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THE PRIVATE PLACEMENT EXEMPTION AND THE BLUE SKY LAWS—SHOALS IN THE SAFE HARBOR

ROBERT M. ROYALTY* and THOMAS E. JONES, JR.**

I. THE PROBLEM

During the past 65 years, the federal and state securities regulation laws have developed an increasingly significant regulatory roadblock between the seekers of capital and the furnishers of capital.¹ The general format of these laws is that the seller of securities — the seeker of capital — must register the securities under the Securities Act of 1933² with the Securities and Exchange Commission (hereinafter called the “SEC”) and with the securities commissioners³ of the various states in which the securities will be sold prior to sale, unless the offering fits within an exemption to registration requirements. A principal exemption to the registration requirements of these laws is the “private placement” or “limited offering” exemption.

Two developing factors in recent years have enhanced the value of the private placement exemption: the skyrocketing costs of the securities registration process; and the proliferation of new types of investment vehicles whose financing fits into the private placement mold, including tax shelter investment programs and private investment funds. At the same time there have been some rather dramatic developments in the area of the 1933 Act private placement exemption and some less dramatic, but equally significant developments in the area of the state securities, or Blue Sky, law private placement exemptions.

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¹ In this context, “capital” means both equity investment and long-term debt investment, both of which are regulated “securities” under the federal and state securities regulation laws.

² 15 U.S.C. § 77a *et seq.* [hereinafter the “1933 Act”].

³ The chief administrative official of the securities regulation department in any state may carry any one of a number of titles. For purposes of this paper, we will refer to any such chief administrator as the “securities commissioner” or the “commissioner.”

While the 1933 Act private placement exemption has proved to be a remarkably difficult concept to reduce to predictable law,⁴ it is the only requirement to be met from the federal standpoint. In spite of developments toward uniformity, the Blue Sky laws are still significantly diverse, and the offeror seeking the private placement exemption must be sure to satisfy not only the federal requirements, but also the requirements of each state in which he proposes to sell securities. This paper will explore these variances in state approach to the private placement issue; it will point out how these varying exemptions present some significant shoals, or rocks, in the safe harbor of private placement which the SEC has made some effort to construct; it will describe developing trends in the Blue Sky private placement area; it will consider the merit of criticisms of the Blue Sky exemption; and it will offer some suggestions for future action.

It is helpful to keep in mind the types of security offerings which most frequently seek the private placement exemption. In terms of dollars, by far the most significant is the offering of long-term debt issues of relatively seasoned companies to financial institutions such as insurance companies and pension funds.⁵ Aside from that, there are a number of differing types of equity offerings which seek the exemption. In earlier years, the emphasis was on the capital needs of small business,⁶ but in recent years companies whose operations are more than locally significant have sought initial, and even second and third round, infusions of equity through the private placement exemption. Finally, a major recent trend has been the use of the private placement exemption for pooled investment vehicles of all types including cattle feeding and natural resources development tax shelter programs, private securities investment partnerships, real estate land and commercial building syndications, and any number of other business enterprises sought to be developed through the pooled capital of relatively modest (\$15,000 to \$25,000) equity investments.

II. THE FEDERAL APPROACH TO THE PRIVATE PLACEMENT EXEMPTION

A. *Statutory Basis and Interpretation*

The federal approach to the private placement exemption has, as

⁴ See generally, Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273.

⁵ In 1975, some \$12.5 billion of long-term debt was placed with institutions, and this figure will probably be surpassed in 1976. FORBES, May 1, 1976, at 82.

⁶ See Garcia & Kantor, *Dark Clouds in a Blue Sky: An Analysis of the Limited Offering Exemption*, 23 U. MIAMI L. REV. 568 (1969).

does the Federal Constitution, the virtue of simplicity and brevity. Like the Constitution, it has generated a multitude of interpretative case law, and its meaning has, through this judicial interpretation, somewhat changed through the years.

Section 4(2) of the 1933 Act provides:

The provisions of [the registration requirements of Section 5 shall not apply to . . . (2) transactions by an issuer not involving any public offering.⁷

The legislative history of this exemption indicates that Congress intended it to apply to the following situations:

- (1) A specific or isolated sale to a particular person.
- (2) Where there is no practical need for application of the registration provisions of the 1933 Act.
- (3) Where the public benefits of the registration provisions are too remote to cause them to apply.
- (4) Where the stockholders are so small in number that the sale to them does not constitute a public offering.⁸

After the passage of the 1933 Act, practitioners relied principally on a 1935 opinion of the General Counsel of the SEC⁹ (which clearly did not exhaust the subject) for guidance in determining the proper application of the exemption until 1953, when the *Ralston Purina* case set forth some further, but still imprecise, guidelines.¹⁰ The SEC sought to achieve further clarification in a 1962 release,¹¹ but the waters were muddied in the extreme by a series of cases in 1971 and 1972 which seemed to require, among other things, a preexisting relationship between the offerees and the issuer.¹²

B. Rule 146

The obvious problem with the Section 4(2) approach to the private placement exemption is its lack of objective standards and the

⁷ 15 U.S.C. § 77d(2).

⁸ H.R. REP. NO. 85, 73d Cong., 1st Sess. 5-7, 15-16 (1933); see also H.R. REP. NO. 152, 73d Cong., 1st Sess. 1-29 (1933).

⁹ SEC SEC. REL. NO. 33-285 (January 24, 1935), CCH FED. SEC. L. REP. ¶ 2740-44.

¹⁰ SEC v. *Ralston Purina Co.*, 346 U.S. 119 (1953).

¹¹ SEC SEC. ACT. REL. NO. 33-4552 (November 6, 1962), CCH FED. SEC. L. REP. ¶ 2770-83.

¹² SEC v. *Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972); *Henderson v. Hayden Stone, Inc.*, 461 F.2d 1069 (5th Cir. 1972); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971); *Lively v. Hirschfield*, 440 F.2d 631 (10th Cir. 1971).

attendant difficulty of predicting the effects of a proposed method of conduct. After 41 confusing years of experience with this approach, the SEC promulgated its Rule 146¹³ effective June 10, 1974. This Rule is designed to provide a safe harbor for the seeker of the private placement exemption on the basis of largely objective standards. In its Release issuing the Rule, the SEC stated:

The Rule is designed to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed to be transactions not involving any public offering within the meaning of the Act and thus would be exempt from the registration provisions of the Act.¹⁴

Briefly, Rule 146 says that the Section 4(2) exemption is available for an "offering" of securities if:

1. There is no general solicitation or general advertising involved in the offering.
2. The purchaser has sufficient knowledge and experience to evaluate the offering or, if he does not, that he is able to bear the economic risk of the investment and that he is represented by someone who does have the requisite knowledge and experience.
3. Each offeree or his representatives has access to, or is furnished with, relevant material information about the offeror.
4. There are no more than 35 purchasers in the offering.
5. Specified steps are taken to prohibit the purchasers from reselling their investment in a public distribution (presumably unless the securities are registered under the 1933 Act in connection with such a distribution).

It is not within the scope of this paper to evaluate in detail the merits of Rule 146. That has been, and is being done, with frequency by other writers.¹⁵ For our purposes it is sufficient to note that Rule

¹³ SEC Sec. Act. Rel. No. 33-5487 (April 23, 1974), CCH FED. SEC. L. REP. ¶ 2710.

