

ABA

AMERICAN BAR ASSOCIATION

**Defending Liberty
Pursuing Justice**

Section of Business Law
321 North Clark Street
Chicago, Illinois 60610
(312) 988-5588
FAX: (312) 988-5578
email: businesslaw@abanet.org

March 22, 2007

John W. White, Director,
Division of Corporation Finance,
Securities and Exchange Commission,
100 F Street, N.E.,
Washington, D.C. 20549.

Re: Securities Act of 1933 -
Private Offering Reform

Dear John:

In June 2005, following a monumental effort over a number of years, the Commission adopted amendments to its rules and forms relating to registered public offerings. The rules modernized and streamlined the public offering process and, especially for larger public companies, brought it into line with the realities of modern market practices and communications technologies – all without compromising the protection of investors. In fact, new Rule 159 relating to communication of information to investors by the time of sale and the use of free writing prospectuses have improved the protection of investors. Since these changes went into effect in December 2005, we believe they have worked very well and have been embraced by the corporate and investment banking communities.

The American Bar Association's Committee on Federal Regulation of Securities¹ is writing to request that the Commission embark upon a similar project to review, update, simplify and clarify on a comprehensive basis the requirements applicable to non-public (or private) offerings that are not subject to the registration requirements of the Securities Act and bring these requirements into line with modern market practices and communications technology. For many decades, the law applicable to private offerings has been vague and unclear and, in many respects, has been more the subject of lore than law. Although lore and market practices have changed, it is not clear that changes in the law have kept pace. For example, while a variety of safe harbors have been adopted, changes in market practices have caused these safe harbors to become out of date in important respects. As a result, lawyers are hard pressed to know and advise as to the line between permissible private offerings and public offerings that must be registered. We believe that the changes we suggest will add clarity and efficiency and can be accomplished without adversely affecting protection of investors.

We believe that this request is particularly timely in light of the recommendation of specific changes in private offering requirements contained in the Final Report of the Advisory Committee on Smaller Public Companies to the SEC (Apr. 23, 2006). We also believe that a comprehensive approach, which would address

¹ This letter is provided by the Committee on Federal Regulation of Securities of the American Bar Association's Business Law Section. It does not represent an official position of the American Bar Association or the Section, nor does it necessarily reflect the views of all of the Committee members.

all relevant aspects of unregistered offerings, would be preferable to addressing discrete issues or recommendations on a piecemeal basis.

I. Overview

Since the 1930s, the boundary between offerings to the public required to be registered and private offerings not required to be registered has been a shifting no-man's land. Safe harbors adopted over the years have illogical inconsistencies. For example, under Regulation D unlimited offers are permitted as long as purchases fall within the limits of the Regulation and there is no "general solicitation" or "general advertising" (very imprecise terms), whereas under Rule 144A, "offers" to non-QIBs are not permitted. The risk to issuers and sellers of getting a private offering wrong is that purchasers have a one-year put under § 12(a)(1) of the Securities Act for violation of § 5. In theory at least, for example, there is risk that a court applying the exemption literally and technically could conclude that an offer to an ineligible offeree who does not purchase and thus suffers no harm can result in the loss of an exemption from § 5 for the entire offering and give all purchasers a one-year put, even if those purchasers are limited to eligible ones and the disclosure is unassailable.²

² This Committee has previously expressed a contrary view about the appropriate application of the exemption in such a case: "[We] believe that a court should, and probably would, either find the exemption available vis-a-vis [a non-disqualifying] plaintiff, or find some other basis for denying the plaintiff the right to rescind his transaction." 31 *The Business Lawyer* 493-4 (Nov. 1975).

We believe that the current rules for unregistered offerings have led to the following problems:

- Uncertainty as to whether unregistered offerings run afoul of § 5, with the potential draconian liability of a put right held by purchasers, even in the absence of any harm to investors.
- Restricting communications in ways that hamper legitimate offering techniques and, in some cases, are unworkable given modern technologies and communications practices.
- Impeding secondary market activities in ways that adversely impact private offerings.
- Restricting the ability to conduct private and public offerings that are proximate in time.

Each of these issues adversely affects the costs and complexity of capital formation, which often fall disproportionately on smaller companies.

