St. Mary's Law Journal

Volume 5 | Number 2 Article 2

6-1-1973

Who Has Access to the Private Offering Exemption.

John D. Fisch

Follow this and additional works at: https://commons.stmarytx.edu/thestmaryslawjournal

Part of the Contracts Commons

Recommended Citation

John D. Fisch, *Who Has Access to the Private Offering Exemption.*, 5 St. Mary's L.J. (1973).
Available at: https://commons.stmarytx.edu/thestmaryslawjournal/vol5/iss2/2

This Article is brought to you for free and open access by the St. Mary's Law Journals at Digital Commons at St. Mary's University. It has been accepted for inclusion in St. Mary's Law Journal by an authorized editor of Digital Commons at St. Mary's University. For more information, please contact egoode@stmarytx.edu, sfowler@stmarytx.edu.

WHO HAS "ACCESS" TO THE PRIVATE OFFERING EXEMPTION

JOHN D. FISCH*

Since 1953, when the United States Supreme Court first grappled with the concept of a non-public offering in *SEC v. Ralston Purina Co.*,[1] the parameters of the section 4(2), or private offering, exemption from registration under the Securities Act of 1933[2] has been steadily shrinking in the eyes of the courts and the Securities Bar. This shrinkage has been accelerated recently by decisions in the Court of Appeals for the Fifth Circuit which may have weakened this most important of all registration exemptions to such an extent that, ironically, it must be rescued by the rule-making ability of the SEC.

PURPOSE OF THE EXEMPTION

As noted in the *Ralston* opinion, the Act offers little enlightenment as to the purpose of the exemption or its breadth. Section 4(2) of the Act merely exempts from the registration requirements of section 5 all "transactions by an issuer not involving any public offering."[3] No attempt is made to describe "public offering" in the definition section of the statute.[4] Certainly it can be assumed that Congress intended at least to exempt the very limited organizational offering of securities of closely held family corporations or small business enterprises in which the security offerees are typically the organizers and operators of the business. Congress must have recognized that to subject these transactions to the expense and delay of registration under the Act would be unduly burdensome and unnecessary. However, by choosing not to adopt a simple number of offerees or dollar amount of capitalization test typical of state blue sky law small offering exemptions, Congress indicated its intent to make the section 4(2) exemption available for offers other than the usual small business organizational transactions.

---

* Member, Matthews, Nowlin, Macfarlane & Barrett, San Antonio, Texas; B.A., University of Notre Dame; LL.B., Harvard Law School.

1. 346 U.S. 119 (1953).
2. 15 U.S.C. § 77d(2) (1970).
3. *Id.*
4. 15 U.S.C. § 77b(11) (1970).

Published by Digital Commons at St. Mary's University, 1973

St. Mary's Law Journal, Vol. 5 [1973], No. 2, Art. 2

The Court in *Ralston* concluded that the purpose of the exemption, in its broadest terms, was to exempt those transactions for which there was "no practical need" for the protections of a registration.[5] The Court further concluded that for there to be no practical need for a registration, all of the offerees of a registration must be "shown to be able to fend for themselves" by having "access to the same kind of information that the Act would make available in the form of a registration statement."[6] The Court in *Ralston* applied its newly formulated criteria for a non-public offering based upon what it conceived to be the purpose of the exemption to the facts before them by holding that the Ralston Purina Company's offering of its stock to its employees was not an exempt non-public offering. The holding was based primarily upon the company's offering to non-executive employees such as bakeshop foremen, stock clerks, stenographers and veterinarians, who were sufficiently remote from the key management decisions of the company so as not to have the magic "access" rendering a registration statement impractical.

WHO HAS ACCESS?

The *Ralston* decision was an enormous step toward a workable and certain definition of a non-public offering. If nothing else it laid to rest a previously widely held theory, that by limiting an offering to a small number of offerees (usually less than 25) an issuer avoided the conclusion that its offer had been made to the public, mentioned in an early 1935 release by the SEC's General Counsel.[7] As the opinion points out, the *Ralston* criteria for a non-public offering is at least theoretically compatible with any number of offerees, however, offerings to a substantial number of persons may in practice seldom be exempt simply because of the difficulty in establishing that such a substantial number of offerees have the requisite access.

In silencing the speculation of the Securities Bar with regard to numbers, the *Ralston* opinion launched securities practitioners into a new round of speculations over who has access. The *Ralston* opinion offered little help outside of the narrow area of employee offerings similar to that attempted by the Ralston Purina Company. Certainly decision-making officers and directors of an issuer have the requisite access, but

5. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

6. *Id.* at 125.