¹⁴ *Id.*

¹⁵ Two major criticisms stand out in the current commentaries on Rule 146. First, it has been pointed out that compliance with the Rule, especially for the small issuer may be almost as expensive as a full registration under the 1933 Act. A major basis for this criticism is the Rule's requirement that the purchasers must either have access to, or be provided with, the same information about the issuer as would be contained in a 1933 Act registration statement. Second, despite the avowed purpose of the Rule to provide some objectivity to the Section 4(2) exemption, many of the Rule's requirements require inherently subjective determinations. An example is the requirement that the issuer determine the financial stability and sophistication of potential offerees - often a very difficult task. See Alberg & Lybecker, *New SEC Rules 146 and 147: The*

146 makes a significant change in the federal approach to the private placement exemption — it represents a strong move toward objective standards, but at the same time attempts to assure that the offerees do not need the protection of the registration provisions of the 1933 Act.¹⁶

C. Residual Law

The advent of Rule 146, which is clearly designed to be nonexclusive as to the availability of the private placement exemption,¹⁷ and the continuing confusion created by the *Hill York* line of cases,¹⁸ has generated yet further analysis of what the federal private placement exemption is outside of Rule 146. A thoughtful analysis of this “residual law” was developed by two Committees of the American Bar Association’s Corporation, Banking and Business Law Section, and the results of their work have been published recently.¹⁹ In these papers, the authors give differing treatments to the equity offering on the one hand and the long-term debt offering on the other, although the statute does not.

The authors of the paper dealing with the equity offering conclude that under the residual law there are four essential attributes to the

Non-Public and Intrastate Offering Exemptions from Registration for the Sale of Securities, 74 COLUM. L. REV. 622 (1974); Rosenfeld, *Rule 146 Leaves Private Offering Waters Still Muddied*, 2 SEC. REG. L.J. 195 (1974).

¹⁶ A comment on the philosophy of the protective purposes of the 1933 Act is compelled. The 1933 Act is a disclosure statute; i.e., so long as the seller has met his obligation to tell all that is material about itself and the offering, it is still thereafter a matter of *caveat emptor*. There is not, and could not easily be, a method for the SEC to assure that all the buyers in a registered public offering fully understand the intricacies of the information given them by a 1933 Act Prospectus. But the SEC has been more solicitous to the Rule 146 purchaser — either he must have the knowledge and experience requisite to make the investment decision, or be rich enough to carry the investment and be represented by someone who has such knowledge and experience. This analysis suggests that there is still plenty of room for arguments in favor of the Blue Sky merit review. See text of Section VI *infra*.

¹⁷ In the second paragraph of Release No. 5487 the Commission states:

The Rule is not, however, the exclusive basis for determining whether that exemption is available. Accordingly, although persons claiming the exemption have the burden of proving its availability, persons may continue to rely on the Section 4(2) exemption by complying with the relevant administrative and judicial interpretations in effect at the time of the transactions.

SEC Sec. Act. Rel. No. 33-5487 (April 23, 1974), CCH FED. SEC. L. REP. ¶ 2710.

¹⁸ See note 12 *supra* and accompanying text.

¹⁹ Position Papers, *Private Exemption Under Section 4(2) of the Securities Act of 1933*, 31 BUS. LAW. 483 (1975).

private placement exemption: (1) offeree qualification (which may be sophistication or wealth); (2) availability of information about the issuer; (3) a limited manner of offering through direct communication with qualified offerees or their representatives; and (4) the absence of redistribution by the purchaser.²⁰

The authors of the paper dealing with the long-term debt offering similarly identify these same characteristics as essential for the existence of the exemption. They go on to point out that the nature of institutional investors and of the typical institutional private placement is such that the protection afforded by the 1933 Act is not needed for a long-term debt placement. In other words, one of the reasons for the Section 4(2) exemption is present in the long-term debt private placement situation.²¹

D. Rule 240

Under Section 3(b) of the 1933 Act,²² the Commission is given the authority to exempt certain securities from the registration requirements of the Act upon a finding that registration is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering. The Section goes on to set a limit of \$500,000 on the amount of an offering which may be exempted under the section. Pursuant to Section 3(b) the Commission issued its Rule 240 effective March 15, 1975.²³

Transactions by an issuer involving the offer and sale of its securities in accordance with all the terms and conditions of Rule 240 are exempt from the registration provisions of Section 5 of the 1933 Act. The requirements of the Rule, many of which are quite similar to the requirements of the typical state Blue Sky private placement exemption, are as follows:

1. *Limitation on Manner of Offering.* The securities may not be offered by means of any general advertising or general solicitation.

2. *Prohibition of Remuneration Paid for Solicitation of Sales.* No commission or similar remuneration may be paid for soliciting any prospective buyer or in connection with the sale of securities.

3. *Limitation on Aggregate Sale Price.* The aggregate sales price of all sales of securities by the issuer within the twelve months pre-

²⁰ *Id.* at 489.

²¹ See note 8 *supra* and accompanying text.

²² 15 U.S.C. § 77c(11)(b).

²³ SEC Sec. Act. Rel. No. 33-5560 (March 15, 1975), CCH FED. SEC. L. REP. ¶ 80,066.

ceding the point in time immediately after the last sale under the Rule may not exceed \$100,000; in other words, if no security sales have been made within the past twelve months, then a total of \$100,000 in value of securities may be sold under the Rule.

4. *Limitation on Number of Beneficial Owners.* Both immediately before and immediately after any transaction in reliance on the Rule, the issuer must reasonably believe that it has no more than 100 security holders.

5. *Limitations on Resale.* The issuer must exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of Section 2(11) of the 1933 Act.²⁴ In this connection the issuer must:

- (a) make reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons;
- (b) inform the purchaser of the restrictions on resale; and
- (c) place a legend on the certificate stating that the securities have not been registered under the Act and setting forth the restrictions on transferability and sale of the securities.

6. *Filing of Notice of Sales.* As soon as \$100,000 of securities have been sold pursuant to the Rule, the issuer must thereafter file a Form 240 with the appropriate Regional Office of the Commission within ten days after the close of the first month in which a sale made in reliance on the Rule is made.²⁵

E. *Summary of Federal Approach*

In summary, the federal approach to the private placement exemption is flexible and liberal.

First, the objective standards of Rule 146 are provided, which gives the offeror a significant measure of predictability.²⁶ Second, the residual law of what's left in Section 4(2) is available to the offeror who sets out in all good faith to design an offering in which the

²⁴ 15 U.S.C. § 77b(11).

²⁵ SEC Sec. Act. Rel. No. 33-5560 (March 15, 1975), CCH FED. SEC. L. REP. ¶ 80,066.

²⁶ In this regard, mention should be made of a recent amendment to Rule 146(G). SEC Sec. Act. Rel. No. 35-5585 (May 7, 1975) [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,168. The amendment provides that the offeror is protected so long as he reasonably believes that there are no more than 35 purchasers, even though in fact the numbers may exceed the limit of the Rule.

protections afforded by the 1933 Act are not necessary.²⁷ Third, Rule 240 provides a small issue safety valve for offerings up to \$100,000.

Four aspects of the federal approach should be noted before commencing an examination of the Blue Sky Law approach: (1) the federal statute itself makes no distinction as to the type of offerees involved;²⁸ (2) the federal approach does not require the absence of commissions or other remuneration in connection with a private placement; (3) in keeping with the 1933 Act disclosure philosophy, there is no provision by which the SEC can review the merits of a proposed private offering;²⁹ and (4) Rule 240 is silent on the question of the investment sophistication of the offerees.

F. *Proposed Federal Securities Code Approach*

The federal securities laws have many imperfections, and an attempt is being made to prepare a unified codification and improvement of these laws under the auspices of The American Law Institute³⁰ by seeking to develop a Federal Securities Code. Although this project is still in the tentative draft stage, it is helpful to consider the current thinking of the draftsmen of this proposal as to the private placement exemption.

First, the proposed Federal Securities Code embodies a major shift in approach from the existing pattern of securities regulation. Under the proposed Code there is no requirement for the registration of securities. Rather, the *company* is required to register with the Commission when it first reaches \$1,000,000 of assets and 300 record holders of all its securities, or when the first "distribution" is made of any of its securities.³¹ The basic theme "is a shift in emphasis from

²⁷ See Position Papers, *Private Exemption Under Section 4(2) of the Securities Act of 1933*, 31 BUS. LAW. 483 (1975).

