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Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions

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SECURITIES MARKETS FOR SMALL ISSUERS: 
THE BARRIER OF FEDERAL SOLICITATION 
AND ADVERTISING PROHIBITIONS

Stuart R. Cohn*

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I. INTRODUCTION

Born out of congressional reaction to fraudulent and abusive sales
schemes during the market heydays of the 1920's,1 the Securities Act of

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Jurisprudence 1964, Oxford University; LL.B. 1966, Yale University.
1. H.R. R.P. No. 85, 73d Cong., 1st Sess. 2 (1933):
During the post-war decade some 50 billions of new securities were floated in the United
States. Fully half or $25,000,000,000 worth of securities floated during this period have
been proved to be worthless. These cold figures spelled tragedy in the lives of thousands
of individuals who invested their life savings, accumulated after years of effort, in these
worthless securities. The flotation of such a mass of essentially fraudulent securities was
made possible because of the complete abandonment by many underwriters and dealers
in securities of those standards of fair, honest, and prudent dealing that should be basic
to the encouragement of investment in any enterprise.
1933 created a process of registration and administrative review of securities offerings designed to foster full disclosure to potential investors. Congress did not seek, however, to impose this formalized process upon every offering. In particular, the 1933 Act provided a private offering exemption and authorized the Securities and Exchange Commission to develop further exemptions from registration "where


3. Except for securities offerings exempt under the provisions of §§ 3 or 4 of the Securities Act, a registration statement must be filed prior to any offer to sell a security and be declared "in effect" prior to any sale of the security. 15 U.S.C. § 77(e) (1982). Disclosure requirements for a registration statement are set forth in Schedule A of the Act and are augmented by SEC regulation.


The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000. The exemption ceiling in the original Act was $100,000. See infra note 48. The "Commission" referred to in the statute as enacted was the Federal Trade Commission. Administrative powers and duties were transferred to the Securities and Exchange Commission (SEC) created by, and pursuant to, the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jjj (1982)).

The SEC has promulgated several exemptions pursuant to its § 3(b) authority. Current exemptions are found in Regulation A, 17 C.F.R. §§ 230.251-.264 (1985), providing a modified form of registration for offerings up to $1,500,000, see infra note 18, and Regulation D, 17 C.F.R. §§ 230.501-.506 (1985), setting forth conditions for exempt offerings under Rule 504 (up to $500,000) and Rule 505 (up to $5,000,000), see infra note 51 & text accompanying notes 51-54. Regulation B, 17 C.F.R. §§ 230.300-.346 (1985), exempts from registration offerings of fractional undivided interests in oil and gas rights not in excess of $250,000. The exemption requires certain minimum ownership interests of the operating lessee, 17 C.F.R. § 230.302(b), and the pre-filing with the SEC of an offering sheet containing specified information, 17 C.F.R. § 230.310.

Registration exemption is also provided in § 3(a)(11) of the 1933 Act for intrastate offerings.


Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

Id. The exemption is particularly valuable for small companies which are able to raise all of their capital from local investors, as there are no limitations on the amount offered or the nature and number of offerees or purchasers. The advantages of the intrastate exemption, however, have not led to its common use. The exemption is lost for even a de minimis failure to meet the strict requirements of § 3(a)(11) or the safe harbor Rule 147, 17 C.F.R. § 230.147 (1985). The presence of one out-of-state offeree or purchaser may defeat the exemption, a particularly harsh result where
there is no practical need for its application or where the public benefits are too remote. 176

Exemptions from the costly and time-consuming processes of securities registration are essential for many small companies seeking equity capital. 7 Legislative recognition and reaction to the burdens placed on small companies was reflected most recently in the Small Business Investment Incentive Act of 1980. 9 Yet, despite the statutory promise of relief, exemptions have been saddled with judicial and administrative prerequisites that substantially impair achievement of the legislative goal. 9 Each of the conditions may have an element of merit,
but in combination they constitute a considerable barrier to simplified and inexpensive methods of capital formation.

This article examines one of those conditions, the prohibition against general solicitation and advertising applicable to both private and small offering exemptions. The prohibition has a long history, but its impact upon small companies and broker-dealers deserves greater attention and analysis than the SEC has thus far accorded. This article suggests that the statutory objective underlying the limited offering exemptions has been undermined by the rigid formulation and application of the general solicitation prohibition by the SEC and, to a lesser extent, by the courts.

Consider the following, rather ordinary circumstances:

a) An office supply business needs capital to support growing inventory and to acquire additional showroom space. The business needs are estimated at $300,000, an amount well beyond the collective capabilities of its several principals and the company's borrowing power. The business considers a stock offering. Family and friends both within and outside the state are prepared to invest $100,000. The remainder will be raised through solicitation of customers and other persons in the community. Counsel for the principals has been asked whether the locally-based $200,000 offering presents any problems under the securities laws.

b) A local promoter concludes that his city would prosper from a convention center. The city government cannot fit the project into its budget, but

(c) Limitation on Manner of Offering

Except as provided in § 230.504(b)(1), neither 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:

(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.

Rule 502(c) applies to all Regulation D exemptions, that is, Rules 504, 505, and 506. 17 C.F.R. §§ 230.501-506 (1985); see infra notes 51-52. The exception in Rule 504(b)(1) concerns the delivery of a disclosure statement pursuant to registration of the offering under state law. See infra notes 52 & 55. In addition to the administrative rule, judicial restraints on solicitation and advertising apply to the private offering exemption of § 4(2) and are based principally on a concern for the identity and sophistication of offerees. See infra text accompanying notes 62-68.

11. This article examines exclusively the federal private and small offering exemptions. There is a wide spectrum of analogous provisions among state securities laws, including differing approaches to the question of investor solicitation. The Florida statute, for example, exempts from state registration the sale of securities to no more than 35 purchasers in a twelve-month period provided, among other conditions, that there is no "general solicitation or general advertising in this state." Fla. Stat. § 517.061(1)(a)(2) (1985). Minnesota limits its exemption to 25 purchasers (35 if sales are made in compliance with Regulation D) but imposes no limitation on general solicitation or advertising. Minn. Stat. Ann. § 80A.15.2(h) (West Supp. 1986). Moreover, administrative standards may vary among states concerning what constitutes general solicitation or general advertising. See, e.g., Smith, State 'Blue-Sky' Laws and the Federal Securities Acts, 34 Mich. L. Rev. 1135, 1144 (1936) (noting the diversity among states whether a newspaper prospectus or advertisement constituted a "public offering").
the promoter sees potential in a privately-financed venture. He can arrange for substantial loans, but the lenders are insisting upon a minimum $1,500,000 equity investment. The promoter has talked to several motel owners who are enthusiastic about the project. His out-of-state sister has pledged $500,000. To raise the balance, the promoter plans to write a letter to each of the 50 hotel and motel owners in his town briefly describing the proposed investment. He will provide a complete disclosure statement to any owner who shows interest. The promoter wants to know whether his limited offering will fit within the "private placement" exemption.\(^\text{12}\)

c) A broker-dealer was the "best efforts" underwriter six months ago for an $8,000,000 real estate limited partnership private placement. Each purchaser was carefully screened for suitability and sophistication, and the number of investors was kept well within the numerical limits for private placements. A well-crafted, complete disclosure statement was given to each potential investor, and all appropriate notifications were filed with the SEC.\(^\text{13}\) The real estate project has fallen victim to unforeseeable engineering problems and the investors, looking to get their money back, consider a lawsuit. The firm's attorney learns that during the offering the firm had placed a small advertisement in a real estate trade journal describing in general terms the nature and availability of the investment. The ad, however, fell on deaf ears: no inquiries or potential investors developed as a result. While the client cannot imagine a problem stemming from a non-productive, one-time advertisement, counsel fears otherwise.

Each of the above scenarios involves an effort to raise capital other than through the federal registration process. But for a single factor, each might qualify for a private or small offering exemption.\(^\text{14}\) The Achilles heel in each instance is the judicial and administrative position denying registration exemptions for offerings that include "general solicitation or general advertising."\(^\text{15}\)

To generate the $200,000 in the first scenario, the company may need to attract

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12. The terms "private placement" and "private offer" used in this article refer to the offer and sale of securities pursuant to either the § 4(2) exemption in the 1933 Act or the provisions of the SEC's Rule 506, 17 C.F.R. § 230.506 (1985), setting forth safe harbor conditions for § 4(2) compliance. The terms are distinguished from the small offering exemptions of Rules 504 and 505 created by the SEC pursuant to its § 3(b) rulemaking authority.

13. An offering pursuant to Rule 506, unlike a § 4(2) offering, requires filing with the Commission of periodic sales results. 17 C.F.R. § 230.503 (1985). The filing is made on Form D, requiring information on the issuer's capital and financial status, number and types (accredited or non-accredited) of investors, offering prices, selling expenses and proposed or actual use of proceeds.

14. Focus in these hypotheticals is on the § 4(2) and § 3(b) exemptions. Integration considerations prevent reliance in the first two instances on the intrastate offering exemption, § 3(a)(11) of the 1933 Act, 15 U.S.C. § 77c(a)(11) (1982), and the SEC's Rule 147, 17 C.F.R. § 230.147 (1985). See supra note 5. It is also assumed that the intrastate offering conditions were not met in the third scenario, which sought exemption through Rule 506, 17 C.F.R. § 230.506 (1985). The § 4(6) exemption is also assumed inapplicable on the basis that one or more of the offerees or purchasers in the hypotheticals was not an "accredited investor." See supra note 8.

15. See supra note 10; infra text accompanying notes 55-58.
a large number of potentially small investors, using a combination of group meetings, local announcements and brochures. The second hypothetical involves a proposed mailing to a select group, with some recipients not personally known by the promoter. The third illustrates a carefully controlled sales program jeopardized by a single, harmless advertisement. In each case, no amount of good faith, disclosure or caution will prevent the denial or loss of a registration exemption if the issuer or underwriter has violated the prohibition against general solicitation.

The above hypotheticals are not unusual fabrications. Lawyers representing the multitude of small and medium-sized companies are more likely to encounter such dilemmas than the much more notorious takeovers and multi-state offerings that dominate the business journals. Statistics, although limited, indicate that substantial capital raising activities at local levels fail to conform to exemption requirements either because of issuer ignorance or deliberate disregard of statutory provisions. The economics of the first hypothetical, for example, make federal registration impractical, even under the modified requirements of Regulation A.

