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## Ii. The 140 Series Rules

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The 1974 decisions thus indicate that as new types of transactions arise, courts will continue to interpret and apply the *Howey* criteria liberally in an effort to protect all investors.<sup>46</sup> In light of recent developments, the following may provide a current formulation of the original *Howey* guidelines: a security is the *investment* of money or its equivalent in a *venture*, with some expected *beneficial return*, wherein the investor exercises no more than *minimal managerial control*.

## II. THE 140 SERIES RULES

In spite of their relatively short history or perhaps because of it, there were few significant developments in 1974 regarding the rules in the 140 series. The most noteworthy developments were the adoption of two new rules, Rules 146 and 147. Rule 146<sup>1</sup> is a codification of various objective guidelines for compliance with the "non-public" offering exemption under §4(2) of the Securities Act of 1933.<sup>2</sup> Rule 147<sup>3</sup> is an attempt to clarify the SEC's position regarding the intrastate offering exemption of §3(a)(11) of the 1933 Act. Despite the significant guidelines provided by both Rules, many problem areas remain. Litigation concerning the previously adopted rules, Rules 144<sup>4</sup> and 145,<sup>5</sup> was notably absent. However, SEC staff replies in 1974

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existence of a rental arrangement in a condominium would not result in the creation of an "investment contract." The economic benefits of the rental arrangement must have been represented to the purchasers through advertising, etc., prior to any sales, before a sale of securities occurs. This approach indicates the importance of the potential investor being induced to make his investment. *But see* text accompanying notes 28-30 *supra*.

<sup>46</sup> See *Mocatta Metals Corp.*, CCH FED. SEC. L. REP. ¶ 79,940 (SEC Staff Reply July 1, 1974) (call options on silver are not securities); *Idea Research & Dev. Inc.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶79,759 (SEC Staff Reply Mar. 8, 1974) ("memberships" in an organization which evaluated ideas and inventions and sought promoters in the market, are securities); *Rare Metals Inv. Corp.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,752 (SEC Staff Reply Feb. 26, 1974) (silver rental contracts are securities); *International Silver Soc'y Ltd.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,732 (SEC Staff Reply Feb. 22, 1974) (memberships in a silver society are securities).

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<sup>1</sup> 17 C.F.R. §230.146 (1975) [hereinafter cited as Rule 146]. See SEC Securities Act Release No. 33-5487, 1 CCH FED. SEC. L. REP. ¶ 2710 (Apr. 23, 1974).

<sup>2</sup> 15 U.S.C. §§77a-77aa (1970).

<sup>3</sup> 17 C.F.R. §230.147 (1974) [hereinafter cited as Rule 147]. See SEC Securities Act Release No. 33-5450, 1 CCH FED. SEC. L. REP. ¶ 2340 (Jan. 7, 1974).

<sup>4</sup> 17 C.F.R. §230.144 (1974) [hereinafter cited as Rule 144]. See SEC Securities Act Release No. 33-5223, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶78,487 (Apr. 15, 1972).

provide new guidelines for compliance with Rule 144, which regulates the sale of "restricted" and "control" securities.

#### A. Rule 146

Rule 146 represents an attempt by the SEC to alleviate some of the confusion which arose from the various decisions applying §4(2).<sup>6</sup> In *SEC v. Ralston Purina Co.*,<sup>7</sup> the United States Supreme Court stated that "the applicability of [§4(2)] should turn on whether the particular class of persons affected needs the protection of the Act."<sup>8</sup> The Supreme Court stressed two requirements which, if satisfied, would eliminate the need for statutory protection: (1) the offerees must be able to "fend for themselves;"<sup>9</sup> and (2) the offerees, as a result of their positions in the company, must "have access to the same kind of information that the Act would make available in the form of a registration statement."<sup>10</sup>

The requirements formulated in *Ralston* have been strictly applied,<sup>11</sup> with most courts mandating that the factors stressed by the Supreme Court be satisfied with respect to each offeree before the exemption is available.<sup>12</sup> In considering these factors, courts have examined the relationship between the offering firm and the offerees<sup>13</sup> and the "sophistication" of the offerees in investment matters,<sup>14</sup> as

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<sup>6</sup> 17 C.F.R. § 230.145 (1974). See SEC Securities Act Release No. 33-5316, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,015 (Oct. 6, 1972).

