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Notes and Comments

MARYLAND BLUE SKY REFORM: ONE STATE'S EXPERIMENT WITH THE PRIVATE OFFERING EXEMPTION

When a corporation or other business entity wishes to raise capital by means of an offering of securities,¹ it must register the offering with the federal and state agencies which regulate transactions in securities. The registration process is often time consuming and expensive.² However, exemptions from this registration requirement for certain securities or transactions exist in both the federal Securities Act of 1933 and the Uniform Securities Act, upon which the Maryland Securities Act is based. Under both laws, the most frequently utilized exemption from registration is the so-called "private offering" exemption.³ In Maryland, the state Securities Commissioner recently

1. The definition of "security" is very broad in almost all securities laws. For example, The Maryland Securities Act, MD. ANN. CODE art. 32A, § 25(1) (1971), defines security as:

. . . any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscriptions; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing

2. See Shapiro & Katz, *The "Going Public Through the Back Door" Phenomenon — an Assessment*, 29 MD. L. REV. 320, 321 (1969).

3. The federal exemption is found in the Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970). The Maryland provision is MD. ANN. CODE art. 32A, § 26(b) (9) (1971). The Maryland provision exempts:

[a]ny transaction pursuant to an offer directed by the offeror to not more than twenty-five persons [excluding offers to institutions such as banks and insurance companies] in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this state, if the seller reasonably believes that all the buyers in this state . . . are purchasing for investment; but the Commissioner may by rule or order, as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the condition relating to their investment intent

Because the latter part of the provision clearly gives the Securities Commissioner the statutory authority to "further condition" the exemption as to "any type of

reexamined the private offering exemption of the Maryland Securities Act, and promulgated new rule S-7⁴ in an attempt to redefine the exemption. The general purposes of rule S-7 are to provide more effective regulation where needed, and to offer an incentive in the form of a self-executing exemption for new and small businesses which seek to raise capital without the rigors and expense of registration. The rule assumes additional significance in light of the recent announcement by the Securities and Exchange Commission of Proposed rule 146, which attempts to inject some objectivity into the determination of the applicability of the federal private offering exemption contained in section 4(2) of the Securities Act of 1933.⁵

The purpose of this comment is to examine rule S-7 in the context of the exemption contained in the Maryland Act, to explain its provisions and to evaluate its probable impact upon the private placement of securities in Maryland.

BACKGROUND: THE FEDERAL EXEMPTION AND THE
UNIFORM SECURITIES ACT PROVISION FOR
"LIMITED OFFERINGS"

"Truth in securities" is the ultimate purpose of the federal and state securities laws.⁶ Therefore, whether based upon a disclosure

security or transaction" there would be little merit to a claim that Rule S-7 is beyond the Commissioner's rule-making power.

4. 2 CCH BLUE SKY L. REP. ¶ 23,615 (Nov. 1, 1972). For the text of rule S-7 see Appendix A *infra*.

5. Proposed rule 146, SEC Securities Act Release No. 5336 (Nov. 28, 1972). This rule incorporates many of the concepts enunciated in Maryland rule S-7, and in the proposed Federal Securities Code of the American Law Institute. Compare Proposed rule 146(c)(2) (advertising) with Maryland rule S-7(c)(1); Proposed rule 146(d) (sophistication of offerees) with Maryland rule S-7(a)(4); Proposed rule 146(f) (purchaser limitation) with Maryland rule S-7(b)(1)(ii); Proposed rule 146(f) (institutional investors) with Maryland rule S-7(f); Proposed rule 146(g) (restrictive legends, stop-transfer instructions) with Maryland rule S-7(c)(2)-(4).