16. A 1984 SEC study reported 7,222 Form D filings for the period April, 1982, through April, 1983. DIRECTORATE OF ECON. & POL’Y ANALYSIS, SEC, AN ANALYSIS OF REGULATION D (1984). Of the $15.5 billion securities sales reported, approximately 80% claimed a Rule 506 exemption (17 C.F.R. § 230.506). Only 3% of the total dollar volume was reported under the Rule 504 exemption (17 C.F.R. § 230.504), representing 25% of all Regulation D offerings (496 out of 2,002 offerings). For many small companies, Rule 506 is difficult to utilize unless one or more large investors are able to keep the total number of investors within the 35 numerical limitation. The relatively low use of the Rule 504 exemption suggests that Rule 504 has not proven useful for small companies seeking equity in the $100,000 to $500,000 range. As of 1981 there were over 2.5 million active corporations with assets below $1 million, comprising approximately 90% of all active corporations. BUREAU OF THE CENSUS, U.S. DEP’T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 523 (1985). The relatively low number of reported Rule 504 offerings is not likely to reflect actual securities activities, given on-going capital raising requirements of small companies. See 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, 359 (1984) (“scant evidence exists to indicate that Regulation D has fostered increased utilization of the SEC’s limited offering exemptions or the raising of capital at reduced regulatory costs”). For concerns recently expressed on behalf of small real estate syndications with regard to the solicitation limitations imposed in Regulation D, see infra note 72.

17. See Schneider, Manko & Kant, supra note 7, at 29-31. A recent SEC study of expenses involved in public offerings utilizing Form S-18, the form developed for smaller issuers, indicated average expenses of approximately 16% of the total offering. DIRECTORATE OF ECON. & POL’Y ANALYSIS, supra note 16, at 44. Thus, a $400,000 offering would incur legal, accounting and other expenses of $64,000. The bulk of these expenses are often in sales commissions, as small companies frequently must offer substantial inducement to broker-dealers to help distribute the issue. The overall 16% figure was contrasted with the average expense figure of 4.5% of the total offering for Rule 504 offerings. Id. at 40.

18. Regulation A, 17 C.F.R. §§ 230.251-.264 (1985) (adopted by the Commission pursuant to § 3(b) of the 1933 Act). The exemption is a modified form of registration, as it permits offerings up to $1,500,000 through the use of an offering statement filed with, and reviewed by, the SEC’s regional office in the issuer’s region. Regulation A has not proven to be a popular technique for capital raising. In 1978, the SEC noted a steady decline over a six-year period in the number of Regulation A registrations, dropping from 998 in 1972 to 158 in 1977. SEC Securities Act Release
stock offering, it has little alternative but to ask the inevitable question: what is the risk if the "solicitation" crosses the ambiguous line of being "general"?

Small, developing companies are severely handicapped by the non-solicitation rules in two ways. First, if the company abides by the strict non-solicitation standard, it may well fail to locate enough potential investors to raise the necessary capital or the effort may be doomed by the consequent slowness of its pace. Second, if the narrow non-solicitation bounds are breached, even in good faith, no amount of full disclosure or investor sophistication will save the offering from the strict liability provisions of the 1933 Act.19

The solicitation prohibition is encountered in each of the section 4(2) private offering and section 3(b) small placement exemptions. Although similar in content and application, the source of the limitation is primarily judicial, with respect to section 4(2), and administrative with respect to section 3(b). Courts have consistently regarded broad-based approaches to large groups of offerees as antithetical to the section 4(2) concept of a "private offering."20 On the other hand, a company that seeks to utilize the small offering provisions of Regulation D is subject to SEC Rule 502(c).21 This non-solicitation rule is not statutorily mandated. Presumably it stems from the Commission's judgment of what is necessary for investor protection. Undoubtedly the Commission was influenced by judicial and administrative conditions affecting the section 4(2) exemption. However, the Commission appears to have given little or no thought to the distinctions in congressional purpose between offerings pursuant to section 4(2) and offerings pursuant to section 3(b) rulemaking authority.22

This article proposes that the current prohibitions against solicitation and advertising applicable to private placements and small offerings:

(i) are neither necessary to assure investor protection nor appropriate as a mandatory condition governing the availability of a registration exemption;

(ii) impose hardships for small companies and broker-dealers without commensurate benefits to the investing public;

19. Failure to comply with the provisions of a statutory or regulatory exemption leads inevitably to violation of the registration statement and prospectus requirements of § 5 of the 1933 Act, 15 U.S.C. § 77(e) (1982). Section 12(1) of the Act, 15 U.S.C. § 77l (1982), provides civil remedies of rescission or damages for purchasers of stock sold in violation of § 5, there being no good faith or other mitigating defenses. Civil liability under § 12(1) may be imposed against participants, including broker-dealers, instrumental in the sales process. Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

20. See infra text accompanying notes 62-68.


22. See infra text accompanying notes 56-57.
(iii) create traps that may unfairly punish not only inadvertence but also good faith conduct by issuers and broker-dealers; and
(iv) are inconsistent with legislative goals of facilitating the financing abilities of small companies within appropriate bounds of the securities laws.

The preferred method of resolving the expressed concerns is to revise existing administrative regulations. Failing that, courts should undertake a case-by-case review of exemption conditions, giving proper weight to appropriate policy considerations.

II. Development of Current Standards

A. Transactions Not Involving a Public Offering — Section 4(2)

Limitations on general solicitation originate in the “offering” language of the 1933 Act. The terse language of section 4(2) exempting from registration “transactions by an issuer not involving any public offering” provides little significant guidance as to intended coverage. Resort to other sections of the Act is necessary. In section 2(3), “offer” is defined to include “every attempt or offer to dispose of, or solicitation of an offer to buy” a security for value. Although the ambiguity of these definitional terms may support broad interpretation, it is not readily apparent that the Act sought to impose significant restraints on communication for offerings of a small or non-public nature.

Legislative history of the 1933 Act reflects a primary concern with the broad-based dissemination of securities. The House bill exempted “issuer transactions not through underwriters.” During debate, the phrase “and not involving any public offering” was added as a clarifying amendment. The Senate bill ex-

23. 15 U.S.C. § 77b(3) (1982): “The term ‘offer to sell’, ‘offer for sale’, or ‘offer’ shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.”
24. H.R. 5480, 73d Cong., 1st Sess. § 4 (1933) (as introduced by Mr. Rayburn May 3, 1933):
The provisions of section 5 shall not apply to any of the following transactions:
(1) Transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not with or through an underwriter; or transactions by a dealer (not acting as an underwriter), except transactions within one year after the last date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter (excluding in the computation of such year any time during which a stop order issued under section 8 is in effect as to the security), and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.
25. 77 Cong. Rec. 2954 (1933) (statement of Mr. Rayburn). As passed by the House, the exemption provision read “transactions by an issuer not with or through an underwriter and not involving any public offering.” H.R. 5480, 73d Cong., 1st Sess. § 4(1) (1933). The House Committee Report noted:
[This provision] exempts transactions by an issuer unless made by or through an underwriter so as to permit an issuer to make a specific or an isolated sale of its securities to a particular person, but insisting that if a sale of the issuer’s securities should be made generally to the public that that transaction shall come within the purview of the act.
empted "[i]solated transactions . . . not being made in the course of repeated and successive transactions of a like character."26 After conference, the Act passed in substantially the form it had taken in the House.27 Upon adoption of the Securities and Exchange Act of 1934,28 however, the phrase "not with or through an underwriter" was deleted from section 4(1)29 of the 1933 Act in response to a House report describing the phrase as "really superfluous."30

Given the scant legislative history of the private offering provision, it would be unreasonable to argue that the legislation has created a firmly defined public-private distinction. State court interpretations of "public offering" with respect to then-current state statutes were too diverse to provide meaningful guidance.31 What seems apparent, however, is that the original emphasis on underwritten offerings, coupled with the statutory exemption for intrastate offerings and the delegation to the Commission of the power to exempt offerings up to $100,000, suggests legislative concern principally with substantial, broadly based selling efforts.12

Early interpretations of the private offering exemption emphasized the need to examine all the circumstances underlying the offering. The first administrative opinion, issued in response to a growing dogma in the securities industry that offerings to less than 25 persons were not "public," stated that "the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment."33 One of the four enumerated circumstances requiring examination was the manner of offering.14 The SEC's General Counsel noted that transactions involving direct negotiation

26. S. 875, 73d Cong., 1st Sess. § 12(c) (1933). The Senate bill contained generous advertising provisions for all securities offerings. Id. § 8. The eventual adoption of the House bill eliminated advertising for all but registered offerings. See infra note 121.
27. Compare Securities Act of 1933, ch. 38, 48 Stat. 74 with H.R. 5480, 73d Cong., 1st Sess. (1933). Neither the House nor Senate conference reports commented on the difference between the bills regarding exemptions for issuer transactions. See 77 CONG. REC. 3891 (1933) (House report); id. at 3879 (Senate report).
29. Id. § 203(a), 48 Stat. at 906.
31. See Smith, supra note 11; Comment, Corporations — Interpretation of the "Public Offering" Exemption of the Federal Securities Act and State Blue-Sky Laws, 36 MICH. L. REV. 604, 610 (1938) ("[I]t does not appear to be necessary, proper or, in fact, feasible to define dogmatically a 'public offering' as applicable to exceptions under the Federal Securities Act or the blue-sky laws.").
32. "The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government." Landis, The Legislative History of the Securities Act of 1933, 28 GEO. WASH. L. REV. 29, 37 (1959). James Landis was a principal draftsman of the securities legislation and became chairman of the SEC in 1935.
34. Id. The four enumerated factors were: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of offering.
were more likely private offerings than those involving public distribution. The SEC also expressed concern regarding deceptive selling efforts in the guise of “preliminary” approaches. So-called “preliminary” conversations would be deemed an “offering” if directed to ascertaining a willingness to accept an offer that might eventually be made. The administrative emphasis on the totality of circumstances was echoed by the first major judicial decision in this area. In SEC v. Sunbeam Gold Mines, the court deliberately avoided technical “public” versus “private” tests and instead emphasized “the purposes sought to be achieved by such distinction.”

In SEC v. Ralston Purina, the Supreme Court departed significantly from prior efforts to define “public offering.” The Court elected not to analyze the nature or breadth of solicitations, but to emphasize instead the qualitative characteristics of the offerees. According to the Court, a “public offering” was not determined necessarily by numbers or the method of offering, but rather by a consideration of whether any of the offerees was the type of potential investor for whom the registration process was intended. Thus, a face-to-face private negotiation could be a “public offering” if the potential investor did not have access to, or was not given, registration-type information. If a face-to-face private negotiation could produce a “public offering,” the SEC subsequently reasoned that a sales effort involving mailings, circulars or advertisements was a “public offering” a fortiori. Thus the SEC adopted a position after Ralston

35. Id.
36. Id.

I have very serious doubt whether, in many of those cases where it is stated that an offering is to be made only to an insubstantial number of persons, there may not be preliminary conversations for the purpose of ascertaining which of various possible purchasers would be willing to accept an offer of the security in question if it were made to them. Any such preliminary negotiations or conversations with a substantial number of prospective purchasers would, in my opinion, cause the offering in question to be a public offering, thereby necessitating prior registration of the security in question.