7. SEC Securities Act Release No. 285 (January 24, 1935), 1 CCH FED. SEC. L. REP. ¶¶ 2740-44.

https://commons.stmarytx.edu/thestmaryslawjournal/vol5/iss2/2

what about other experienced investors, whether individuals or institutions, who were traditionally considered proper non-public offerees, yet who did not possess a relationship with an issuer which would afford the requisite access without the issuer's cooperation? Could an issuer create the necessary access merely by compiling in a brochure the information ordinarily contained in a registration statement and providing its brochure to its offerees? Is access alone enough, or must the offeree avail himself of his access by becoming thoroughly familiar with the issuer prior to his investment decision?

A 1959 decision by the Court of Appeals for the Tenth Circuit, *Woodward v. Wright*,[8] followed the *Ralston* decision by rejecting the numbers criterion in favor of a "need for protection" criterion.[9] The *Woodward* case involved the sale of oil and gas interests to some seven investors, most of whom had no relationship with the sellers of the interests other than that they had previously participated in other unprofitable oil leases in the same geographical area as that involved in the *Woodward* case. Only three of the investors made an on-site inspection, the rest relying principally upon the opinions of fellow investors and the organizers of the venture. In determining that the offering was non-public, the court concluded that the "transaction was a closely knit arrangement among friends and *acquaintances*, and was conducted on a personal basis."[10] The court concluded that "the purchasers apparently entered into the transaction with sophisticated discernment."[11] Certainly the *Woodward* facts, although not involving an "access" relationship as obvious and secure as the corporate executive situation, did reflect the limited character of the offer in terms of persons and subject matter involved which prompts a conclusion as it did with the court, that what facts were knowable concerning the venture were available to all investors with reasonable diligence and effort. It is this hard to verbalize sense of closeness and manageability which appears to have swayed the court and accounts for the opinion's lack of stringent reasoning through the *Ralston* access principle. The court expressed a feeling that simple and limited transactions of this type were not meant to have the burdensome registration requirements imposed upon it:

8. 266 F.2d 108 (10th Cir. 1959).
9. *Id.* at 115.
10. *Id.* at 115. The court did allow a recovery for the purchasers, however, by virtue of misrepresentations made to them by the sellers of the securities (court's emphasis).
11. *Id.* at 115.

St. Mary's Law Journal, Vol. 5 [1973], No. 2, Art. 2

> To be sure, an offer to sell an oil and gas lease as a single transaction to a specified party or parties is not a public offering so as to require a registration of it under penalty of absolute liability for rescission.[12]

Unfortunately, although conveying a feeling for one type of limited, face-to-face transaction which, in the opinion of the Court of Appeals for the Tenth Circuit, at least, does not demonstrate a need for registration, the opinion did little toward developing a verbalizable concept of *Ralston*'s access which would be capable of general application.

In a 1962 release the SEC attempted to provide answers to some of the questions raised in the wake of the *Ralston* and *Woodward* decisions.[13] Although couched in the necessarily non-specific terms of any administrative release for general application, the statement did at least re-establish confidence in a number of transactions traditionally considered non-public which may have been the subject of doubt under some interpretations of the *Ralston* access rule. The release confirmed (though little confirmation was needed in view of the Supreme Court's discussion of the *Ralston* facts) that executive employees ordinarily have the necessary access.[14] The release also indicated that sales of securities to persons ordinarily considered promoters or founders of an issuer come within the exemption, although "the transaction tends to become public when the promoters begin to bring in a diverse group of uninformed friends, neighbors and associates."[15] Institutional and professional investors seem also to be included in the class of investors normally considered non-public.[16] No explanation is given as to the source of a non-affiliated institutional or professional investor's access; however, it seems reasonable to assume that a large institutional investor would ordinarily have sufficient bargaining leverage to obtain any information it deemed relevant prior to its investment. Secondly, most large professional or institutional investors are able to marshal such investment experience and expertise that they would have no practical need for the protections of the registration provisions of the Act.

While avoiding specific opinions with regard to transactions not clearly other than public offerings, the 1962 release made clear the SEC's opinion that the determination of the degree of access of an

12. *Id.* at 115.
13. SEC Securities Act Release No. 4552 (November 6, 1962), 1 CCH FED. SEC. L. REP. ¶¶ 2770-83.
14. *Id.* at ¶ 2773.
15. *Id.* at ¶ 2774.
16. *Id.* at ¶ 2780.

offeree to information regarding an issuer must be based solely upon the offeree's relationship or bargaining position with the issuer and it was *not* within the issuer's power to create access *by voluntary disclosure*.[17] It is this emphasis in the release on the relationship which gives rise to the requisite access, and not to the fact of access itself, which appears to have had the greatest effect upon later court decisions.

