U.S. Securities and Exchange Commission

Final Rule:
Nonpublic Offering Exemption

U.S. SECURITIES AND EXCHANGE COMMISSION

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SECURITIES ACT OF 1933

Nonpublic Offering Exemption

The Commission today announced the issuance of a statement regarding the availability of the exemption from the registration requirements of section 5 of the Securities Act of 1933 afforded by the second clause of section 4(1)[1] of the Act for "transactions by an issuer not involving any public offering," the so-called " private offering exemption." Traditionally, the second clause of section 4(1)[1] has been regarded as providing an exemption from registration for bank loans, private placements of securities with institutions, and the promotion of a business venture by a few closely related persons. However, an increasing tendency to rely upon the exemption for offerings of speculative issues to unrelated and uninformed persons prompts this statement to point out the limitations on its availability.

Whether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering.

The Supreme Court in *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 124, 125 (1953), noted that the exemption must be interpreted in the light of the statutory purpose to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions" and held that "the applicability of section 4(1) should turn on whether the particular class of persons affected need the protection of the Act." The court stated that the number of offers is not conclusive as to the availability of the exemption, since the statute seems to apply to an offering "whether to few or many."[2] However, the court indicated that "noting prevents the Commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims." It should be emphasized, therefore, the at the number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available.

Consideration must be given not only to the identity of the actual purchasers but also to the offerees. 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.[3]

A question frequently arises in the context of an offering to an issuer's employees. Limitation of an offering to certain employees designated as key employees may not be a sufficient showing to qualify for the exemptions. As the Supreme Court stated in *Ralston Purina* case: "The exemption as we construe it, does not deprive

corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within section 4(a), e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement. Absent such a showing of special circumstances, employees are just as much members of the investing "public" as any of their neighbors in the community." The Court's concept is that the exemption is necessarily narrow. The exemption does not become available simply because offerees are voluntarily *furnished* information about the issuer. Such a construction would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards and sanctions of the Act.

The sale of stock to promoters who take the initiative in founding or organizing the business would come within the exemption. On the other hand, the transaction tends to become public when the promoters begin to bring in a diverse group of uninformed friends, neighbors and associates.

The size of the offering may also raise questions as to the probability that the offering will be completed within the strict confines of the exemption. An offering of millions of dollars to non-institutional and non-affiliated investors or one divided, or convertible, into many units would suggest that a public offering may be involved.

When the services of an investment banker, or other facility through which public distributions are normally effected, are used to place the securities, special care must be taken to avoid a public offering. If the investment banker places the securities with discretionary accounts and other customers without regard to the ability of such customers to meet the tests implicit in the *Ralston Purina* case, the exemption may be lost. Public advertising of the offerings would, of course, be incompatible with a claim of a private offering. Similarly, the use of the facilities of a securities exchange to place the securities necessarily involves an offering to the public.

An important factor to be considered is whether the securities offered have come to rest in the hands of the initial informed group or whether the purchasers are merely conduits for a wider distribution. Persons who act in this capacity, whether or not engaged in the securities business, are deemed to be "underwriters" within the meaning of section 2(11) of the Act. If the purchasers do in fact acquire the securities with a view to public distribution, the sell assumes the risk of possible violation of the registration requirements of the Act and consequent civil liabilities.[4] This has led to the practice whereby the issuer secures from the initial purchasers representations that they have acquired the securities for investment. Sometimes a legend to this effect is placed on the stock certificates and stop-transfer instructions issued to the transfer agent. However, a statement by the initial purchaser, at the time of his acquisition that the securities are taken for investment and not for distribution is necessarily self-serving and not conclusive as to his actual intent. Mere acceptance at face value of such assurances will not provide a basis for reliance on the exemption when inquiry would suggest to a reasonable person that these assurances are formal rather than real. The additional precautions of placing a legend on the securities and issuing stop-transfer orders have proved in many cases to be an effective means of preventing illegal distributions. Nevertheless, these are only precautions and are not to be regarded as a basis for exemption from registration. The nature of the purchaser's past investment and trading practices or the character and scope of his business may be inconsistent with the purchase of large blocks of securities for investment. In particular, purchases by persons engaged in the business of buying and selling securities require careful scrutiny for the purpose of determining whether such person may be acting as an underwriter for the issuer.

