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# THE PREEXISTING RELATIONSHIP DOCTRINE UNDER REGULATION D: A RULE WITHOUT REASON?

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## INTRODUCTION

Congress intended the Securities Act of 1933<sup>1</sup> (the "Securities Act") to provide, principally through the registration process, full and fair disclosure to purchasers of securities sold in interstate commerce. Because, however, in many instances the registration requirements of the Securities Act are unnecessary to protect investors or are unduly burdensome for small issuers attempting to raise capital, Congress and the Securities and Exchange Commission (the "Commission") have created exemptions from registration. Of these exemptions, the three exemptions in regulation D<sup>2</sup> under the Securities Act have the broadest and most significant utility, especially for small issuers. Prior to the adoption of regulation D in 1982,<sup>3</sup> the Commission had received a substantial number of comments complaining that compliance with the federal securities laws was having an inordinate impact on small businesses. Regulation D was a principal component of the Commission's attempt to accommodate the concerns expressed on behalf of small businesses and the policy mandate of the Securities Act. Regulation D generally has drawn support from commentators and practitioners. One of the requirements of regulation D, however, the prohibition on general solicitation and general advertising in rule 502(c), has presented serious questions to issuers and their counsel and has diminished the utility of regulation D exemptions because of the requirement's uncertain reach and ambiguous precedent. The Commission staff has amplified these problems by issuing a series of particularly restrictive interpretations of rule 502(c). Specifically, these interpretations imply that, to comply with rule 502(c), an issuer or its agents must have a preexisting, substantive relationship with persons to whom the securities are being offered. This Article examines the background of the general solicitation and general advertising prohibition and argues for a more liberal interpretation of rule 502(c), an interpretation that is more consistent with the policies underlying regulation D and the Securities Act.

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1. 15 U.S.C. §§ 77a-77aa (1987).

2. 17 C.F.R. §§ 230.501-506 (1988).

3. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106, at 84,907 (Mar. 8, 1982).

## OVERVIEW OF REGULATION D

In response to concerns that compliance with the requirements of the Securities Act might unduly burden capital raising efforts by small issuers,<sup>4</sup> the Commission in 1978 began an extensive reexamination of the exemptive scheme under the Securities Act. This reexamination included an experimental rule,<sup>5</sup> publication of a concept release and solicitation of written comments,<sup>6</sup> adoption of a simplified form of registration for small initial public offerings (Form S-18),<sup>7</sup> and public hearings to determine "the extent to which the burdens imposed on small business [could] be alleviated consistent with the protection of investors."<sup>8</sup> In the midst of the Commission's efforts, Congress provided further impetus for revising the Securities Act exemptions for limited offerings by enacting the Small Business Investment Incentive Act of 1980.<sup>9</sup> This act amended section 3(b) of the Securities Act to give the Commission authority to create exemptions for offerings up to \$5,000,000, expanded the definition of "accredited investor" in section 2(15) of the Securities Act, and provided for the development of a uniform, federal-state exemption from registration for small issuers.

One of the principal elements in the Commission's reexamination of the exemptive scheme under the Securities Act and a major response to the new Congressional mandate was the proposal to adopt a new regulation, regulation D, which would replace rules 240, 242, and 146 under the Securities Act.<sup>10</sup> After receiving numerous substantive comments on this proposal, the Commission adopted a revised version of regulation D, effective April 15, 1982.<sup>11</sup> Since then the Commission has amended regulation

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4. See, e.g., Warren, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 356 (1984).

5. In 1980, the Commission adopted rule 242 (formerly 17 C.F.R. § 230.242), a limited offering exemption under section 3(b) of the Securities Act, for offerings up to \$2,000,000, stating that the rule was in the "nature of an experiment." Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act Release No. 6180, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,426, at 82812 (Jan. 17, 1980).

6. Consideration of the Impact of the Small Business Investment Incentive Act of 1980 on Certain Exemptions from the Registration Provisions of the Securities Act of 1933, Securities Act Release No. 6274, 46 Fed. Reg. 2631 (1981) (Release Date Dec. 23, 1980).

7. Simplified Registration and Reporting Requirements for Small Issuers, Securities Act Release No. 6049, 44 Fed. Reg. 21,562 (1979) (Release Date Apr. 10, 1979).

8. Examination of the Effects of Rules and Regulations on the Ability of Small Businesses to Raise Capital and the Impact on Small Businesses of Disclosure Requirements Under the Securities Acts, Securities Act Release No. 5914, 43 Fed. Reg. 10,876 (1978) (Release Date Mar. 6, 1978).

9. Pub. L. No. 96-477, 94 Stat. 2275 (codified as amended in scattered sections of 15 U.S.C.).

10. See Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6339, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,014, at 84,453 (Aug. 7, 1981).

11. Securities Act Release No. 6389, *supra* note 3. As stated in the adopting release, the new regulation was "designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between Federal and state exemptions in order to facilitate capital formation consistent with the protection of investors." *Id.*

D twice,<sup>12</sup> and the Commission staff has authored numerous interpretative letters and one interpretative release.<sup>13</sup>

Regulation D provides three transactional exemptions from registration under the Securities Act.<sup>14</sup> Two of the exemptions, rules 504 and 505, were adopted under section 3(b) of the Securities Act. The third exemption, rule 506, was adopted under section 4(2). Rule 504 is available for offerings up to \$1,000,000; rule 505 is available for offerings up to \$5,000,000; and rule 506 is available for offerings without regard to the amount being raised. Rules 504 and 505 replaced predecessor small issue exemptions under section 3(b), rules 240 and 242.<sup>15</sup> Rule 506 replaced rule 146, a rule that the Commission had adopted in 1974<sup>16</sup> to provide objective standards for offerings under section 4(2) of the Securities Act, the so-called "private offering" exemption.<sup>17</sup> These exemptions are part of a coordinated formulation of limited and private offering exemptions under the Securities Act with common definitions, terms, and conditions set forth in rules 501 through 503.