In an opinion written only some 6 months following the SEC's 1962 release, the Court of Appeals for the Tenth Circuit, in *Garfield v. Strain*,[18] dealt with a transaction which, like the *Woodward* case, did not fall into any of the safe areas outlined in the 1962 SEC release. Strain and his associate Maresh contracted to sell fractional interests in certain oil leases to Garfield, a past social and business acquaintance of Strain's. After Garfield had contracted to purchase the oil interest, but before payment, Strain was presented with an untimely dry hole on the property in question. Garfield resisted Strain's attempts to defray some of the drilling costs by collecting the purchase money called for in Garfield's participation purchase contract on the grounds, among others, that the offering of the oil interest to him was an unregistered public offering entitling him to a right to rescind his contract to purchase the now worthless oil interest.[19] The Court of Appeals for the Tenth Circuit found the transaction to be exempt from the registration requirement of the Act even though Garfield was neither a promoter, operator of the venture, nor an institutional investor. Although Garfield had previously done business with Strain, it does not appear from the opinion that these past relationships had been of any permanence nor does it appear that they had been at all frequent. The opinion indicates that these past transactions were in real estate, but there is no indication that they involved oil ventures. The entire transaction was conducted through the mails without any face-to-face negotiations, on-site inspections, or questioning regarding the prospects of the enterprise. Garfield was provided only with a geological report, maps, and other data pertaining to the leases. The court, after summarizing the *Ralston* principles, decided that Garfield was not a public offeree es-

17. *Id.* at ¶ 2773 which states:

The exemption does not become available simply because officers 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.

18. 320 F.2d 116 (10th Cir. 1963).

19. 15 U.S.C. § 771 (1970) provides the right rescission to purchasers in a public offering not registered under the Act and not otherwise exempt.

St. Mary's Law Journal, Vol. 5 [1973], No. 2, Art. 2

sentially because of the small number of offerees and securities offered, the business and social acquaintanceship of Garfield and Strain, general requests by Garfield prior to the venture that Strain include Garfield in Strain's future oil deals, and Garfield's past business experience "including the stock market and ownership of oil stocks . . . ."[20]

Although citing *Ralston*, the *Garfield* opinion does not specifically deal with the "access" question, but contents itself with a broader statement of the *Ralston* doctrine, that non-public offerees be "shown to be able to fend for themselves,"[21] thereby negating the necessity for the protections of a registration. No mention is made in the opinion of the SEC interpretation of the exemption released 6 months previously. Without detailed reasoning, the court merely concludes that the evidence was sufficient to support the finding of the trial court that Mr. Garfield was capable of fending for himself during his brief encounter by correspondence with Messrs. Strain and Maresh. As in its earlier *Woodward* decision, the Court of Appeals for the Tenth Circuit found the offering to be non-public primarily on the basis of a "smallness" factor which presumably affords the participants in the transaction the necessary access.[22]

In 1971 the Court of Appeals for the Tenth Circuit was presented a fact situation which did not portray the intimacy associated with the *Woodward* and *Garfield* cases. The defendants in *Lively v. Hirschfeld*[23] had offered 8,000 shares of stock of the Wun Drop Company to 25 offerees without benefit of registration. Although defendants offered general testimony that all of the offerees were "friends, educated persons, business associates and acquaintances of the individual defendant or of the president of the corporate defendant,"[24] the court held that defendants did not meet their burden of establishing the section 4(2) exemption. The court described the meeting of that burden as requiring explicit evidence that *each* offeree is a person of "unusual business experience and skill"[25] *and* has "regular access to all the information and records which would show the potential for the corporation."[26] Simply conclusory statements of defendants with regard to the sophistication of the class of offerees was not sufficient.[27]

20. Garfield v. Strain, 320 F.2d 116, 119 (10th Cir. 1963).
21. *Id.* at 119.
22. *Id.* at 119.
23. 440 F.2d 631 (10th Cir. 1971).
24. *Id.* at 632.
25. *Id.* at 633.
26. *Id.* at 633.
27. *Id.* at 633.

Fisch: Who Has Access to the Private Offering Exemption.

Although no more revealing with regard to the factual question of who has access than the *Woodward* or *Garfield* cases, the *Lively* case did describe the burden of establishing the applicability of the section 4(2) exemption in rigorous, if abstract, terms. Each offeree, whether or not ultimately a purchaser must be proven by specific evidence to have available to him all of the facts regarding the issuer of the securities offered, material to the potential of the investment ("access") and possess the business acumen necessary to form a reasonable opinion regarding this potential based upon such facts.

