Proposed SEC Rules for Private Offerings: The Impact on Venture Capital Financing

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PROPOSED SEC RULES FOR PRIVATE OFFERINGS: THE IMPACT ON VENTURE CAPITAL FINANCING

I. INTRODUCTION

In order to facilitate venture capital financing, corporations rely upon the private offering exemption from the registration and prospectus requirements of the Securities Act of 1933. In an attempt to prevent this exemption from serving as a conduit for the flow of securities into the public securities markets, the Securities and Exchange Commission (SEC) has proposed new rules regulating the resale of securities purchased in a private offering. These proposals would alter, among other things, the existing holding period, sales limitation, and financial information requirements.

This article will examine the impact of the proposed rules on venture capital financing of small corporations. Special emphasis will be placed upon the proposed revised rule 144, released by the SEC on September 14, 1971. By way of background, it is first necessary to consider the importance of venture capital to small corporations and the nature of present law and SEC policy in this area.

II. THE IMPORTANCE OF VENTURE CAPITAL TO SMALL CORPORATIONS

The capital for initiating a small corporation comes almost totally from the organizing group of owners. At some time, however, the corporation may find that its growth is restricted because it is not generating sufficient internal funds and the owners lack additional personal funds to invest in their corporation. Although the business must then seek outside capital, it is often

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2 15 U.S.C. § 77 (1970). See U.S.C. §§ 77(f), (g), (h), and (j) for the registration statement and the prospectus requirements.
4 H. Broom and J. Longenecker, Small Business Management (2d ed. 1966), at 187–188.
5 It is recognized that small corporations are also financed through credit financing; however, funds from this source are available to the small corporation only to a limited extent. Difficulty raising credit funds is experienced because of the lenders' preference for secure holdings. Moreover, during periods of general monetary restraint, the impact of a
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hindered from doing so by its undiversified business operations (frequently a single market and financial locality) and keen competition from other firms.6

Raising capital is essentially a bargaining process based upon the relative strength of the firm and the investors in relation to the risks and urgency of capital requirements. If the potential rewards relative to the risk are attractive or if risk can be reduced by contractual or management devices,7 the small business and the investor can usually agree on a mutually satisfactory financing arrangement. While most investors are reluctant to invest in a small corporation, the venture capitalist is particularly interested in its investment possibilities.

The venture capitalist generally invests early in the corporate life of a business by providing "seed" capital, that is, capital for initiating the corporation and for those financial needs arising several years before the corporation seeks capital through the public securities markets. Here the risk is tremendous, but the prospect of large returns often proves worth the risk.8 To a lesser extent, venture capitalists also invest at a later stage in the corporation's life, usually just prior to a public offering of securities.9 Of

6 University of South Carolina, supra note 5, at 121.
7 Restrictions may include the prohibition of raising capital from other sources and of dividend pay-outs above a specified limit; there may also be a provision which allows the financier to assume control if the corporation finds itself in an unstable financial condition.
8 Most recent activity in venture capital has been in the high technology areas where the risks are great because of the industry involved and the stiff competition. For these reasons, venture capitalists have definite approaches, like the approach utilized by Data Science Ventures. Here, academic specialists in computers and data processing are hired, taught what they have to know about finance (this particular aspect is unusual in the venture capital industry), and assigned a maximum of four investments each, which they are to monitor. The Money Men: Improving on the General-Collins of Data Science Ventures, 105 Forbes, April 15, 1970, at 78.
9 Examples of this investor type are insurance companies like Prudential, Wall Streeters like Donaldson, Lufkin, and Jenrette, and large industrial firms like Singer, American Broadcasting, Swift, Boise Cascade, and others. See, Has the Bear Market Killed Venture Capital? 105 Forbes, June 15, 1970, at 28-29, 42; The Money Men: What do you do with $81 Million? Edgar F. Heizer, Jr. of Heizer Corp. in Chicago, 106 Forbes, July 15, 1970, at 44. It is this aspect of venture capital which has been hardest hit by the recent tight money squeeze in the economy. To spread the risks around, to assure themselves of adequate second-round financing, and to draw out this hidden money, some venture capitalists have set up partnerships on a participation basis for specific investments. This
course the pay-off is less, but so is the risk. In addition to meeting the capital requirements of the small corporation, venture capitalists often provide managerial and financial consulting services to the developing enterprise.¹⁰ This is designed to alleviate problems which may arise from inexperienced management and thus, to some extent, minimize the risk of investment.

There are various reasons why a small corporation would prefer private placement of securities with a venture capitalist as opposed to a public offering. The absence of an extended operating history, the lack of a profitable operation, or an erratic financial history serve to make a new offering undesirable to the potential public investor.¹¹ Although projections of future business performance might reduce the degree of investor uncertainty, the SEC prohibits their use in the prospectus and registration statement issued prior to a public offering.¹² On the other hand, sophisticated private investors analyze all of the relevant data, including projections, before deciding whether to invest in a business.¹³

Private placements are also cheaper and consume less time than public offerings. The cost of going public for a small corporation trying to raise one million dollars through a public stock offering could easily reach 20 percent of the face amount of the stock.¹⁴ In contrast, private placement does not involve costly registration requirements or the preparation of a lengthy prospectus. Additionally, while public offerings generally take months of preparation, a private placement can "raise millions in as little time as 96 hours."¹⁵

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¹⁰ FORBES, supra note 8.
¹¹ SEC. DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (1969) [hereinafter cited as THE WHEAT REPORT]. This was a study which evaluated the entire area of disclosure with a view to constructive recommendations for improvements.
¹² Reports to the SEC are based on historical financial data.
¹⁴ Id. at 81. The cost breakdown is approximated as follows:
   a. No less than 10 percent to the underwriter (usually investment bankers also demand warrants);
   b. $25,000 Finder's fees;
   c. 15,000 Legal fee;
   d. 7,500 Accountant's fee for certified statements;
   e. 10,000 Printing expenses;
   f. 15,000 Public relations firm to handle the annual report;
   g. 15,000 "Blue-sky" or otherwise unaccountable extras.
   $187,500 Approximated total expenses.
¹⁵ Id. at 24.
Public offerings lift the "veil of privacy" from the affairs of the corporation, and "it can be embarrassing to reveal what the public (and competitors) wish to learn."