#### BACKGROUND OF RULE 502(c)

With a limited exception, the Commission conditions each exemption in regulation D upon the absence of general solicitation and general advertising.<sup>18</sup> Specifically, rule 502(c) provides that

[n]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

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12. See Form D and Regulation D, Securities Act Release No. 6663, [1986-1987 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,032, at 88,271 (Oct. 2, 1986); Regulation D Revisions, Securities Act Release No. 6758, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,221, at 89,012 (Mar. 3, 1988). The Commission recently has proposed further amendments to regulation D. See Regulation D, Securities Act Release No. 6759, [1987-1988 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,222, at 89,016 (Mar. 3, 1988).

13. Interpretive Release on Regulation D, Securities Act Release No. 6455, 48 Fed. Reg. 10,045 (1983) (Release Date Mar. 3, 1983).

14. Sections 3(a)(2) through 3(a)(8) of the Securities Act provide exemptions from registration based on the type of security involved. See 15 U.S.C. § 77c(a)(2)-(8) (1987). These exemptions run with the securities and are available both for initial issuances by issuers and secondary transactions. Sections 3(a)(9)-(11), 3(b) and 4(1)-(6) of the Securities Act provide transactional exemptions, i.e., exemptions that apply only to particular offerings. See 15 U.S.C. §§ 77c(a)(9)-(11), (b), 77d(1)-(6) (1987). Subsequent offers or sales of the securities issued under these sections may only be made under another transactional exemption.

15. Rule 240 (formerly 17 C.F.R. § 230.240) was an exemption from registration for offerings of \$100,000 or less within a 12-month period. Rule 242 was an exemption from registration for offerings of \$2,000,000 or less within a 6-month period.

16. See Notice of Adoption of Rule 146 Under the Securities Act of 1933—"Transactions By an Issuer Deemed Not to Involve Any Public Offering," Securities Act Release No. 5487, 39 Fed. Reg. 15,261 (1974) (Release Date Apr. 23, 1974).

17. Section 4(2) provides an exemption from registration for "transactions by an issuer not involving any public offering."

18. Rule 504(b)(1) provides that the limitation on general advertising and general solicitation will not apply in certain state registered offerings.

1. Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
2. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.<sup>19</sup>

The immediate source of this limitation on general advertising and general solicitation is found in the similar provisions of former rule 146(c).<sup>20</sup> In addition, rules 240(c) and 242(d) contained manner of offering limitations that were similar to rule 502(c).<sup>21</sup> Under regulation D's predecessor rules, however, the limitation on general solicitation and general advertising had not been a well-defined concept. The Commission released no significant staff interpretations of the manner of offering limitation under rules 240 and 242 and only limited staff analyses of the prohibition under rule 146. The Commission staff made clear, for instance, that advertising in publications generally was not permitted under rule 146.<sup>22</sup> This was hardly a

19. 17 C.F.R. § 230.502 (1988).

20. See Securities Act Release No. 6339, *supra* note 10.

21. Rule 146(c) provided as follows:

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

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

(2) Any seminar or meeting, *except* that if paragraph (d)(1) of this section is satisfied as to each person invited to or attending such seminar or meeting and, as to persons qualifying only under paragraph (d)(1)(ii) of this section, such persons are accompanied by their offeree representative(s), then such seminar or meeting shall be deemed not to be a form of general solicitation or general advertising; and

(3) Any letter, circular, notice or other written communication, except that if paragraph (d)(1) of this section is satisfied as to each person to whom the communication is directed, such communication shall be deemed not to be a form of general solicitation or general advertising.

Rule 240(c) provided as follows:

(c) *Limitation on Manner of Offering.* The securities shall not be offered, offered for sale or sold in reliance on this rule by any means of general advertising or general solicitation.

Rule 242(d) provided as follows:

(d) *Limitation on Manner of Offering.* Neither the issuer nor any person acting on its behalf shall offer or sell securities pursuant to this rule by means of any form of general solicitation or general advertising, including, but not limited to, any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over the television or radio.

22. See, e.g., A.A. Ajax Co., SEC No-Action Letter, (Jan. 15, 1979) (LEXIS, Fedsec library, Noact file) (denying no-action relief to loan brokerage company that proposed advertising in publication of special interest to pension and profit sharing plans); Trust Mortgage and Loan Service, Inc., SEC No-Action Letter, (Dec. 27, 1979) (LEXIS, Fedsec library, Noact file) (denying no-action relief to tri-state advertising campaign in general circulation newspapers, soliciting investors for first and second trust deeds); Econative Corp., SEC No-Action Letter, (Feb. 27, 1978) (LEXIS, Fedsec library, Noact file) (denying no-action relief to broker/dealer

profound proposition, however, given the private placement exemption statutory foundation that would not reasonably lend support to such general and public forms of promotion.<sup>23</sup> Beyond this rudimentary tenet, interpretations of rule 146(c) were limited.<sup>24</sup>

In large measure, the lack of interpretations in this area under rule 146 may have been due to the general flexibility of the rule. Rule 146(c) provided that any letter, circular, notice or other written communication would not be deemed a form of general solicitation or general advertising if all persons to whom the communication was directed were qualified offerees under rule 146(d)(1). For offerees to meet the rule 146(d)(1) definition, the issuer had to believe reasonably that the offeree had sufficient knowledge and experience in financial and business matters to evaluate capably the merits and risks of the prospective investment, or that the offeree was a person who was able to bear the economic risks. This provision operated as a "safe harbor" within a "safe harbor" and minimized close questions on the application of the condition prohibiting general solicitation.