Id.
37. 95 F.2d 699 (9th Cir. 1938).
38. Id. at 701. “To determine the distinction between ‘public’ and ‘private’ in any particular context, it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction.” Id. The court found a “public offering” in the corporation’s solicitation of loans from its 530 stockholders through letters offering “shareholder loan receipts.” The decision was based on the large number of offerees and the lack of proof regarding their knowledge about the issuer. See id. at 702. The manner of offering, through letters to each offeree, did not appear to be a factor in the court’s determination.
40. Id. at 124-25.

The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those to which “there is no practical need for [the bill’s] application,” the applicability of § 4(1) should turn on whether the particular class of persons affected need 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.”

Id.
41. Id. at 127.
that public advertising of an offering was not appropriate when claiming a private offering exemption.\textsuperscript{41} The SEC has maintained this position, with varying explanatory embellishments, in subsequent rules.\textsuperscript{44}

The Commission's fixed non-solicitation rule was an over-reaction to the problems raised by \textit{Ralston Purina}. The Court quoted with approval the Ninth Circuit's admonition in \textit{Sunbeam Gold Mines}\textsuperscript{42} to examine the circumstances and purposes of the offering in the particular context.\textsuperscript{43} The stock offerings in \textit{Ralston Purina} involved hundreds of employees scattered throughout the country, many of whom received low salaries and lacked the ability to obtain meaningful disclosures. In such circumstances, the Court found "obvious opportunities for pressure and imposition."\textsuperscript{46} The Court's focus on the particular circumstances of the offering sharply contrasts with the SEC's elevation of the manner of offering factor to an inflexible and inviolable standard. Indeed, the Supreme Court specifically rejected the SEC's attempt in \textit{Ralston Purina} to promote the adoption of a strict rule for future application.\textsuperscript{47}

By administrative fiat, however, the SEC has succeeded in creating an impregnable rule against public solicitation which replaces a judgment based upon consideration of the circumstances of the case. Moreover, the SEC's blunt treatment permits no distinction among forms of solicitation; non-aggressive cautionary style is considered equally as noxious as the pressurized tactics that concerned the Court in \textit{Ralston Purina}. The issue should not be whether the single factor of general solicitation vitiates a section 4(2) exemption, but rather, under all of the circumstances, whether the solicitation rose to the level of an offer, and whether subsequent measures were taken to assure adequate disclosure and other safeguards prior to completion of the investment decision. Returning

\textsuperscript{43} See, e.g., id.

Negotiations 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.

\textit{Id.} Rule 146, 17 C.F.R. \textsection 230.146 (1981), establishing a safe harbor for \textsection 4(2) offerings, elaborated upon the advertising and solicitation prohibitions by listing forbidden forms of communication such as newspapers, radio and television broadcasts, promotional meetings, letters and circulars. Similar constraints in varying terms were set forth in Rules 240 and 242. In 1982, Rules 146, 240 and 242 were replaced by the provisions of Regulation D, 17 C.F.R. \textsection\textsection 230.501-.506 (1985). \textit{See infra} note 51.

\textsuperscript{44} 95 F.2d at 699.
\textsuperscript{45} 346 U.S. at 123-24.
\textsuperscript{46} 346 U.S. at 127.

\textsuperscript{47} The Commission would have us go one step further and hold that "an offering to a substantial number of the public" is not exempt under \textsection 4(1). . . . It may well be that offerings to a substantial number of persons would rarely be exempt . . . . But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation.

\textit{Id.} at 125. The SEC's argument was directed at the question of numbers rather than manner of solicitation, but the Court's avoidance of strict categorizations applies equally to each element of the private offering equation.
to the standards set in *Ralston Purina*, the SEC should place its regulatory emphasis on achieving the statutory purpose of investor protection.

**B. Exemptions in the Public Interest — Section 3(b)**

In recent years, Congress and the Commission have responded to concerns that small or developing companies need relief from the costly registration provision of the 1933 Act. Congress has raised the monetary limit on the Commission's authority to establish registration exemptions five times. The Commission reacted by increasing the aggregate limits of Regulation A offerings and issuing new rules under its expanded authority.

The pressure for regulatory exemptions culminated in the Commission’s adoption of Regulation D in 1982. Of particular interest to smaller companies was the adoption of Rule 504, which exempts from registration securities offerings not greater than $500,000. Rule 504 allows developing companies the


51. SEC Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251 (1982). Regulation D consists of Rules 501 through 506, 17 C.F.R. §§ 230.501-.506 (1985). Rule 504, which replaced Rule 240, see supra note 50, permits sales up to $500,000 to an unlimited number of purchasers. Rule 505, which replaced Rule 242, see supra note 50, permits sales up to $5,000,000 to not more than 35 purchasers, excluding accredited investors from the numerical limitation. Rule 506, which replaced Rule 146, see supra note 43, creates a § 4(2) safe harbor for sales to not more than 35 purchasers, also excluding accredited investors.


   (a) Exception. Offers and sales of securities that satisfy the conditions in paragraph (b) of this section by an issuer that is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act and that is not an investment company shall be exempt from the provisions of section 5 of the Act under section 3(b) of the Act.

   (b) Conditions to Be Met — (1) General Conditions. To qualify for exemption under this section offers and sales must satisfy the terms and conditions of §§ 230.501 through 230.503,
opportunity to raise capital without the expense or delay of federal registration. In particular, the rule freed such offerings from mandatory detailed disclosure requirements and from limitations on the number and level of sophistication of offerees or purchasers.

Had the SEC imposed no further constraint on Rule 504 offerings, capital generation by small companies would have been substantially facilitated without loss of adequate antifraud control. Unfortunately, the SEC subjected Rule 504 and other Regulation D offerings to a strict prohibition against any general solicitation or advertising. By imposing a constraint which simply reiterated prior regulatory policy, the Commission appeared to give little consideration to the serious negative effects of the prohibition on developing companies. The Release proposing adoption of Regulation D only briefly described the limitation on solicitation. The only justification given for the proposed rule was that its provisions were similar to those found in Rule 146(c). Curiously, while the Release indicated the SEC wanted to act under section 3(b) to alleviate the burdens placed on small businesses, its perfunctory adoption of a non-solicitation rule was drawn from an entirely different statutory context. Ironically, the prohibition considerably negates the salutary capital generating objectives otherwise promoted by the regulatory provisions.

except that the provisions of §§ 230.502(c) and (d) shall not apply to offers and sales of securities under this section that are made exclusively in one or more states each of which provides for the registration of the securities and requires the delivery of a disclosure document before sale and that are made in accordance with those state provisions.

(2) Specific Condition.—(i) Limitation on Aggregate Offering Price. The aggregate offering price for an offering of securities under this § 230.504, as defined in § 230.501(c), shall not exceed $500,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this section in reliance on any exemption under section 3(b) of the Act or in violation of section 5(a) of the Act.

53. Rule 504 offerings require no disclosure or disclosure format. Rule 505 offerings require disclosure of "the same kind of information as would be required in Part I of Form S-18" except for financial statements, 17 C.F.R. § 230.502(b)(2)(A) (1985). Rule 506 offerings require disclosure of the "same kind of information as would be required in Part I of a registration statement," except for audited financial statements that cannot be obtained "without unreasonable effort or expense." Id. § 230.502(b)(2)(B).

54. Both Rule 505 and Rule 506 limit the number of purchasers to 35 unaccredited persons plus an unlimited number of accredited persons. Rule 506 requires sophistication for non-accredited purchasers or their representatives. 17 C.F.R. § 230.506(b)(2)(ii) (1985) ("such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment").

55. 17 C.F.R. § 230.502(c) (1985); see supra note 10. The solicitation prohibitions do not apply if a solicitation is made under state securities laws is effected in each state where an offer is made and no sale of securities is made without delivery of a state-mandated disclosure document. 17 C.F.R. § 230.504(b)(1) (1985). The relief accorded by this provision is of little practical value, as most issuers that seek exemption from federal registration similarly seek to avoid state registration, since the latter also entails filing and review of a disclosure document, additional costs, delays and, in some instances, uncertainties related to the "merit review" standards of state law.


57. Id. at 41,791-92.

58. In footnote 30 of the release, the Commission "cautioned" issuers that offerings to large numbers of accredited investors may violate the general solicitation and advertising prohibition. Id.
In adopting Regulation D, the Commission was mindful of existing limitations on sales efforts by issuers. Significantly, Rule 506 abandoned "offeree" concerns. Former Rule 146, influenced by the "offeree" emphasis of section 4(2) litigation, required sophistication of both offerees and purchasers. By shifting the focus in Rule 506 entirely to purchasers, the SEC moved to a damnum sine injuria position. Thus, the private offering exemption is not lost simply because there happens to be a non-sophisticated offeree who does not purchase the security. If this moderation of rules was designed to avoid burdens on capital-raising where investor protection is unnecessary, it is difficult to understand why the strict rule against advertising or solicitation could not similarly be relaxed where other safeguards assure that investor interests have been satisfied.

The solicitation and advertising prohibitions for private and small offerings could have included safe harbor guidelines permitting limited preliminary contact between issuers or broker-dealers and potential investors. The terms "offer," "offeree," and "solicitation" could have been defined to exclude limited forms of communication. Neither the courts nor the Commission have chosen this course, perhaps fearing inability to control solicitation efforts. In view of the problems caused by existing policy limitations and the valid concerns of small issuers and broker-dealers, re-evaluation of judicial and administrative action is appropriate.

III. CREATING THE POOL OF POTENTIAL INVESTORS

A. Judicial and Administrative Limitations

The solicitation decisions of the courts and the Commission evidence a marked consistency. Since the emphasis on offeree protection in Ralston Purina, no offerings have been exempted from registration requirements when there was a hint of solicitation extending beyond the narrow confines of identified, knowledgeable investors. In Henderson v. Hayden Stone, Inc., the Fifth Circuit permitted at 41,799 n.30. This is a regulation with a vengeance, as the overall thrust of the Regulation D provisions is to permit accredited investors to fend for themselves. Offerings limited to accredited investors, for example, do not invoke the particular disclosure requirements of Rules 505 and 506. 17 C.F.R. § 230.502(b)(1)(i) (1985). The Commission did not repeat note 30 or its cautionary language in the release adopting Regulation D, SEC Securities Act Release No. 33-6389, supra note 51, but its position has remained constant that general solicitation must be avoided regardless of the nature of the recipients.