6. In his message to Congress proposing regulation of the securities industry, President Roosevelt stated: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." S. REP. NO. 47, 73d Cong., 1st Sess. 6-7 (1933); H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-2 (1933). Writing about liability under the Securities Act of 1933, then Professor William O. Douglas, with George Bates, wrote that "[t]he civil liabilities imposed by the Act . . . have been set high to guarantee that the risk of their invocation will be effective in assuring that the 'truth about securities' will be told." Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933). See also Maryland Securities Act Release No. 5, The Daily Record (Baltimore), Sept. 28, 1972, at 2, col. 4 [hereinafter cited as Maryland Securities Act Release No. 5 (Sept. 28, 1972)]; Landis, *The Legislative History of*

concept or some other regulatory philosophy,⁷ all securities laws require that the issuer of securities in a public distribution file with the appropriate regulatory agency a registration statement and prospectus containing information about the issuer and its securities. The objective of the registration statement is to place on file information pertinent to the issuer and the securities offering; the purpose of the prospectus, which must be delivered to the investor prior to or concurrently with the securities, is to give the investor substantially the same information about the offering as is contained in the registration statement. The investor can then make an informed decision whether to buy the security.⁸

The Federal Exemption

The Securities Act of 1933 contains several exemptions from the registration requirement which relate to certain classes of securities and certain types of securities transactions.⁹ The philosophy behind each of the exemptions in sections 3 and 4 of the Act is that either there is no need for registration in such instances or the need for

the Securities Act of 1933, 28 GEO. WASH. L. REV. 29 (1959); Wheat, "Truth in Securities" *Three Decades Later*, 13 HOW. L.J. 100 (1967).

7. Three general regulatory philosophies fought for predominance in the debate preceding the adoption of the Securities Act of 1933. The least restrictive was that which was based upon New York's old "fraud" acts; this approach merely granted the power to investigate and enjoin frauds which violated various penal codes. For an updated version of this approach see Saxon, *Extinction via Regulation — An Indictment of the SEC and ICC*, 177 COM. & FIN. CHRON. 1849 (1953). The most restrictive approach was that contained in the various Blue Sky Laws of the day, which required an administrative determination as to the merit of the offering and the quality of the offeror. For a discussion of this approach see Steig, *What Can the Regulatory Securities Act Accomplish?*, 31 MICH. L. REV. 775 (1933). The original bills in 1933 included provisions for revocation of registration upon a finding that "the enterprise or business of the issuer * * * or the security is not based upon sound principles" or that the issuer "is in any other way dishonest" or "in unsound condition or insolvent." 1 L. LOSS, SECURITIES REGULATION 122 (2d ed. 1961). The compromise disclosure approach favored by Louis D. Brandeis finally prevailed. See L. BRANDEIS, OTHER PEOPLE'S MONEY (1914). See generally 1 L. LOSS, SECURITIES REGULATION 123-28 (2d ed. 1961).

8. The registration requirements of the federal Act of 1933 are enumerated at 15 U.S.C. §§ 77a-aa (1970). The Maryland registration provisions are contained in MD. ANN. CODE art. 32A, §§ 19-22 (1971).

9. The most important of these are contained in the Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970) (transactions within a single state); § 4(1), 15 U.S.C. § 77d(1) (1970) (transactions by any person other than an issuer, underwriter, or dealer); § 4(2), 15 U.S.C. § 77d(2) (1970) (transactions not involving any public offering); § 4(3), 15 U.S.C. § 77d(3) (1970) (transactions by dealers); § 4(4), 15 U.S.C. § 77d(4) (1970) (transactions by brokers).

registration is not sufficient to justify imposing the burdens of registration.¹⁰ The most important exemption is that of section 4(2), which exempts "transactions by an issuer not involving any public offering."¹¹ The lack of statutory guidance as to what offerings are "non-public" has made the exemption difficult to define and apply with any degree of certainty.

The SEC at an early date established the principle that compliance with section 4(2) depends upon all of the surrounding circumstances of an offering and not upon any particular factor.¹² The number of offerees and their relationship to each other, and to the issuer, are important factors in determining the applicability of the exemption;¹³ the number of offerees, rather than the number of ultimate purchasers, determines the size of the offering. While an offering to no more than twenty-five persons is generally considered sufficiently insubstantial so as not to be a public offering, there is no rule of thumb for determining the nature of an offering to more than that number.¹⁴

Sophistication of the offerees is a second factor of primary importance; the Supreme Court has interpreted this requirement to mean that the offerees must be "able to fend for themselves" in investment matters.¹⁵ Of further significance in determining whether an offering is "private" under section 4(2) is the investment intent of the purchasers.¹⁶ Issuers usually take from each buyer an "invest-

10. The House Report on the Securities Act of 1933 stated that the exemptions were designed for situations "where there is no practical need for [the bill's] application or where the public benefits are too remote." H.R. REP. NO. 85, 73d Cong., 1st Sess. 5-6 (1933).