The time has come to take a fresh and comprehensive look at the private offering exemption, identify and state the underlying rationale in a principles-based fashion in the light of today's information and communications technologies and market realities, bring clarity to the area and protect conduct that does not adversely affect investors or offerees. We believe that the following basic changes are needed:

- Re-examine the definition of investors not needing the protection of the registration requirements of the Securities Act and reduce the disparity among definitions in the securities laws for such investors.
- Focus the protections on those who purchase and in effect deregulate all offers to offerees who do not purchase. Offerees who do not purchase do not need the protection of registration. Eliminate the vague concepts of "general solicitation" and "general advertising," which are wholly inconsistent with today's information and communications technologies. Any misconduct in

making offers would still be subject to § 17(a) of the Securities Act and § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

- Identify more clearly, through a presumptive definition, control persons whose sales require registration. Where a control person is treated as an “issuer” under § 2(a)(11), it should be entitled to the same safe harbors as issuers.
- Replace the current five factors relating to integration of offerings, which do not work and are largely ignored, with a more meaningful and useful set of factors, and adopt meaningful safe harbors where appropriate. Eliminate the restrictions on public and private offerings that are proximate in time where the restrictions serve no public interest in protecting investors or markets.³
- Re-examine the time periods for holding securities and separating offerings in light of today’s volatile markets and make those periods more consistent under similar circumstances.

II. History⁴

The Statute. The Securities Act was enacted almost 75 years ago. The approach to offerings by issuers not requiring registration was incredibly simple. In what is now § 4(2),⁵ it simply exempted “transactions by an issuer not involving any public offering”. As the U.S. Supreme Court said 20 years later:

“The Securities Act nowhere defines the scope of § 4([2])’s private offering exemption. Nor is the legislative

³ See, for example, the staff position cited in fn. 12 below.

⁴ This is not a complete chronological recitation of the requirements from time to time of a non-public or private offering. Rather, it is an attempt to sketch the evolution of the changing concepts through the years that have shaped views of the scope of the private offering exemption.

⁵ Throughout this letter we shall refer to statutory provisions by their current numbering.

history of much help in staking out its boundaries.” SEC v. Ralston Purina Co., 346 U.S. 119, 122 (1953).

The other relevant provision of the Securities Act was § 2(a)(11), the definition of “underwriter”. In a backhanded way, this definition (coupled with the exemptions in §§ 4(1) and 4(3), which are not available to underwriters) limited the scope of § 4(2) by preventing indirect public offerings by issuers and “control” persons through third parties:

“The term ‘underwriter’ means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any securities As used in this paragraph, the term ‘issuer’ shall include ... any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.”⁶

The term “distribution” is not defined in the statute but has always been understood to be synonymous with a public offering, *i.e.*, an offering in which the securities end up in the hands of the public.⁷ The term “control” is not defined in the statute either. It is, however, defined in Rule 405:

⁶ Interestingly, and as becomes relevant below, the statutory concept of underwriter does not turn on a person’s status as a dealer under the Securities Act or a broker or dealer under the Exchange Act.

⁷ “‘Distribution’ ... comprises the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public....” In re Oklahoma-Texas Trust, 2 S.E.C. 764, 774 (1937).

A purchase with a view to a resale that is registered or exempt does not violate § 5. See Newwirth Inv. Fund v. Swanton, 422 F.Supp. 1187 (S.D.N.Y. 1975), and Berkeley Inv. Group Ltd. v. Colkitt, 455 F.3d 195, 215 (3d Cir. 2006) (collecting cases). Thus, anyone may buy from an issuer with a view to resale in

“The term ‘control’ (including the terms ‘controlling’, ‘controlled by’ and ‘under common control with’) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”

The Commission and its staff have always taken a very expansive view of “control”, presumably to maximize the reach of the Securities Act’s registration requirements.

But, interestingly, in other statutory and regulatory contexts the term is not viewed so broadly. Thus, in the Investment Company Act of 1940:

“‘Control’ means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

“Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. A natural person shall be presumed not to be a control person within the meaning of this title. Any

a registered offering (e.g., underwriters in a conventional public offering and holders of registration rights), in a Rule 144A offering or in an offering outside the United States meeting the requirements of Regulation S. See Preliminary Note 7 to Rule 144A. See also SEC amicus curiae letters in In re Safety-Kleen Bondholders Litigation (Aug. 9, 2001) and In re HealthSouth Securities Litigation (Nov. 28, 2006).

“Distribution,” as used in the Securities Act, is to be distinguished from “distribution” as used for the purpose of Regulation M and the trading rules. See Regulation M, Rule 100.

such presumption may be rebutted by evidence. ...”
§ 2(a)(9)⁸

Early Opinion of SEC General Counsel (1935). In January 1935, in an effort to clarify the application of § 4(2), the SEC’s General Counsel issued a letter⁹ discussing the factors to be considered in determining the availability of the § 4(2) exemption. After noting that the office had previously expressed the opinion that under ordinary circumstances an offering to not more than approximately 25 persons is not an offering to a substantial number and presumably does not involve a public offering, the General Counsel said that “what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment.” He then went on to discuss the following factors as bearing on the existence or non-existence of a public offering:

- Number of offerees – not the number of actual purchasers but number of persons to whom securities are offered for sale – any attempt to dispose of a security to be regarded as an offer
- Relationship of offerees to each other and to the issuer, *e.g.*, offering to class of high executive officers who should have special knowledge of the issuer is less likely to be a public offering
- Number of units offered – large minimum denomination
- Size of offering – exemption intended to be applied chiefly to small offerings

⁸ See also Exchange Act Rule 10A-3(e) (relating to independent directors for audit committee purposes), which provides a safe harbor that one person shall not be deemed to be in control of another person if the former (a) is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the latter and (b) is not an executive officer of the latter.