Who Has Access According to the Court of Appeals for the Fifth Circuit

The Court of Appeals for the Fifth Circuit has recently been presented with two fact situations which involved offerings of an extremely speculative nature and, in one case, allegations of misrepresentation and apparent over-reaching, in which the principal issue was the availability of the non-public offering exemption. In its zeal to protect investors from apparent folly, the Court of Appeals for the Fifth Circuit may, by its discussion of the facts of these cases under what it perceived to be the *Ralston* principles as interpreted by the 1962 SEC release, have reduced the practical parameters of the non-public offering in its jurisdiction to an extent no longer useful for any offering to other than organizational promoters and corporate executives.

The first of these decisions is *Hill York Corp. v. American International Franchises, Inc.*[28] The defendants were promoters of a nationwide restaurant franchise distribution system which incorporated and sold shares of stock in state and regional franchise sales centers to a small number of purchasers who, it was anticipated, would be furnishing supplies and services to the restaurants ultimately franchised. The only examples of such purchasers provided by the court were a real estate firm, an air conditioning concern, a builder, and a lawyer. Although the defendants apparently organized several of such centers nationwide, the court specifically limited its inquiry to a single Florida center in which shares of stock were purchased by the plaintiffs in the case.

The Florida sales center corporation sold stock to 13 investors, all of whom the court indicates were "sophisticated businessmen and at-

28. 448 F.2d 680 (5th Cir. 1971).

torneys who planned to do business with the new firm."[29] The court further admits that all of the purchasers probably had access to any information concerning the Florida corporation or the promoters' national franchise concern upon request.[30]

In determining that the *Hill* offering did not qualify for the section 4(2) exemption, the Court of Appeals for the Fifth Circuit considered the following factors, which first appeared in the 1935, pre-*Ralston*, SEC release previously referred to:

1. The number of offerees and their relationship to each other and to the issuer,
2. Number of units of securities offered,
3. Size of the offering, and
4. The manner of offering.[31]

As to the first factor, the court, citing *Ralston*, gave the executive officers of a corporation as an example of a class of offerees having a relationship with the issuer which tends to show the necessary access.[32] In referring to the *Ralston* principles, the court added the significant new phrase, "privileged relationship with the issuer,"[33] to the *Ralston* jargon, implying the necessity for some pre-offering legal or business intimacy between the issuer and offeree. The court justified the importance of a special relationship between offerees by simply indicating that an unrelated group has the "appearance" of being public.[34] The second and third factors were not thoroughly discussed by the court and do not appear to have been considered of great importance as applied to the *Hill* facts.[35] The court indicated that under the fourth factor offerings made through finders, investment bankers, exchange mechanisms, and broadly distributed advertising, rather than through the direct contact of buyer and seller, tend to show a public offering.[36]

Although the evidence showed that the identified *Hill* offerees had a rather close relationship with the issuer as businessmen and attorneys who planned to do business with the issuer independent of the purchase of the issuer's securities, the court avoided a direct applica-

29. *Id.* at 690.
30. *Id.* at 690.
31. *Id.* at 687.
32. *Id.* at 687.
33. *Id.* at 688 n.6.
34. *Id.* at 688.
35. *Id.* at 689.
36. *Id.* at 689.

Fisch: Who Has Access to the Private Offering Exemption.

tion of its newly minted "privileged relationship" doctrine by determining that this relationship did not produce the requisite *Ralston* access because of inaccuracies and incomplete statements of facts contained in a brochure provided to them by the issuer.[37] Unlike the Court of Appeals for the Tenth Circuit in the *Woodward* case, the Court of Appeals for the Fifth Circuit refused to distinguish between the registration provisions of the Act and the so-called anti-fraud provisions of the Act which apply to virtually all offerings of securities, whether or not exempt from registration.[38] In so doing, the *Hill* opinion further confused the concept of "access" by engrafting a determination of the quality and quantity of information actually received by the offeree on to the *Ralston* test of whether an offeree *could* by virtue of his relationship with the issuer acquire the information reasonably necessary in making an informed investment decision.[39]

The *Hill* decision dealt a second blow to the clarity of the *Ralston* principle by an apparent heavy reliance upon the principle that the offerees of a non-public offering should enjoy a common relationship between each other in order to avoid the "appearance" of being public.[40] This concept of a relationship between offerees is certainly not clearly stated in the *Ralston* requirements, and a group of unrelated but sophisticated individuals, each with a relationship with the issuer sufficient to provide the required *Ralston* access, is far from a logical repugnancy. However, the *Hill* opinion seemed to elevate the concept to a virtual requirement in finding that the *Hill* offerees were a "diverse and unrelated group,"[41] thereby constituting public offerees. Even if this concept of interrelated offerees was shown to be a logical requirement under the *Ralston* principle, the *Hill* decision chose to ignore the fact that each of the known offerees was a present or prospective supplier of goods or services to the issuer and thereby related to each other.