60. Rule 146(d), 17 C.F.R. § 230.146(d) (1981).
61. The pragmatic shift from offeree to purchaser concerns is nullified and the exemption lost if the Rule 502(c) prohibition on general solicitation is violated. Thus, the existence of non-purchasing offerees may continue to disqualify the Rule 506 exemption. This illustrates a primary fault of Rule 502(c); it applies even in situations of non-productive solicitations, thus raising potential liability for the broker-dealer in scenario three. See supra text accompanying note 13.
62. 346 U.S. at 119.
63. 461 F.2d 1069 (5th Cir. 1972).
an admittedly sophisticated investor\textsuperscript{64} to rescind his transaction because the defendants could not establish the identity of each of the other persons who might have received an offer. The court reasoned that since solicitation might have extended to non-qualified offerees, even plaintiff's purchase was not exempt from registration requirements.\textsuperscript{65} Similarly, the Fourth Circuit held invalid a company's solicitation limited to its customers, stressing the possible lack of financial sophistication of the offerees.\textsuperscript{66}

Meticulous controls and recordkeeping as to each offeree helped sustain a Rule 146 private placement in \textit{Mary S. Krech Trust v. Lakes Apartments}.\textsuperscript{67} This decision provides little comfort to small companies, however, because the issuer relied extensively on a major brokerage firm contacting its knowledgeable and wealthy investor clientele.\textsuperscript{68} Companies without access to such broker-dealers, whether because of size or risk of the offering, are more likely to begin their search for investors within a broader pool that may unintentionally include persons of limited financial experience.

Relief from the tight constraints of the non-solicitation rules might be available if courts construed "offer" and "solicitation of an offer" in a manner analogous to, although not identical with, their meaning in contract law.\textsuperscript{69} Thus, an "offer" for securities law purposes might be limited to circumstances where the "offeree" could accept and create a binding commitment without further action by either party.\textsuperscript{70} Such a standard, however, would not provide sufficient

\textsuperscript{64} "Mr. Henderson can only be described as a sophisticated investor." \textit{Id.} at 1071.

\textsuperscript{65} \textit{Id.} at 1071-72; \textit{accord} Doran \textit{v.} Petroleum Mgt. Corp., 545 F.2d 893 (5th Cir. 1977); SEC \textit{v.} Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).

\textsuperscript{66} SEC \textit{v.} Tax Serv., Inc., 357 F.2d 143 (4th Cir. 1966). The issuer, a publisher of tax materials, sought to offer shares to the approximately 800 purchasers or subscribers of its publications. The offer was subsequently extended to certain attorneys who were neither purchasers nor subscribers. The court made no distinction between the groups of offerees, concluding: "The mere fact that the offerees were attorneys or subscribers ... has no bearing on the critical question respecting the offerees' access to the kind of information which would be made available to them by registration." \textit{Id.} at 144; \textit{see also} SEC No-Action Letter, Mineral Lands Research \& Mktg. Corp., available Dec. 4, 1985.

\textsuperscript{67} 642 F.2d 98 (5th Cir. 1981).

\textsuperscript{68} \textit{Id.} at 102. The court was also influenced by the fact that none of the offerees was determined except by examination of responses to an offeree questionnaire setting forth information as to net worth and financial sophistication. "These offeree questionaires [sic] were reviewed by Mr. Gary [vice-president of the issuer], and only those persons to whom he was willing to sell were given offers." \textit{Id.} at 103. The court's apparent willingness to distinguish between initial contact and "offer" was not essential to its holding. \textit{See infra} note 71.

\textsuperscript{69} The contract law analogy was rejected in Feitler \textit{v.} Midas Assoc., 418 F. Supp. 735 (E.D. Wis. 1976), construing similar statutory language in the Wisconsin Uniform Securities Law. \textit{See also} SEC \textit{v.} Starmont, 31 F. Supp. 264, 266 (E.D. Wash. 1940) ("Indication of Possible Acceptance" signed by potential investors held an offer under the 1933 Act).

\textsuperscript{70} A. \textsc{Corbin}, \textsc{Corbin on Contracts} § 11 (1963) (footnote omitted):

What kind of act creates a power of acceptance and is therefore an offer? ... It must be an act that leads the offeree reasonably to believe that a power to create a contract is conferred upon him. ... It is on this ground that we must exclude invitations to deal or acts of mere preliminary negotiation. ... So long as it is reasonably apparent that some further act of the offeror is necessary, the offeree has no power to create contractual relations by an act of his own, and there is as yet no operative offer.
protection against puffery and misleading statements occurring in the preliminary, “non-offering” phase. Therefore, analogy to the contract standard would be appropriate only where the initial communication makes it abundantly clear that the potential investor cannot purchase the security without receiving further disclosure of material terms. Unfortunately, confining the statutory terms in such manner has been a road not taken.

Except for several relatively ambiguous references,\footnote{71} case law does not distinguish between preliminary contacts and offers. The Commission, however, has addressed this issue aggressively. A proposed advertisement by an issuer, which made no reference to specific securities and asked only that readers who “want to find out more” make written inquiry, was regarded by the SEC as an improper “first step” in the offer and sale of securities.\footnote{72} Similarly, an institutional advertisement by a syndicator of limited partnerships, which made no reference to a specific offering and asked readers to call or write for more information, was regarded by the SEC as “an offer even at a time when securities are not being sold if the syndicator expects in the near future to offer and sell securities.”\footnote{73} A tombstone advertisement\footnote{74} indicating completion of a

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\textit{Accord I. S. Williston, A Treatise on the Law of Contracts § 27 (3d ed. 1957) (footnote omitted):}

\begin{quote}
Frequently negotiations for a contract are begun between parties by general expressions of willingness to enter into a bargain upon stated terms and yet the natural construction of the words and conduct of the parties is rather that they are inviting offers, or suggesting the terms of a possible future bargain, than making positive offers.
\end{quote}

\textit{71. In SEC v. Freeman, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,361 (N.D. Ill. Mar. 3, 1978), defendants sought to establish a § 4(2) private offering exemption despite the use of newspaper advertisements that “equity positions” were available. In denying summary judgment to the defendants, the court noted: “This apparent pattern of soliciting offerees from among the public casts grave doubt on the claim that all offerees were qualified, even if the advertising of ‘equity positions’ is not itself considered to be an offer.” Id. at 93,243 (emphasis added). A similar distinction between communication and an offering was indicated in Mary S. Krech Trust v. Lakes Apts., 642 F.2d at 98. A private offering exemption was permitted on the basis of a questionnaire filled out by interested investors who were subsequently made offers based upon the qualifying information so disclosed. Id. at 102-03. Neither of these cases analyzed whether or to what extent preliminary communications might differ from the “offer” concept of the 1933 Act.}


\begin{quote}
As you recognize, such advertisements may attract individual private investors as well as issuers. The question whether such a response will entail the offer or sale of securities to particular investors in a manner prohibited by Rule 146(c) remains a factual question which will be governed by the special facts and circumstances of each situation. \footnote{Id. at 2.}
\end{quote}

\textit{74. A “tombstone advertisement” is the securities industry’s term for the limited form of}
particular private placement was approved only on the condition that the advertisement would not enhance any current or contemplated offerings.\textsuperscript{75}

The judicial and administrative responses to the "offering" concept provide little room for maneuvering by companies or broker-dealers who do not have ready access to large lists of qualified investors. Current limitations permit potential investors to be contacted through general interest inquiries, provided such contacts are made considerably prior to the commencement of an offering.\textsuperscript{76} Such planning activity is much more likely to be undertaken by well-established broker-dealers than by small companies.\textsuperscript{77} Once an offering is contemplated or begun, solicitations become limited to persons with whom the issuer or broker has pre-existing business relationships.\textsuperscript{78}

The SEC's response to the 1977 Borden no-action request illustrates the breadth of its position.\textsuperscript{79} During the pendency of a Rule 146 offering, the issuer planned to enlarge its list of qualified offerees by mailing offering circulars to its known list of offerees and asking the recipients to compile a list of additional qualified offerees. The issuer would then decide whether it was appropriate to send offering materials to additional persons so listed. Despite the fact that solicitation was to be limited to qualified offerees as defined by Rule 146(d), the SEC determined that the mailing would violate the solicitation provisions

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\textsuperscript{77} Broker-dealers and syndicators whose businesses involve a fairly regular stream of private placement offerings may, through advance planning, alleviate the strictures of the non-solicitation rules by developing lists of potential, pre-deared investors obtained through general interest inquiries and questionnaires. The SEC conditions approval of solicitation from such lists on such persons not being subjected to any securities offering in progress or contemplated at the time of initial contact and information-gathering. SEC No-Action Letter, Bateman Eichler, available Dec. 3, 1985, reported in 17 SEC. REG. & L. REP. (BNA) No. 50, at 2193-94 (Dec. 20, 1985).
\textsuperscript{78} SEC No-Action Letter, Woodtrails-Seattle, Ltd., available Aug. 9, 1982, [1982-1983 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 77,342. The proposed sale of limited partnership interests under Rule 505 was to be made by written offer to approximately 330 persons who had previously invested in other limited partnerships sponsored by the general partner over a three-year period. Both the inquiry and staff reply pointed out that the issuer believed each of the proposed offerees was knowledgeable in business matters and capable of evaluating the risks of the proposed investment. Id. at 78,285. All of the issuer's prior offerings had been pursuant to Rule 146, for which the sophistication standard was required. Rule 505, however, does not contain a similar requirement. It is unclear why the issuer and the SEC believed it appropriate to point out the sophistication of the offerees unless sophistication is a necessary element for permissible solicitation along with a pre-existing business relationship. If that is the SEC's position, offers under Rule 505 may be made to anyone, but written communications that amount to "general solicitation" may be made only to sophisticated investors with a prior relationship to the offeror. The SEC supported this position in two recent no-action letters. These staff replies stressed that the establishment of a prior relationship is satisfied only if the broker-dealer or issuer receives sufficient information from the potential investor to evaluate the individual's sophistication and financial circumstances. SEC No-Action Letter, E.F. Hutton & Co., available Dec. 3, 1985; SEC No-Action Letter, Bateman Eichler, supra note 77; see infra text accompanying notes 92-93.
of Rule 146(c). The result created a major setback to efforts by companies and brokers seeking to identify potential offerees once an offering was underway.

As an alternative to focusing on the "offering" concept, the SEC could also have chosen to examine the sophistication and knowledge of the solicited potential investors. Private offering litigation has often dealt with the issue of whether particular offerees need the protection of the Act. Additionally, section 3(b) speaks in terms of public interest and the necessity of investor protection. Yet, offeree identity is a forgotten, irrelevant factor in the SEC application of its non-solicitation rules. The SEC has indicated that the non-solicitation rules apply even to solicitation directed only at accredited investors. Thus, a newsletter financed by an issuer and sent only to accredited investors did not pass Rule 502(c) muster. Likewise, limited partnership advertisements directed solely to potential tenants of a building constituting the partnership's primary asset also violated Rule 502(c).