²⁸ Although the federal statute makes no distinction as to the type of offeree involved, at least one court has emphasized the "sophisticated knowledgeable [and] experienced" character of two mutual fund plaintiffs in determining that the section 4(2) exemption applied. *The Value Line Fund, Inc. v. Marcus*, 64-66 CCH DEC. ¶ 91-523 (S.D.N.Y. March 31, 1965). The *Marcus* case involved the sale of stock, and no cases have been found discussing the 4(2) exemption in the area of private placement of debt securities.

²⁹ The SEC could, of course, enjoin the continuation of a fraudulent offering under Rule 10b-5.

³⁰ Although in this paper we will refer to the Federal Securities Code, it should be remembered that the Code is at present in the tentative draft stage only. All citations to the Federal Securities Code refer to the various tentative drafts published by the American Law Institute.

³¹ FEDERAL SECURITIES CODE §§ 401-02 (Tentative Draft No. 3, October 1, 1974).

the occasional, hit-or-miss, static registration statement under the 1933 Act to permanent company registration followed by the continual disclosure, on as current a basis as practical, more along the lines of the 1934 Act."³² The proposed Code still recognizes the need for, and requires a special filing with the SEC at the time of a significant distribution in the form of an "offering statement"³³ as well as the delivery of a prospectus to prospective buyers.³⁴

The proposed Federal Securities Code provides an exemption from its filing and registration requirements for offerings not involving a "distribution."³⁵ The term distribution is defined to exclude a "limited offering" which is in turn defined as one in which the following conditions are satisfied: (A) the initial buyers of the securities are institutional investors or consist of not more than 35 other persons, or both; (B) resales of any of the securities to persons other than institutional investors within three years do not result in more than 35 owners of such securities; and (C) the original offeror and all sellers in such resales comply with any rules promulgated by the SEC.³⁶

The proposed Code then states that the SEC is authorized to require by rule: (A) that the seller obtain an appropriate written undertaking from his buyer, (B) that the securities involved contain an appropriate restriction on transferability, and (C) that any transfer agent be given an appropriate stop-transfer notice designed to avoid an illegal distribution.³⁷ The Commission is given the further authority to modify, by rule, the conditions of the exemption or to require additional conditions.³⁸

This proposed approach contains many of the elements of present Rule 146.

III. THE BLUE SKY LAW APPROACH TO THE PRIVATE PLACEMENT EXEMPTION

A. *Introduction to Blue Sky Approach*

1. *Basic Format of Blue Sky Laws*

Although traditionally Blue Sky statutes have been categorized as either: (a) antifraud; (b) "broker" registration; i.e., registration of the

³² FEDERAL SECURITIES CODE at XIX. (Tentative Draft No. 1, April 25, 1972).

³³ FEDERAL SECURITIES CODE § 501. (Tentative Draft No. 3, October 1, 1974).

³⁴ FEDERAL SECURITIES CODE § 504. (Tentative Draft No. 3, October 1, 1974).

³⁵ FEDERAL SECURITIES CODE § 501. (Tentative Draft No. 3, October 1, 1974).

³⁶ FEDERAL SECURITIES CODE § 227(b)(1). (Tentative Draft No. 3, October 1, 1974).

³⁷ FEDERAL SECURITIES CODE § 227(b)(4). (Tentative Draft No. 3, October 1, 1974).

³⁸ FEDERAL SECURITIES CODE § 227(b)(3). (Tentative Draft No. 3, October 1, 1974).

sellers of securities; or (c) securities registration in format, in fact, the predominant Blue Sky pattern today is similar to the federal pattern achieved by the 1933 Act and the Securities and Exchange Act of 1934³⁹ in requiring registration of both securities and the sellers thereof.⁴⁰

At present 48 states require some form of securities registration,⁴¹ and all states require some form of broker-dealer registration. The Blue Sky laws of almost all of the securities registration states have some form of private placement exemption from the registration provisions. As will be seen from the analysis below, the varieties of types of exemptions are many — in fact perhaps more than there are states, because very few states have exactly the same approach, and many have two and sometimes three different types of private offering exemptions.

The basic format of the private placement exemption of the Blue Sky laws, however, is similar. That format is: (1) to provide a statutory exemption for any offering to financial institutions; (2) to provide special and separate handling for offerings of enterprises in the preincorporation stage; (3) to provide by statute a general private offering which contains an objective “numbers test,” usually limiting the number of offerees which are allowed for the exemption; (4) to require that the purchasers buy the securities for investment purposes only; and (5) to prohibit the payment of commissions in connection with the private placement.

Consistent with the basic regulatory, as opposed to disclosure, philosophy of many Blue Sky laws, the securities commissioners have the power to prevent the making or continuation of a private offering if the offering lacks sufficient business merit for purchases by citizens of the state. This format differs in a number of material respects from the federal approach.⁴²

2. *Uniform Securities Act Approach*

The Uniform Securities Act (hereinafter sometimes called the “Uniform Act”) was officially approved in 1956.⁴³ It represents the

³⁹ 15 U.S.C. §§ 78a *et seq.* [hereinafter the “1934 Act”].

⁴⁰ Registration of securities is required by Section 5 of the 1933 Act. 15 U.S.C. § 77e. The registration of brokers and dealers is required by Section 15 of the 1934 Act. 15 U.S.C. § 78o.

⁴¹ Connecticut and New York do not.

⁴² See text of Section II E *supra*.

⁴³ The Act was approved by the National Conference of Commissioners on Uniform State Laws on August 25, 1956.

most recent comprehensive and considered thinking as to what a model Blue Sky Act should contain (keeping in mind the practical need recognized by the Draftsmen not to depart too dramatically from existing law).⁴⁴ For this reason, and because the Uniform Act has been used as the statutory source of the Blue Sky laws in 32 states, it is useful for the purposes of this article to examine in some detail the Uniform Act approach to the private placement exemption. In this regard, it must be kept in mind that we have not said that the Uniform Act has been "adopted" in 32 states. The manner in which the various states have worked from the Uniform Act pattern are almost as varied as the number of states which have used its format,⁴⁵ and this was anticipated by the Draftsmen of the Act.⁴⁶

Following the basic state format, the Uniform Act divides the private placement exemption into three parts. First, Section 402(b)(8) of the Uniform Act recognizes the absence of the need for the protections offered by securities registration in connection with sales to highly sophisticated institutional investors. That Section exempts from registration:

. . . any offer or sale to a bank, savings institution, trust company, insurance company, investment company, pension or profit-sharing trust or other financial institution or institutional buyer, or to a broker-dealer.

There is no limitation on the numbers of institutions which might be involved in an institutional offer by statute, and the practicalities of the business world assure that a numbers test is unnecessary in the typical institutional offering — long-term debt of seasoned companies.⁴⁷

The principal (or equity) portion of the private offering exemption in the Uniform Act is Section 402(b)(9) which provides an exemption from securities registration in the case of:

⁴⁴ The Draftsmen of the Uniform Securities Act were Professor Louis Loss of the Harvard Law School and Mr. Edward M. Cowett, his Research Assistant. Their comments on the Uniform Act are published in their work, *BLUE SKY LAW*, (1958), which is an invaluable tool to anyone working in the Blue Sky area. The authors indicate in their work their desire to present a statute which did not depart from existing law so much that it would be unacceptable to the various states.

⁴⁵ Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?* 1976 *Wis. L. REV.* 79, 83.

⁴⁶ Loss & Cowett, *BLUE SKY LAW* 374 (1958).

⁴⁷ See Position Papers, *Private Exemption Under Section 4(2) of the Securities Act of 1933*, 31 *BUS. LAW.* 483, 525 (1975).

(9) any transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in paragraph (8)) in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this state, if (A) the seller reasonably believes that all the buyers in this state are purchasing for investment, and (B) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state; but the Administrator may by rule or order, as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in Clauses (A) and (B) with or without the substitution of a limitation on remuneration.