11. 15 U.S.C. § 77d(2) (1970).

12. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967), *aff'g* 247 F. Supp. 481 (D. Md. 1965), *cert. denied*, 389 U.S. 850 (1967); SEC Securities Act Release No. 4552 (Nov. 6, 1962); *In re* Crowell-Collier Publ. Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957); SEC Securities Act Release No. 285 (Jan. 24, 1935).

13. See, e.g., Empire Trust Co. v. Smith, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,581 (N.Y. Sup. Ct. 1965); 1 L. LOSS, SECURITIES REGULATION 654 n.45 (2d ed. 1961).

14. "[T]he [*Ralston Purina*] Court rejected a rule of thumb on the top side, not the bottom side." 1 L. LOSS, SECURITIES REGULATION 661 (2d ed. 1961).

15. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). The Court established the general rule that offerees must have essentially the same "access to the kind of information which registration would disclose." 346 U.S. at 127. Cf. Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,523 (S.D.N.Y. 1965). See also United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967), *aff'g* 247 F. Supp. 481 (D. Md. 1965), *cert. denied*, 389 U.S. 850 (1967); Strathmore Sec., Inc. SEC Securities Act Release No. 8207 (Dec. 13, 1967).

16. SEC Securities Act Release No. 285 (Jan. 24, 1935).

ment letter" which states that the buyer is not taking with a view to further distribution of the securities. While they are of some evidentiary value, investment letters are not conclusive proof of investment intent.¹⁷ The length of the time period during which the purchaser holds the securities is also relevant to the issue of intent, but is similarly not conclusive.¹⁸

These criteria, as well as certain more restrictive interpretations of section 4(2) recently announced in a decision by the Fifth Circuit,¹⁹ have made any determination of the applicability of the exemption hazardous. The resulting complexity surrounding the section 4(2) exemption has produced a wide variety of intentional²⁰ and uninten-

17. See *In re Hayden Lynch & Co.*, SEC Securities Act Release No. 7935 (Aug. 10, 1966) (mere signing of investment letters by four purchasers of 50,000 shares and debentures not enough to prove exemption).

18. A one year holding period strongly indicates that the motive at the time of purchase was to take for investment only. See Op. Gen. Counsel, SEC Securities Act Release No. 1862 (Dec. 13, 1938). The holding period requirement will be relaxed if there are certain "changes of circumstances" which necessitate an early resale. See *Crowell-Collier Publishing Co.*, SEC Securities Act Release No. 3825 (Aug. 12, 1957). See generally 1 L. LOSS, SECURITIES REGULATION 665-73 (2d ed. 1961).

19. *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972). In that case the defendant company was found guilty of violating the registration provisions of the Securities Act of 1933. Continental, as part of a private refinancing following a discharge in bankruptcy, had offered its common shares to thirty-eight persons, which offers resulted in thirty-five sales. It claimed that almost all of the purchasers had given investment letters, that it had given each purchaser oral and written information about the company, and that the investors had personal contact with officers of the company. Witnesses who had purchased Continental's shares testified that they had understood the risks involved, had purchased for investment only, were prohibited by the company from reselling the unregistered shares and that the shares had not been redistributed. The district court concluded that the tests set forth in *Ralston Purina* [see note 15 *supra* and accompanying text] were satisfied and therefore denied the SEC's request for an injunction. The Court of Appeals reversed, holding that the defendant corporation had not met the burden of proving the applicability of the exemption. The court stressed that there was not a sufficiently close relationship between the offerees and the company or its officers. It also pointed out that the company neither proved the exact number of offerees nor that each offeree had access to the same information which registration would disclose. The court stated: "Continental did not affirmatively prove that all offerees of its securities had received both written and oral information concerning Continental, that all offerees of its securities had access to any additional information which they might have required or requested, and that all offerees of its securities had personal contacts with the officers of Continental." 463 F.2d at 160. While the *Continental Tobacco* decision does not establish new criteria for the section 4(2) exemption, it does set a standard of proof for the exemption which is arguably impossible to meet.