<sup>7</sup> See *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953); *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. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971).

<sup>8</sup> 346 U.S. 119 (1953).

<sup>9</sup> *Id.* at 125. Since the expenses involved in registration are great, it would be overly burdensome to impose the registration requirement in situations where investor protection is unnecessary.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 125-26 (footnote omitted).

<sup>12</sup> See, e.g., *Lively v. Hirschfeld*, 440 F.2d 631, 632 (10th Cir. 1971).

<sup>13</sup> *Id.* at 633.

<sup>14</sup> The SEC and the courts have developed a few factors for determining whether an offering is public in nature: (1) the number of offerees; (2) the relationship among the offerees; (3) the relationship between the offerees and the issuer; (4) the number of shares offered; and (5) the manner of the offering. See *Alberg & Lybecker, New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions From Registration For the Sale of Securities*, 74 COLUM. L. REV. 622, 624 (1974). For a more detailed listing of the various judicially required elements in a valid private placement, see *Erwin, Marketing Investment Condominiums and Real Estate Syndications without Securities Registration: SEC Rule 146*, 3 REAL EST. L.J. 119, 123 (1974).

<sup>15</sup> See, e.g., *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972).

well as offeree access to certain pertinent information concerning the issuer.<sup>15</sup>

Rule 146 loosens the "sophistication" requirement by permitting a person who is wealthy but unsophisticated in investment matters to appoint an "offeree representative" as advisor.<sup>16</sup> The Rule also adopts the requirement of access to and availability of pertinent information,<sup>17</sup> and limits the manner in which offerings may be made.<sup>18</sup> Although the Rule restricts the number of purchasers to thirty-five,<sup>19</sup> an unlimited number of offerees is permitted.

Despite the substantial clarification provided by Rule 146, numerous problem areas remain. Uncertainty continues with respect to such issues as: (1) the meaning of the term "sophistication;"<sup>20</sup> (2) the frequent reference to "reasonableness" as a standard;<sup>21</sup> and (3) a consideration of the duty, if any, which an offeree representative owes the offeree he is representing.<sup>22</sup> The question of integration of offer-

<sup>15</sup> *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971).

<sup>16</sup> Rule 146(a)(1).

<sup>17</sup> Prior to adoption of Rule 146, the Fifth Circuit determined that the sophistication of the investor was not alone sufficient. Reasoning that sophistication without the necessary information was useless, the court concluded that the offeree must also have access to the critical information. *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972).

It is interesting to note that while an offeree representative may satisfy the Rule's requirement by being furnished with information concerning the corporation, he may not satisfy the requirement by merely having access to that information. Rule 146(e)(1). See text accompanying notes 32-34 *infra*.

<sup>18</sup> Rule 146(c).

<sup>19</sup> This restriction was recently amended to abolish the absolute thirty-five purchaser requirement, and now merely states that the issuer must have reasonable grounds to believe there are only thirty-five purchasers. Rule 146(g)(1). See SEC Securities Act Release No. 33-5585, CCH FED. SEC. L. REP. ¶ 80,163 at 85,313-14 (May 7, 1975).

In a recent staff reply, the SEC stated that non-resident aliens who acquire securities of an issuer "in an offering made in reliance upon Rule 146 need not be included in the computation used to determine compliance with the thirty-five purchaser requirement of Rule 146(g)(1)." *Salt Cay Beaches Ltd.*, CCH FED. SEC. L. REP. ¶ 79,985 (SEC Staff Reply Sept. 12, 1974).

<sup>20</sup> The Rule allows more than one person to act as offeree representative for an offeree, and their collective expertise may satisfy the sophistication requirement. Also, the offeree may provide some expertise for establishing a "collective sophistication" with his representative. See Rule 146(a)(1)(ii) and (d)(2)(ii).

<sup>21</sup> Rule 146(a)(4), (d), (e)(1), (e)(2), (f)(3), and (h).