The exemption has four principal attributes: (1) it provides two objective tests in that the offer is precisely limited as to offerees and to time — the offer may be made to not more than ten persons *in the state* during any period of 12 consecutive months; (2) attention is given to redistribution, because the seller must reasonably believe that the buyers are purchasing for investment; (3) the selling effort is strictly limited because the exemption is not available if any commission or other remuneration is paid for soliciting any prospective buyer; and (4) flexibility is provided through the provision that the securities commissioner may withdraw or further condition the exemption, increase or decrease the number of offerees permitted, or waive any of the above conditions by rule or order. This latter power has been used to some extent in recent years in several states.⁴⁸

Section 402(b)(9) of the Uniform Act is complemented by Section 402(b)(10) which exempts from registration:

(10) any offer or sale of a preorganization certificate or subscription if (A) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective subscriber, (B) the number of subscribers does not exceed ten, and (C) no payment is made by any subscriber;

This section does not exempt the actual sale of the stock for the new enterprise; it exempts only the offer (and sale) of the preincorporation document. When the subscriptions are called, the offeror must come within Section 402(b)(9), or register the stock.

⁴⁸ See text of Section III C(2) *infra*.

The concept of a merit review for privately placed securities is retained in a somewhat attenuated form in the Uniform Act. Section 402(c) empowers the securities commissioner to revoke any Section 402(b) exemption, including the private placement and private offering exemptions, upon due notice and after fair hearing. Also, as we have seen, Section 402(b)(9) itself specifically authorizes the securities commissioner to withdraw or further condition the exemption by order as to a specific offering.

B. *The Varieties of State Approaches to the Private Placement Exemption*

The heart of the problem for the offeror proposing a multi-state private placement is the broad variety of state approaches to the problem. There are at least seven general categories of approaches for the equity financing area and a number of variations are found in each of these categories.

1. *General Exemption (Equity Financing)*

First, we will examine the variations in the equity area:

(a) *Limitations Based on Number of Offerees.* This is by far the most prevalent approach. Thirty-two states, the District of Columbia and Puerto Rico have adopted or substantially adopted the Uniform Securities Act.⁴⁹ Most of these jurisdictions have followed the Uniform Act's concept of providing, as a threshold test of the availability of the exemption, a limit on the number of persons to whom the offering may be made.⁵⁰ In addition, two states which have not adopted the Uniform Securities Act nonetheless follow its basic pattern so far as the equity private offering exemption is concerned.⁵¹

The "uniform" approach is in fact by no means uniform. The principal variation is as to the number of offerees which are allowed. The numbers range from the ten suggested by the Uniform Act⁵² to as many as 25,⁵³ with some states choosing 15.⁵⁴ Several states allow

⁴⁹ Alabama, Alaska, Arkansas, Colorado, Delaware, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, South Carolina, Utah, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

⁵⁰ *E.g.*, ALA. CODE ANN. tit. 53, § 38(1) (Supp. 1967).

⁵¹ LA. REV. STAT. § 51.705(12) (1968); N.D. CENT. CODE § 10-04.06.9 (Supp. 1967).

⁵² *E.g.*, IDAHO CODE ANN. § 30-1435(8) (1967).

⁵³ *E.g.*, ARK. STAT. ANN. § 67-1748(b)(9) (1966).

⁵⁴ *E.g.*, MICH. COMP. LAWS § 451.802(b)(9) (1970).

the payment of commissions in connection with the offering,⁵⁵ while some limit the exemption to offerings made by domestic corporations.⁵⁶ Several states which are denominated as Uniform Securities Act states have so changed the private offering exemption provision that it is virtually unrecognizable.⁵⁷ All of these states limit the "offering" to a 12-month period.

The Uniform Act,⁵⁸ and the statutes of some nonuniform states,⁵⁹ provide that the securities commissioner may by rule or order, vary the number of offerees or otherwise vary the limitations on the exemption. Several states have established such variations by rule.⁶⁰ It is possible that some commissioners will vary the exemption by order in a specific case, but we have been unable to identify any state in which this has been done with any frequency.

A sometimes overlooked variation common to the offeree exemption variety of statute is the form of statute which on its face appears to have an extraterritorial effect in its limitation. For example, the statute of Vermont limits the exemption to cases in which "the number of offerees of such sale does not exceed twenty-five."⁶¹ The comforting words of the Uniform Act (and of the acts of most offeree limitation states) "in this state" are omitted. On its face, the statute appears to prevent a multistate offering which exceeds twenty-five, even though only one offeree is located in the state. It appears that there is a constitutional question as to whether the exemption can be construed in that fashion, although we have found no case in which this issue was raised. Indeed, it is possible to interpret the statute as meaning to relate the numbers test only to offers in the state, but at least one commissioner has refused to accept that interpretation.⁶²

(b) *Limitation Based on Number of Security Holders.* Nine

⁵⁵ DEL. CODE ANN. tit. 6 § 7309(b)(9) (1973); MD. CODE ANN. § 11-602(9) (1975); MASS. GEN. LAWS ANN. § 402(b)(9) (1975); OREGON REV. STAT. § 59.035(12) (1967).

⁵⁶ KANS. STAT. ANN. § 17-1262(h) (1963); MISS. CODE ANN. § 5384.5(9) (Supp. 1966); VT. STAT. ANN. § 9-4204(10) (1959).

⁵⁷ *E.g.*, COLO. REV. STAT. § 11-51-114(a)(i) (1973), which exempts "any transaction in this state not involving any public offering. . . ."

⁵⁸ See text of Section III A(2) *supra*.

⁵⁹ *E.g.*, LA. REV. STAT. § 51.705(12) (1968).

⁶⁰ See text of Section III C(2) *infra*.

⁶¹ VT. STAT. ANN. § 9-4204(10) (1959). This problem also appears to exist in Indiana, Missouri, New York, Tennessee, Texas, Vermont, Virginia and Wyoming.

⁶² The prior Georgia Securities Act presented this problem, GA. CODE ANN. § 97-107(j) (1968), and the securities commissioner's department took the position that all participants wherever located, must be included in determining the number of permitted offerees. Trotter and Copeland, *An Appeal For Revision of the Georgia Securities Act*, 4 GA. L. REV. 341 n.39 (1970).

states assure that the equity private offering exemption is limited to close corporations by conditioning the exemption on the number of security holders; i.e., the exemption is not available if there are more than a specified number of security holders of the issuer when the offer is completed.⁶³ Here, again, the practitioner is forced into the numbers game, and the numbers vary widely, from a low of five in Ohio⁶⁴ to a high of 35 in Texas.⁶⁵

Each of the states in this category restricts the exemption to offerings made without payment of commission. It appears that the laws of the states in this category purport to have an extraterritorial effect.

(c) *Limitation Based on Capitalization of Issuer.* Four states add an additional complication by adding a new number — the aggregate capitalization of the issuer, or the aggregate amount of money raised in the offering.⁶⁶ This limitation tends not only to assure that the exemption is for the close corporation, but also that it is for the small close corporation. And the effects of inflation in the past thirty-five years without concurrent changes in the numbers have assured that the exemption is only for the truly small corporation.

(d) *Limitations Based on Number of Purchasers.* Thirteen states anticipated (or provided a model for) the Rule 146 approach in at least one respect, by making the exemption turn on the number of purchasers of the securities in the period — 12 months in each case.⁶⁷ The failure to include “in this state” language in some of these statutes creates difficult interpretative questions.⁶⁸

(e) *Limitations Based on Local Offeror.* Four states are essentially out of consideration for a multistate equity private offering,

⁶³ CALIF. CORP. CODE § 25102(h) (1968); ME. REV. STAT. ANN. tit. 32, § 874(9) (Supp. 1968); MISS. CODE ANN. § 5384.5(9) (Supp. 1966); N.M. STAT. ANN. § 48-18-22(J) (1965); OHIO REV. CODE ANN. § 1707-03(0) (1964); TEX. REV. CIV. STAT. ANN. art. 581-5(I) (1964); VT. STAT. ANN. § 9-4204(10) (1959); VA. CODE ANN. § 13.1-514(b)(8) (1968); WISC. STAT. ANN. § 551.23(10) (1973).

⁶⁴ OHIO REV. CODE ANN. § 1707.03(o) (1964).

⁶⁵ TEX. REV. CIV. STAT. ANN. art. 581-5(I) (1964).