The *Hill* opinion relied upon two additional grounds for finding a public offering which do appear to be logical corollaries to the *Ralston* doctrine. The defendants in *Hill* could not establish all of the identity of offerees involved in order to meet the burden of proof established in

37. *Id.* at 696.
38. 15 U.S.C. § 771(2) (1970).
39. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971).
40. *Id.* at 688.
41. *Id.* at 688.

Published by Digital Commons at St. Mary's University, 1973

Lively, nor was there any showing of direct contact between the representatives of the issuer and the offerees tending to indicate the type of access to facts regarding the issuer which results from direct verbal questioning of the principal personnel of the issuer.

A second recent construction of the non-public offering exemption by the Court of Appeals for the Fifth Circuit is *SEC v. Continental Tobacco Co.*[42] The Continental Tobacco Company made two attempts at achieving a non-public offering. Continental's 1967 attempt at a non-public offering was wide of the mark established by the *Ralston* case under any court's criteria. From July through the Fall of 1967, Continental offered, sold and delivered subordinated debentures and warrants to a group of investors, primarily through a series of sales meetings at which films were shown to a small number of prospective investors describing the company's product—Venture cigarettes. The sales meetings appear to have been devoid of financial facts with regard to the condition of the company, although upon request prospective investors could secure unaudited financials for the company's previous year. The usual safeguards of investment legends and statements indicating the general availability of facts concerning the company were not utilized. This offering resulted in the issuance of a preliminary injunction against Continental and certain of its officers, enjoining their use of any means or instruments of transportation or communication in interstate commerce for the purpose of the sale of securities by Continental absent a registration statement in effect as required by Section 5 of the Securities Act of 1933. The order also provided for the rescission of previously issued securities.

Fresh from a reorganization under Chapter XI of the Bankruptcy Act and armed with new knowledge of the section 4(2) exemption, garnered from the SEC policing of its 1967 attempt at a private offering, and two new attorneys, Continental set out in the Spring of 1969 to have a second try at a non-public offering. Continental began its second try with a sincere attempt to inform its offerees by preparing what appears to have been a very comprehensive brochure describing the company's prospects and containing essentially all of the information called for by a registration under the Act.[43] In addition to the brochure, Continental's new attorneys prepared a subscription agreement and investment letter containing the usual investment representations

42. 463 F.2d 137 (5th Cir. 1972).

43. For a detailed description of the brochure, see the trial court opinion at SEC v. Continental Tobacco Co., 326 F. Supp. 588, 590 (S.D. Fla. 1971).

and a declaration that the investors have "questioned the officers of the company and counsel for the company concerning the business and financial statements of the company and have been offered access to any and all records of the company . . . ."[44]

The second Continental offering took place over a period of approximately one year and resulted in the sale of Continental securities to approximately 35 purchasers. The general plan of the offer consisted of arranging a series of small meetings of prospective investors (usually 5 to 15 persons), the nucleus of which was comprised of purchasers under the previous Continental offering who had rescinded their previous purchases coincident with the SEC's injunctive action. In most cases those attending these meetings were provided with Continental's brochure and were given an opportunity to question some of the key personnel of Continental. The majority of the offerees and purchasers were not professional investors, although they did have some prior knowledge of Continental. Most purchasers invested $5,000 to $25,000, but three purchasers invested less than $1,000.

Certainly these facts did not present a strong case for a non-public offering under the *Ralston* criteria (at least, not as strong as the *Hill* facts). As the Court of Appeals for the Fifth Circuit pointed out in great detail, the facts included flagrant examples of non-discriminate offers to persons without any colorable claim to *Ralston* access, such as an office assistant and patients of a dentist who happened to be an enthusiastic investor of Continental.[45] Although the court describes the spectrum of offerees and investors in almost transaction-by-transaction detail, it did not see fit to take the opportunity, presented by its own clear and detailed description of the varied circumstances and relationships of the offerees involved, to offer any enlightening discussion by applying the *Ralston* criteria to some of the individual Continental offerees. It might be noted here that some of the offerees were personal friends of one or more key Continental personnel, and may very well have individually met the *Ralston* access and sophistication standards. Instead, the court merely relied upon a reference to the more obvious failures of the Continental offering to comply with the *Ralston* criteria for a non-public offering as previously interpreted by the same court in *Hill*, including a lengthy quotation of the *Hill* "privileged relationship" addition.[46] The court's reluctance in *Continental*