<sup>22</sup> Another question in this regard is whether, in the case of two or more persons acting as offeree representatives, any duty is owed among the representatives themselves, *i.e.*, is an accountant required to disclose certain information to the attorney working with him, so that the lawyer can provide adequate legal counsel, or is the lawyer required to procure his own information.

ings also remains a problem<sup>23</sup> despite the discussion in the preliminary notes to Rule 146, which indicates that reference should be made to the factors enumerated in a prior Securities Act Release for determining integration.<sup>24</sup>

The "sophistication" requirement as presently formulated under the Rule is satisfied if the offeree is either "capable of evaluating the merits and risks of the prospective investment,"<sup>25</sup> or "able to bear the economic risk of the investment."<sup>26</sup> However, both criteria pose difficult questions: when is an offeree capable of making the proper evaluation, and when is an offeree economically able to bear investment risks? Presumably, the offeree must be more sophisticated than the average investor, since it is the average investor that the securities acts were intended to protect. On the other hand, it can hardly be contended that only a securities dealer should be able to satisfy the "sophistication" requirement.<sup>27</sup>

The use of "reasonableness" as a standard throughout the Rule at least implicitly recognizes the defense of good faith effort on the part of the parties involved in certain cases of technical non-compliance with the Rule. A case decided before promulgation of Rule 146 supports this conclusion. In *Livens v. William D. Witter, Inc.*,<sup>28</sup> the district court, after considering the traditional §4(2) requirements, stated that although the offeree lacked access to certain information which registration would have disclosed, the information was of minimal importance and was therefore not per se fatal to the exemption claim. Presumably, the same argument may be made under Rule 146. Subsection (e)(1) of the Rule states that an offeree must have access to the required information, "to the extent that the issuer possesses such information or *can acquire it without unreasonable effort or expense.*"<sup>29</sup> The *Livens* decision thus provides a basis for arguing that an issuer should expend greater effort in providing offerees with important information than in providing them with non-essential, although technically required, information.<sup>30</sup> By em-

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<sup>23</sup> See Rule 146(b)(1).

<sup>24</sup> Rule 146, Preliminary note 3. See SEC Securities Act Release No. 4552, 1 CCH FED. SEC. L. REP. ¶¶ 2770-83 (Nov. 6, 1962).

<sup>25</sup> Rule 146(d)(1)(i).

<sup>26</sup> Rule 146(d)(1)(ii).

<sup>27</sup> Numerous responses to the proposed versions of the Rule suggested "that specific types of persons such as lawyers, accountants, stockbrokers, and investment bankers" automatically qualify as offeree representatives. Note, *SEC Rule 146—The Private Placement Exemption*, 58 MINN. L. REV. 1125, 1147 (1974).

<sup>28</sup> CCH FED. SEC. L. REP. ¶ 94,906 (D. Mass. Sept. 6, 1974).

<sup>29</sup> Rule 146(e)(1)(i) (emphasis added).

<sup>30</sup> One commentator has suggested: "Thus, the use of such phrases and the ambi-

ploying this flexible standard, the magnitude of the error can be considered and a determination made whether rescission of the transaction or loss of the exemption is an appropriate sanction.

Rule 146 provides no guidelines for determining what duty an offeree representative owes his offeree. However, by comparing the proposed<sup>31</sup> and revised<sup>32</sup> versions with the Rule as finally adopted an inference can be drawn. Prior to adoption, the Rule stated that the disclosure requirement was satisfied if an offeree representative had access to the type of information a registration statement would have revealed.<sup>33</sup> The present Rule eliminates this method of fulfilling the disclosure requirement and provides that an offeree representative must be furnished with the information. This change may indicate SEC concern that merely requiring access by the representative does not adequately protect the offeree, since his representative may not investigate the accessible information.<sup>34</sup>

Although Rule 146 provides a "safe harbor" for securities sold in compliance with its provisions,<sup>35</sup> it is purported not to be the exclusive means by which an issuer can qualify for the non-public offering

guity of the conditions themselves suggest that in practice the defense of an innocent and immaterial error may be available to the issuer. However, the Commission has not explicitly declared whether or not such a defense will be recognized." Note, *SEC Rule 146—The Private Placement Exemption*, 58 MINN. L. REV. 1125, 1139 (1974).