From time to time the Commission has mentioned manner of offering restrictions outside of rule 146 as a factor to be considered in determining the availability of an exemption under section 4(2) of the Securities Act. Precise guidelines for applying such restrictions are absent in legislative history and judicial construction of that provision. Early legislative history indicates that the private offering exemption was directed to transactions in which there is no practical need for registration or in which the public benefits of registration are too remote.<sup>25</sup> Short of such policy pronouncements, however, the legislative history of the private offering exemption furnishes little guidance on specific characteristics of a private offering.

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who proposed advertisement seeking investment banking clients on the grounds that proposed advertisement "would constitute the first step in a public offering and consequently would exceed the boundaries set forth in [Rule 146(c)]"; *Damson Oil Corp.*, SEC No-Action Letter, (Jul. 5, 1974) (LEXIS, Fedsec library, Noact file) (finding that advertisement in in-flight airline magazine designed to identify prospective oil and gas program investors did not comply with rule 146).

23. See *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 689 (5th Cir. 1971) (holding that advertising is incompatible with claim of private offering); see also *Waterman v. Alta Verde Indus.*, 643 F. Supp. 797, 807 (E.D.N.C. 1986), *aff'd*, 833 F.2d 1004 (4th Cir. 1987).

24. One issue that was nettlesome under rule 146(c) and continues to bother the analysis of the manner of offering limitation in regulation D involves determining whether a particular communication actually was designed to sell securities. In *Arthur M. Borden*, SEC No-Action Letter (Sept. 15, 1977) (LEXIS, Fedsec library, Noact file) the staff advised that the provisions of rule 146 did not permit an issuer or broker/dealer to solicit the names of prospective qualified offerees from various intermediaries who would be qualified offerees themselves. In a response to a subsequent request, however, the staff elaborated on its earlier position and clarified that rule 146 would permit an offer to be made to a qualified offeree referred to an issuer or broker/dealer by another qualified offeree provided the issuer or broker/dealer did not solicit the names of any prospective qualified offerees from persons originally solicited. *Arthur M. Borden*, SEC No-Action Letter, (Oct. 6, 1978) (LEXIS library, Noact file).

25. H.R. 85, 73d Cong., 1st Sess. (1933).

In 1935 the Commission issued a release stating the opinion of its General Counsel concerning the factors to be used in determining the availability of the section 4(2) exemption.<sup>26</sup> One of those factors was the manner of offering. As with many early Commission releases, however, this statement was more conclusory than analytical. The General Counsel merely stated that "I feel that transactions which are effected by direct negotiation by the issuer are more likely to be non-public than those effected through the use of the machinery of public distribution."<sup>27</sup> The Commission offered little further analysis on general solicitation or general advertising in later releases and commentaries. In fact, for many years the Commission emphasized, and courts and practitioners seemed to follow, an objective standard based on the number of offerees as the dominant test.<sup>28</sup> The Commission's 1935 release suggested that an offering to not more than approximately twenty-five persons was not an offering to a substantial number and presumably did not involve a public offering.

In 1953 the United States Supreme Court explicitly rejected the idea that an objective numerical test should govern the applicability of the nonpublic offering exemption. In *SEC v. Ralston Purina*<sup>29</sup> the Supreme Court found that an offering of stock to 500 company employees was not exempt. In so doing, the Court rejected the Commission's contention that the number of offerees was the critical factor. Instead, the *Ralston Purina* Court stated that "[t]he focus of inquiry should be on the need of the offerees for the protections afforded by registration," and that "[t]he employees here were not shown to have access to the kind of information which registration would disclose."<sup>30</sup> The issuer had based its contention that an exemption was available upon the fact that the offering was not made indiscriminately to all of its 7,000 employees, but rather had been restricted to those it considered "key employees." Some of the employees that the issuer alleged to be "key employees," however, were low in the company's organization and included clerks and foremen. In what has become landmark language, the Supreme Court determined that the applicability of the exemption should turn on whether the particular class of persons affected needs the protection of the Securities Act or whether such persons are able "to fend for themselves."<sup>31</sup> Notably, the *Ralston Purina* Court did not mention general solicitation or general advertising as factors to consider when determining whether the nonpublic offering exemption

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26. Opinion of General Counsel Concerning Exemption Under Section 4(1) of "Transactions By an Issuer Not Involving Any Public Offering," Securities Act Release No. 285, FED. SEC. L. REP. (CCH) ¶ 2020.102, at 2740-2744 (Jan. 24, 1935).

27. *Id.*

28. *See, e.g.,* Merger Mines Corp. v. Grismer, 137 F.2d 335 (9th Cir.) (offer by issuer to its 1,100 shareholders could not qualify for nonpublic offering exemption), *cert. denied*, 320 U.S. 794 (1943).