Since private placements are "financial contracts," the terms of which generally remain undisclosed to the public, this form of financing allows "more flexibility for complicated transactions and greater facility in making subsequent changes in the sales documents."

The most important factor favoring the private placement of a small corporation's securities can only be discerned from an objective viewpoint. Management may become too price conscious and push for growth solely in order to influence a higher price-earnings ratio. When a new public corporation misses its earnings or growth projections, the company finds it difficult to obtain additional public financing. On the other hand, the experienced venture capitalist is not greatly influenced by early price-earnings ratios. He generally realizes this is a long term investment and has sufficient money in reserve to invest in the corporation on very short notice.

In view of these considerations, it is not surprising that the demand for venture capital far exceeds its availability. Out of every five hundred potential investments, a venture capitalist will generally invest in only two or three. Even so, "out of every ten investments made, two or three will go down the tube, three or four will rock along, and the remainder may prove outstanding." Only the professional financiers survive in this business, for most decisions are based purely on their well-developed instincts. Although they can look for solid earnings, great potential, and sound management, because of the absence of a sound financial history the ultimate decision is instinctive.

Thus, the venture capitalist is important in the development of new corporate business. Since small corporations rely heavily upon the availability of venture capital through private placement of securities, the proposed changes in the SEC rules for this type of investment could have a profound effect upon the financing of new business in the United States.
III. PRESENT LAW AND SEC POLICY

A. Scope

The reasons for the enactment of the Securities Act of 1933\(^\text{25}\) and the Securities Exchange Act of 1934\(^\text{26}\) were threefold: to provide information to investors so they could arrive at their own rational investment decisions, to protect the investor from fraud and misrepresentation in the purchase of new securities, and to deter questionable business practices through appropriate publicity.\(^\text{27}\) Although the 1933 Act covered the issuer, underwriter, and dealer,\(^\text{28}\) the primary emphasis was on the issuer since he was the major source of financial information required to be disclosed.

1. Private Offering—The 1933 Act was designed to regulate new public offerings of securities. The principal provision, section 5, prohibits the offer or sale through any instrumentality of interstate commerce or the mails of any security which has not conformed with the registration and prospectus requirements of the Act.\(^\text{29}\) Although certain other securities\(^\text{30}\) and transactions\(^\text{31}\) are exempt from section 5, the section 4(2) transactional exemption for private financing, which provides that section 5 is not applicable to "transactions by an issuer not involving any public offering,"\(^\text{32}\) is most important to the small corporation. The Act specifically provides that a transaction will be deemed a public offering whenever the purchaser intends to distribute the securities to other investors.

In general, determining whether a transaction is a public offering involves a consideration of the number of offerees, the relationship between the offerees and issuer,\(^\text{33}\) and the adequacy of information exchanged between these parties. Thus, in \textit{SEC v. Ralston Purina Co.},\(^\text{34}\) the United States Supreme Court held that stock issued to the company's employees was a public offering, because these employees did not have access to the kind of information disclosed in a registration statement. In developing this "knowledge of the offeree" concept, the Court rejected the straight numerical test\(^\text{35}\) which exempted offerings which are

\(^{27}\) The Wheat Report, \textit{supra} note 11, at 10.
\(^{34}\) 346 U.S. 119 (1932).
\(^{35}\) \textit{Id.} at 125.
made to a limited number of offerees. Nevertheless, an offering to a small number of offerees (generally less than twenty-five) who are close to, and have sophisticated knowledge of, the corporation will probably be exempt.36

2. Subsequent Resale—A second problem arises when the initial offering is proper, but resales by the purchaser change the private offering into a public distribution. The section 4(1) transactional exemption, covering a sale made by "any person other than an issuer, underwriter, or dealer,"37 is available to the typical shareholder selling his securities. A purchaser under a transaction exempted by section 4(2) who subsequently sells his stock is not an issuer or a dealer, but may be an underwriter as defined by section 2(11) of the 1933 Act.38 Whether this resale is a public distribution involves an analysis of the "nature, scope, size, type and manner of the offering."39 Significantly, whenever such resale is determined to be a public distribution, the issuer's underlying private offering exemption under section 4(2) is lost.40

In order to safeguard against public resale, an issuer may resort to several devices. The first of these is the investment letter, which is a statement from the purchaser which represents that acquisition of the securities is for investment purposes and not for distribution. Unfortunately, placing exclusive reliance on the investment letter is risky, as evidenced by In re The Crowell-Collier Publishing Company.41 Crowell-Collier privately placed certain convertible debentures some of which were immediately converted into common stock and distributed. The SEC concluded that this financing arrangement violated section 5 of the 1933 Act. Regarding the investment letters, the Commission stated that the "issuer may not establish claim to an exemption merely by collecting investment representations from a limited group of purchasers if, in fact, a distribution by such person occurs."42

Alternatively, the issuer might utilize two devices which effectively prohibit resale of privately placed securities. The first device is the affixation of a restrictive legend to the face of the certificate, indicating the existence of a restriction on the transfer of that security. Notice is therefore given to the purchaser or the

38 15 U.S.C. § 77(B)(11) (1970). The statutory definition of underwriter is "any person who has purchased from an issuer with a view to ... the distribution of any security."
40 Id.
42 Id.
transfer agent that a subsequent transfer is void without the issuer’s permission. The second device involves instituting a stop transfer notice with the transfer agent.\textsuperscript{43} Although these devices may be particularly effective, they create an obvious inconvenience for the purchaser.