Advertisements directed to the managers of pension and profit-sharing plans, unquestionably a sophisticated group of potential investors, received a negative SEC response under its solicitation rules, as did an issuer's intended purchase and use of a list of accredited investors.

The cumulative effect of administrative responses is to limit solicitation to a distinct group of sophisticated persons with whom the issuer or broker-dealer enjoys a pre-existing business relationship. The "pre-existing relationship" qualification has been imposed by the SEC through interpretation of its own rules. It is questionable whether this significant, substantive modification has been

80. "[A] permitted communication must not only be directed to a qualified offeree but must also be directed to him in his capacity as offeree, rather than in his capacity as an intermediary who is asked to locate other qualified offerees." Id. at 88,597.

81. Interpretive Release on Regulation D, SEC Securities Act Release No. 33-6455, 48 Fed. Reg. 10,045, ¶ 60, at 10,052 (1983). Curiously, former Rule 146(c) permitted exceptions to its non-solicitation rule for (1) seminars or meetings where each person invited was a qualified offeree or was accompanied by an offeree representative, and (2) letters or other communication addressed solely to qualified offerees. 17 C.F.R. § 230.146(c)(2)-(3) (1981). In adopting Regulation D, which replaced Rule 146, the SEC did not explain why the exceptions were not continued at least for Rule 506 offerings. See SEC Securities Act Release No. 33-6389, supra note 51.

82. SEC No-Action Letter, Texas Investor Newsletter, available Jan. 23, 1984. A newsletter analyzing intrastate private offerings, directed solely to accountants and lawyers in the state of Louisiana, prepared by attorneys, accountants and an investment adviser, also failed to receive SEC approval, despite the fact that none of the newsletter participants was affiliated with or an investor in any of the issuers described. SEC No-Action Letter, Tax Inv. Information Corp., available Feb. 7, 1983, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,379. The staff set forth its reasoning in SEC Securities Act Release No. 33-6455, supra note 81, at 10,052: "Although Regulation D does not directly prohibit such a third party publication, the staff refused to agree that such a publication would be permitted under Regulation D because of its susceptibility to use by participants in an offering." This incomplete explanation fails to delineate the harm or potential dangers that "use by participants" would entail.


appropriately adopted through interpretive release, rather than being subjected to the statutory rulemaking process.\(^{26}\)

Case law does not appear as riveted to the requirement of a pre-existing business relationship, although several decisions upholding private offering exemptions have stressed this factor. In *Woodward v. Wright*,\(^{87}\) for example, the Tenth Circuit in upholding a private offering noted that ""the whole transaction was a closely knit arrangement among friends and acquaintances, and was conducted on a personal basis.""\(^{90}\) In *Garfield v. Strain*,\(^{89}\) the same court again upheld a private offering and observed that one important factor in the decision was the ""close relationship and past dealings"" of the parties.\(^{90}\)

In *Doran v. Petroleum Management Corp.*,\(^{91}\) however, where the Fifth Circuit discussed at length the elements of the private offering exemption, the court made no reference to a pre-existing relationship between the offerees and the issuer. Rather, the discussion regarding the offeree-issuer relationship dealt solely with access to information. It was not the pre-existing relationship between the parties that was critical in private offerings, but rather the impact which the relationship or lack of relationship had on the disclosure process.\(^{92}\) The *Doran* court’s emphasis on disclosure demonstrates an appropriate return to the fundamental concern for investor protection rather than reliance upon a relationship factor that may be irrelevant for investor protection purposes.

The SEC requirement limiting solicitation to a pre-existing business relationship pool is not only unduly burdensome but suffers from narrow application. For example, the SEC is unlikely to find that a sufficient relationship exists between a company and its principal suppliers and customers, although such individuals may have a thorough knowledge of the nature of the business and its financial condition. Thus far the SEC has permitted issuers to solicit only pre-existing investors.\(^{93}\)

If the concern is one of enticement, however, pre-existing knowledge acquired through means other than investment should suffice. Moreover, under SEC guidelines, even a pre-existing relationship does not permit general solicitation unless the relationship provides the broker-dealer or issuer with sufficient information\(^{94}\) to determine the offeree’s sophistication and financial circumstan-

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86. At issue is the extent to which formal rulemaking procedures may be avoided through administrative interpretation of existing rules. The uncertain yet significant scope of the ""pre-existing relationship"" requirement raises such an issue. The author is indebted for this point to Linda Wertheimer, Esq., of Dallas, Texas, who raised the issue during discussion of Regulation D at the March 1985 meeting of the Corporation, Banking and Business Law Section of the American Bar Association in Los Angeles, California.

87. 266 F.2d 108 (10th Cir. 1959).
88. Id. at 115.
89. 320 F.2d 116 (10th Cir. 1963).
90. Id. at 119; accord Collier v. Mikel Drilling Co., 183 F. Supp. 104 (D. Minn. 1958) (purchasers were all long-time friends and associates); Campbell v. Degenther, 97 F. Supp. 975 (W.D. Pa. 1951) (offering limited to participants in prior, similar offerings).
91. 545 F.2d 893 (5th Cir. 1977).
92. Id. at 902-04.
94. In two recent no-action letters the SEC doubted whether the questionnaires submitted
ces. Thus, a proposed solicitation of business clients of the issuer’s officer raised Commission concern about possible non-sophistication of the offerees. Requiring this additional element of sophistication incorporates into small offering exemptions the section 4(2) concern regarding the identity of offerees. The merging of section 3(b) and section 4(2) concerns serves only to further inhibit the congressional purpose of facilitating small company financing.

B. Internal Problems of Rule Interpretation

No less problematic are the two subsections of Rule 502(c) which set forth examples of forbidden solicitation and advertising. Subsection (1), which prohibits any communication through public media, relies totally on form rather than content. Under subsection (1), if the advertisement or notice is arguably related to a securities offering, then the content of the notice, the recipient, and other factors pertinent to the fundamental issue of investor protection become irrelevant. Indeed, the breadth of subsection (1) has allowed the SEC to go so far as to question product advertising occurring prior to or during a stock offering. The provision has also been applied to newsletters describing private placements distributed by subscription to attorneys and accountants within a single state which are prepared by third parties not controlled by or affiliated with the issuers. While the Commission’s vigilance is admirable, it comes at a very high price. In view of the legitimate needs of small businesses for capital, and the potential first amendment considerations, the SEC seemingly could have adopted more modest limitations.
Subsection (2) of Rule 502(c) addresses the problem of seminars and group meetings. Experience supports a genuine concern about slick, pressurized selling tactics that may occur at such gatherings. However, Rule 502(c) proscribes such meetings and seminars only when the attendees have been invited by general solicitation or advertising. The SEC does not object to meetings per se, but rather to the method of attracting those who attend. This is a curious and confusing position. Under Rule 502(c), representatives of an issuer may meet with persons introduced through mutual acquaintances or attracted to the issuer through means other than general solicitation or advertising. In those circumstances, the issuer and the potential investor probably will be total strangers. Moreover, nothing in Rule 502(c) precludes the issuer from meeting with several persons at a joint meeting. But, should several persons be attracted to a meeting by reason of a general notice, the forbidden line would be crossed. Again, the SEC focuses on form only. Two group meetings with strangers, identical in substance and disclosure, may result in different applications of a small offering exemption. Fraud unquestionably may occur in group meetings, but it is the element of disclosure that should concern the SEC, not the form or manner of gathering.

More troublesome than the breadth and severity of the non-solicitation doctrine is its warping of the fundamental objectives of securities laws. The Securities Act seeks to prevent fraud and protect potential investors by requiring full disclosure of material information. The manner of offering is important in determining how investors were attracted to the offer and whether the means create disclosure concerns. Thus, early administrative analysis regarded solicitation as one of several elements to consider in determining the availability of a private offering exemption.

Such a position did not suggest that the manner of offering become a sole, dispositive criterion. Rather, the manner would constitute one element to be considered as part of the whole. The SEC's rigidified, inflexible standard now seen in Rule 502(c) left no substance either to the Supreme Court's admo-

100. Rule 502(c)(2), 17 C.F.R. § 230.502(c)(2) (1985) (prohibiting "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising"); see supra note 10.

101. See, e.g., SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974). The principal design of the meetings is to foster an illusion of affluence. Investors and Koscot employees are instructed to drive to meetings in expensive cars, preferably Cadillacs, to dress expensively, and to flaunt large amounts of money. It is intended that prospects will be galvanized into signing a contract by these ostentations displayed in the evangelical atmosphere of the meetings.

Id. at 476.

102. See supra text accompanying notes 33-36.

103. See supra note 10. The proposed Federal Securities Code developed by the American Law Institute retained a limitation against "general advertising" for limited offerings but, "because the concept of 'general advertising' is inherently vague," the provision was not a condition of the exemption. Violation would subject the issuer to "the usual public sanctions," but would not impose absolute civil liability for rescission or damages as in § 12(1) of the 1933 Act. Federal Securities Code § 227(b) comment 2(b) (Tent. Draft No. 1, 1972). This compromise position would also be unsatisfactory, for it would retain without adequate analysis an ambiguous, blanket
nition to analyze the circumstances of each case, or to the legislative policy to permit avoidance of the burdens of registration where investor protection does not otherwise demand. The non-solicitation rules have thus broken loose from the moorings of the fundamental statutory concerns of disclosure and prevention of fraud.

C. First Amendment Concerns

In addition to policy concerns, the restraints on communication raise first amendment questions. While courts have allowed appropriate regulation of commercial speech, the scope of the Commission’s non-solicitation rules may prove too restrictive to survive constitutional scrutiny. The rules create a classic prior restraint and preclude companies and broker-dealers from informing the public of even the existence of an offering. This restraint is far more restrictive than the pre-clearance provisions for proxy and registration statements, which justify prior restraint only on grounds of inadequate disclosure. Rule 502(c), however, permits no communication falling within the ambiguous range of general solicitation or advertising, regardless of content, recipient, effect or intended result.

Recent cases have expanded the arena of corporate speech and have delimited the SEC’s ability to regulate forms of investment advice. In one recent case regarding proxy regulations, the trial court noted that a constitutional presumption existed against statutes that paternalistically regulated commercial prohibition and would continue to subject issuers to the risks of unspecified “public sanctions” should hazy lines be crossed. Removing the prohibition as a condition of the exemption is appealing, but a more specific foundation should be created in defining the parameters of solicitation and advertising.