In recent amendments to Rule 146, the SEC has revised the furnishing of information requirement under subsection (e)(1)(ii) to permit non-reporting issuers under (e)(1)(ii)(b) to omit non-material information from that required to be furnished to an offeree or his representative. See Rule 146(e)(1)(ii)(b). See also SEC Securities Act Release No. 33-5585, CCH FED. SEC. L. REP. ¶ 80,168 at 85,312-13 (May 7, 1975). This revision permits greater flexibility for issuers, and is in keeping with the good faith argument discussed in the text.

<sup>31</sup> First Proposed SEC rule 146(e)(1), 37 Fed. Reg. 26137, 26140 (1972).

<sup>32</sup> Second Proposed SEC rule 146(e)(1)(i), 38 Fed. Reg. 28951, 28956 (1973).

<sup>33</sup> The first proposal of Rule 146(e)(1) reads as follows:

*Each offeree or his investment representative [offeree representative] shall, during the course of the negotiated transaction;*

(1) Have the same kind of information that the Act would make available in the form of a registration statement, to the extent such information is available, *or have access to such information;*

Rule 146(e)(1), 37 Fed. Reg. 26137, 26140 (1972) (emphasis added).

<sup>34</sup> With regard to the revised proposed Rule, Mr. John Merow, an attorney for Sullivan & Cromwell in New York City, stated before the Fifth Annual Institute on Securities Regulation that a standard of negligence should be imposed on the offeree representative in the performance of his function. Mr. Merow posited that "the performance of the offeree representative may also be tested against such provisions as Rule 10b-5 and the general provisions relating to investment advisor conduct." PLI FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION, Transcript at 368 (1974).

<sup>35</sup> Rule 146(b).

exemption. The preliminary note to Rule 146 states specifically that issuers may continue to sell securities outside of the Rule if they comply with traditional requirements for application of the §4(2) exemption.<sup>36</sup> However, consideration of the problem of "creeping exclusivity" which has accompanied development of Rule 144 belies this non-exclusivity of Rule 146. Rule 144 similarly provides that non-compliance with the Rule does not preclude qualification for the exemption. However, replies and releases by the SEC subsequent to the adoption of Rule 144 indicate that persons attempting to establish an exemption outside of the Rule must overcome a presumption of non-compliance. A similar presumption may arise under Rule 146.

### B. Rule 147

The SEC in 1974 also adopted Rule 147<sup>37</sup> which provides guidelines for compliance with the intrastate offering exemption of §3(a)(11) of the 1933 Act. The Rule adheres to the long line of precedent which established that the exemption is only available for the local financing of companies primarily intrastate in character.<sup>38</sup> Because of the narrow provisions of the Rule, it provides a very limited safe harbor under the §3(a)(11) exemption.<sup>39</sup>

Despite Rule 147's attempt to clarify the §3(a)(11) exemption, two major problem areas exist with respect to the Rule's application. Rule 147 unnecessarily burdens the issuer with a provision which requires

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<sup>36</sup> Rule 146, Preliminary Note 1.

<sup>37</sup> For a general discussion of Rule 147 and its origins see Gardiner, *Intrastate Offering Exemption: Rule 147—Progress Or Stalemate?* 35 OHIO ST. L.J. 340 (1974); Kant, *SEC Rule 147—A Further Narrowing of The Intrastate Offering Exemption*, 30 BUS. LAW. 73 (1974); Comment, *SEC Rule 147—Distilling Substance From the Spirit of the Intrastate Exemption*, 79 DICKINSON L. REV. 18 (1974).

<sup>38</sup> SEC Securities Act Release No. 33-5450, 1 CCH FED. SEC. L. REP. ¶ 2253 (Jan. 7, 1974). The Rule requires that the issuer conduct a certain percentage of its business within the state. For SEC replies to questions concerning the Rule's "doing business" requirement, see Jones, Crouch, McCarty & Bannasch, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,822 (SEC Staff Reply May 3, 1974); CoinVest, Inc., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,823 (SEC Staff Reply Apr. 8, 1974) (purchase and sale of coins, etc. outside of the state does not prevent the corporation from meeting the "doing business" requirement); Robert Enright, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,714 (SEC Staff Reply Jan. 10, 1974) (use of investors' funds for trading in commodities futures contracts on exchanges outside of the state).