The relationship between investment intent and the private offering becomes clear only when the purchaser desires to dispose of his investment through a public offering. At that time, the original placement is scrutinized to analyze the purchaser’s intent—was it to invest or to distribute? Evidence of investment intent is primarily derived from the length of time securities are held by the purchaser. With respect to how long the securities must be held in order to prove investment intent, the present rule is vague and no definitive answer can be given.\textsuperscript{44} However, the longer the holding period, the more likely the SEC will find investment intent.

\textbf{B. Re-examination of Disclosure Policy: A Need for Change}

The 1933 Act was designed to prevent investor fraud in the new issues market where the pressure to sell was greatest. Today the emphasis is still on the prevention of fraud, but the focus of regulation has shifted to the trading markets and the continuous disclosure requirements of the 1934 Act.\textsuperscript{45} This shift in emphasis recognizes that today sales pressure is as great in the resale market as in the original issues market, and that it is therefore more effective to regulate the broker than the issuer.

In connection with the private offering exemption and investment intent, certain criticisms exist which reflect upon the administration of the present laws. The application of vague and imprecise standards leads to investor uncertainty.\textsuperscript{46} When there is serious doubt as to the purchaser’s subjective investment intent or when the issuer will not remove the security restrictions, the purchaser may resort to the “change of circumstances” doctrine.

\textsuperscript{43} Securities Act Release No. 5121 (December 30, 1970). Although the issuer is protected through notice to the transfer agent, this method is conducive to defrauding a subsequent investment purchaser. Therefore, the restrictive legend is preferred since it extends protection to both the original issuer and the subsequent purchaser.


\textsuperscript{45} The Wheat Report \textbf{58–59}.

\textsuperscript{46} Id. at 174.
and seek a "no-action" letter. But the outcome is uncertain, because the doctrine is applied in an imprecise and subjective manner. In addition, inequities may result since the present rules may prevent non-controlling security holders from selling indefinitely, while a change of circumstances may allow a controlling security holder to publicly sell a considerable amount of his holdings.

The confusion stemming from these vague standards has produced two detrimental consequences. In attempting to respond to the numerous requests for interpretative advice and no action letters, the workload of the SEC's staff has expanded so much that its efficiency has decreased. Also, the integrity of the SEC will soon be challenged if it continues to provide inconsistent advice. Finally, the confusion as to when and how private shares may be publicly offered has provided "an unfortunate leeway for the unscrupulous."

The SEC also faces a challenge in another area. When the evidence strongly suggests a flagrant registration violation, these vague standards work against the SEC; substantial manpower must be used to prove intent and all of the surrounding circumstances. The result is an even greater drain on the SEC's manpower and efficiency.

These criticisms have arisen because the SEC has tried to provide too much flexibility. The regulatory goal is public disclosure of financial information for investor decision-making. From the standpoint of this regulatory goal, the vague and imprecise change of circumstances doctrine and holding period limitation are irrelevant because they do not provide the prospective purchaser with needed information; rather, they serve only as a

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47 Securities Act Release No. 4552, supra note 33. For the investor who is "locked" into an investment for a long holding period, relief is provided through the change of circumstances doctrine. Recognizing that original investment intent may change due to a subsequent change in the investor's circumstances, the SEC's review process entails the "no action" letter and an analysis of all the relevant facts. In discussing this, the WHEAT REPORT, at 167, stated: "The substantiality of the required change of circumstances varies directly with the length of time between purchase and sale." Thus, the shorter the length of time, the more drastic the change required.


49 THE WHEAT REPORT 168.

50 Id. at 175.

51 Id. at 176.

52 Id. at 177. The Wheat Report went on to state: "It has been the Commission's experience that unprincipled counsel will often give opinions on the availability of exemption from registration when careful or responsible counsel would not do so." Id.

53 Id.
basis for ad hoc relief to present investors who would otherwise be locked into their investments.\textsuperscript{54}

In addition to the problems connected with the present rules, one writer concisely states the more general problems accompanying the disclosure policies of the 1933 and 1934 Acts:

First, the American shareholder population has increased from 6,490,000 in 1952 to 26,400,000 in 1968. Accompanying this growth has been a vast increase in the number of investment decisions which are based, directly or indirectly, on information disclosed by corporations. Second, an increased demand for accurate and adequate disclosure has resulted from an increase in professionalism within the investment business. . . . Third, the 1964 Amendments to the Securities Act have made it more practicable to integrate the disclosure required by the Securities Act [the 1933 Act] and the Exchange Act [the 1934 Act]. Finally, faster, less expensive methods of distributing to interested parties the information disclosed to the S.E.C. are now available mainly through the use of the microfiche system.\textsuperscript{55}

\section*{IV. PROPOSED RULES}

\subsection*{A. Rule 160 Series}

\textit{1. Explanation}—Acting upon the Wheat Report’s recommendations, the SEC proposed the rule 160 series.\textsuperscript{56} These proposals attempted to further the objectives of disclosure, inhibit the development of public securities markets where the issuers have not disclosed material information about themselves, and permit limited quantity sales in ordinary transactions when the issuer has made adequate disclosure.\textsuperscript{57}

Rule 160 extended the definition of “underwriter” in section 2(11) of the 1933 Act to include “any person who disposes of a restricted security in a distribution.”\textsuperscript{58} This objectively defined the term underwriter without reference to state of mind or purity of intent when the securities were purchased and therefore would have removed a large area of uncertainty in the Act.