104. See supra text accompanying note 45.

105. Commercial speech involves “expression related solely to the economic interests of the speaker and its audience.” Central Hudson Gas & Elec. Corp. v. Public Serv. Comm’n, 447 U.S. 557, 561 (1980). In Valentine v. Chrestensen, 316 U.S. 52 (1942), the Supreme Court refused to recognize any first amendment protection for such speech, a position it overruled 34 years later in Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748 (1976). In invalidating a state statute prohibiting advertising of prescription drug prices, the Court rejected the “highly paternalistic” view that government power extends to the control and suppression of commercial speech. 425 U.S. at 770. In Central Hudson, the Court developed a four-part test to analyze regulation of commercial speech. The advertisement must not be misleading or deceptive; the government regulation must promote a substantial government interest; the regulation must directly advance that interest; and the regulation must be no more extensive than is necessary to serve the government interest. 447 U.S. at 563-66.

106. 17 C.F.R. § 240.14a-9(a) (1985) prohibits proxy solicitation “which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading. . .”

107. See supra note 3.


free speech for the "good" of the people." Although none of these cases
provides controlling precedent for an argument that the non-solicitation rules
are constitutionally infirm, the cases reflect developing doctrine that regulation
of commercial speech has its limitations.

Coincidentally, three of the leading Supreme Court decisions invalidating
restraints involved statutory limitations on advertising. None of the cases
involved securities, a field whose history of abusive tactics seemingly justifies
substantial controls on communication. Despite the historical justification, how-
ever, regulation must directly advance the asserted interest and cannot be more
extensive than necessary to serve that interest. If rigid rule application cannot
be based on justifiable investor protection concerns, or if such concerns can be
met by less intrusive means, grounds exist for suspecting the continued validity
of sweeping restraints on communication.

A recent SEC staff response to a no-action letter request by a corporation
proposing to publish an investment newsletter illustrates the breadth of the
Commission's impact on commercial communication. The newsletter would have
described closely-held business which expected, in the indefinite future, to be

F.2d 793 (2d Cir. 1985). The district court ruled an advertisement critical of the plaintiff's man-
gagement published in several New York area newspapers was not a proxy solicitation. Id. The
Second Circuit reversed based in part on the district court's abuse of discretion in limiting discovery
and in part on interpretation of the SEC's proxy solicitation rules. Long Island Lighting Co. v.
Barbash, 779 F.2d 793, 795-96 (2d Cir. 1985). The appellate court found it "unnecessary to express
an opinion on any claim of privilege under the First Amendment" pending resolution of the
solicitation issue on remand. Id. at 796.

The SEC proposal to expand the definition of "solicitation" in the proxy context, 17 C.F.R.
(1985), has been criticized by American Bar Association representatives on first amendment grounds
for potential stifling of communications between shareholders and management. 18 SEC. REG. &
L. REP. (BNA) No. 15, at 529 (Apr. 11, 1986). The current provision defines solicitation as a
communication "reasonably calculated to result in the procurement, withholding or revocation of a
proxy." 17 C.F.R. § 240.14a-1(f) (iii). The proposed definition adds the phrase "or which rea-
sonably could be expected to affect" such proxy matters. 50 Fed. Reg. at 29,411.

(advertising to promote the use of electricity); Linmark Assocs. v. Willingboro, 431 U.S. 85 (1977)
(posting of real estate "For Sale" signs); Virginia State Bd. of Pharmacy v. Virginia Citizens

(1980); see supra note 105. In an article addressing advertising limitations solely in the context of
registered offerings, Michael Schoeman concludes that the Supreme Court's extension of first amend-
ment protection to commercial speech requires a re-examination of governmental regulation of
advertising. Schoeman, The First Amendment and Restrictions on Advertising of Securities Under the Securities
Act of 1933, 41 BUS. LAW. 377, 392 (1986). "In the advertising of securities . . . there is a public
interest in the free flow of information, an interest that is disserved by the restrictions on ad-
vertising." Id.; see also Farber, Commercial Speech and First Amendment Theory, 74 NW. U.L. REV. 372
(1979) (contrasting the informative function of commercial speech, deserving of protection, from
the contractual function, which may be appropriately regulated).

113. SEC No-Action Letter, J.D. Manning, Inc., available Feb. 27, 1986, reported in 18 SEC.
raising capital through one or more exempt securities offerings. The newsletter, to be sent only to subscribers, would focus on companies within a limited geographic locale.114 Companies choosing to be described would pay a fee for three months of publication, which would set forth in not more than twelve lines the business, its financial history, and the estimated amount of capital the company might eventually seek. Each company would submit to the newsletter a written representation that it was not then offering securities and did not plan to offer securities during the newsletter's publication period.115 The newsletter would offer no investment advice on any of the described companies.

In denying the newsletter's request for a no-action letter under the general solicitation provisions of Regulation D, the SEC staff's reply set forth a laundry list of concerns, including: Rule 502(c) of Regulation D, the "offering" concept of section 2(3),116 and the "prospectus" rules of section 2(10).117 Yet no explanation or reasoning was provided.118 Viewing the proposed newsletter as an effort to bring potential investment opportunities to the attention of interested subscribers, and accepting in good faith the assertion that the company descriptions would not run concurrent with securities offerings, and, finally, having confidence in the capabilities of anti-fraud enforcement should problems of timing or deception arise, there is little reason, other than pure formalism, to stifle the proposed communications. Indeed, the market should be encouraging publication of precisely these kinds of documented and verifiable data. The chilling effect on newsletters not associated with issuers and not engaged in brokering

114. At first, the geographic limit was to be central and southwest Florida. Id.

115. It is not clear whether the company was required to state that it would not sell any securities during such period. No doubt the possibility of sales weighed heavier with the SEC staff than the company's professed intent against offers.

116. See supra note 23.

117. See infra text accompanying notes 121-22. The staff response also hinted that the newsletter might be considered an underwriter or dealer. A similarly negative SEC reaction to a proposed investment newsletter is contained in SEC No-Action Letter, Tax Inv. Information Corp., supra note 82.

The impact of the SEC's strict position is further illustrated in SEC No-Action Letter, Venture Capital Exchange, available Apr. 23, 1986, reported in 18 Sec. Reg. & L. Rep. (BNA) No. 20, at 730 (May 16, 1986). A not-for-profit matching service run by the University of Tulsa provided an introductory match between potential investors and private companies in Oklahoma. The SEC staff determined that the service did not require registration under either the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1982), or the broker-dealer provisions of the 1934 Act. However, the staff added the cautionary statement that "it appears that your service may raise an issue under Rule 502(c)," regarding general solicitation by issuers engaged in Regulation D transactions. Id. That caveat made the otherwise favorable no-action letter less significant. Given the strictures of SEC interpretation of Rule 502(c), the newsletter may choose not to run the gauntlet as a potential accessory to a series of 1933 Act registration violations.

118. The entire response on the issues raised stated:

Under these facts it appears that an offer, within the purview of § 2(3) of the Securities Act, of the participating businesses' securities may be involved, consequently we are unable to conclude that there would be no general solicitation for purposes of Rule 502(c). For this same reason, the Company's newsletter could be deemed to be a prospectus as defined by § 2(10) of the Securities Act.

activities reduces rather than expands the disclosure opportunities available to potential investors. No clear commensurate benefits are gained by such restrictions. If the disclosures are or tend to be misleading, adequate remedies exist under section 12(2) of the 1933 Act and Rule 10b-5 of the 1934 Act. SEC actions which drive potential offering efforts underground lead inevitably to both an underinformed and an unequally informed investing community.

IV. Room To Breathe: Proposed Grounds for Modification

Reformers will seek in vain for clues signaling that either the courts or the Commission is prepared to loosen significantly the taut reins of the non-solicitation rules. Any relaxation which might occur will not be the result of applied precedent. Reform will come only after recognition that current standards or interpretations are no longer appropriate. The SEC has, in other contexts, proven its willingness to undertake a volte-face. Here, the continued affirmation of its position through restrictive interpretations and no-action letters suggests that no near-term revolution is at hand. Yet, substantial ground for reconsideration exists. The starting point is recognizing that serious capital raising problems exist for small companies and their brokers, that costly registration cannot continue as the short and unsatisfactory answer, that application of strict and inflexible standards may be inconsistent with the statutory and regulatory objectives, and that a modification of the solicitation rules can be achieved without loss of investor protection. Recognition of these premises by the courts and Commission provides an essential predicate to a reform which will revitalize the "statutory purpose" rationale of Ralston Purina. Appropriate questions are the following:

A. Has an Offer or Solicitation Been Made?

Justifiable concern persists over whether potential investors will be unduly influenced by solicitation methods, the effects of which will not be overcome later by simple receipt of a disclosure document. The appropriate response, however, is not a complete ban on solicitation, but rather an analysis of whether effective controls can be established which preserve both capital financing and investor interests. The most fundamental response would be to consider whether any circumstances exist under which approaching or contacting a potential investor would not be regarded as an "offer" or "solicitation."

Nothing in the securities laws prevents the SEC from establishing reasonable guidelines to distinguish permissible from impermissible solicitation. The 1933

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119. A clear example of the SEC's rejection of its prior position came in the adoption of Rule 145, 17 C.F.R. ¶ 230.145 (1985), reversing its interpretation that certain reorganizations taken through shareholder vote did not involve the "sale" of securities. SEC Securities Act Release No. 33-5316, 37 Fed. Reg. 23,631, at 23,636 (1972). In rescinding its prior Rule 133 and adopting Rule 145, the Commission noted: "Administrative agencies as well as courts from time to time change their interpretation of statutory provisions in light of reexamination, new considerations, or changing conditions which indicate that earlier interpretations are no longer in keeping with the statutory objectives." Id. at 23,632.

120. 346 U.S. at 119.
Act exempts from its definition of "prospectus" advertisements or other communications containing information limited to the identity of the issuer, the price of the offering, and other matters that may be permitted by the Commission. Indeed, the Commission has expanded the list of permitted "tombstone" disclosures to include a brief indication of the issuer's general type of business.

Although the statutory provision for such limited advertising applies solely to registered offerings, the SEC has adopted similar standards for the advertising of oil and gas offerings exempt from registration under Regulation B. The

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121. 15 U.S.C. § 77b(10) (1982). The Commission's authority under § 2(10), 15 U.S.C. § 77b(10) (1982), to determine the parameters of such limited advertising was added to the Act in 1954. Act of Aug. 10, 1954, Pub. L. No. 577, 68 Stat. 683. Advertising was not viewed with alarm by the Senate draftsmen of the 1933 Act. The Senate bill contained express permission for advertising of any kind of offering, information to include a brief description of the security, its price, the issuer's assets, liabilities, profits and losses, and a reference to additional information being contained in the registration statement. S. 875, 73rd Cong., 1st Sess. § 8 (1933). Indeed, the practical concerns of advertising were specifically addressed in § 8(f):

[I]n any case where, by reason of limited size of such written, printed or other graphic or radio communications, it is impractical to set forth all the foregoing information, there shall be set forth such parts thereof or such other information as the Commission may by rules or regulations prescribe . . . . The Senate hearings reflected no adverse reaction to the advertising provisions, except comments from newspapers as to the amount of space the advertising would take. Hearings on S. 875 Before The Senate Comm. on Banking and Currency, 73rd Cong., 1st Sess. 251 (1933). The Senate bill was substantially replaced upon final adoption by the House version, see supra note 27, which restricted advertising to registered offerings. H.R. Rep. No. 5480, 73rd Cong., 1st Sess. § 2(10) (1933).