29. 346 U.S. 119 (1953).

30. *SEC v. Ralston Purina*, 346 U.S. 119, 127 (1953).

31. *Id.*

applied. Rather, the Court found the offering not to be exempt because the offering had reached some persons who lacked access to the kind of information that registration ordinarily would have provided and who thus needed the protection of the Securities Act.

The *Ralston Purina* test has weathered much application. Its simplicity and general utility for even the most complex factual analyses have made the test close to the common denominator in section 4(2) case law. Some courts have amplified the *Ralston Purina* test by articulating various factors that should be considered when determining whether an offering is non-public. Courts have stated, for instance, that the question of what determines a public offering is one of fact and depends on the circumstances of each particular case. These courts have included as relevant such factors as the relationship between the offerees and the issuer, and the nature, scope, size, type, and manner of the offering.<sup>32</sup> In a significant release in the early 1960s the Commission took a similar approach by evaluating various factors that bear on the availability of the private offering exemption.<sup>33</sup> One factor was the predecessor to the manner of offering condition in rule 146(c). The Commission noted that

[n]egotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers.<sup>34</sup>

The Commission further reasoned that care should be taken when an offeror employs the services of an investment banker or other facility through which public distributions are normally effected. The release also pointed out that public advertising was incompatible with a claim of a private offering.

Rule 502(c) of regulation D succeeded to this hazy precedent with little explanation. Moreover, the elimination in rule 502(c) of the "qualified offeree" exception found in rule 146(c) placed the manner of offering condition in a position of new and exposed importance. In this context the Commission staff has addressed a large number of requests for interpretation, both formal and informal, of the manner of offering limitation. Without clear precedent or an analytical model, the staff's responses have begun to produce a regulatory common law that has little grounding in the statute from which the regulation derives.<sup>35</sup>

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32. See, e.g., *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977); *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 689 (5th Cir. 1971); *Garfield v. Strain*, 320 F.2d 116 (10th Cir. 1963); *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959); *Campbell v. Degenther*, 97 F. Supp. 975 (D. Pa. 1951).

33. See Non-Public Offering Exemption, Securities Act Release No. 4552, 27 Fed. Reg. 11,316 (1962) (Release Date Nov. 6, 1962).

34. *Id.*

35. One of the first commentaries on the new regulations accurately predicted this



## INTERPRETATIONS OF RULE 502(C)

Rule 502(c) provides that neither the issuer nor any person acting on the issuer's behalf shall offer or sell securities by means of any form of general solicitation or general advertising. Analysis of rule 502(c) should center on its three elements:

- (1) the issuer or any person acting on the issuer's behalf
- (2) offering or selling securities by means of
- (3) general solicitation or general advertising.

*By or on Behalf of the Issuer*

Regarding the first element of rule 502(c), the significant interpretive issue has involved determining whether the activity in question has been conducted by a person acting on the issuer's behalf. The staff generally has taken a cautious, though logical, approach. If an issuer has had no contact with or ability to influence the content of a communication, and if the communication has no direct connection with a current or immediately prospective offering, the Commission staff has deemed the activity not to be on the issuer's behalf. This proposition derives most clearly from a series of requests for interpretation regarding newsletters.

In *Richard Daniels*<sup>36</sup> the Commission staff found a newsletter containing public information regarding private limited partnerships in Arizona not to be a general advertisement by or on behalf of the limited partnerships because none of the limited partnerships provided the information or paid to have the material included in the newsletter. In *Nancy H. Blasberg*<sup>37</sup> the Commission staff reached a similar conclusion about a newsletter containing publicly available information regarding privately-placed or closely-held preferred stock of utility, industrial, financial, and transportation companies. If the issuer prepares or pays for the inclusion of information in a newsletter, however, the Commission staff appropriately has found such involvement to render publication of the newsletter as being on the issuer's behalf.<sup>38</sup>

development: "Since there is no longer a requirement (comparable to Rule 146(d)(1)) to pre-screen offerees, it can be anticipated that a body of interpretive law will develop regarding the terms 'general solicitation,' and 'general advertising.'" Schneider, *Introduction to Regulation D*, 15 REV. SEC. REG. 990, 996 (1982).

36. SEC No-Action Letter, (Dec. 19, 1984) (LEXIS, Fedsec library, Noact file).

37. SEC No-Action Letter, (Jul. 12, 1984) (LEXIS, Fedsec library, Noact file).

38. See, e.g., J.D. Manning, Inc., SEC No-Action Letter, [1985-86 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,219, at 76,859 (Dec. 20, 1985); The Texas Investor Newsletter, SEC No-Action Letter, (Jan. 23, 1984) (LEXIS, Fedsec library, Noact file); see also Oil and Gas Investor, SEC No-Action Letter (Sept. 9, 1983) (LEXIS, Fedsec library, Noact file) (Sept. 9, 1983) (taking no position on whether newsletter would be deemed issuer's general solicitation because not enough facts as to issuer's involvement); Tax Investment Information Corporation, SEC No-Action Letter, [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,379, at 78,393 (Feb. 7, 1983) (refusing to concur that newsletter was not general advertisement by or on behalf of issuer because no facts on issuer's involvement were available).