⁶⁶ ILL. REV. STAT. ch. 121-½, § 137.4(G) (Supp. 1967); MISS. CODE ANN. § 5384.5(9) (Supp. 1966); WASH. REV. CODE ANN. § 21.20.320(9) (1961); *Rule of Arizona Corporate Commission*, Order S-1 (1966).

⁶⁷ FLA. STAT. ANN. § 517.06(11) (1971); GA. CODE ANN. § 97-109(M) (1973); ILL. REV. STAT. ch. 121-½, § 137.4(G) (Supp. 1976); IND. STAT. ANN. § 23-2-1-2(b)(10) (Supp. 1968); IOWA CODE ANN. § 203(9) (1975); MINN. STAT. ANN. § 80A.15(2)(h) (1971); MO. REV. STAT. § 409.402(b)(10) (1969); OKLA. STAT. ANN. § 401(b)(9) (1971); PA. STAT. ANN. § 203(d) (1973); S.D. COMP. LAWS § 47-31-86.1 (1967); TENN. CODE ANN. § 48-1632(H) (1964); TEX. REV. CIV. STAT. ANN. § 581-5(I) (1964); WASH. REV. CODE § 21.20.320(9) (1974).

⁶⁸ For example, Indiana.

because their statutes limit the availability of the exemption to domestic corporations of the state.⁶⁹ By way of duplication, the laws of these states fall into categories one and two, above. These states clearly follow the philosophy that the exemption should be limited to small, local offerings. Happily, for those who believe a more flexible approach is in the best interests of the nation's economic well-being, the number of states in this category is dwindling.⁷⁰

(f) *Isolated Transaction States.* Four states provide an additional means of effecting offerings without registration by making the "isolated transactions" exemption available to issuers as well as individuals.⁷¹ The typical statutory formulation of the isolated transaction is ". . . one which is not made in the course of successive and repeated transactions of a similar nature. . . ." Because of the narrowness with which this exemption has been construed, it is probably of slight utility.

(g) *States Which Require Filing With Securities Commissioner for Exemption.* Twenty-one states require the issuer to take some affirmative act with respect to the securities commissioner's office in connection with the exemption.⁷² There are almost as many types of filings required as there are states which require filings. These requirements present the crucial question of whether it is necessary to make the filing in order to achieve the exemption. It is beyond the scope of this article to explore that question with respect to each of these states. We note, however, the recent interesting case of *Feitler v. Midas Associates*⁷³ in which it was held that failure to comply with a rule of the Wisconsin securities commissioner requiring a filing within ten days after a private placement has exceeded \$100,000 did not cause the issuer to lose the exemption because the commissioner, in devising the rule, was only exercising his authority to require reports of sales under the exemption, and not his authority to withdraw or further condition the exemption. Presumably, the commissioner

⁶⁹ KANS. STAT. ANN. § 17-1262(h) (1963); ME. REV. STAT. ANN. tit. 32 § 874(9) (Supp. 1968); MISS. CODE ANN. § 5384.5(9) (Supp. 1966); VT. STAT. ANN. § 9-4204 (10) (1959). In addition, Wisconsin provides a 15-shareholders exemption for corporations whose principal place of business is in the state. WISC. STAT. ANN. § 551.23(10) (Supp. 1968).

⁷⁰ Compare FLA. STAT. § 517.06(11) (1967) with FLA. STAT. § 517.06(11) (1971).

⁷¹ KANS. STAT. ANN. § 17-1262(h) (1963); MINN. STAT. ANN. § 80A.15(2)(h) (1971); N.D. CENT. CODE § 10-04.06.9 (Supp. 1967); R.I. GEN. LAWS § 7-11-9(a) (1969).

⁷² Alaska, Arizona, Arkansas, Colorado, Delaware, Indiana, Iowa, Massachusetts, Minnesota, Mississippi, Missouri, New Mexico, North Dakota, Oklahoma, Oregon, Pennsylvania, South Dakota, Texas, Utah, Washington, Wisconsin.

⁷³ BNA SEC. REG. & L. REP. 366 at A-6 (E.D. Wis. Aug. 5, 1976).

will change the result for future cases by changing the rule.

(h) *The Overall Effect of the Merit Review Power On the Private Offering Exemption.* As indicated above, the Blue Sky laws, in their inception were paternalistic in approach, as opposed to the avowed disclosure approach of the 1933 Act. In the state approach there are found various statutory formulations which allow the securities commissioners to prohibit an offering in his state if he finds reason to doubt the fairness of the offering to citizens of his state. This doctrine is articulated in a variety of formulations, which allow the securities commissioners to revoke or deny effectiveness to a registration statement if he finds the offering not to be "fair, just and equitable" or not based on "sound business principles."⁷⁴

These merit review statutes apply to registered offerings, and since the sanction is for the commissioner to deny effectiveness to a registration statement, they do not have application in the private placement situation, where registration is not necessary. However, there is yet an element of the merit review concept in the state approach to the private placement exemption. This is exemplified by Section 402(c) of the Uniform Securities Act which provides that the securities commissioner may by order deny or revoke certain exemptions including the private placement exemption and the financial institutional exemption with respect to a specific security or transaction. The section goes on to provide that this action can be taken only upon notice and after opportunity for a hearing and that no order under the section may operate retroactively.

The state variations on this theme are many, but virtually all states allow the commissioner to revoke certain exemptions. We have found no case in which this power was tested or interpreted in the private placement area, and it is difficult to see how a commissioner's staff, usually extremely small in terms of the tasks assigned to it, could make effective use of this power except in the states requiring prior filings before completion of the private placement.

2. *Institutional Investor Exemption*

There is substantially more uniformity in the Blue Sky approach to the private placement exemption for offerings to institutional investors. All of the states (plus Puerto Rico and the District of Columbia) which have a securities registration requirement also have an exemption for offerings to institutional investors, and of the three

⁷⁴ See UNIFORM SECURITIES ACT § 306(a)(2)E.

non-securities registration states one has a Uniform Act-type exemption which provides that one selling an offering to institutions need not register as a dealer.⁷⁵

A major advantage of the separate Blue Sky exemption for institutions is that it avoids the general Blue Sky prohibition against payment of commissions in private offerings. The great majority of long-term debt institutional private placements are made through investment bankers who work on a commission basis.

Proponents of state uniformity have little to find fault with in regard to the Blue Sky approach to the institutional exemption. None of the 34 jurisdictions which have used the Uniform Act has varied the Section 402(b)(8) formulation to any significant degree,⁷⁶ an additional three⁷⁷ jurisdictions which did not use the Uniform Act have essentially the same formulation as Section 402(b)(8), and the remaining twelve⁷⁸ securities registration states have the same basic provisions as to types of institutions to whom offerings are exempted.

These formulations all cover the standard institutional buyer — banks, savings and loan associations, insurance companies, mutual funds, and employee benefit plans.

Problems occur in anticipating new types of institutions which should be included in the exempt category. The Uniform Act solution to this problem is to exempt any "other financial institution or institutional buyer," and also to leave to the securities commissioner the power to define the term by an interpretative rule.⁷⁹ A number of states provide what appears to be an even more useful, and rational, broad brush exemption by including in the exemption sales to:

. . . a person a principal part of whose business consists of buying securities.⁸⁰

⁷⁵ This is New York. N.Y. CONSOL. LAWS § 359e(1)(a) (1975). Connecticut and New Hampshire require that only a registered broker-dealer may sell a private placement to institutions, CONN. GEN. STAT. § 36-322(a)(6)(A) (1967); N.H. REV. STAT. ANN. § 421:7 (1971).

⁷⁶ See text of Section III A(2) *supra*.

⁷⁷ ME. REV. STAT. ANN. tit. 32 § 874.8 (Supp. 1968); MISS. CODE ANN. § 75-71-53-7 (Supp. 1966); R.I. GEN. LAWS § 7-11-9(b) (1956).