It follows from the express language and the legislative history of the Securities Act that an issuer, underwriter or dealer may not legally begin a public offering or initiate a public sales campaign prior to the filing of a registration statement. It apparently is not generally understood, however, that the publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort. Id. at 8359.

123. 17 C.F.R. § 230.318(a) (1985):

Any written advertisement or other written communication, or any radio or television broadcast, which states from whom an offering sheet meeting the requirements of this Regulation B (§§ 230.300-230.346) may be obtained and, in addition, contains no more than the following information, may be published, or broadcast at or after the commencement of the public offering to any person prior to sending or giving such person a copy of the offering sheet:

(1) The name of the offeror of the interests;
(2) The identity or type of the interests to be offered;
(3) The number of such interests to be offered;
(4) The location (county and state) of the tract or tracts involved;
(5) The price of the interest to be offered; or
(6) The type of well to be drilled, such as an exploratory or developmental well.
Commission has also sanctioned a controlled form of advertising in response to the problem of intrastate offerings advertised in newspapers distributed across state lines. These advertisements are not regarded as offers to out-of-state residents if they explicitly restrict offers and sales to residents of the particular state involved.

The securities laws can tolerate a limited form of solicitation and advertisement if carefully controlled. A communication should not be regarded as an offer, general solicitation, or advertisement if it does no more than provide the following information: the identity of the issuer, the nature and price of the security, the aggregate number of securities to be sold, a brief indication of the issuer's business, the issuer's principal place of business, the method for obtaining further information, and a statement that no offer or sale of the security will be made without additional disclosure. This limited form of communication could be regarded as outside the statutory references to "offer" and "solicitation of an offer," and similarly outside the administrative scope of the non-solicitation rule. The broad statutory definition of "offer," arguably extending to any advertisement or circular regarding the sale of securities, need not be maximized if reasonable interpretation would satisfy the concerns.


125. SEC Securities Act Release No. 33-4434, 26 Fed. Reg. 11,896 (1961). Analogous approval was given in SEC No-Action Letter, Elwill Dev. Ltd., available Aug. 14, 1974, for a newspaper advertisement of a private placement where the shares were to be sold in a block to a single, sophisticated purchaser. The SEC conditioned approval on the advertisement stating that (1) the securities may be sold to only one individual purchaser for his own account and not as a representative of purchasers other than himself and (2) the purchaser may not resell the securities publicly without compliance with the registration provision of the Act.

126. If the Commission were to act by rule, it might consider requiring a statement in boldface type, similar to the disclaimer required for tombstone advertisements, that the securities may not be sold nor may offers to buy be accepted prior to the time that a written disclosure statement is delivered to the potential investor. Cf. 17 C.F.R. §230.134(b)(1) (1985) (limited advertising allowed where registration not yet effective).

127. 15 U.S.C. §77b(3) (1982). The statutory definition specifically excludes from coverage "preliminary negotiations or agreements between an issuer...and any underwriter." At least one court has held, under principles of statutory interpretation, that the concept of "offer" was intended to include preliminary negotiations between an issuer and anyone other than an underwriter. SEC v. Starmont, 31 F. Supp. 264, 267 (E.D. Wash. 1940). The court's reasoning is problematic. The exception was not intended to equate all forms of preliminary negotiations with "offers" or "solicitation of an offer," as the provision could simply have been drafted to include preliminary negotiations as an explicit form of "offer" or "solicitation." The exception deals with the common industry practice of negotiations between issuers and underwriters that generally occur prior to the development of any offering documents. In order to assure that such negotiations, particularly for firm commitment underwritings, not be burdened with concerns of potential violation of the registration provisions, a specific exception was inserted. The term "preliminary negotiations" covers all aspects of bargaining with underwriters up to the moment of commitment, including the exact price for which the underwriter is willing to purchase the securities. These preliminary negotiations would be substantially different from initial contacts an issuer might make to determine the interest of potential investors.
for investors by permitting carefully limited statements and preliminary contacts.\footnote{A major concern for courts and the SEC involves oral solicitations for which no written documents have been previously furnished. The anti-solicitation rules reflect appropriate concern that widespread "hawking" of securities is contrary to the best interests of potential investors. The limited form of communication proposed in this article is addressed to the written form of communication. Where oral solicitation is used, analogous limitations could well apply. Thus, oral discussion that stays within the narrow confines of limited description should be tolerated, provided that no offer is sought or accepted until further and full disclosure has been made. The problems of proof will be difficult for the company or broker seeking to establish the exemption. If the solicitation rules were relaxed to permit limited communications as proposed, written communications may become the preferred form.}

In considering section 4(2) private placements, where offeree qualifications are relevant, the limited communication should include the statement that no offer to purchase will be made except to those who meet qualification standards as determined by the issuer. This announcement would further detract from the characterization of the solicitation as a "public offering" and substantially limit the impact of an advertisement upon potential investors.

Even if communication goes beyond this narrow, permissible boundary, the exemption should not be lost as long as the overriding purposes of the securities law — disclosure and the prevention of fraud — are satisfied. To hold otherwise, as SEC rules currently do, would elevate harmless technicality over substantive purpose. Thus, a communication which arguably involves an "offer" should be examined in light of a second fundamental issue, whether such communication affronts the statutory purpose of investor protection.

B. Are the Potential Investors Adequately Protected?

If a solicitation crosses the line and becomes an "offer," the impact for exemption purposes may vary depending upon the nature of the recipients. In light of the statutory concern for offerees applicable to private offerings, the private offering and small offering exemptions must be independently evaluated.

1. Section 4(2) Offerees and Rule 506 Purchasers

Statutory emphasis upon "offers" has led to the section 4(2) condition which precludes solicitations to persons who fail to meet the offeree qualifications of Ralston Purina. Absent statutory amendment or judicial modification of Ralston Purina's offeree concerns,\footnote{Schwartz, Rule 146: The Private Offering Exemption — Historical Perspective and Analysis, 35 Ohio St. L.J. 738, 776 (1974). The author argues Ralston Purina should be reinterpreted. He suggests that the breadth of the offering in that case could readily distinguish, on the basis of public benefits, the application of the statute in those circumstances from an offering to a much more limited group of employees.} solicitations under section 4(2) that amount to "offers" will continue to carry a substantial risk of invalidating the exemption.

Alternatively, private placements utilizing the safe harbor provisions of Rule 506 consider only the sophistication of the purchasers or their designated representatives, not the entire group of offerees.\footnote{See supra text accompanying notes 60-61.} Therefore, the means by which
sophisticated and knowledgeable purchasers are attracted to the offer ought not to be relevant. Furthermore, Rule 506 provides substantial disclosure requirements. As a result, no readily apparent public interest exists to limit communication in a Rule 506 offering. The continued applicability of Rule 502(c) to a Rule 506 offering should be re-examined by the Commission.

2. Non-sophisticated Rule 504 and Rule 505 Purchasers

Regulation D provisions should be judged in light of the legislative purpose to permit exemption where registration "is not necessary in the public interest and for the protection of investors." While the SEC could theoretically refuse to create any section 3(b) exemptions, the existence of discretionary power does not excuse its inappropriate exercise. Viewed against public interest concerns, Rule 502(c) creates a blanket prohibition which exceeds the reasonable limits of its statutory base. For offerees who do not become subsequent purchasers, solicitations may prove to be harmless or may present only limited time and energy concerns. For offerees who ultimately purchase a security, adequate statutory and administrative provisions exist to assure investor protection.

The extensive disclosure required for offerings under Rule 505 should provide any necessary elaboration or explanation of matters raised in initial communications. For offerings under Rule 504, the critical question is whether the overall process of communicating, negotiating and closing a securities transaction was done in a manner which provided for a reasoned, knowledgeable investment decision. While Rule 504 requires no specific disclosure document, the omnipresent anti-fraud provisions present a powerful incentive for the disclosure of material information to potential investors. Even assuming that


132. See supra note 5.

133. For Rule 505 offerings, Rule 502(b)(2)(i)(A) requires that issuers not already subject to the reporting requirements of the Exchange Act disclose to purchasers "[t]he same kind of information as would be required in Part I of Form S-18 (17 C.F.R. § 239.28), except that only the financial statements for the issuer's most recent fiscal year must be certified by an independent public or certified accountant." 17 C.F.R. § 230.502(b)(2)(i)(A) (1985). The information must also be furnished to accredited investors if sales are made to both accredited and non-accredited investors. Id. § 230.502(b)(1)(ii).

134. The 1933 Act antifraud provisions requiring disclosure of all material information are specifically applicable to offerings exempt from registration. See § 12(2), 15 U.S.C. § 77l (1982); § 17(c), 15 U.S.C. § 77q(e) (1982). Section 12(2) remedies in the event of inadequate or misleading disclosure are either rescission plus interest or damages if the security was sold. The availability of a private cause of action under § 17 has not been clarified. Compare Kirchner v. United States, 603 F.2d 234 (2d Cir. 1979) (implied private right of action exists), cert. denied, 444 U.S. 995 (1979) with Landry v. All Am. Assurance Co., 688 F.2d 381 (5th Cir. 1982) (no private right of action). The Supreme Court has noted the dispute without expressing opinion. See Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.2 (1983). Section 17 mirrors the provisions of § 10b of the 1934 Exchange Act, 15 U.S.C. § 78j(b) (1982), for which a private right of action was confirmed in Herman & MacLean. Injunctions may be obtained by the SEC under § 17 of the 1933 Act, and criminal penalties are provided in § 24, 15 U.S.C. § 77x (1982), for willful violation of the Act or any rules thereunder.
post-solicitation disclosure will be an ineffective antidote to the influence of initial communications, no basis exists for concluding that a combination of existing anti-fraud provisions and modified controls permitting limited communications would be similarly ineffective.