An issue in this area that the Commission staff has not resolved is whether to use principles of agency law to impute to an issuer the conduct of employees or third party contractors. The reference to agency law might have a certain superficial appeal given the lack of substantive doctrine underlying rule 502(c). However, the policies governing agency law are not necessarily at issue in the context of a securities offering. Assume, for instance, that an issuer is conducting a limited and controlled mailing to selected individuals in connection with a regulation D offering. Assume further that an employee of the issuer makes an unauthorized distribution of this mailing to hundreds of persons on a mailing list obtained from a third party. If the issuer can establish that it did not authorize this distribution, and if the issuer does not sell securities to persons who receive the distribution, it is not clear that a regulation D exemption for the issuer's offering should be invalidated by the employee's unauthorized conduct, even if the employee might be deemed the issuer's agent under agency law.

#### *Offering or Selling Securities by Means of*

Beyond determining whether a particular communication is by or on behalf of an issuer, it is necessary under rule 502(c) to determine whether the issuer is offering or selling securities *by means of* the communication.<sup>39</sup> If a communication postdates an isolated offering, there generally should be little question that the activity is not part of an offer or sale.<sup>40</sup> Advertisements and other widespread communications during or before an offering, however, present closer factual questions.

In *Gerald F. Gerstenfeld*<sup>41</sup> counsel to several syndicators requested advice about the publication in newspapers of an institutional advertisement relating to a syndicator as an entity and not to any given limited partnership. The Commission staff reasoned that the advertisement, which clearly was "general," would violate rule 502(c) if its primary purpose was to sell securities of entities that were or would be affiliated with the syndicator. Because it appeared the syndicators were using the advertisements to sell securities or to condition the market for future sales, the staff found that the advertisements would constitute offers "even at a time when securities are not being sold if the syndicator expects in the near future to offer and sell securities."

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39. Often a question regarding issuer involvement under the first prong of rule 502(c) or regarding whether a solicitation is "general" under the third prong of the rule can be rephrased under this element. If, for instance, it is unclear whether the activity is by or on behalf of the issuer, it may be more certain that, in any event, the activity is not related to the offer or sale of securities.

40. See *Alma Securities Corp.*, SEC No-Action Letter, (Aug. 2, 1982) (LEXIS, Fedsec library, Noact file) (although unable to express view given lack of facts, staff noted that tombstone advertisement could be published without being used to offer or sell securities if such advertisement followed completion of isolated regulation D offering and was not directed at any contemporaneous or subsequent offers or sales of securities by same issuer).

41. SEC No-Action Letter, (Dec. 3, 1985), [1985] Wash. Serv. Bur. Microfiche, Fiche 976, Frame F11.

In *Young, Smith & Peacock, Inc.*<sup>42</sup> a broker/dealer proposed to issue a generic newspaper advertisement to attract interest in "tax advantaged investments specifically designed for accredited investors." Prior to its actual publication and absent additional facts, the Commission staff was unable to determine whether the advertisement would relate to a particular offer and sale of securities. In *Randall S. Dalton, Esq.*<sup>43</sup> a licensed real estate broker advertised space available for tenants in an office building. Because all tenants in the building were to be given an opportunity to participate in the building's contemporaneous syndication, the Commission staff refused to take a position on whether the broker's activities would be deemed an offering and sale of securities by means of general advertising. The staff also has refused to take a position on generic product advertising that a company published at the same time the company was conducting a regulation D offering.<sup>44</sup>

Solicitations of information prior to an offering, unlike advertising to condition a market, might not be deemed offers or sales. In *Bateman Eichler, Hill Richards, Inc.*<sup>45</sup> a broker/dealer proposed to let some of its account executives make a mailing to prospective investors. The mailing would include a questionnaire and a letter. After reviewing responses to the questionnaire, account executives would contact certain respondents to obtain additional information. The account executives would not send offering materials for at least forty-five days following a preliminary mailing. Noting that the proposed solicitation was generic in nature and would not refer to any specific investment currently offered or contemplated, the Commission staff agreed with counsel's view that the program would not constitute an offer to sell securities.

#### *Interpretation of the Term "General Solicitation"*<sup>46</sup>

By far the most difficult and pervasive questions under rule 502(c) of regulation D have concerned the determination of what will be deemed a

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42. SEC No-Action Letter, (Apr. 8, 1984) (LEXIS, Fedsec library, Noact file).

43. SEC No-Action Letter, (Jun. 22, 1984) (LEXIS, Fedsec library, Noact file).

44. *See* Printing Enterprises Management Science, Inc. SEC No-Action Letter, (Apr. 25, 1983) (LEXIS, Fedsec library, Noact file); *see also* REMCO Securities, Inc., SEC No-Action Letter (Aug. 20, 1985) (LEXIS, Fedsec library, Noact File) (failing to express view on legality of press release announcing completion of two oil wells owned by two private limited partnerships where affiliate of those partnerships was conducting contemporaneous regulation D offerings); Alma Securities Corp., SEC No-Action Letter (Aug. 2, 1982) (LEXIS, Fedsec library, Noact file) (failing to confirm that tombstone advertisement announcing completion of offer was not in violation of rule 502(c) because there were no facts on the possibility of contemporaneous or subsequent offers or sales of securities by same or affiliated issuer).