The view is occasionally expressed that, solely by reason of continued holding of a security for the six month capital-gain period specified in the income-tax laws, or for a year from the date of purchase, the security may be sold without registration. There is no statutory basis for such assumption. Of course, the longer the period of retention, the more persuasive would be the argument that the resale is not at variance with an original investment intent, but the length of time between

acquisition and resale is merely one evidentiary fact to be considered. The weight to be accorded this evidentiary fact must, of necessity, vary with the circumstances of each case. Further, a limitation upon resale for a stated period of time or under certain circumstances would tend to raise a question as to original intent even though such limitation might otherwise recommend itself as a policing devise. There is no legal justification for the assumption that holding a security in an "investment account" rather than a "trading account," holding for a deferred sale, for a market rise, for sale if the market does not rise, or for a statutory escrow period, without more, establishes a valid basis for an exemption from registration under the Securities Act.[5]

An unforeseen change of circumstances since the date of purchase may be a basis for an opinion that the proposed resale is not inconsistent with an investment representation. However, such claim must be considered in the light of all of the relevant facts. Thus, an advance or decline in market price or a change in the issuer's operating results are normal investment risks and do not usually provide an acceptable basis for such claim of changed circumstances. Possible inability of the purchaser to pay off loans incurred in connection with the purchase of the stock would ordinarily not be deemed an unforeseeable change of circumstances. Further, in the case of securities pledged for a loan, the pledgee should not assume that he is free to distribute without registration. The Congressional mandate of disclosure to investors is not to be avoided to permit a public distribution of unregistered securities because the pledgee took the securities from a purchaser, subsequently delinquent.[6]

The view is sometimes expressed that investment companies and other institutional investors are not subject to any restrictions regarding disposition of securities stated to be taken for investment and that any securities so acquired may be sold by them whenever the investment decision to sell is made, no matter how brief the holding period. Institutional investors are, however, subject to the same restrictions on sale of securities acquired from an issuer or a person in a control relationship with an issuer insofar as compliance with the registration requirements of the Securities Act is concerned.

Integration of Offerings

A determination whether an offering is public or private would also include a consideration of the question whether it should be regarded as a part of a larger offering made or to be made. The following factors are relevant to such question of integration: whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the general purpose.

What may appear to be a separate offering to a properly limited group will not be so considered if it is one of a related series of offerings. A person may not separate parts of a series of related transactions, the sum total of which is really one offering, and claim that a particular part is a nonpublic transaction. Thus, in the case of offerings of fractional undivided interests in separate oil or gas properties where the promoters must constantly find new participants for each new venture, it would appear to be appropriate to consider the entire series of offerings to determine the scope of this solicitation.

As has been emphasized in other releases discussing exemptions from the registration and prospectus requirements of the Securities Act, the terms of an exemption are to be strictly construed against the claimant who also has the burden of proving its availability.[7] Moreover, persons receiving advise from the staff of the Commission that no action will be recommended if they proceed without registration in reliance upon the exemption should do so only with full realization that the tests so applied may not be proof against claims by purchasers of the security that registration should have been effected. Finally, sections 12(2) and 17 of the Act, which provide civil liabilities and criminal sanctions for fraud in the sale of a security, are applicable to the transactions notwithstanding the availability of an

exemption from registration.

*Footnotes renumbered in 1986 reprint.

1 Second clause of section 4(1) is now section 4(2), as amended August 20, 1964.

2 See, also, *Gilligan, Will & Co. v. S.E.C.*, 267 F. 2d 461, 467 (C.A. 2, 1959), *cert. denied*, 361 U.S. 896 (1960).

3 Reference is made to the so-called "investment clubs" which have been organized under claim of an exemption from the registration provisions of the Securities Act of 1933 as well as the Investment Company Act of 1940. It should not be assumed that so long as the investment club, which is an investment company within the meaning of the later Act, does not *obtain* more than 100 members, a public offering of its securities, namely the memberships, will not be involved. An investment company may be exempt from the provisions of the Investment Company Act if its securities are owned by no more than 100 persons *and* it is not making and does not presently propose to make a public offering of its securities (section 3(c)(1)). Both elements must be considered in determining whether the exemption is available.

4 See Release No. 33-4445.

5 See Release No. 33-3825 re *The Crowell-Collier Publishing Company*.

6 *S.E.C. v. Guild Films Company, Inc. et al.*, 279 F. 2d 485 (C.A. 2, 1960), *cert. denied sub nom. Santa Monica Bank v. S.E.C.*, 364 U.S. 819 (1960).

7 *S.E.C. v. Sunbeam Gold Mining Co.*, 95 F. 2d 699, 701 (C.A. 9, 1938); *Gilligan, Will & Co. v. S.E.C.*, 267 F. 2d 461, 466 (C.A. 2, 1959); *S.E.C. v. Ralton Purina Co.*, 346 U.S. 119, 126 (1953); *S.E.C. v. Culpepper et al.*, 270 F. 2d 241, 246 (C.A. 2, 1959).