\footnotesize{\textsuperscript{54} In addition, the present disclosure regulations give rise to enforcement problems. Interstate, public securities markets are now permitted to develop “prior to the time the issuer has made disclosure of its affairs by registering under the ’33 or ’34 Acts.” These markets are the ones which the “disclosure policy should strive to prevent.” Wheat, \textit{The Disclosure Policy Study of the SEC}, 24 \textit{Bus. Law} 33, 43 (1968).


\textsuperscript{56} Securities Act Release No. 4997 (September 15, 1969).

\textsuperscript{57} Id.

\textsuperscript{58} Id.}
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Rule 161 defined "restricted security" as any security acquired directly or indirectly from its issuer or affiliate in a transaction which was not a public offering. This restriction was removed if the security was not traded for any five consecutive years during which the issuer had annual gross revenues from operations of at least $250,000, or if the security was subsequently registered.\(^{59}\)

Rule 162 defined the term "distribution" as any public offering of a security.\(^{60}\) Rule 162 did, however, permit the resale of Rule 163 "qualified securities," if the securities were held for at least one year, no more than 1 percent of the outstanding securities were sold in any six month period, and the securities were subsequently sold in an unsolicited brokerage transaction with the broker acting as the seller's agent.\(^{61}\)

Rule 162 distinguished between reporting and non-reporting companies while Rule 163 set forth the criteria for this distinction. In general, reporting companies were those companies which had total assets exceeding $1,000,000 and a class of equity security held by 750 or more persons or which were listed on a national securities exchange.\(^{62}\) Limited public offerings of reporting companies were exempted from the rule 162 definition of "distribution."\(^{63}\)

Finally, broker's transactions were extended to include transactions where the broker acted for an affiliate of the issuer or a person selling a restricted security. The broker was exempted from the requirements of section 5 if, after a reasonable inquiry, he believed that the sale was not a distribution and if he did not solicit a buy order.\(^{64}\)

2. Critique—The proposed rules were severely criticized. In order to inhibit the development of public markets for securities when the issuer had not disclosed sufficient information, the new distribution definition only allowed limited resales of qualified securities (rule 163) after a one year holding period. The SEC believed that this holding period was too short and would allow sales of large amounts of unregulated securities.\(^{65}\) However, advocates of the one year holding period viewed it as a means of

\(^{59}\) Id.
\(^{60}\) Id.
\(^{61}\) Id.
\(^{62}\) 15 U.S.C. § 78(l)(b) (1970) sets forth the requirements for listing on a national securities exchange. 15 U.S.C. § 78(l)(g) (1970), with certain exceptions, extends the registration requirements to all companies with total assets exceeding $1,000,000 and a class of equity security held by 750 or more persons. 15 U.S.C. § 78(o)(d)(1970), provides that the SEC may require additional information from a registered company.
\(^{63}\) Securities Act Release No. 4997, supra note 56.
\(^{64}\) Id.
precluding sales of unregistered securities through the medium of a conduit.\endnote{66} As one advocate stated:

\begin{quote}
If the initial purchaser from the issuer is required to be at significant investment risk for a period of time, the potential loophole of sales to the public by the issuer through a conduit is closed.\endnote{67}
\end{quote}

The rule 160 series also distinguished between reporting and non-reporting companies. A purchaser of securities from a reporting company could sell limited quantities of the security after one year; a purchaser from a non-reporting company was prohibited from any public resale for a five year period. To effectuate this rule, the SEC was required to maintain a current list of "qualified issuers" reporting companies. But the SEC did not have "sufficient staff available for this purpose"\endnote{68} and feared that use of the term "qualified issuer" would carry an implication of the SEC's approval of the reporting company on the basis of its investment merit.\endnote{69}

A basic objection to the reporting/non-reporting concept of the rule 160 series was raised by the Federal Regulation of Securities Committee:

\begin{quote}
It is difficult to quarrel, on practical grounds, with the basic dichotomy between reporting and non-reporting companies. However, the adoption by the Commission, as a matter of interpretation of the provisions of the '33 Act, of a distinction which could not possibly have been made if there had been no '34 Act and no 1964 Amendments thereof, reflects the extent to which legislation in other areas of the securities field, subsequent to the '33 Act, is recognized by the Commission as having brought about a \textit{de facto} amendment of the '33 Act.\endnote{70}
\end{quote}

The Committee is questioning the legislative impact of the SEC's rule-making authority.