V. Fashioning Relief

Ideally the Commission will reconsider Rule 502(c) and its interpretations of the "offering" concept. The non-solicitation rules may be overdue for hearings and commentary. To some extent, the longevity of the judicial and administrative positions may have numbed the motivation for a reconsideration of principles; inertia may have replaced continued analysis of fundamental bases. No-action letters, for example, have done little more than clarify uncertain areas, leaving intact the broad interpretations of "solicitation" and "offering" concepts. Reconsideration at the administrative level should be directed principally to considering the impact of the Commission's position upon small issuers and broker-dealers, the problems of abuse which could arise if non-solicitation limitations are eased, and the possible modifications to non-solicitation rules which may satisfy both capital financing and investor protection concerns.

Absent administrative reform, modification could be accomplished through judicial review. The courts continue to be the primary arbiters of "public offering" interpretations under section 4(2) and are equally capable of considering the parameters of the "public interest" provisions of section 3(b).

Judicial relief may be based on a particularized finding that the Commission's non-solicitation position is beyond the scope of its authority, or is inconsistent with statutory policy. Initially, the statute should be examined. It sets forth two factors qualifying public interest and investor protection concerns, "the small amount involved" and "the limited character of the public offering." These references are in the disjunctive, thus either factor justifies an exemption.

The statute does not expressly delineate the "amount involved" standard. The phrase should be read, however, in light of the current statutory limit of $5,000,000, and the legislative history reflecting four increases since 1970. To suggest Congress intended that all offerings up to $5,000,000 escape statutory and administrative controls is untenable. However, it is not unreasonable to suggest that Rule 504, governing exempt offerings up to only one-tenth of the statutory ceiling, imposes such substantial administrative constraints as to defeat the legislative purpose.

Legislative reference to "the limited character of the public offering" also

136. "The Commission may . . . add any class of securities to the securities exempted . . . if it finds that the enforcement of this subchapter . . . is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering. . . ." § 3(b), 15 U.S.C. § 77c(b) (1982) (emphasis added).
137. See supra note 48.
138. The maximum that may be offered in any twelve-month period pursuant to a Rule 504 exemption is $500,000. 17 C.F.R. § 230.504(b)(2)(i) (1985); see supra note 52.
challenges the scope of the SEC’s position. The statutory language infers that not all public solicitation of offerees is to be condemned. A “public offering” of a “limited character” does not offend the statute. The SEC, however, has adamantly restricted issuers’ access to the public arena. The Commission has relied on the “limited character” provision in establishing its non-solicitation rules, and simultaneously has failed to give reasonable meaning to the statutory phrase in its entirety.

Judicial review should not be deterred by the agency discretion argument. The Supreme Court has very narrowly construed the Administrative Procedure Act’s exclusion from judicial review of “agency action . . . committed to agency discretion by law.”

Although the SEC could have chosen to permit no exceptions under section 3(b), the discretion once exercised is subject to judicial determination that the action is consistent with delegated authority and legislative policy. Thus, a statute providing that the Administrator of the Federal Aviation Administration “may grant exemptions [from the mandatory age 60 retirement rule for airline pilots] . . . if he finds that such action would be in the public interest” did not create unreviewable discretion as the agency maintained. The court determined that it could review the discretionary action of the Administrator against the statutory standard of public interest. In the securities field, administrative action must be measured against the expressed legislative desire to facilitate the capital financing abilities of small businesses.

139. At the time of adoption of § 3(b) in 1933, the “public offering” phrase related more to the extent of the solicitation effort rather than to the eventual Supreme Court interpretation based upon the nature of the offerees. See supra text accompanying notes 24-32.

140. In SEC Securities Act Release No. 33-5499, 39 Fed. Reg. 20,609 (1974), proposing adoption of Rule 240 creating a $100,000 exemption under § 3(b), the non-solicitation provision was justified in the following terms:

The intention of this provision is that the offers and sales generally be made through individual contact between persons who have some knowledge of each other, or some reason to know about each other, and not through newspapers, advertisements or other means of general advertising. Where such means are used, it is difficult to justify an exemption on the basis of the “limited character” of the offering.

39 Fed. Reg. at 20,610. Apparently the Commission chose not to consider circumstances other than at the noted extremities.


142. No exemption was established by the SEC under its § 3(b) authority until the 1956 promulgation of Regulation A. See 21 Fed. Reg. 5739 (1956); supra note 18.

143. American Power & Light Co. v. SEC, 329 U.S. 90, 106 (1946) (“All that can be required is that the Commission’s actions conform to the statutory language and policy.”).

144. 49 U.S.C. § 1421(c) (1982).


146. See supra note 48. Recent Congressional action appears, at first glance, to contradict the
Substantial deference is ordinarily and appropriately accorded to administrative expertise. However, the validity of Rule 502(c), as applied through interpretive releases, must be questioned in light of the following factors:

(i) its deviation from the judicial mandate to examine the totality of circumstances relevant to the offering;\(^{147}\)

(ii) its derivation from a statutory standard not containing any policy considerations similar to those found in section 3(b);\(^{148}\)

(iii) the lack of any evidentiary record supporting the adoption of the rule;\(^{149}\) and

(iv) the apparent failure of the Commission to consider less restrictive alternatives.\(^{150}\)

It may appear harsh to suggest the SEC has abused its discretion. That standard of review, however, is not a pejorative reflection on the SEC, but rather a customary affirmation of the principle that a regulation must be both reasonable and consistent with the statute.\(^{151}\)


The concern prompting this limitation may have been for "unsophisticated fat cats," i.e. inexperienced investors who qualify under financial standards as "accredited investors." Because § 4(6) contains no disclosure requirements, and can be used to raise up to $5,000,000, the concern for investors expending substantial sums may have motivated the legislative provision. Rule 504, limited to $500,000, is much more appropriate for use by small businesses; limitations on their efforts ought to be viewed from a different perspective. The 1980 Act also added § 19(c) to the Securities Act, stating: "It is the declared policy of this subsection that there should be greater Federal and State cooperation in securities matters including ... (D) a substantial reduction in costs and paperwork to diminish the burdens of raising investment capital (particularly by small business) ... ." Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 505, 94 Stat. 2275, 2292 (amending 15 U.S.C. § 77s(c)).

147. Ralston Purina, 346 U.S. at 119.  
148. See supra text accompanying note 56.  
149. See supra text accompanying notes 55-56; see also Warren, supra note 16, at 359-60 ("Instead of developing new regulatory concepts through careful analysis of previous experience, the SEC has reworked and retooled a highly criticized and fragmented exemption scheme into an equally complex and potentially unreliable unified regulation.").  
150. The term "apparent" is used because the author is not aware of any internal SEC proposals moderating the non-solicitation rules. None of the SEC releases suggests consideration of material changes. Rather, it appears that the historical antipathy to public solicitation has enjoyed a position of sheltered dogma.  
151. Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129, 134 (1926) (amended IRS regulation valid and could be applied retroactively although original regulation was inconsistent with the statute and unreasonable). A second issue that may arise in judicial review is severability. Although Rule 502(c) is part of a set of administrative conditions, the invalidity of one part would not necessarily affect the remaining conditions or the exemptions. See United States v. Jackson, 390 U.S. 570 (1968) (constitutional invalidity of one portion of Federal Kidnapping Act did not alter the substantive reach of the statute); Moore v. Fowinkle, 512 F.2d 629 (6th Cir. 1975) (balance of statute retained unless the invalid portion so essential, and so interwoven with other portions, that it cannot be reasonably presumed the legislature intended the statute to operate otherwise than as a whole).
VI. Conclusion

Restraints on general solicitation and advertising in connection with limited offerings enjoy both longevity and relative freedom from significant challenge. These characteristics partially reflect the breadth of statutory definition, the force of early administrative interpretations, and a legitimate but generalized concern that exempt offerings may involve the dangers of "hawking" or other undesirable salesmanship tactics. Thus, both the judiciary and the SEC have maintained an effective barrier against the erosion of non-solicitation rules. Repeated legislative concerns for the capital-generating abilities of small businesses have resulted in periodic revisions of registration exemptions. Yet, no material modification of the solicitation and advertising restraints, whether by definition or interpretation, has been achieved.

Longevity is an admirable attribute if it does not create an inertia that stifles ongoing analysis. The SEC has given its non-solicitation rules very broad application with little evidence that investors need such extensive protection. Current rules continue a position adopted fifty years ago during the infancy of the 1933 Act, when the reach of the securities laws was still being explored. Even when the SEC began to develop section 3(b) exemptions, it looked to the traditional rules, despite the fact that a different statutory provision supported its original position. Moreover, while the manner of offering was initially one element to be considered as part of the totality of circumstances in determining the availability of an exemption, the Commission transformed the manner of offering into a single and inviolable prerequisite without regard to other relevant factors.

The private and small offering exemptions should be re-examined to determine whether and to what extent they can tolerate limited forms of solicitation and advertising. Concern for small businesses and the broker-dealers who assist

Severability issues generally arise in cases of statutory construction, but the principles developed should be applicable to the analogous process of administrative review. Provisions regarding integration of offerings (Rule 502(a)), information requirements (Rule 502(b)), limitations on resale (Rule 502(d)), and the numerical limitations in Rules 505 and 506 are not dependent upon or functionally linked to the non-solicitation provisions of Rule 502(c). That portion of the rule could be eliminated without affecting the continued viability of the other Regulation D provisions, particularly if modified conditions on solicitation and advertising were continued. Alternatively, a court concerned with the issue of severability, or with the setting of more appropriate bounds for non-solicitation provisions, might keep the rule in effect on a short-term basis pending review by the SEC of rule revisions. That procedure was used in Natural Resources Defense Council, Inc. v. SEC, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,910 (D.D.C. 1974). The court, uncertain whether the SEC had acted in accordance with the National Environmental Policy Act, 42 U.S.C. §§ 4321-4370 (1982), but finding that the SEC had in any event acted improperly under rulemaking procedures, kept the rules as promulgated in existence pending remand to the SEC for further rulemaking consideration. A similar procedure was utilized in Addison v. Holly Hill Fruit Co., 322 U.S. 607 (1944), where a portion of the Administrator of the Wage and Hour Division's regulation dealing with area of coverage was found to be inconsistent with the Fair Labor Standards Act. Rather than declare the entire regulation invalid, the case was remanded to the district court "to hold it until the Administrator, by making a valid determination of the area with all deliberate speed, acts within the authority given him by Congress." 322 U.S. at 619. The Court noted, and was prepared to accept, the retroactive application that would ensue from the revised regulation. Id. at 620.
them will not be materially alleviated until issuers and their representatives are able to utilize a broader base of potential investors than the rules currently permit. Considerable room exists for modification of restraints without generating fears of uncontrolled and deceptive solicitations. The SEC provides the preferable forum for developing alternatives. However, in the absence of administrative reform, the judiciary can play a significant role by reinterpreting the section 4(2) "offering" concept and by reviewing the administrative restrictions in light of the legislative purpose expressed in the section 3(b) exemption provisions.