20. See, e.g., *MacClain v. Bules*, 275 F.2d 431 (8th Cir. 1960) (scheme to avoid registration); *SEC v. Mono-Kearsarge Consol. Mining Co.*, 167 F. Supp. 248 (D. Utah 1958) (avoidance of section 5 with subsequent resale and public distribution).

tional²¹ abuses. In apparent recognition of the many problems caused by imprecise definition in this area, the SEC recently indicated that it would promulgate rule 146 to provide better guidance as to when the section 4(2) exemption is available to issuers of securities.²²

State Exemptions

Forty-nine states have "private" or "limited" offering exemptions, which can be placed in four distinct categories. First are those which are based upon the Uniform Securities Act provision, which limits the total number of permissible offerees of the securities.²³ Second, statutes in fourteen states place restrictions upon the number of shareholders of corporations which issue securities in reliance upon the exemption.²⁴ This category of exemption can be very restrictive.²⁵ Third, a few states limit the offering to a prescribed number of buyers and a fixed maximum dollar amount.²⁶ Finally, some states exempt only "isolated sales" of shares of the issuer which are held by the issuer or owner thereof.²⁷ Some states also require a short registration prior to the commencement of any offering made in reliance upon the exemption to determine whether the offering has merit.²⁸ In

21. Frequently in this category are issuers whose "private offerings" are later "integrated" and found to constitute a violation of the registration provisions of the Act. Integration is the combining of a private offering or other exempt transaction with a later public or exempted transaction, which results in a determination that the prior offering involved the sale of unregistered securities in violation of the Act. For an excellent discussion of the integration doctrine see Shapiro & Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always*. . . ., 31 MD. L. REV. 3 (1971), reprinted in 1972 SEC. L. REV. 202. See also SEC Securities Act Release No. 4552 (Nov. 6, 1962).

22. See note 5 *supra*.

23. For a complete list of statutes falling within this category see Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273, 277 n.13, reprinted in 1970 SEC. L. REV. 791. See also 4 L. LOSS, SECURITIES REGULATION 2634-41 (Supp. 1969).

24. See Mofsky, *supra* note 23, at 278 n.14; 4 L. LOSS, *supra* note 23, at 2634-41.

25. For example, in California, to qualify for the exemption there can be no more than ten shareholders of the issuing corporation. CAL. CORP. CODE § 25102(h) (West Supp. 1968). This statute is criticized in J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS 81 (1971).

26. See Mofsky, *supra* note 23, at 278 n.15; 4 L. LOSS, *supra* note 23, at 2634-41.

27. See Mofsky, *supra* note 23, at 276 n.11; 4 L. LOSS, *supra* note 23, at 2634-41.

28. For example, in these so-called "fair and equitable" states, the issuer must file certain documents with the state securities agency for approval of the offering on its merits. This not only causes delays but also gives the state securities commissioner the discretion to deny the issuer the right to offer its securities despite full disclosure of the objectionable qualities of the issuer or its securities. See 4 L. LOSS *supra* note 23, at 2634-41.

addition to these restrictions, most states prohibit the taking of any form of commission for the placement of securities in an exempt transaction.²⁹ The purpose of this limitation, which has been strongly attacked as placing an unnecessary burden on small issuers,³⁰ is to prevent the dilution of the investor's funds by the payment of broker's fees.

The Maryland private offering exemption, heretofore contained exclusively within section 26(b)(9) of the state Act,³¹ falls within the first of the aforementioned categories and is based upon the limited offering exemption of the Uniform Securities Act.³² Thus, prior to the adoption of rule S-7, an offering of securities was exempt in Maryland if offers of securities were directed to no more than twenty-five persons within any twelve-month period, irrespective of whether the "offerees" ultimately purchased any of the offered securities.