The 1933 and 1934 Acts require full disclosure, but it was suggested that the rule 160 series, by requiring that before resale restricted securities be held for five consecutive years during which the issuing company has annual gross revenues of at least $250,000, would go beyond full disclosure and enter the realm of

\begin{footnotes}
\item[66] Letter from Carl W. Schneider to SEC, October 20, 1970.
\item[67] \textit{Id}.
\item[69] \textit{Id}. A neutral term such as "reporting company" could have solved this problem. Schneider, \textit{supra} note 66, at 4.
\end{footnotes}
corporate regulation.\textsuperscript{71} Others thought that five years was too restrictive a holding period and that a shorter period would be sufficient to afford the requisite investor protection.\textsuperscript{72} The reason for the annual gross revenue test of $250,000 was to protect investors by insuring that the issuer was an active business and not a "shell" corporation maintained for five years in order to circumvent the five year holding period.\textsuperscript{73} The SEC was concerned that this requirement would give the impression that it was judging the securities of these companies on their merits.\textsuperscript{74}

Finally, although the main purpose of these restrictions was to force registration and therefore disclosure upon the issuer, in the opinion of some writers, the rules would not have resulted in increased registration:

By and large, the effect of a rule that minor sales cannot be made without registration has not been to cause registration. Rather, it has been to discourage sales entirely, since issuers have been unwilling to incur the numerous burdens of registration. As a consequence, controlling and investment holders have been forced to assume a serious degree of non-liquidity for their securities which is not justified by the underlying policy objectives of the 1933 Act.\textsuperscript{75}

After analyzing all of these criticisms, the SEC concluded that the rule 160 series unduly restricted the investment of capital in the small corporation.\textsuperscript{76} The severe curtailment of the liquidity and flexibility of private investment was not worth the certainty that might result in this area.\textsuperscript{77} For these reasons, the rule 160 series was replaced by proposed rule 144.

\textbf{B. An Alternative: Proposed Rule 144}

\textbf{1. Explanation—}The SEC proposed rule 144 in order to provide "more objective standards for determining when a person may be presumed not to be an underwriter or not to be engaged in a distribution"\textsuperscript{78} under the 1933 Act.

Rule 144 states that any person who offers or sells securities of an issuer is presumed \textit{not} to be an underwriter and \textit{not} to be be

\textsuperscript{71} Interview with Thomas Geis, Professor of Finance at the University of Michigan School of Business Administration, May 28, 1971.
\textsuperscript{72} Throop, \textit{supra} note 70, at 46.
\textsuperscript{73} \textit{Id.} at 48.
\textsuperscript{74} Securities Act Release No. 5087, \textit{supra} note 65.
\textsuperscript{75} Schneider, \textit{supra} note 66, at 1.
\textsuperscript{76} Securities Act Release No. 5087, \textit{supra} note 65.
\textsuperscript{78} Securities Act Release No. 5087, \textit{supra} note 65.
engaged in a distribution, 79 if all of the following conditions are met:

(1) **Holding Period:** For at least the last eighteen months, the offeror must have owned and paid for his securities, and must not have acquired any new securities of this same class. 80

(2) **Limitation on Amount of Securities:**
   (a) Within the last twelve months, all sales by or for the offeror shall not exceed:
      (i) if unlisted, 1 percent of the shares outstanding, or
      (ii) if listed, the lesser of 1 percent of the shares outstanding or the largest trading volume during any week within the last four calendar weeks. 81
   (b) All sales under this rule within the preceding twelve months must not exceed twice the maximum amount permitted in (a) above. 82

(3) **Current Public Information:** Current financial and other information concerning the issuer must be made public in order to provide full and fair disclosure to investors. This information is presumed available if the issuer files under sections 1383 or 15(d) 84 of the 1934 Act. In other situations, the seller and broker have the option of determining whether adequate current information has been published or furnished to security holders. 85

(4) **Manner of Offering:** The seller must not have any material non-public information about the issuer which he has not disclosed to the broker, and the transaction must be made through a broker acting as agent for the seller. 86

In addition to the proposed rule, the SEC also stated that if rule 144 were adopted, "no action" letters based on change of circumstances in individual investment situations would no longer be issued; rather the seller would have the burden of determining whether an exemption was available under the change of circumstances doctrine. 87

2. **Critique**—In general, rule 144 does not itself alter existing law and SEC policy with respect to investment or the change of

79 Id. Proposed SEC R. 144(a).
80 Id. Proposed SEC R 144(a)(1).
81 Id. Proposed SEC R 144(a)(2)(A).
82 Id. Proposed SEC R. 144(a)(2)(B).
83 15 U.S.C. § 78(m) (1970) states the type of information required for companies filing under § 78 (I). This includes information to keep registration statement information current, annual reports, quarterly reports, and any other information required by the SEC.
85 Proposed SEC R. 144(a)(3), supra note 56.
86 Id. Proposed SEC R. 144(a)(4).
circumstances doctrine; rather, it merely provides additional tests for determining when a resale is to be permitted without registration.\textsuperscript{88} However, the rule fails in its attempt to provide objective standards for the resale of securities.

Rule 144 provides that if all of its conditions are met, the seller of a security will be presumed not to be an underwriter. This is a substantial change from the current rule 154, which provides that if its conditions are met the seller is not an underwriter. There is some doubt as to whether rule 144's presumption is intended to be conclusive or rebuttable;\textsuperscript{89} if it is rebuttable, the seller will face the onerous task of determining whether all the conditions have been fulfilled.