<sup>39</sup> Rule 147 presents an identical problem of "creeping exclusivity" discussed with regard to Rule 146, see text accompanying note 36 *supra*, despite the SEC's express assertion that no presumption against availability of the exemption arises upon non-compliance with Rule 147. Rule 147, Preliminary Note 1.

that the offerees, as well as the purchasers, be residents of the same state as the issuer, and the state in which the offering occurs.<sup>40</sup> Another problem unresolved by the Rule involves situations in which residents purchasing securities under installment plans move to another state before completing their payments. Various courts had previously found that in such circumstances the exemption is destroyed since a sale is not completed until final payment is made.<sup>41</sup> There is no indication that this policy has been changed, despite the Rule's lack of clarity on this particular issue.<sup>42</sup>

The primary difficulty with Rule 147 is its extremely restrictive provisions which will probably greatly limit its use by issuers.<sup>43</sup> Furthermore, the problem of creeping exclusivity which analysis of developments under Rule 144 indicates may arise under Rule 147, will dissuade issuers from attempting to invoke the intrastate offering exemption outside of the Rule. Thus, compliance with the provisions of Rule 147 may become the sole means of qualifying for the intrastate offering exemption, with the result that the overall availability of the §3(a)(11) exemption will be severely restricted.

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<sup>40</sup> Rule 147(d). One commentator has suggested that this requirement is misplaced since not all offerees will become purchasers, and the purpose of the intrastate exemption would seem equally furthered by merely requiring the purchasers to be residents. See Hicks, *Intrastate Offerings Under Rule 147*, 72 MICH. L. REV. 463 (1974). By comparison, Rule 146 considers the number of offerees to be irrelevant since adequate restrictions exist with respect to the purchasers.

Similarly, in the proposed version of the recently adopted Rule 240, see notes 58-59 *infra*, the SEC placed a limitation on the number of purchasers and the number of beneficial owners. However, the SEC concluded that the purchaser limitation was not necessary in light of the limitation on beneficial owners, and therefore dropped the requirement from the Rule as finally adopted. See SEC Securities Act Release No. 33-5560, CCH FED. SEC. L. REP. ¶ 80,066 at 84,949 (Jan. 24, 1975).

The American Law Institute, in its Fourth Tentative Draft of the Federal Securities Code, has provided a definition of "local distributions" which imposes no offer requirement and applies merely to sales. Furthermore, the proposal allows sales in areas in adjoining states without defeating the exemption. The proposed section on "local distributions" is generally more ambiguous and allows for greater flexibility than Rule 147. See ALI FED. SEC. CODE, §513 (Apr. 1, 1975 Draft).

<sup>41</sup> Cf. *United States v. Kormel, Inc.*, 230 F. Supp. 275, 278 (D. Nev. 1964); note 63 *infra*. But see *In re Whitehall Corp.*, 3 SEC 259, 269 (1956).

<sup>42</sup> The resolution of this issue may depend on the conditions of the purchase. If the purchaser can stop payment at any time and retain a pro rata share of the securities he has paid for, this seems to indicate that each installment represents a new purchase and thus, once the purchaser becomes a non-resident, the exemption is destroyed.

<sup>43</sup> See Fraidin, *Developments in Federal Securities Regulation*, 30 BUS. LAW. 313, 324 (1974).



### C. Rule 144

Rule 144 applies primarily to the sale of "restricted" securities which traditionally have included securities obtained in a chain of transactions not involving any public offering.<sup>44</sup> The Rule imposes numerous conditions on public sales by control persons ("affiliates") and holders of privately placed or restricted securities, to insure that a public distribution does not occur.<sup>45</sup> The Rule requires that: (1) adequate public information concerning the issuer be available;<sup>46</sup> (2) the securities be held for two years before resale;<sup>47</sup> (3) a limited number of "control" or "restricted" securities be sold during any six-month period;<sup>48</sup> (4) the sales be made in ordinary brokerage transactions;<sup>49</sup> and (5) except for small sales, the seller file a notice of sale with the SEC.<sup>50</sup>

In 1974, the SEC adopted a number of amendments to Rule 144<sup>51</sup> in an attempt to clarify the Commission's position with respect to resales under the Rule.<sup>52</sup> Subsection (c)(1) dealing with the availability of adequate public information concerning the issuer, was amended to permit compliance when the issuer "has been subject to the reporting requirements of section 13 of [the Act of 1934] for a period of at least 90 days immediately preceding the sale of the securities and has filed all the reports required to be filed thereunder during the 12 months preceding such sale."<sup>53</sup> The amendment removes the burden placed on the issuer by the old Rule which provided that all statements ever required of the issuer be on file.