45. SEC No-Action Letter, (Dec. 3, 1985) (LEXIS Fedsec library, Noact file).

46. The concept of "general advertising" has presented no interpretive issues of significance. Generally, the Commission staff considers any advertisement published in a newspaper, magazine, or other print medium or issued over broadcast media to be "general." This would be so even if the issuer limited circulation because these forms of advertising have no controls and can be spread indefinitely and indiscriminately. In Aspen Grove, SEC No-Action Letter,

“general solicitation.” This difficulty generally did not arise under rule 146(c) because of the “qualified offeree” exception. Under rule 146, a solicitation was not “general” if the issuer could establish that it had been made only to “qualified offerees.” This exception is not available under rule 502(c). In its place, however, the staff has developed an interpretation that virtually requires all recipients of a solicitation to have a preexisting, substantive relationship with the issuer to establish that a particular solicitation is not “general.”<sup>47</sup>

The Commission staff initiated the focus on preexisting relationships only months after the adoption of regulation D in the staff’s first interpretive letter addressing the issue of “general solicitation.” In *Woodtrails-Seattle, Ltd.*<sup>48</sup> the general partner of a limited partnership proposed to make a written offer to sell interests in the limited partnership to over 300 persons who previously had invested in limited partnership offerings sponsored by the general partner. The general partner made the offering in reliance on rule 505 of regulation D. The Commission staff found that the proposed offers would not violate the terms of rule 502(c). The staff noted that each of the proposed offerees had a preexisting business relationship with the general partner. The staff also noted that

the nature of this relationship is evidenced, in part, by the determination by the general partner at the time of the original investment that the investors met certain suitability standards and by the belief by Woodtrails that each of the proposed offerees currently has such

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(Dec. 8, 1982) (LEXIS, Fedsec library, Noact file), the staff declined to give “no-action” relief for a limited partnership’s advertising campaign involving racehorses. The partnership proposed to distribute brochures and to advertise in a trade journal. The staff viewed the advertising component of the promotion as “general” even though circulation may have been limited to a specialized audience.

47. Apart from the fact that this interpretation may represent an evolutionary return to the “qualified offeree” concept of rule 146(c), the “preexisting relationship” test may also be an attempt to resurrect a judicial standard that has long been discredited. In 1938 the United States Court of Appeals for the Ninth Circuit in *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699 (9th Cir. 1938), held that to determine the distinction between “public” and “private,” it is necessary to find a “sensible relationship” between the basis for selecting prospective investors and the purposes for which the selection was made. This test was not only too difficult to apply but also was not particularly logical. It is, for instance, not always clear what constitutes a “sensible relationship” between the class of investors selected and the purpose of the selection. Also, even if a “sensible relationship” exists, the particular transaction might not deserve exemption as a private offering. While the reasoning of *Sunbeam* generally has not been persuasive, the following language from the case has been a popular adornment to section 4(2) analysis and may be an implicit consensus on what “nonpublic” connotes:

An offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less “public” in every realistic sense of the word, than an unrestricted offering to the world at large.

*Id.* at 701.

48. SEC No-Action Letter, [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,342, at 78,284 (Aug. 8, 1982).

knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment.<sup>49</sup>

Seizing on this preexisting relationship factor, the Commission staff firmly entrenched the standard in a series of subsequent interpretive letters. In *E.F. Hutton & Co.*<sup>50</sup> and *Bateman Eichler, Hill Richards, Inc.*,<sup>51</sup> broker/dealer firms sought to send offering materials to lists of investors that the firms had developed through general solicitations. Both firms described programs whereby prospective investors were identified through suitability questionnaires and other inquiries to determine personal and financial information as well as investment objectives. The Commission staff held that a prescreening process could establish a substantive relationship with persons if those persons provided responses to questionnaires sufficient to enable the issuer or its agent to evaluate the sophistication and financial circumstances of the respondees. In both of these cases, however, the staff found the proposed questionnaires were not detailed enough for the firms properly to evaluate respondees' sophistication and financial circumstances. Assuming for argument that a substantive relationship had been established through the questionnaire process, the staff emphasized that the relationship must be "preexisting"—that is, established prior to any offer that had commenced or was contemplated—for the general solicitation not to be deemed part of an offer or sale.<sup>52</sup>

The Commission staff reinforced the analysis of *E.F. Hutton* and *Bateman Eichler* in a subsequent letter in which the broker/dealer firm's prescreening questionnaire was sufficiently detailed to serve as the basis for establishing a substantive relationship. In *H.B. Shaine & Co.*<sup>53</sup> a broker/dealer proposed the use of questionnaires to identify investors who would be either "accredited" under rule 501(a)(1) or sophisticated in the context of rule 506. The broker/dealer would update the questionnaires annually and the questionnaires would serve as the basis for an established client list of the firm. Subsequent private placements would be offered to individuals that the prescreening process had identified as being qualified. In agreeing

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49. *Id.*

50. SEC No-Action Letter, (Dec. 3, 1985) (LEXIS, Fedsec library, Noact file).

51. SEC No-Action Letter, (Dec. 3, 1985) (LEXIS, Fedsec library, Noact file).

52. In *Mineral Lands Research & Marketing Corp.*, SEC No-Action Letter, (Dec. 4, 1985) (LEXIS, Fedsec library, Noact file), the staff reiterated the preexisting relationship test but found insufficient facts from which to draw a conclusion as to the solicitation by a company's officers and directors, one of whom was an insurance broker who proposed to offer securities to up to 600 of his existing clientele. The staff stated that

the types of relationships with offerees that may be important in establishing that a general solicitation has not taken place are those that would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration.