The text of rule 144 did not discuss the change of circumstances doctrine, but the accompanying securities release\textsuperscript{90} announcing the rule stated that

the staff [of the SEC] will not issue . . . "no action" . . . letters with respect to "changes in circumstances" which might warrant the sale of securities sooner than the rule provides. . . . If a person is to rely upon a "change in circumstances," . . . he must sustain the burden of showing that such change is legally sufficient to justify sale of the securities. . . . "[C]hanges in circumstances" relate only to the holding period and not to the other provisions of the rule.\textsuperscript{91}

Thus, the change of circumstances doctrine is intended to survive, but the SEC has indicated that in the future it will be applied more restrictively.

As the above release states, the change of circumstances doctrine will now only apply to the holding period.\textsuperscript{92} The implication from that language is that the minimum holding period under rule 144 can be accelerated to permit resale.\textsuperscript{93} Nevertheless, since the release further provides that the change of circumstances doctrine will not apply to any other provisions of the rule, a seller could be classified as an underwriter despite any change of circumstances "unless he limits the quantity and method of his sales as provided in the rule."\textsuperscript{94}

This approach has been criticized for two reasons. First, rule 144 alters the well-established application of the change of circumstances doctrine without the use of the SEC's rule-making

\textsuperscript{88} MORROW, supra note 44, at 49.
\textsuperscript{89} Id.
\textsuperscript{90} Securities Act Release No. 5087, supra note 65.
\textsuperscript{91} Id.
\textsuperscript{92} Id.
\textsuperscript{93} Schneider, supra note 66, at 1.
\textsuperscript{94} Id.
authority. Second, although some believe that the change of circumstances doctrine does not promote the public's need for current information, if the doctrine is to survive, the SEC should continue the "no action" letter practice. Indeed, the SEC should also publicly release its conclusions, "so that a body of 'case law' may develop for the guidance of the Bar."

Under the current rule 154, the holding period, which functions as a presumption of investment intent, ranges from twenty-four to thirty-six months and thus is indefinite. The eighteen month holding period in rule 144 attempts to rectify this situation. After the eighteen month period, the rule provides for limited leakage (limited sales) over a twelve month period. This seems unreasonable because it constitutes a doubling of the leakage time under the current rule 154, thus effectively cutting in half the potential distribution by a control person. Moreover, the holding period applies to all securities purchased by a control person, even in a public market. But there is absolutely no statutory or policy basis for this limitation if the sale is not a "distribution."

Other leakage provisions of rule 144 also severely restrain sales of unregistered securities by control persons. The 1 percent formula over a one year period is unduly restrictive; even more so is the 2 percent absolute maximum leakage provision. Under this latter provision, all sales under rule 144 by any person in the control group (defined as all directors, officers and affiliates of the issuer and their associates) are limited to 2 percent of the outstanding shares during any twelve month period. The practical effect will be that controlling persons must reduce their sales because of the amount of sales by others in the control group. Inequities among the control group members will occur since members will be forced to sell early in the period to prevent later preclusion from sale. Also, enforcement will be difficult since there is no standard to identify the group or to keep track of their group sales. Finally, the proposed numerical test is inflexible,

95 Id.
96 Id.
97 Id.; see also Morrow, supra note 44, at 49, for a general discussion of this problem.
98 Schneider, supra note 66, at 1.
100 Id. at 290–291; see also Schneider, supra note 66, at 2; and Morrow, supra note 44, at 51.
101 Morrow, supra note 44, at 50–5.
102 Schneider, supra note 66, at 3.
103 Morrow, supra note 44, at 51.
105 Morrow, supra note 44, at 51.
106 Id. at 52.
because it would not permit a seller whose sales exceed the 1 percent limitation to show that in light of the amount of the issuer's securities outstanding his sale is insignificant. The current rule 154 does permit such a showing.

The proposed rule 163 stated that companies required to report were those companies which had total assets exceeding $1,000,000 and a class of equity security held by 750 or more persons or which were listed on a national securities exchange. The reporting concept is modified slightly in proposed rule 144(a)(3) to emphasize the type of information required to be filed by those companies under sections 13 and 15(d) of the 1934 Act. Information required to be filed under these sections includes information and documents necessary to keep registration statement information current, annual reports, quarterly reports, and any other information required by the SEC. In addition, proposed rule 144(a)(3) extends this reporting concept to other companies who have published or furnished financial information to their security holders. These new reporting requirements place the non-control person at a distinct disadvantage. If the issuer is reporting, there is a presumption that by filing this information the reporting requirements are satisfied. If the issuer is not reporting pursuant to the 1934 Act requirements, then the presumption is that the reporting standards have not been met. In order to rebut this latter presumption the seller and broker must determine whether adequate current information has been published or furnished to the security holders. However, the non-control person, unlike the control person, lacks information as to whether the reporting requirements have been met and must assume a greater risk on these transactions.

The impact that rule 144 might have on private financing is substantial. In summary, the venture capital investor, to avoid being locked into a security for long periods of time, has generally attempted, by means of contractual provisions, to compel the issuer to register his securities for sale. These attempts generally

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107 Rice, supra note 99, at 291.
108 Id. In addition, current rule 154 makes no provision for the non-control person, consequently he must hold at least twenty-four months to “prove” investment intent before freely selling under section 4(1) of the 1933 Act. His position has improved under rule 144 since he can leak after eighteen months, instead of the previous twenty-four to thirty-six month requirement. See Rice, supra note 99, at 291.
109 See text accompanying note 70 supra.
111 Id.
112 Morrow, supra note 44, at 50.
113 Rice, supra note 99, at 293–305, presents a comprehensive discussion of the impact of rule 144 on venture capital financing.
take the form of a "demand registration" provision or a "piggyback" provision. Unfortunately, demand registration, when tied to other factors, may serve as evidence of control which will result in forfeiture of the seller's section 4(1) exemption.