While some form of exemption for private placements is generally considered necessary,³³ the compromise³⁴ private offering exemption contained within the Uniform Securities Act, after more than ten years of operation in Maryland, has not been effective either to regulate private placements of securities or to stimulate new business promotions. Nor has the Act achieved uniformity among states. Less than half of the states have adopted the Uniform Act provision,³⁵ and those states have administered the exemption inconsistently.³⁶

29. No such prohibition exists in Maryland.

30. See Mofsky, *supra* note 23, at 279.

31. MD. ANN. CODE art. 32A, § 26(b)(9) (1971).

32. UNIFORM SECURITIES ACT § 402(b)(9). For a complete text of this provision, the draftsmen's commentary and an excellent discussion see L. LOSS & E. COWETT, *BLUE SKY LAW* 368-74 (1958).

33. "It seems quite clear that some exemption along these lines is essential in any well-ordered blue sky law, if for no other reason than to permit the incorporated corner grocery store or gasoline station to raise additional capital from a few relatives and friends without going through registration or — as is more likely today — violating the statute in complete oblivion of the possibility that anything like a blue sky law might be applicable." Draftsmen's Comment, UNIFORM SECURITIES ACT § 402(b)(9), quoted in L. LOSS & E. COWETT, *supra* note 32, at 372.

34. The Draftsmen's Commentary makes it clear that section 402(b) was a compromise provision. Thus, "[the section] in its present form . . . represents an attempt to follow some of the more common denominators in the present statutes, to provide an adequate degree of administrative flexibility, and to achieve an exemption which will be acceptable to those states which have no exemption at all in this area today." Draftsmen's Comment, UNIFORM SECURITIES ACT § 402(b)(9), quoted in L. LOSS & E. COWETT, *supra* note 32, at 372.

35. See Mofsky, *supra* note 23, at 277 n.12.

36. Inconsistent interpretations by state securities agencies which work with virtually identical statutory provisions is a most severe problem for issuers who wish to offer securities in exempt transactions in several states. As Mofsky points out, it is possible for an issuer to obtain approval in one state and not in another, despite

Generally, the exemption in section 26(b)(9) of the state Act has not been administered by the state Securities Division in a manner consistent with a literal reading of the statute. For example, the statutory provision does not require any degree of sophistication on the part of offerees, yet the Securities Division has in the past interpreted the provision to include such a requirement.³⁷ Therefore, one of the purposes of the new rule is to codify this administrative interpretation of the statutory exemption.

The major difficulties with the statutory provision concern achieving the desired characteristics of the typical private placement, which are that it be limited to a small number of people and that those people be sophisticated investors who are acquiring the securities for investment purposes only. The Maryland Securities Commissioner has found numerous abuses of the exemption involving these requirements.³⁸ For example, with regard to the number of permissible offerees, it is clear that many issuers offer to more than the prescribed number of persons and then reconstruct the number of offerees in communications to the agency to make the offering appear to comply with the state Act. If there are less than twenty-five purchasers of the securities, there is no practicable way for the agency to discover noncompliance with the exemption unless, prompted by complaints, it investigates and finds more than twenty-five persons to whom the issuer directed an offer of its securities.

Equally or more serious are abuses which involve the sale of securities to extremely unsophisticated investors who can neither understand the high risks involved in the typical private offering nor absorb the loss when the investment fails. While the state Securities Division has given the state provision an interpretation similar to the federal requirement³⁹ that offerees be sophisticated, the absence of any such requirement in the statute or regulations, as well as the absence of any definition of the term "sophisticated investor," decreases the likelihood of compliance with the exemption provision.

The federal exemption has been interpreted to mean that private offerings must be made to persons who will purchase the securities

the fact that the states' exemption provisions are identical and both based upon the Uniform Act. Mofsky, *supra* note 23, at 792 n.3. Mofsky believes that the power of the individual commissioner to limit the terms of the exemption in individual cases is the primary cause of this problem.

37. Maryland Securities Act Release No. 5 (Sept. 28, 1972).

38. *Id.*

39. See note 15 *supra* and accompanying text.

for investment only, and not with a view to further distribution.⁴⁰ Some holding period, however ill-defined it may be, is thus implied. The Maryland exemption explicitly requires that securities sold in reliance upon the statutory provision be acquired for investment purposes only; however, there is no statutory holding period or other provision to make compliance with this requirement more ascertainable. Representations of the issuer are of minimal value and the investment intent of the purchaser at the time of sale is impossible to determine,⁴¹ therefore, in the absence of such a holding period this requirement is unenforceable.