⁷⁸ ARIZ. REV. STAT. § 44-1844.8 (1967); CAL. CORP. CODE § 25102(i) (1968); FLA. STAT. § 517.06(5) (1967); GA. CODE ANN. § 97-109(G) (1976); ILL. REV. STAT. ch. 121-½, 137.4(c) (1967); LA. REV. STAT. § 51:705(5) (1968); OHIO REV. CODE § 1707.03(D) (1964); N.D. CENT. CODE § 10-04-06.5 (Supp. 1967); S.D. CODE § 47-31-88 (1967); TENN. CODE ANN. § 48-1632(E) (1964); TEX. REV. CIV. STAT. ANN. art. 581-5(H) (1964); VT. STAT. ANN. § 9-4204(5) (Supp. 1975).

⁷⁹ UNIFORM SECURITIES ACT § 412(a).

⁸⁰ *E.g.*, ARIZ. REV. STAT. § 44-1844(8) (1967).

Probably the real estate investment company is covered by either of these approaches,⁸¹ and the small business investment company is covered, perhaps with somewhat less surety.⁸² The ingenuity of the business world will undoubtedly create new investment vehicles whose qualifications as institutional investors that should or should not be included in the exemption must be considered.⁸³

One always surprising aspect of the Blue Sky institutional exemption is the broad, and apparently archaic, language in the formulations of seven states which exempt sales to *any* corporations.⁸⁴

C. Recent Trends in Blue Sky Private Placement Exemptions

1. Statutory Trends

There has been a considerable amount of statutory revision in the Blue Sky area in the current decade.⁸⁵ These revisions show a distinctive trend toward liberalizing and clarifying the private placement exemption. Four states which did not have a private placement exemption at all in 1970 have adopted the exemption.⁸⁶ One state which had limited the exemption to domestic corporations has removed that limitation.⁸⁷ Six states which already had the exemption have increased the permissible number of offerees or purchasers.⁸⁸ Three states have abandoned the proscription on commissions for soliciting buyers,⁸⁹ although the prohibition still holds sway in most states.

⁸¹ The Georgia statute expressly exempts a real estate investment company. GA. CODE ANN. § 97-109(G) (1976).

⁸² Again, the Georgia statute expressly exempts small business investment companies. GA. CODE ANN. § 97-109(G) (1976). Minnesota, on the other hand, specifically denies the exemption for a sale to a small business investment company unless it can be "demonstrated that it possesses adequate sophistication with respect to the specific offer and sale." *Minn. Admin. Regs.* S. Div. 2117, 1A BLUE SKY L. REP. ¶ 26.610 at 22,562.

⁸³ An example is the service corporation of a savings and loan association. Hawaii exempts sales to any institution which is tax exempt under INTERNAL REVENUE CODE OF 1954, § 501(c)(3).

⁸⁴ FLA. STAT. § 517.06(5) (1971); ILL. REV. STAT. § 4(c) (Supp. 1967); LA. REV. STAT. § 51-705(5) (1968); N.C. GEN. STAT. § 78A-17(8) (1975); OHIO REV. CODE § 1707.03(D) (1964); TENN. CODE ANN. § 48-1632(E) (1964); VA. CODE ANN. § 13.1-513(b)(7) (1968). Pennsylvania, with somewhat more logic, exempts sales to a corporation with a net worth of \$10,000,000 and which can meet certain earnings tests. PA. SEC. REGS. § 112.1111(a). BLUE SKY L. REP. ¶ 1301.

⁸⁵ Eighteen states have substantially changed their Blue Sky Laws since 1970.

⁸⁶ Minnesota, North Dakota, Pennsylvania and South Dakota.

⁸⁷ Florida.

⁸⁸ Florida, California, Colorado, Illinois, Indiana, and Louisiana.

⁸⁹ Georgia, Illinois, and Louisiana.

Finally, four states have shifted from an offeree-oriented numbers test to a purchaser numbers test,⁹⁰ a change which facilitates both compliance in general as well as coordination with the federal approach.

2. *State Reaction to Rule 146*

From the standpoint of federal-state coordination, the most important current question is: how have the states reacted to Rule 146? The answer is that in the relatively short period that has elapsed since the Rule was adopted in June, 1974, there has been a surprisingly prompt and significant reaction to Rule 146 at the state level. Seven states have adopted its philosophy, either by statute or by regulation.⁹¹ One state has rejected it, and clearly articulated its reasons for doing so.⁹²

The states which have adopted Rule 146 as a private placement exemption have done so in a variety of ways, again evidencing the real and sometimes baffling diversity of the federal system.

Hawaii took the simplest approach. In 1975, its legislature added a section to its blue sky law exempting from the registration provisions:

Any offer or sale not involving a public offering within the meaning of Rule 146 (Code of Federal Regulations Section 230.146) or any successor rule, as amended from time to time, of the Securities and Exchange Commission.⁹³

Arizona also has taken a simple approach. Its private exemption is almost verbatim the same as the 1933 Act's Section 4(2) in that it exempts, "transactions by an issuer not involving any public offering."⁹⁴ Acting under his rule-making power, the Arizona securities commissioner adopted almost verbatim Rule 146 in defining what is meant by this exemption.⁹⁵

Delaware and Maryland jointly took a straightforward approach. Each of these states had adopted Section 402(b)(9) of the Uniform Act almost verbatim (using 25 as the number of offerees). On October 24, 1974, just four months after the effective date of Rule 146, the securities commissioners of these states exercised their power under

⁹⁰ Colorado, Georgia, Indiana and Washington.

⁹¹ Arizona, Colorado, Delaware, Hawaii, Maryland, Minnesota, and Utah.

⁹² California.

⁹³ HAWAII REV. STAT. § 485-6(15) (1968).

⁹⁴ ARIZ. REV. STAT. § 44-1844.1 (1975).

⁹⁵ ARIZ. CORP. COMM. REGS. Order No. S-26, 1 BLUE SKY L. REP. ¶ 6676 at 2510.

this formulation of the private placement exemption to vary the exemption by adopting the substance of Rule 146 for intrastate offerings and by adding a further provision that any offering which complies with Rule 146 is deemed to be in compliance with the states' exemptive rule upon the filing of a specified form for interstate offerings.⁹⁶ Delaware and Maryland had been in the forefront of attempts to clarify the private placement exemption; the securities commissioners of those states had previously utilized their rule-making power to adopt a "purchaser" rather than "offeree" test, and the well-reasoned Release of the Delaware commissioner accompanying the new rule states that the commissioners recognize ". . . that Rule 146 is an improvement, in a number of respects, over their states' current rules. . . ."⁹⁷ The Release goes on to express a strong view in favor of uniformity in blue sky regulation:

More significantly, because of compliance confusion attributable to the lack of conformity among the various states among themselves and the SEC respecting the conditions of a private offering exemption, the Commissioners, serving two contiguous states, propose to adopt jointly the same rule. The Commissioners hope their joint action will not only contribute to federal and state uniformity respecting Maryland and Delaware private offerings, but also will serve as an example to spur conformity in state securities regulation in other areas where confusion and complexity abound.⁹⁸

Minnesota has also adopted the basic form of the Uniform Act's private placement exemption, except that its numbers test is 25 purchasers. The Minnesota commissioner has kept the substance of the Uniform Act exemption and added aspects of Rule 146 by adopting a rule increasing the number of allowed purchasers in the state to 35 if the sales are made in compliance with Rule 146.⁹⁹

The Colorado approach is substantially different. That state's statute is based on the Uniform Securities Act, but the private offering exemption provision departs substantially from the Uniform Act formulation. The statute provides an exemption for a transaction "not involving a public offering" or one which the securities commissioner exempts by rule or by order upon his finding that the protec-

⁹⁶ *Del. Sec. Rel.* (October 24, 1974), 2 BLUE SKY L. REP. ¶ 11,653 at 7522.

⁹⁷ *Id.* at 7524.