44. SEC v. Continental Tobacco Co., 436 F.2d 137 (5th Cir. 1972).
45. *Id.* at 158.
46. *Id.* at 159.

to admit by dicta that any of the *Continental* offerees may have had the requisite *Ralston* access, coupled with the application of the *Hill* "privileged relationship" test leaves the clear implication that the court was looking for a pre-offering legal or business relationship between all of the Continental offerees and the issuer. Completely abandoning the *Ralston* language of "access" and "ability to fend for themselves," the *Continental* opinion described Continental's burden as that of "affirmatively proving that all of the offerees of Continental enjoyed a *relationship* with Continental making registration unnecessary."[47]

Both *Hill* and *Continental* have been widely hailed as threats to the established assumption among the Securities Bar that wealthy, sophisticated individuals and professional and institutional investors are qualified offerees under the non-public offering exemption by virtue of their obvious ability to fend for themselves.[48] Seldom do such venture capitalists have any relationship with the issuers, prior to their first purchase, which would ordinarily be considered a "privileged relationship" such as having representatives on the board of directors or in the management of the issuer. It has been pointed out that, should these cases prevent the application of the section 4(2) exemption to the typical venture capital offering, a valuable, and perhaps essential, source of capital funds for new and speculative enterprises will be eliminated.[49] The considerable time, effort and expense of a registration under the Securities Act of 1933 is not a practicable alternative in most situations now involving institutional or professional venture capital investment.

It is imperative that, until other courts of appeals or the Supreme Court come to the rescue of the private offering exemption, the Securities Bar re-examine the *Ralston* opinion and, keeping in mind the *Hill* and *Continental* decisions, superimpose the basic *Ralston* con-

47. *Id.* at 161 (emphasis added); *accord*, Henderson v. Hayden, Stone Inc., 461 F.2d 1069 (5th Cir. 1972) which was decided on the principle that the seekers of the private offering exemption have the burden of establishing the number, identity, sophistication and access of each offeree. *Id.* at 1072. *Henderson* illustrates the prevailing bearish attitude of the Court of Appeals for the Fifth Circuit with regard to typical venture capital offerings and the availability of the private offering exemption. The plaintiff offeree in *Henderson* was allowed rescission, even though he was, as the court stated:

> certainly not the average innocent investor . . . . [T]he concomitant of the legislative purpose is affirmatively served here. Congress sought to encourage sellers of securities to register those securities prior to any sales or offers to sell. *By allowing recoveries such as the one in this case, unregistered sales are discouraged.*

Id. at 1072 (emphasis added).

48. *See* Note, 50 TEXAS L. REV. 1447 (1972) for a similar discussion of the effect of the *Continental* and *Hill* cases upon unregistered sales to professional venture capitalists.

49. *Id.* at 1453.

cepts of "access" and the ability of offerees to "fend for themselves" upon the Court of Appeals for the Fifth Circuit created "privileged relationship" test. Both the *Hill* and *Continental* cases purported to follow, as indeed they must, the *Ralston* decision, and neither purported to break new ground with its "privileged relationship" jargon. Each case dealt with ample facts justifying the finding of an unregistered public offering under the *Ralston* principles as interpreted in other courts of appeals without the need for additional private offering lore. The Securities Bar must assume for now that the "privileged relationship" referred to by the Court of Appeals for the Fifth Circuit does not refer to a formal pre-offering legal or business relationship with the issuer, but can encompass any relationship which results in *Ralston* access. The alternative is the abandonment of the benefits of private investment venture capital financing.

Most issuers seeking private offerings of their securities do so because their stage of development or the condition of the public market is such that a public registered offering is not practicable. More often than not an issuer under circumstances not conducive to a public offering needs financing more urgently than issuers who have the necessary resources, time and readily demonstrable long-term potential to enable them to seek capital through a usually less dilutive, registered public offering. Consequently, the venture capitalist is usually in a position (or "relationship," if you will) to request and receive any information regarding the issuer which his usually broad experience suggests will aid him in making his investment decision. Anyone living through a private offering of securities to truly sophisticated venture capitalists, whether professional or institutional investors, or simply wealthy persons experienced in speculative investment, should readily see that the relationship built by the issuer's need for financing is productive of the most effective access possible.[50]