⁹ Securities Act Release No. 285, 1 CCH Fed. Sec. L. Rep. ¶ 2740 (Jan. 24, 1935).

– Manner of offering

The General Counsel went on to say that if the initial purchaser had purchased with a view to distribution, the initial purchaser would be an underwriter, and sales of securities bought from such initial purchaser by a dealer “would, as a general rule, not be exempt until at least a year after the purchase of the securities by the dealer (Emphasis added).”¹⁰

Rule 152 (1935). In 1935, the Commission adopted a rule to the effect that an otherwise lawful attempted private placement is not retroactively rendered illegal by the fact that the issuer subsequently “decides to make a public offering and/or files a registration statement”. Although there is little of help in the adopting release,¹¹ it would appear that the Rule was designed to facilitate and encourage registration.¹²

Ralston Purina. The leading case interpreting § 4(2) came approximately 20 years after adoption of the Securities Act and remains the leading case more than 50 years later! In retrospect, it is curious that such an important case was decided 6-2, with a majority opinion that took little more than seven pages (one page being the most

¹⁰ See also In re Brooklyn Manhattan Transit Corp., 1 SEC 147 (1935); Securities Act Release No. 603 (1935); and Throop & Lane, Some Problems of Exemption under the Securities Act of 1933, 4 Law & Contemp. Probs. 89 (1937).

¹¹ “The rule allows those who have contemplated or begun to undertake a private offering to register the securities without incurring any risk of liability as a consequence of having first contemplated or begun to undertake a private offering.” Securities Act Release No. 305 (Mar. 2, 1935).

¹² See Verticom, Inc. (avail. Feb. 12, 1986), reversing LaserFax, Inc. (avail. Sept. 16, 1985). The staff has construed Rule 152 to prevent a privately offered security from being sold to the original offeree pursuant to a registration statement without an intervening period of at least a year.

important) and without a dissenting opinion. The Court stated that it had granted certiorari based on “an apparent need to define the scope of the private offering exemption”. The Court declined the Commission’s request to hold that “an offering to a substantial number of the public” is not exempt under § 4(2) (at p. 125). “[T]he statute would seem to apply to a ‘public offering’ whether to few or to many. ... There is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation.” (At p. 125.)

Instead, the Court chose to interpret the exemption in light of the statutory purposes of the Securities Act. The availability of the exemption

“should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering’”. (At p. 125.)

The Court stated that an offering to “executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of registration statement” may come within § 4(2). (At pp. 125-126.)

Law, Lore and Legal Advice – Issuer Offerings. All things considered, the guidance of the SEC General Counsel and the Supreme Court did not do much to define the boundary between private and public offerings. As a result, the securities bar applied a case-by-case “facts and circumstances” analysis, focusing on the following factors:

- Number of offerees
- Financial sophistication of purchasers or their investment advisers

- Ability to bear economic risk of a loss of their investment
- Information about the issuer or access to such information
- Investment intent – did the investor intend to invest?¹³ – but a purchase may be with view to resell in a registered or exempt transaction. See fn. 7.

Law, Lore and Legal Advice – Sales by Control Persons and Holders of

Restricted Securities. The § 4(2) exemption, by its terms, is available only to issuers and, presumably, their agents. It does not address sales by control persons, who are “issuers” for purposes of § 2(a)(11), or resales by non-control persons of securities acquired without registration from issuers and control persons. Based on staff “no-action” letters, patterns developed as to the likelihood of being deemed a “control person” and the holding periods and changes in circumstances following a purchase from an issuer or a control person that would negate underwriter status. Following a holding period of two to three years or an unforeseen “change in circumstances,” a holder of privately placed securities could resell without registration. Absent relief under the “no-action” letters, and based on §§ 4(1) and 4(3) and by analogy to issuer private offerings under § 4(2), the

¹³ The staff has taken the rather arbitrary position that a broker-dealer can never purchase with the requisite investment intent and, therefore, regardless of any holding period is always an underwriter. See fn. 6 above. It sometimes also has applied this position to affiliates of broker-dealers who may not have had any involvement in the transaction other than as a purchaser. In other areas of the securities laws the presence of informational and operational barriers between a broker-dealer and its affiliates might preclude the treatment of affiliates as “affiliated purchasers” for purposes of Regulation M, or the attribution to both a broker-dealer and its affiliates of beneficial ownership for purposes of Regulation 13D/G.

securities bar concluded that non-public sales of those securities were permissible.¹⁴

These private sales or resales are frequently referred to as “§ 4(1½)” sales.