In addition, because of rule 144 brokers may be reluctant to handle leakage (limited sale) transactions. Failure to meet the requirements that the seller have no inside information and that the issuer actually file current financial reports may prevent application of the rule 144 exemption and subject the broker to civil penalties under section 12(1) of the 1933 Act.

Rule 144's imposition of greater disabilities upon control persons requires the venture capitalist to be more alert to the negative implications of control. The investor must "weigh the greater certainty attached to a demand registration provision against the more contingent use of leakage." For additional protection, the "control" investor should demand contractual provisions with other members of the control group restricting their sales of securities, so that their sales will not bar his use of rule 144.

These provisions may deter investors' participation in later private financing, for the rule provides that the eighteen month holding period runs from the date of the most recent security purchase. This could severely restrict the ability of small firms to raise subsequent capital; it may also affect the investor's initial investment decision.

Rule 144 will deter that type of financing arrangement whereby several investors agree to provide capital to the issuer in successive stages. Under rule 144 the full purchase price of the securities must be paid at least eighteen months prior to the leakage offering. Rule 144's holding period will not begin to run until after funding obligations under the contract have been fulfilled and the total purchase price paid. "This restriction is somewhat illogical, since an unconstitutional obligation to pay for securities is all that is required under other laws."

C. Proposed Revised Rule 144

1. Explanation—The SEC recently released the proposed re-

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114 Demand registration occurs when the issuer is required to "file a 1933 Act registration upon the investor's request." See Rice, supra note 99, at 294.
115 The piggyback provision takes the form where "the issuer, upon independently electing to register under the 1933 Act, must afford the investor an opportunity to have the latter's securities included in the registration on a secondary basis." Id.
116 Id. at 296.
117 Id. at 296–298.
118 Id. at 299.
vised rule 144.\textsuperscript{119} Under this rule the underwriting exemption for the sale of restricted securities\textsuperscript{120} is contingent upon all of the following conditions:

(1) \textit{Current Public Information}: Adequate disclosure requirements are satisfied if:
   (a) the issuer is registered under section 12 and files current reports under section 13 of the 1934 Act, or is registered under the 1933 Act and files current reports under section 15 of the 1934 Act;\textsuperscript{121} or
   (b) the issuer has satisfied the requirements set forth in rule 15c 2-11 (a)(4).\textsuperscript{122}

(2) \textit{Holding Period}: For two years prior to sale, the offeror must have beneficially owned and paid for his securities,\textsuperscript{123} and must not have acquired any new restricted securities of the same issuer.\textsuperscript{124}

(3) \textit{Limitations on Amount of Securities Sold}:
   (a) Within the last six months, all sales by affiliates of restricted and other securities of the same class shall not exceed;
      (i) if listed, the lesser of 1 percent of the class outstanding or the average weekly reported volume of trading over a four calendar week period. This is determined within ten days prior to the date of filing the notice to sell or to the receipt by the broker of the sell order.\textsuperscript{125}
      (ii) if unlisted, 1 percent of the class outstanding as of a date within ten days prior to the notice filing or to the broker’s receipt of the order.\textsuperscript{126}
   (b) Within the last six months, all sales by any persons\textsuperscript{127} (other than affiliates) of all the restricted securities of the


\textsuperscript{120} Restricted security is defined as any security not acquired in a public offering.

\textsuperscript{121} \textit{id.} Proposed Revised SEC R. 144(a)(3), Securities Act Release No. 5186, \textit{supra} note 119.

\textsuperscript{122} \textit{id.} Proposed Revised SEC R. 144(c)(2).

\textsuperscript{123} \textit{id.} Proposed Revised SEC R. 144(c)(2).

\textsuperscript{124} \textit{id.} Proposed Revised SEC R. 144(d)(1).

\textsuperscript{125} \textit{id.} Proposed Revised SEC R. 144(d)(2).

\textsuperscript{126} \textit{id.} Proposed Revised SEC R. 144(e)(1)(A).

\textsuperscript{127} \textit{id.} Proposed Revised SEC R. 144(e)(1)(B).
same class shall not exceed the limits specified in (3)(a) above.128

(4) **Manner of Sale:** The securities must be sold in brokers' transactions.129 The broker may not solicit a buy order, but may only execute sell orders after a reasonable inquiry into the circumstances has been made.130

(5) **Notice of Proposed Sale:** In the sale of any securities under this rule where the amount of securities is not less than 500 shares or units and the aggregate sale price is not less than $10,000, the seller must file a sale notice on form 144131 with the Commission.132

This rule would be applied prospectively133 and proof of its availability would rest on the seller.134 The change of circumstances doctrine would no longer be available,135 but letters interpreting the new rule would be issued.136

In order to provide relief for the non-controlling person who owns restricted securities and does not qualify for relief under revised rule 144, the SEC has proposed rule 237,137 under which a non-controlling person is exempt from registering the sale of securities where the domestic issuer has been a going concern for the last five years.138 The holding period is also five years, prior to which the offeror must have paid for the security and must have been the beneficial owner of the security.139 Moreover, these securities must be negotiated through a non-brokerage transaction.140

Rule 237 exempts from its requirements 1 percent of the class of securities outstanding during any one year period.141 The maximum gross revenue exemption for any one year is $50,000.142
In a release accompanying revised rule 144, the Commission proposed to amend regulation A, which "provides an exemption from registration . . . for limited amounts of securities of certain issuers" by the issuance of proposed rule 254 which would provide that offerings by or on behalf of persons other than the issuer would not be counted against the amount which the issuer could offer for its own account. The maximum amounts which could be offered by the various persons during any 12-month period would be as follows: the issuer could offer $500,000; all affiliates . . . could offer in the aggregate $100,000; and other persons could offer $100,000 each but the aggregate amount offered by all such other persons could not exceed $300,000.