⁹⁸ *Id.*

⁹⁹ *Minn. Admin. Regs.* S. Div. 2118(b), 1A BLUE SKY L. REP. ¶ 26,610 at 22,562.

tions afforded by registration are not required.¹⁰⁰ Acting under this statute, the commissioner adopted a rule¹⁰¹ which provides an exemption where: (a) there is compliance with Rule 146; (b) a Claim for Exemption has been filed; and (apparently): (i) the number of purchasers does not exceed 35; (ii) a minimum cash investment of \$5,000; (iii) unless the investment exceeds \$150,000, any offeree must meet certain minimum gross annual income and net worth tests; (iv) detailed questionnaires are obtained from the offeree showing the suitability of the investment for him and his (or his offeree representatives') investment sophistication. This appears to be a remarkable blend of the federal and paternalistic approaches, but it focuses on the original purpose of a private placement exemption — that the offerees do not need the protection of registration.

Utah has adopted the Utah Uniform Securities Act, although the statute varies in some degree from the original Act. That Act does not contain the Uniform Act Section 402(b)(9) private placement exemption; instead, it exempts "any isolated transaction."¹⁰² But the Act empowers the securities commissioner to make such rules "as are necessary to carry out the provisions" of the statute,¹⁰³ and it contains a provision that:

This Act shall be so construed as to effectuate its general purpose to make uniform the laws of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation.¹⁰⁴

Pursuant to this authority, the commissioner has adopted a rule¹⁰⁵ which provides that an offer is "an isolated transaction" if: (a) there are 35 or fewer purchasers in the state in a 12-month period; (b) an application is filed in advance; (c) the investors meet the suitability standards of Rule 146(d); and (d) the investors receive a disclosure statement, previously filed with the commissioner, which contains the information set forth in Rule 146(e). This approach is similar to the Georgia small offering registration — much of the philosophy of Rule 146 is accepted, but it is required that the purchaser be given a disclosure statement, rather than the Rule 146(E)(1)(i) alternative merely that he "shall have access" to the type of information that

¹⁰⁰ COLO. REV. STAT. § 11-51-114(2)(i) (1963).

¹⁰¹ COLO. DIV. SEC. Rule 817, 1 BLUE SKY L. REP. ¶ 9709 at 5636.

¹⁰² UTAH CODE ANN. § 61-1-14(2)(a) (1967).

¹⁰³ UTAH CODE ANN. § 61-1-24 (1967).

¹⁰⁴ UTAH CODE ANN. § 61-1-27 (1967).

¹⁰⁵ UTAH SEC. COMM. RULE A67-03-7, 3 BLUE SKY L. REP. ¶ 47,607 at 43,515.

would be provided if the offer had been registered.

After providing the liberality of a Rule 146-type approach, the Utah commission stresses that the offeror seeking the private placement exemption must come within that type of exemption as a practical matter, because subparagraph four of the order says that otherwise an isolated transaction means that the seller of securities is entitled to make two sales within a twelve-month period of time.¹⁰⁶

California is the one state which considered and rejected the Rule 146 concept and articulated its reasons for doing so. It must be remembered, of course, that California is a leading exponent of the merit review, or patriarchal, approach to securities regulation. It does not have a typical private offering exemption, and the Securities Department examines any proposed issues from the standpoint of whether they are fair, just and equitable.¹⁰⁷ The reasons for rejection of the Rule 146 approach were set forth in the *Corporate Securities Newsletter* for November, 1974 published by the California Department of Corporations.¹⁰⁸ This release stated that the contributing elements for rejecting the approach were:

. . . the keen interest of the State in local securities transactions and the fundamental differences between a disclosure standard and a fair, just and equitable standard.¹⁰⁹

The release goes on to note that the California law imposes on the commissioner the affirmative burden of reviewing each proposed securities transaction from the standpoint of fairness, and the Rule 146 type of approach is inconsistent with meeting that burden.¹¹⁰

3. *Effect of Proposed Federal Securities Code on Blue Sky Private Placement Exemption*

As we have explained in Section II F above, the American Law Institute is sponsoring the development of a proposed Federal Securities Code. We have described the private placement provisions of the proposed Code in Section II F, and it is appropriate at this point to examine the effect of the proposed Code on the State private placement exemption.

As we have noted, the Federal Securities Code's limited offering exemption, which is somewhat reminiscent of Rule 146, is probably

¹⁰⁶ *Id.*

¹⁰⁷ CAL. CORP. CODE § 25140(a) (1968).

¹⁰⁸ 1 BLUE SKY L. REP. ¶ 8708 at 4656.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

less restrictive than the private placement exemptions of most of the state Blue Sky Laws.¹¹¹ There consequently arises the interesting and somewhat perplexing question of the preemptive effect of the Federal Securities Code on the various state private placement exemptions.

The Code states that it "is exclusive and plenary in the area [of registration] with respect to a state whose procedure in that area is not substantially coordinated with the procedure [of the Code]."¹¹² The Code proceeds to provide that a state's procedure is "substantially coordinated" when the state accepts the commission's forms and waiting periods for purposes of its own comparable requirements.¹¹³ The Code thus implies that a state law which is "coordinated" will not be preempted by the Code.

The question then must be raised, what if a particular state has a narrower exemption than that of the Code? If the state is "coordinated," then presumably the offeror will be required to register under the state law even though the offering is exempt under the Code. On the other hand, if the state is not coordinated, the Code seems to say that the state law is preempted and no registration would be required.

Professor Louis Loss of the Harvard Law School, the Reporter for the proposed Code, however, seems to take the position that there is no preemption in the private placement exemption area:

Otherwise the areas in which there is *no* preemption are the postdistribution exemptions in § 511(b) and (c) . . . the \$100,000 exemption of local distributions in § 513, the offering of interests or instruments that do not come within the Code's definition of "security" and, of course, the "limited offering."¹¹⁴

It therefore appears to us that the question of the proposed Code's preemption of the state limited offering exemptions is unsettled and that some further clarification of this question is required.

IV. MAJOR DIFFERENCES BETWEEN FEDERAL AND STATE APPROACHES TO PRIVATE PLACEMENT EXEMPTION

It is evident from the preceding material that there are major

¹¹¹ See text of Section II *F supra*.

¹¹² FEDERAL SECURITIES CODE § 1603(a)(1). (Tentative Draft No. 3, October 1, 1974).

¹¹³ FEDERAL SECURITIES CODE § 1603(a)(2). (Tentative Draft No. 3, October 1, 1974).

¹¹⁴ FEDERAL SECURITIES CODE at 143. (Tentative Draft No. 3, October 1, 1974). (Reporter's Commentary).

differences in the approaches to the private placement problem between the 1933 Act on the one hand and the varying Blue Sky approaches on the other. These provide a complexity to any multistate private placement (except, in most cases, an institutional investor offering)¹¹⁵ which often results in extra costs and sometimes prevents the completion of a private placement along the lines originally proposed. It is also obvious from the preceding material that the private placement exemption of each state in which a private placement is proposed to be made must be reviewed in advance with care.

1. *No Mesh Between Federal and State Approaches; The Numbers Game.* The principal practical difference is that no securities registration state has a private placement exemption which meshes with Section 4(2) of the 1933 Act, and very few have an exemption which meshes with Rule 146.¹¹⁶

As a result, the major difficulty in achieving a federal-state mesh arises from the numbers game. The development of the residual law under Section 4(2) of the 1933 Act has seemingly made it clear that there is no precise limitation on the number of offerees or of purchasers which may be present in a Section 4(2) offering.¹¹⁷ The state approach, on the other hand, is almost invariably to provide a precise numbers test — usually a limit on the number of offerees. Thus, for example, an offering that is clearly exempt under Section 4(2) could, at the same time, not qualify for a Blue Sky exemption in either state if the offering were made to a total of 27 offerees in Arkansas and Louisiana.¹¹⁸ Further, Rule 146 doesn't solve this problem. To be sure, it provides an objective numbers test, but that test is in terms of purchasers rather than the typical state test of offerees. Again, an offering to 27 offerees, all of whom purchase the securities, might easily comply with Rule 146, but would not qualify for an exemption if made in both Arkansas and Louisiana.

