment on this, but I don't see why, with the greater information requirements which make it safer for the buyer under Rule 205, the order wasn't initially reversed: i.e., it would seem more exigent to forbid the "bad people" from using Rule 504 than Rule 505.

My principal criticism is, however, directed to Rule 504, since it doesn't seem to me to provide a satisfactory exemption for the formation, and later re-sales of securities, of a truly close corporation. Such an exemption appears to me to be one of the most important functions the new rules should perform if they are really to assist small business.

Unless I misread the law, absent registration, if a person from one state, approaches a person from another state to participate in setting up an ordinary business, a common occurrence even in the formation of a "mom & pop" grocery store, and e.g., uses an interstate telephone call or the mails, he is violating the Act unless he can prove his entitlement to the private placement exemption of § 4(2), or some § 3(b) exemption.

I suspect that few small legal practitioners realize the dangers thus present (even where no fraud is involved), i.e., possible liability under § 12(1) in a suit by the security purchaser and a consequent malpractice suit against the organizer's attorney; at least where the business fails shortly after formation.

The "statutory law" on the availability of such a private placement is too uncertain-to rely on as a defense. (See Release No. 33-4552). Fortunately, Rule 240 provided some protection for both the organizer and his attorney, even though both were unaware of its existence, as I suspect is frequently the case. Rule 504, however, requires filing a, notice to take advantage of its safe harbor even for de minimis sales. Accordingly, as the Commission requests, I strongly urge that the notice filing requirement be deleted for small offerings, as was, in effect, done by Rule 240, to prevent the necessity for reliance on the dubious "statutory law", as a result of failure to comply fully with the Rule.

Furthermore, Rule 504 requires that resales of the securities be restricted unless the law of the state in which they are offered requires their registration, and delivery of a disclosure document. A number of state statutes exempt from their requirements sales to a limited number of purchasers. (See e.g., NJSA § 49:3-50(b); N.Y. Gen. Bus. Law § 359-ff. and Regulations thereunder.) This will mean, as I read the proposed Rules that where a really small business is involved, the securities will be restricted under the SEC Rule, because the state law does not, under Rule 504(a), meet the requirements for exemption from Rule 502(d).

There will, therefore, be no safe harbor for such common, and unharmful, transactions as a sale of a business to new owners by the sale of stock method. Rules 144 and 237 will not be available. Accordingly, only the uncertain "§ 4 (1-1/2)" exemption will be available.

Therefore, as I previously suggested (44 Fordham L. Rev. 37), I feel that the SEC should adopt ALI Federal Securities Code § 227(b) as a part of Rule 504, or a separate rule for really small businesses to avoid uncertainty in this area. The exemption's availability could, of course, be restricted to "offerings" of even less than $500,000.

In any event, it should be made clear that the initial issuance, as well as later resales, of small amounts of securities, where the danger to the public is not a serious one, is exempt from Federal law, including any filing requirement, even where the issuer and his attorney may be ignorant of the Act and its Rules. Any additional regulations that individual states desire to impose will, of course, still be available.

Sincerely,

Robert A. Kessler
Professor of Law