Subsection (e)(3)(G) of the old Rule provided that securities sold pursuant to an effective registration or in reliance on a Regulation A

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<sup>44</sup> One question, as yet unresolved, is whether the Rule applies to securities which were sold in a purported private placement which did not comply with the necessary private offering exemption, and therefore, were sold illegally. See generally Lipton, Fogelson & Warnken, *Rule 144—A Summary Review After Two Years*, 29 BUS. LAW. 1183, 1185 (1974).

<sup>45</sup> Section 4(1) exempts "transactions by any person other than an issuer, underwriter, or dealer" from the registration provisions of §5. 15 U.S.C. §77(d)(1) (1970).

<sup>46</sup> Rule 144(c).

<sup>47</sup> Rule 144(d).

<sup>48</sup> Rule 144(e).

<sup>49</sup> Rule 144(f).

<sup>50</sup> Rule 144(h).

<sup>51</sup> SEC Securities Act Release No. 5452, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,633 (Feb. 1, 1974).

<sup>52</sup> It is important to remember that while Rules 146 and 147 apply to initial offerings, Rule 144 merely applies to resales.

<sup>53</sup> Rule 144(c)(1). Concurrently, Forms 10-Q and 10-K were amended to conform to the changes in subsection (c)(1).

or §4(2) exemption should not be included in calculating the number of securities which may be sold under the Rule. The amended subsection (e)(3)(vii) now excludes §4 transactions generally from the required calculation, rather than restricting the exclusion to §4(2) transactions.<sup>54</sup> This change is apparently to avoid the problem of "creeping exclusivity" by permitting a person to sell shares under the other §4 exemptions and outside of Rule 144, without affecting sales under the Rule.

As currently amended, subsection (g)(2)(iii) permits broker-dealers under certain conditions to continue their quotations in an inter-dealer quotation system while selling securities pursuant to the Rule.<sup>55</sup> The broker may make inquiries of customers who have indicated a bona fide unsolicited interest in the securities within 10 days preceding the receipt of orders to sell securities pursuant to Rule 144.<sup>56</sup> The SEC revised subsection (h) to require that all amended notices of a proposed sale be transmitted on Form 144 to the principal stock exchange on which the securities to be sold are listed.<sup>57</sup>

Furthermore, Rule 144 was amended to provide that securities sold pursuant to the new Rule 240 would be deemed "restricted" securities for the purpose of Rule 144. Rule 240 provides "an exemption from registration . . . for limited offers and sales of small dollar amounts of securities by an issuer that before and after the transaction pursuant to the rule has a limited number (100) of beneficial owners of its securities."<sup>58</sup> As was the case with Rules 146 and 147, the purpose of adopting Rule 240 was to allow small businesses to raise capital when "because of the small size and limited character of the offering, the public benefits of registration are too remote."<sup>59</sup>

Clarification of Rule 144 in 1974 also came from SEC staff replies<sup>60</sup>

<sup>54</sup> Rule 144(e)(3)(vii). For a discussion of this change *see generally* Schwartz, *Rule 146: The Private Offering Exemption—Historical Perspective and Analysis*, 35 OHIO ST. L.J. 738, 750-52 (1974).

<sup>55</sup> This change was intended to increase the liquidity of the investments "both of persons desiring to resell securities pursuant to Rule 144 through the broker and of other persons who are deprived of the service of a market-maker." SEC Securities Act Release No. 5452, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,633 at 83,699 (Feb. 1, 1974).

<sup>56</sup> Rule 144(g)(2)(ii).

<sup>57</sup> Rule 144(h).

<sup>58</sup> SEC Securities Act Release No. 5560, CCH FED. SEC. L. REP. ¶ 80,066, at 84,945 (Jan. 24, 1975), effective March 15, 1975.

<sup>59</sup> *Id.* Rule 240 applies solely to issuers and is not available to affiliates of the issuer or other persons in the resales of securities.