As we have seen, the courts since the *Ralston* decision have attempted to find a non-public offering by judging the closeness of the offerees to the material facts regarding the issuer. In other words, the courts have tended to assume that the executive officers of an issuer have the greatest access to the facts regarding the issuer, and all other potential offerees take on an ever darkening shade of gray until a point is reached where the requisite access is no longer found. This

50. This "leverage" access was well described in Israels, *Some Commercial Overtones of Private Placement,* 45 VA. L. REV. 851, 859 (1959). *See also* Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,523 at 94,970.

concept has probably resulted from the accident of the *Ralston* facts themselves. Because the *Ralston* offering was made only to employees of the Ralston Purina Company, the Court was forced to analyze the facts before them by comparing the relative availability of material facts with regard to Ralston Purina to various classes of employees by virtue of such employees' duties. However, the *Ralston* principles were meant for a much more general application than simply applying them to employment related access. The *Ralston* decision did not say that non-public offerees must by virtue of a relationship with the issuer, independent of the offering involved, have sufficient access; the *Ralston* opinion simply said that to be non-public, an offeree must, for whatever reason, have the ability to fend for himself in acquiring information with regard to the issuer which makes registration no longer a practical necessity.[51] It appears to be the assumption of the Court of Appeals for the Fifth Circuit, as demonstrated by the *Hill* and *Continental* decisions, that the necessary access can only come about through pre-existing relationships with the issuer similar to the relationships existing between the executive officers and Ralston Purina Company. By contrast, the Court of Appeals for the Tenth Circuit opinions in *Woodward* and *Garfield* seem to adhere to the broader view that the structure of the offering itself may provide the needed access. Both cases involved a small group of offerees whose participation in the venture was absolutely necessary for the enterprise to succeed. The lack of extensive reasoning under the *Ralston* principles in these cases has been noted previously, but it appears reasonable to urge that the *Woodward* and *Garfield* decisions recognized a leverage on the part of the offerees in such cases sufficient to elicit any facts with regard to the enterprise they may have required prior to their investment. Indeed, the leverage of a substantial investor in an enterprise much in need of capital is usually a far more effective source of information with regard to an issuer than the situational access of most executive employees.

The concept that the required *Ralston* access can be "boot-strapped" from the circumstances of the offering itself would probably not en-

51. *See* Patton, *The Private Offering: A Simplified Analysis of the Initial Placement*, 27 BUS. LAW. 1089 (1972) for similar criticism of SEC Release 285 and cases relying upon it. Patton urges that "relationship" should be looked upon as evidentiary of access and not necessary for the attainment of the section 4(2) exemption and suggests that SEC Release 285 be rescinded on the grounds that it has contributed to the general tendency of the courts to confuse the evidencing or giving the appearance of access with the ultimate determination of access itself.

Fisch: Who Has Access to the Private Offering Exemption.

gender a different result in the *Hill* or *Continental* cases. In any event, *all* the offerees must have the requisite sophistication to benefit from the leverage they may enjoy, and in many instances the structure of the offering may be such that an individual offeree may not enjoy the leverage described in the previous paragraph, regardless of his sophistication. Probably the issuers in either the *Hill* or *Continental* cases could have easily refused information requested by any one offeree without jeopardizing the overall plan of financing. However, in a typical venture capital offering each investor takes a substantial portion of the total offering and, even if it is not financially necessary that each such portion be ultimately placed, the withdrawal of one such potential investor typically tends to shake the confidence of the other potential investors to an extent that the entire offering is endangered.

In order for the Securities Bar to live with the Court of Appeals for the Fifth Circuit "privileged relationship" jargon, the courts must be made aware that the realities of most venture capital transactions create a "privileged relationship" between an experienced and substantial venture capitalist and an issuer with a specific need for financing.

WILL PROPOSED RULE 146 SAVE THE PRIVATE OFFERING EXEMPTION?

The SEC has been accused of being the principal contributor to the Court of Appeals for the Fifth Circuit campaign against the section 4(2) exemption.[52] Ironically, however, it may be that Proposed Rule 146 of the SEC[53] will prove to be the savior of the section 4(2) exemption as a useful venture capital exemption from the registration requirements of the 1933 Act.[54] It seems almost as if the SEC sought to increase the effectiveness of its new rule by destroying as much as possible of the old lore of the section 4(2) exemption in order to assure that the Securities Bar will seek refuge in any safe harbor the SEC can create.[55] Certainly, urging the proposition upon the Court of Appeals for

52. Note, 50 TEXAS L. REV. 1447 (1972).

53. SEC Securities Act Release No. 5336 (November 28, 1972), 1 CCH FED. SEC. L. REP. ¶ 2709 [hereinafter cited as Proposed Rule 146].