*Id.*

53. SEC No-Action Letter, (May 1, 1987) (LEXIS, Fedsec library, Noact file).

that the questionnaires provided sufficient detail to establish a substantive relationship, the Commission staff stated that "a satisfactory response by a prospective offeree to a questionnaire that provides a broker/dealer with sufficient information to evaluate the respondent's sophistication and financial situation will establish a substantive relationship." Because this relationship would be established prior to any offering, the staff also agreed that the relationship was "preexisting."

*Webster Management Assured Return Equity Management Group Trust*<sup>54</sup> represents perhaps the most extreme application of the preexisting relationship criterion to date. In *Webster Management*, a placement agent proposed to sell units of beneficial interest in a group trust to groups of pension, profit-sharing and other employee benefit trusts, the characteristics of which indicated a high degree of investor sophistication. The minimum investment was \$250,000. The applicant conceded that the placement agent would not have any prior relationship with some of the offerees but was of the view that the solicitation would not be deemed "general" because all purchases in the offering would be substantial, the trustees for the trusts would be sophisticated, and registration would be costly and unnecessarily burdensome for this kind of offering. The Commission staff refused to issue a favorable response, placing significant emphasis on the absence of a preexisting relationship with some of the trusts. The staff also implicated the old rule 146(c) qualified offeree standard by noting that "some offerees would not even be accredited as defined in rule 501(a)(1), although highly sophisticated" and underscored the fact that there was no limit on the manner by which trusts would be contacted.<sup>55</sup>

#### CRITIQUE OF RULE 502(C) AND ITS APPLICATION

Although there is little substantive precedent for limiting general solicitation and general advertising in exemptions for limited and nonpublic offerings, the Commission has a logical and justifiable basis for imposing some conditions on the manner by which exempt offerings of this nature are conducted. As applied to offerings under section 4(2), for instance, the use of the term "public" in the statute certainly seems to call for some limitation on the manner of offering. And, in fact, there always has been support for certain implicit manner of offering limitations on general advertising and the use of selling syndicates and other public offering machinery. Few, if any, interpretive questions have arisen as to limitations of this nature, and most issuers find such limitations predictable, comprehensible, and reasonable.

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54. SEC No-Action Letter, (Feb. 7, 1987) (LEXIS, Fedsec library, Noact file).

55. See also Robert T. Willis, Jr., P.C., SEC No-Action Letter, (Jan. 18, 1988) (LEXIS, Fedsec library, Noact file) (finding that solicitation by investment adviser of existing clientele and new referrals was not in compliance with rule 502(c) due to lack of preexisting relationship with issuer).

The Commission staff, however, has gone well beyond those limits by adopting an unduly restrictive and unsupported interpretation of the phrase "general solicitation." The staff's interpretive letters under rule 502(c) indicate that the staff believes a preexisting relationship between the issuer or its agents and offerees to be an almost absolute prerequisite to avoiding general solicitation in a regulation D offering. The type of relationship required is one that allows the issuer to evaluate the financial circumstances and sophistication of the offerees or one that otherwise is of some substance and duration. The only methods of establishing these relationships that the staff has approved are prior investments by the offerees with the issuer or its agents and the use of questionnaires in accordance with criteria developed in *E.F. Hutton, Bateman Eichler* and *H.B. Shaine*.<sup>56</sup>

The Commission staff has indicated informally that there may be circumstances under which "general solicitation" would not be present even though the issuer had no preexisting relationship with the offerees. Moreover, it appears likely that in pending rulemaking involving a proposed rule 508 to regulation D the Commission may indicate that in fact the staff is not of the view that the existence of preexisting relationships is the only way to comply with rule 502(c). Little guidance, however, has been provided as to the circumstances where preexisting relationships would not be required. Uncertainty on this issue is further suggested by informal statements by members of the staff to the effect that the issuer's actual knowledge of the financial circumstances or sophistication of offerees is irrelevant in determining whether a general solicitation has occurred. These informal statements contradict statements in interpretive letters, particularly *Webster Management*, that imply that the issuer's knowledge is relevant.

In articulating the conditions for establishing a private offering exemption under section 4(2), the Supreme Court in *Ralston Purina* reasoned that (1) the purpose of the Securities Act is "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions," (2) "the natural way to interpret the private offering exemption is in light of the statutory purpose," and (3) the applicability of the exemption should turn on whether the particular class of persons affected needs the protections afforded by the Securities Act. Given this reasoning, the Commission should apply the general solicitation prohibition under regulation D in a manner that, in conjunction with the other elements of

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56. Even prior investments standing alone may not be sufficient. Under *Woodtrails*, the Commission staff cited prior investments as evidence of a preexisting relationship, but the staff also considered other factors as to the substance of the relationship. Presumably, the staff would not sanction a solicitation of a substantial number of shareholders of a corporation on the grounds that their prior investment established the required preexisting relationship. Early section 4(2) case law stumbled over this dichotomy. Compare *Merger Mines Corp. v. Grismer*, 137 F.2d 335 (9th Cir. 1943) (solicitation of 1,100 shareholders contravened private offering exemption) with *Campbell v. Degenthers*, 97 F. Supp. 975 (W.D. Pa. 1951) (holding solicitation of persons who had previously invested in oil drilling ventures by same promoter on similar properties to be nonpublic offering).

the regulation, will result in the exemptions afforded being available in circumstances in which investors do not need the protections afforded by the Securities Act. Logically, this would mean that, to the extent "general solicitation" is to be limited, the distinction between "general" and "non-general" would be drawn by objective criteria designed to prevent solicitation from being so widespread or uncontrolled that investors who are unable to fend for themselves are brought into an offering. While preexisting relationships may be a *sufficient condition* to demonstrate the absence of general solicitation, it should not be a *necessary condition*, because, as an independent factor, the preexisting relationship criterion has little, if any, bearing on whether the protections of the Securities Act are necessary in particular circumstances.