The adoption of rule 15c2-11 under the 1934 Act was another recent step taken by the SEC:

In general, Rule 15c2-11 prohibits the initiation or resumption of quotations respecting a security by a broker or dealer who lacks specified information concerning the security and the issuer.

This rule highlights the increased emphasis placed upon the investment practices arising in the trading markets. In particular, it aims to prevent fraudulent and manipulative activities which, in the absence of available information, sometimes occur during the making of a market or during activity in infrequently-traded securities.

2. Critique—Criticisms of the rule 160 series and of rule 144 were essentially categorized into two general areas: first, the imprecision of the proposals did not reduce the uncertainty in the investment process or in the enforcement of the regulations; and, second, the new standards were unreasonable and adversely affected venture capital financing. Revised rule 144 does not completely meet these criticisms.

Revised rule 144 has eliminated some of the uncertainties existing under the old rules. The rule will be applied prospectively, not retroactively. The rule eliminates the change of circumstances

reliance upon rule 144." [Rule 237(b), id.] In addition, the filing requirement of form 237, the notice to sell provision, is similar to rule 144(h) and provides the SEC with information for enforcement of this regulation. [Rule 237(c), id.].

143 Id.
144 Id.
146 Id.
147 Id.
148 Id.
but "no action" letters and letters interpreting the revised rule will be available. The problem of the holding period has been resolved by the two year standard in rule 144 and the five year standard in rule 237. Thus, the SEC has moved closer to achieving the second goal of the Wheat Report, that is, "to reduce the areas of uncertainty in the interpretation" of the statutes.

The reasonableness of these modifications is, however, open to question. The SEC's reason for the two and five year holding periods is to prevent a public distribution of securities through the medium of a conduit. In this respect, revised rule 144 is more restrictive than either of its two predecessor rules. Assuming financial information were available, rule 160 imposed a minimum holding period of one year, and rule 144 imposed an eighteen month holding period. Revised rule 144 imposes a two year holding period. Since the revised rule eliminates the change in circumstances excuse, even in unusual circumstances, such as the serious illness of the investor, the resale of the securities is prohibited for at least two years. In addition, the distinction between a controlling investor (rule 144 with its two year holding period) and a non-controlling investor (rule 237 with its five year holding period) is unreasonable, when the same information is available to both investors. Likewise, there is little justification for regulating the purchases of a sophisticated investor or of an investor who realizes that the security constitutes a speculative investment. Greater flexibility could be provided if rule 237 were changed to shorten the holding period to one year and to permit transactions to be handled through a broker, thereby subjecting the transaction to the rule 15c 2-11 requirements. This latter change would exempt a private transaction between informed investors and provide a control at the broker level for the uninformed purchaser.

The sales limitation of 1 percent within any six months peri-
Proposed SEC rules are an improvement over the original rule 144 proposal of 1 percent for 1 year for a control person and a maximum 2 percent for 1 year for the control group. However, it contradicts the concept of a "free" market which allows the buyer and the seller independently to transact business in a large, impersonal market place. If the market can absorb that particular sale, the transaction should be allowed so long as no broker initiative is involved. These reasons also suggest that the $50,000 maximum for a one year period for the non-control person is unduly restrictive. Not only is the $50,000 maximum subject to criticism, but even more so is the requirement that this limit be reduced by other sales under section 3(b) or rule 144. The SEC has provided some relief in proposed rule 254 by increasing the maximum exemptions allowed. But these exemptions are available only if the small firm fulfills the burdensome regulation A requirements. These sales limitations are also unreasonable because there is no flexibility and no additional relief provided in cases of extreme urgency or unusual circumstances.

Revised rule 144 will have substantially the same adverse effects upon private financing as those discussed in the critique of the original rule 144. The SEC recommends the use of restrictive legends, stop-transfer instructions, and contractual registration provisions, but these items are subject to negotiation in private financing and will affect the investors' decision. Additionally, the "control" investor must consider no-sale contractual provisions with other control members in order to protect his exemption. Finally, like the earlier rules, Revised rule 144's requirement that the security be fully paid for before the holding period begins to run may deter future participation in successive stages of financing.

V. CONCLUSION

By increasing the length of the holding period and abolishing, for most purposes, the change in circumstances doctrine, proposed revised rule 144 attempts to encourage registration of securities and thereby force disclosure of pertinent information to the

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160 Rice, supra note 99, at 291.
161 For a thorough discussion see id. at 293–305; for a summary discussion see text accompanying notes 113–118 supra.
public. At the same time, the rule attempts to eliminate some of the uncertainty that confronts the potential purchaser of a security in a private offering.

Unfortunately, increasing the benefits of disclosure while minimizing its burdens still has not been accomplished. Moreover, the SEC has failed to recognize that, in at least one respect, private placement ought to be encouraged. The venture capitalist, who gains his interest through private placement, protects the uninformed investor, because he helps insure the stability of the corporation in its early years and thus helps insure that the investment of later investors is safe. The restrictions of revised rule 144 discourage such investment and may hinder the growth of small corporations in the United States.

—Gregory A. Kearns