Another aspect of the numbers game problem is posed by states whose offeree limitation is not modified by the phrase "in this state." Under a literal construction of this language, the state's numbers test will control the offering if the offer is made in the state at all.¹¹⁹

¹¹⁵ Of course one-state offering does not involve the same complications, but the Blue Sky exemptions, because of their variety, still present shoals in a one-state private placement which meets the 1933 Act exemption for any reason including the intrastate exemption of Section 3(a)(11), 15 U.S.C. § 77c(a)(11).

¹¹⁶ See text of Section III C(2) *supra*.

¹¹⁷ See text of Section II C *supra*.

¹¹⁸ ARK. STAT. ANN. § 67-1248(b)(9) (1966) (25 offerees); LA. REV. STAT. § 51.705(12) (1968) (25 offerees).

¹¹⁹ See text of Section III B(1)(a) *supra*.

Yet one more variation of the numbers game problem is presented by those states which limit the shareholders or capitalization, or both, of the offeror.¹²⁰

2. *State Filing Requirements.* A second major difference between the federal and state approaches stems from the filing requirements of some states. Neither Section 4(2) of the 1933 Act nor Rule 146 requires that anything be filed with the SEC to secure the exemption (but Rule 240 requires a filing). Twenty-three states, on the other hand, require that some type of document be filed with the securities commissioner in connection with the exemption. These filings vary from a simple post-sale statement of who purchased the securities to a complete pre-sale offering circular which will be reviewed by the securities commissioner from, among other things, the standpoint of whether the offering is fair, just and equitable.¹²¹

3. *Payment of Commissions.* A third major difference is the typical state prohibition against payment of commissions in a private placement (except in the case of an institutional investor placement). This prohibition is nowhere present in the federal approach. This prohibition often has the effect of keeping a perfectly sound venture capital situation from being placed because the issuer may not know where the money is and the investment banker who does may not place the securities without a commission. It also tends to limit somewhat the selling effort for tax shelter offerings. A number of states are doing away with this limitation, and venture capital financing tends to move to those states.¹²²

4. *Domestic Corporation Limitation.* A fourth major difference is posed by the laws of the states which limit the private offering to domestic corporations.¹²³ No multistate offerings can be made from outside such states.

5. *Miscellaneous.* Two other major differences, which are not within the scope of this paper, but which should be considered in greater detail are: (a) in some states the private placement exemption for a secondary offering is not clear;¹²⁴ and (b) in some other states the private placement must be made by a registered broker-dealer.¹²⁵

¹²⁰ See text of Section III B(1)(b)-(c) *supra*.

¹²¹ See text of Section III B(1)(g) *supra*.

¹²² See text of Section III C(1) *supra*.

¹²³ See text of Section III B(1)(e) *supra*.

¹²⁴ A secondary offering is one made by a person other than the issuer.

¹²⁵ Arizona, Maine, Nebraska, New Hampshire, New York, North Carolina, North Dakota, Ohio, Tennessee, and Texas.

V. POSSIBLE SOLUTION — UNIFORMITY OF APPROACH

In recent years, the difficulties presented by the varying state approaches to the private placement exemption have attracted some scholarly attention, and considerable criticism, the essence of which is that the state approaches make it too difficult for new business or struggling venture capital companies to acquire investment capital.¹²⁶ These critics have, in effect, urged that the state differences be abolished and that all states adopt a uniform exemption based on the federal approach — in short, a uniform private placement exemption. There are sound arguments supporting this position, and, perhaps, equally sound arguments which support the present status.

A. *Arguments In Favor of Uniformity*

The merit of a uniform approach is simplicity. The sweeping away of the state variations would ease the multistate private placement offeror's task immensely in that he would be concerned with only one set of rules, rather than as many sets as there are states in which it is proposed to make the offering. The argument goes on to state that state variations are unnecessary; the varying numbers tests are arbitrary and the numbers test approach gives no attention to the investment sophistication of the offerees. The requirement for filings are either a trap for the unwary, or an overly officious state interference with the right of an informed investor to make a fool of himself with his money. The restrictions against payment of commissioners, justified on the ground of preventing the dilution of the investor's capital, serves rather to prevent the business venture from finding the knowledgeable capitalist. Finally, there is simply no rational justification for the state approach which limits the exemption to domestic corporations.

B. *Arguments Against Uniformity*

The principal argument against uniformity is that there is no certain truth as to what is the best type of private placement exemption. The federal approach has been criticized for years as being entirely unsatisfactory.¹²⁷ The Draftsmen of the Uniform Securities

¹²⁶ Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273; Garcia & Kantor, *Dark Clouds In a Blue Sky: An Analysis of the Limited Offering Exemption*, 28 U. MIAMI L. REV. 568 (1969).

¹²⁷ See Position Papers, *Private Exemption Under Section 4(2) of the Securities Act of 1933*, 31 BUS. LAW. 483, 489 (1975).

Act wrote that the one recommendation they received about the private placement exemption which was virtually unanimous was to stay away from the vague and undefined federal approach of "public offering."¹²⁸ It took 41 years of confusing experience before a serious attempt was made at the federal level to clarify the private placement exemption, and that attempt, Rule 146, has been criticized and will undoubtedly be the subject of further criticism.¹²⁹ In short, it is argued that the states should continue to serve the function accredited to them by Justice Brandeis of serving as laboratories for the development of laws. And in justification of that view it must be noted that Rule 146 drew on state experience.

Another major argument against uniformity reaches a major difference between the federal and state securities statutes; i.e., whether the federal disclosure approach or the state merit, or *parens patriae* approach, is the proper method to regulate the sale of securities. As noted, some states require some pre-sale review by the securities commissioner before a private placement sale can be made. In these states, the commissioner can refuse to allow the offering to proceed if he decides it does not have sufficient business merit.¹³⁰ The great battle on philosophies of securities regulation was fought when the 1933 Act was adopted,¹³¹ but the battle did not end the war. A recent article has examined the uses of the merit review for public offerings in Wisconsin, and found the review to be of considerable value to the public.¹³² Possibly the same argument could be made to support the merit review for private placements.

VI. SUMMARY AND CONCLUSIONS

In summary, the private placement exemptions of both the federal and the Blue Sky formulations have not reached perfection, and the present state of interrelationships between the federal and state approaches is far from satisfactory.

The uncertainty about the limits of the exemption under Section 4(2) of the 1933 Act has been a source of doubt and of litigation for 43 years, and the promulgation of Rule 146 has not solved the questions.

¹²⁸ LOSS & COWETT, *BLUE SKY LAW*, *supra* note 46, at 373.

¹²⁹ See note 15 *supra* and accompanying text.

¹³⁰ See text of Section III a(1) *supra*.

¹³¹ See LOSS, 1 *SECURITIES REGULATION* 121-28 (2d ed. 1961); Landis, *The Legislative History of the Securities Act of 1933*, 28 *GEO. WASH. L. REV.* 29 (1959).

¹³² See Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?* 1976 *WIS. L. REV.* 79.

The extreme diversity of state approaches to the private placement exemption have built far too many shoals in the Rule 146 safe harbor. In particular, the odd results achieved by the numbers game are unacceptable. In addition, the various state approaches are subject to criticism on their own merits. For example, the Uniform Securities Act formulation, which is the pattern of the majority of state approaches, does not give any attention to the investor's sophistication; i.e., his need for the protections afforded by registration.

The question of whether the federal disclosure approach or the state merit review approach to securities regulation is best is a part of this problem, and that has not, and may never, be resolved.

We think it is clear that these questions will not be wholly answered by one, or a dozen, law review articles. The issues involved are far too complex. The private placement exemption is one of the most important aspects of the securities laws. We think that the problems pointed out by this paper are of sufficient importance and complexity to warrant the establishment of a funded study project to consider and recommend a satisfactory approach for both federal and state laws.

We are not ready to accept the somewhat simplistic approach of abolishing the Blue Sky laws through federal preemption, because we think the Blue Sky laws have an extremely useful place in our country's securities regulatory system.

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