<sup>60</sup> The SEC has reiterated its policy of refusing to answer no-action requests regarding Rule 144. *See Kane-Miller Corp.*, [1973-1974 Transfer Binder] CCH FED. SEC.

which indicate the SEC's position on such matters as computation of "holding" and "tacking" periods, what are "restricted" securities, and computation of other time limits under the Rule. The majority of requests for SEC interpretations in 1974 concerned the holding periods for "restricted" securities.<sup>61</sup> The SEC reaffirmed its position on the issue of fungibility,<sup>62</sup> that any securities other than those to be sold under the Rule which are acquired by the issuer during the two-year holding period will not start the holding period running anew. The SEC has also continued to allow tacking of holding periods under certain circumstances.<sup>63</sup> However, with respect to determining the time for commencement of holding periods, the Commission has made a notable change. In 1973 the Commission stated that when employees received with certain limitations shares in a company with which they were employed,<sup>64</sup> the holding period would commence

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L. REP. ¶ 79,747 (SEC Staff Reply Feb. 22, 1974).

<sup>61</sup> Rule 144(a)(3) defines "restricted securities." See *Ag-MET, Inc.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,796 (SEC Staff Reply Apr. 2, 1974) (short positions in issues taken by market-maker will not affect holding period for issuer's shares held in investment account of market-maker when certain conditions are met).

<sup>62</sup> See *NLT Corp.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,710 (SEC Staff Reply Jan. 11, 1974) (holder of securities purchased in single block may sell those which were fully paid for more than two years previous, even though other securities in the block remain unpaid). The doctrine of fungibility states that a subsequent acquisition of "restricted securities" requires commencement of a new holding period as to all previously acquired "restricted securities." This position was explained in the release adopting the Rule. See SEC Securities Act Release No. 33-5223, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487 (Jan. 11, 1972).

<sup>63</sup> See *Dolman, Kaplan, Neiter & Hard*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,789 (SEC Staff Reply Mar. 29, 1974) (divorced woman who received restricted securities from her ex-husband as part of the property settlement may tack her holding period to that of her husband). In this case, the SEC also considered the question of how many securities the wife may resell without violating the provisions of Rule 144(e). The SEC replied that the divorced woman was not required to aggregate her sales during any six-month period with those of her husband, provided they did not act in concert. Their divorce was considered to present a rebuttable presumption against any concerted action.

<sup>64</sup> The employees were permitted to purchase the shares with the restriction that they were not to be sold or hypothecated for three years. These restrictions would lapse as to 1/5 of the shares purchased upon expiration of each year in a period, for example, between the third and seventh years after the shares were acquired. Therefore, until the end of the seventh year, there would be some securities subject to restrictions. Furthermore, if the employee's employment was terminated at any time prior to the end of the third year, the employer had a 30-day option to repurchase all the shares at the employee's cost plus interest. At any time after the three years, while the employee retained restricted securities, the employer had the same purchase option but only as to those shares which remained restricted.

when they acquired the shares, if they retained beneficial ownership of the securities thereafter.<sup>65</sup> Recently, however, the Commission has stated that the important consideration in such cases is when the purchase price is fully paid,<sup>66</sup> rather than when the purchaser acquires beneficial ownership. Because the 1973 position effectuated the Rule's purpose of subjecting the purchaser to the risks of his investment and prevented him from becoming a conduit for a public distribution, it is unclear why the SEC imposed a stricter requirement in 1974.<sup>67</sup>

Rule 144 applies to securities which were not acquired through any public distributions.<sup>68</sup> However, a recent reply by the SEC states that securities originally sold in a public offering, which were acquired by an affiliate of the issuer in a transaction effected on a national exchange, and subsequently sold to another affiliate in a non-public transaction, are "restricted" securities despite the fact that they were originally publicly traded.<sup>69</sup>

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<sup>65</sup> Warner Communications, Inc., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,463 (SEC Staff Reply July 16, 1973); Kappa Sys., Inc., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,491 (SEC Staff Reply July 5, 1973).