54. Although Rule 146 in its proposed form may prove useful to the well-financed venture capitalist, the SEC has proposed a "suitability" requirement in subparagraph (d)(2) which, if adopted, could create an area of uncertainty even more troublesome than that caused by the use of the term "access." This proposed "suitability" requirement of the SEC has apparently received the most adverse comments of all the Rule 146 proposals. Mgmt. Reports, Inc., SEC. REG. & TRANSFER REPORT 2 (March 23, 1973).

55. The SEC has conceded the Rule 146, if adopted, would not be exclusive. SEC Securities Act Release No. 5336 (November 28, 1972), [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,108, at 82,398.

the Fifth Circuit that the use of an informational brochure to insure that an offeree is fully informed concerning an issue demonstrates lack of an offeree's ability to fend for himself[56] seems inconsistent in principle with subparagraph (d) of the proposed rule which would allow an issuer to measure the requisite sophistication of a prospective offeree by the experience and acumen of its offeree's "investment representative."[57]

On November 28, 1972, only a few months following the rendering of the *Continental* decision, the SEC released its Proposed Rule 146 for comment. Part of the introductory matter to the new rule was a statement by then Chairman William J. Casey of the Securities and Exchange Commission which appears to be calculated to assure the Securities Bar that the section 4(2) exemption was still available for traditional venture capital transactions.[58] The first paragraph of Mr. Casey's statement asserts that there is an element of overall public investor protection generated by the purchase of unseasoned securities by "sophisticated individuals and institutions who have the knowledge, opportunity and ability to dig in more deeply and evaluate new ventures more effectively than can be done by reading a printed prospectus."[59] Mr. Casey also indicates that one of the principal objectives of Proposed Rule 146 is to make private offering guidelines more objective in order to give the venture capitalists "greater assurance as to when and how they can ban together to provide seed money and to meet immediate cash demands of young companies . . . ."[60]

Mr. Casey's statement and the notice of the proposed rule itself states one of the primary purposes of the rule to be the providing of objective criteria for the operation of the section 4(2) exemption. There is room for serious doubts, however, that the rule, as presently proposed, would provide much of the hoped-for objectivity. The proposed rule does answer some peripheral questions related to the access question which have arisen through the cases and SEC releases following *Ralston*. For example, subparagraph (c)(1) requires that offerings under the rules be completed only in "negotiated transactions," generally defined as face-to-face transactions between repre-

56. Brief for appellant at 29, SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).
57. Proposed Rule 146(a)(2).
58. SEC Securities Act Release No. 5336 (November 28, 1972), [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,108, at 82,396.
59. *Id.*
60. *Id.*

Fisch: Who Has Access to the Private Offering Exemption.

sentatives of the issuer and purchaser, and subparagraph (c)(2) excludes transactions involving broad circulation advertisement of any sort, or seminars and promotional meetings. As previously mentioned, the proposed rule would also allow the issuer to rely upon the sophistication of investment representatives of the purchaser or offeree. Finally, subparagraph (f) would limit the number of *purchasers* of securities under the section 4(2) exemption to 35 for any 12 month period, except that purchasers of more than $250,000 in securities shall not be counted (an apparent tacit recognition that large individual purchasers who also meet the sophistication test usually are in a leverage position sufficient to demonstrate the required *Ralston* access). However, the rule makes no attempt to define "access," although subparagraph (e) of the proposed rule requires that "during the course of the negotiated transaction" each offeree shall have "access" to the "kind of information" that would be available in a registration statement, and to "have access to any additional information necessary to verify the accuracy" of any information given to the offeree by the issuer.

CONCLUSION

Although begging the question as to the meaning of "access," in requiring that access be achieved "during the course of a negotiated transaction," it seems clear that Proposed Rule 146 presupposes that a safe haven of the proposed rule and the section 4(2) exemption would be and is available in the usual venture capital transaction. This is assuming, of course, sufficient sophistication on the part of the offerees and an offer structured such that each offeree would have demonstrable leverage to discover requested material facts. It is this statement of the access rule, along with Mr. Casey's statement introducing the proposed rule, which offers the greatest hope of guiding the Court of Appeals for the Fifth Circuit away from a narrow and mechanistic view of its "privileged relationship" addition to the *Ralston* access criteria. The very failure, despite its ambitious prologue, of the proposed rule to truly objectify the *Ralston* access concept is a confirmation that the concept cannot be confined to a description in terms of concrete circumstances such as the existence of standard legal or business relationships.

Published by Digital Commons at St. Mary's University, 1973