Resale Safe Harbor I (1972). In 1972 the Commission adopted Rule 144, a non-exclusive safe harbor for (a) sales by “affiliates” (defined in terms of control) and (b) resales of “restricted securities” by non-affiliates. “Restricted securities” include securities acquired, directly or indirectly, from the issuer or an affiliate in a transaction or chain of transactions not involving a public offering. The Rule, based on an interpretation of § 2(a)(11) (the definition of “underwriter”), made three important changes in the law of private offerings. First, it established bright-line holding periods after the first of which (originally two years and now one year) the seller could sell limited amounts of the securities in accordance with the limitations of the Rule (designed with the definition of “underwriter” in mind) and after the second of which (originally three years and now two years) it could freely sell unlimited amounts of the securities as long as it was not an affiliate of the issuer. Second, it defined the circumstances in which successive holders could tack their holding periods¹⁵. Third, it stated in the adopting Release that the Commission would no longer consider “investment intent” and “change in circumstances” in determining whether a seller is an “underwriter” and would no

¹⁴ See Resales by Institutional Investors of Debt Securities Acquired in Private Placements, 34 Business Lawyer 1927 (July 1979); and The Section “4(1½)” Phenomenon: Private Resales of Restricted Securities, 34 Business Lawyer 1961 (July 1979).

longer issue no-action letters addressing whether a person was or was not an underwriter based on those concepts.¹⁶ The Rule addressed equity securities that could be sold into public trading markets. For privately placed debt and preferred stock, the Rule has never really worked during the three-year/two-year holding period – the Rule’s volume and manner-of-sale limitations and the absence of public trading markets for these securities combine to make the safe harbor essentially unavailable.

Issuer Safe Harbor (1982). Ten years later the Commission promulgated Regulation D, which defined a variety of situations in which an issuer could offer and sell securities without registration. Rules 501-03 and 506 addressed offerings intended to be exempt under § 4(2). Regulation D is not by its terms available to persons other than issuers. These Rules (as they have been amended) made a number of changes in conventional wisdom regarding private offerings:

- Eligibility of offerees. While there were requirements applicable to purchasers and their “purchaser representatives”, offerees did not have to meet any eligibility requirements.
- Number of offerees. Subject to the limitation on manner of offering, the number of offerees in and of itself was not important.
- Manner of offering. The only limit was a prohibition of “general solicitation” or “general advertising”. Rule 502(c). In addition to

¹⁵ Originally, the Rule suspended the holding period as long as and to the extent the holder had a short position in the securities, but the Commission later eliminated that provision. See fn. 22.

¹⁶ Securities Act Release No. 5223, Adoption of Rule 144 (Jan. 11, 1972). Inasmuch as the Rule is non-exclusive, this does not mean that the letters issued before adoption of the Rule no longer have any validity (except to the extent they involve the repudiated “change-in-circumstances” doctrine).

any policy bases for this limitation, the Commission may have been concerned that at the time it had the power to define terms used in the statute but not to grant exemptions from the requirements of the statute. Accordingly, it could not read “offers” entirely out of the statute.

- Number of purchasers. Except for purchasers that did not meet specified qualifications, the number of purchasers was no longer important. There could be an unlimited number of “accredited investor” purchasers. Rule 501(e)(1).
- Information. In the case of “accredited investors”, access to information was sufficient. In the case of purchasers other than “accredited investors”, reporting issuers were required to “furnish” documents filed under the Exchange Act, and other issuers must furnish similar information. Rule 502(b)(2).
- Limitations on resale. Whereas it had been common practice, at least in the case of equity securities, to legend stock certificates, issue stop transfer instructions to the transfer agent and perhaps even require opinions of counsel that resales could be effected without registration, the new Rule required simply that the issuer exercise reasonable care to assure that the purchasers were not “underwriters”, which could be demonstrated (non-exclusively) by (a) reasonable inquiry to determine whether the purchaser was purchasing for himself or herself or another, (b) prior written disclosure that the securities had not been registered under the Securities Act and could not be resold unless registered or sold in accordance with an available exemption from registration, and (c) legending the certificate or other document evidencing the securities stating that the securities had not been registered and setting forth or referring to “the restrictions on transferability and sale of the securities”.¹⁷ Rule 502(d).

Staff Study. In 1986, in an address to the Federal Regulation of Securities Committee, Linda Quinn, then Director of the Division of Corporation Finance, advised

¹⁷ Since the adoption of Regulation D, and with the Commission’s active encouragement, securities of publicly-traded companies have largely been dematerialized or immobilized in DTC. As a result, legending, stop transfer instructions etc. are increasingly impractical for these companies.