<sup>66</sup> In *Bourns, Inc.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,820 (SEC Staff Reply Dec. 27, 1973), the SEC considered §83 of the Internal Revenue Code, which provides for the deferral of tax liabilities in those cases in which property is still subject to substantial risk of forfeiture. The SEC noted that risk of forfeiture was defined in the Code as a conditioning of rights in the property "upon the future performance of substantial services by an individual," (INT. REV. CODE OF 1954, §83(c)(1)), and stated that the holding period would therefore not commence until the full purchase price had been paid. Finding that "the restrictions on disposition of the stock purchased under the Bourns plan are not to be lifted as to each portion of the shares until additional consideration is forthcoming," namely, the additional years of employees' services, the SEC stated that full consideration is not paid until the restrictions are lifted. *Bourns, Inc.* at 84,220-84,221. See Ralph M. Parsons Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,821 (SEC Staff Reply Feb. 7, 1974).

<sup>67</sup> In 1973 the SEC stated that subjecting the investor to the risks of his investment was the Commission's major concern and so long as the purchaser had beneficial ownership of the stock, he was subject to such risks. Even the 30-day option would not prevent the assumption of risk since the employer was not required to exercise his option. The difference in the two approaches is that in 1974 the SEC analyzed the issue before it in terms of the Internal Revenue Code, since the reason for the plan was to avail the purchasers of the tax deferral under §83.

<sup>68</sup> The Rule is generally not applicable to securities acquired in reorganizations. *But see* American Commonwealth Financial Corp., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,659 (SEC Staff Reply Dec. 5, 1973) (SEC stated that "persons who do not receive an amount of securities which is substantial in relation to the amount of securities issued in the reorganization and who are not affiliated with [any companies involved] may resell their shares in reliance upon the exemption provided by §4(1)").

<sup>69</sup> See *Citizens & So. Realty Investors*, CCH FED. SEC. L. REP. ¶ 79,980 (SEC Staff

In addition, subsection (c)(1) of the Rule provides added protection for Rule 144 purchasers by prohibiting an issuer from making any sales under the Rule until a registration statement filed by the issuer has been in effect 90 days. To effectuate this purpose of disclosure, the SEC has vigorously reaffirmed its position that the 90-day requirement will not commence until the registration statement becomes effective.<sup>70</sup>

Although SEC staff replies were the primary source of clarification of Rule 144 in 1974, the Southern District of New York recently decided a case involving the 90-day requirement under subsection (c)(1) of the Rule.<sup>71</sup> In that case the district court held an issuer liable under both securities acts for failure to disclose in a prospectus the possibility that 90 days after registration "restricted" securities could be sold pursuant to Rule 144.<sup>72</sup> Basing its decision on judicial interpretation of the "materiality" of a misstatement or omission,<sup>73</sup> the court concluded that, depending on the number of unregistered shares outstanding, failure to disclose the possibility of a sale of these shares under Rule 144 was a material omission.<sup>74</sup>

#### D. Conclusion

While both Rules 146 and 147 provide "safe harbors" for the §4(2) and §3(a)(11) exemptions under the 1933 Act, Rule 147 is more restrictive and it is likely that issuers will avoid the use of this exemption. Rule 146, however, is drafted broadly enough to allow flexibility in its interpretation and implementation by the courts. Nevertheless, the problem of "creeping exclusivity" exists under both Rules, and in light of the development of Rule 144, a presumption against availa-

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Reply July 31, 1974).

<sup>70</sup> Thus, although the wording of subsection (c)(1) was changed in 1974, *see* note 55 *supra*, this requirement has not changed. *See* DuFour, Levy, Marx, Lucas & Osborne, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,826 (SEC Staff Reply May 2, 1974).

<sup>71</sup> Langert v. Q-1 Corp., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,445 (S.D.N.Y. Mar. 15, 1974).

<sup>72</sup> The prospectus did state that "the unregistered shares could not be disposed of in a 'public distribution' unless covered by a registration statement." *Id.* at 95,539. However, the court noted that the average investor is unfamiliar with the phrase "public distribution" as a term of art, and therefore, concluded that the above disclosure was insufficient. *Id.*

<sup>73</sup> A misstatement or omission is "material" if a reasonable man would attach significance to it and would have acted differently had he known this fact. *See, e.g.,* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 362-63 (2d Cir. 1973).

<sup>74</sup> ¶ 94,445, at 95,539.