The Commission staff may have fixed on the preexisting relationship test for a number of reasons. First, one may argue that knowledge of the financial circumstances and sophistication of offerees obtained through preexisting relationships is important to protect potential investors. Through the accredited investor concept of rule 501(a) and through the sophistication requirements of rule 506 regulation D takes into account the fact that sophisticated or wealthy investors have less need for the protection of the Securities Act, while not limiting the availability of the exemption to offerings directed solely to those persons. It is the actual financial circumstance or sophistication of the investor, however, that is essential to that analysis. To require that the issuer have knowledge regarding financial circumstances or sophistication in advance of an offering through preexisting relationships is superfluous.

Another basis for the preexisting relationship requirement could be the knowledge of the issuer that the offerees would have because of the relationship. For example, a key employee's relationship with an issuer may be such that the employee has no need for the type of disclosure required under the Securities Act. There is no justification for elevating the preexisting relationship factor to an absolute requirement on this basis, however, because offerees can be protected adequately in other ways in the absence of preexisting relationships, for example, through the information requirements of rule 502(b).

Finally, an unspoken reason for the preexisting relationship doctrine may be the possibility that an issuer could, at least in theory, make a regulation D offering to an unlimited number of offerees. To some members of the Commission staff, making an offering to an unlimited number of offerees may seem inconsistent with a limited offering exemption.<sup>57</sup> The preexisting relationship criterion certainly limits the number of potential offerees for some small issuers. Under *E.F. Hutton, Bateman Eichler*, and *H.B. Shaine*, however, if a seller employs a brokerage firm, the brokerage

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57. See Securities Act Release No. 6339, *supra* note 10, at 84,464 n.30 (offerings to large number of purchasers may involve violation of prohibitions against general solicitation and general advertising).



firm may be able to access a multitude of prequalified eligible prospects. Ironically, the preexisting relationship criterion has created a situation in which those entities that constitute the "machinery of public offerings" can utilize regulation D more easily than can the small issuer that regulation D was designed to benefit. In any event, the number of offerees, in and of itself, should have no relationship to whether the protections afforded by the Securities Act are necessary.

Regardless of the rationale employed, preexisting relationships are not accurate indicators of whether offerees need the protections afforded by the Securities Act. Instead, the focus should be on whether, considering the particular exemption being utilized and all relevant circumstances, the manner by which the communication is occurring is so widespread and uncontrolled that it creates a substantial likelihood of involving investors for whom the protections of the Securities Act are necessary. To this end, the Commission staff should view preexisting relationships as only one way in which the nature and extent of the solicitation can be measured.

Because of the restrictions imposed by other provisions of regulation D, it is questionable whether the prohibition against general solicitation is necessary for investor protection in many offerings that qualify for an exemption under regulation D. In particular, the prohibition against general solicitation does not appear necessary for investor protection in offerings meeting the requirements of rule 506 or in any offering that is limited to accredited investors.<sup>58</sup> The Commission should restrict the applicability of the general solicitation prohibition to those offerings in which the presence of general solicitation is relevant to investor protection.

#### CONCLUSION

The purpose of the registration provisions of the Securities Act is to compel the disclosure of information about issuers of securities to persons interested in purchasing the securities so that the interested persons can make informed investment decisions. Congress intended exemptions from registration for limited or nonpublic offerings to cover offerings to persons who can make informed investment decisions without having received the benefits of the registration process. In certain instances it may be inappropriate to permit unbridled general solicitation or general advertising in offerings that are exempt from registration. Neither legislative history nor case law under the private offering exemption of the Securities Act, however, suggests that any single factor is dispositive of whether an issuer's actions constitute general solicitation. Rather, the focus has been on the more

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58. In this regard, it is interesting to note that in a current rulemaking proceeding involving proposed conditions for the resale of restricted securities, the Commission is proposing to ignore manner of offering conditions entirely where purchasers (not offerees) are institutions satisfying certain standards. See *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Securities Act Release No. 6806, 53 Fed. Reg. 44,016 (1988) (Release Date Oct. 25, 1988).

substantive question of whether an offering as a whole is conducted so that it reaches persons who need the protections of the registration process. In general, the Commission successfully has reduced the broad policy direction of the Securities Act to objective criteria in regulatory exemptions established by regulation D. The condition in rule 502(c) prohibiting general solicitation in regulation D exemptions as currently interpreted, however, lacks a sound basis in policy and in judicial and regulatory precedent. It is not difficult to support the proposition that limited and nonpublic offering exemptions should not include general advertising or other means of mass communication that would create a likelihood that securities will be sold to investors who require the protection of the registration provisions of the Securities Act. It does not follow from a well-reasoned analysis, however, that limited or nonpublic offering exemptions should be conditioned on the existence of preexisting relationships among issuers and offerees. Preexisting relationships may be relevant to the scope or the manner of offering but should not be preconditions to an exemption. The Commission staff should revise its interpretation of the phrase "general solicitation" so that offerings which do not involve investors who require the protections of the registration process under the Securities Act will not be excluded arbitrarily from coverage under regulation D.



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