It is clear, therefore, that under past practices section 26(b)(9) has not been applied so as to limit private offerings to situations in which no need for registration exists. Rule S-7 is designed to halt these practices.

RULE S-7: A NEW PRIVATE OFFERING CONCEPT

Definitions

The most significant definition added by rule S-7 is that of the term "sophisticated investor."⁴² It provides that one is sophisticated if as the result of his financial experience, net worth, or the advice of one who is able to make such an evaluation he is able to evaluate an investment and understand the risks involved merely from the information given to him by the offeror.⁴³ Alternatively, one is sophisticated if he has substantially the same information about the issuer which registration would provide and if, in the language of the Supreme Court in *SEC v. Ralston Purina*,⁴⁴ he is able to "fend for himself" in investment matters. The Commissioner of Securities has taken the position that although this definition may be vague, it is clearer than the prior definition. The burden will be placed upon the issuer to prove a person's sophistication under the new rule.⁴⁵

Offerees who are not considered sophisticated under the above definition may still qualify under rule S-7 if they are related persons

40. See note 17 *supra* and accompanying text.

41. See Maryland Securities Act Release No. 5 (Sept. 28, 1972).

42. Maryland Securities Rule S-7(a)(4), reproduced in Appendix A *infra*.

43. It is significant that the definition permits a purchaser or offeree to be sophisticated "by virtue of his representation by an advisor." *Id.* However, the mere presence of counsel or an investment adviser is insufficient to make the purchaser or offeree sophisticated. The language "by virtue of" implies a cause and effect relationship.

44. 346 U.S. 119 (1953).

45. Maryland Securities Act Release No. 5 (Sept. 28, 1972).

as defined by the rule.⁴⁶ This latter provision was added after the initial publication of the proposed rule to avoid any prohibition of "mom and pop" capitalizations. It is the only exception to the requirement that offerees and purchasers be sophisticated.

Amount to be Raised by the Offering

The criteria for compliance with the rule vary according to the amount which the issuer seeks to raise by the offering. For offerings which involve less than fifty thousand dollars — "small offerings" — the rule requires only that there be no more than twenty-five ultimate purchasers of the securities who are either sophisticated or a member of a related group.⁴⁷ The significance of this provision lies in the change from the offeree concept embodied in section 4(2) of the Securities Act of 1933 and section 402(b)(9) of the Uniform Securities Act to a purchaser concept. As previously discussed, a limitation on the number of permissible offerees is difficult to police. It is also disadvantageous for small issuers with an uncertain private market for their securities. Theoretically, when the small issuer solicited the twenty-fifth potential investor, the offering had to cease whether or not the desired amount of capital had been raised. Under the new purchaser limitation, there will be greater certainty in the amount which can be raised in an offering exempt by virtue of rule S-7; any number of persons can be solicited until the required number of sales is made. The purchaser limitation was one reform suggested by the American Law Institute in its proposed Federal Securities Code⁴⁸ and the rationale for the suggested change — that a person who does not buy is not hurt — is difficult to refute.⁴⁹ While it might be argued that

46. Maryland Securities Rule S-7(a)(5) defines "related person" as "the officers and directors, or general and managing partners, of the issuer, their spouses, parents, brothers, sisters, and children."

47. Maryland Securities Rule S-7(b)(i).

48. ALI FED. SEC. CODE § 227(b)(1)(A), Comment 2 at 16 (Tent. Draft No. 1, April 25, 1972).

49. The ALI draftsmen state:

In the past, insofar as numbers are relevant at all in determining the existence of a 'public offering,' the emphasis has always been on the number of *offerees*. This draft goes over to the number of *buyers*, leaving the number of offerees unlimited, for two reasons: because the breadth of the definition of 'offer' makes it difficult to count offerees, and because it is difficult to see how an offeree who does not buy is hurt.

ALI FED. SEC. CODE § 227(b)(1)(A), Comment 2 at 16 (Tent. Draft No. 1, April 25, 1972).

rule S-7(b)(i) may push issuers into non-compliance with the exemption from the federal Act provided by section 4(2),⁵⁰ the adoption of Proposed rule 146 by the SEC would reduce this possibility to a considerable extent.

For offerings which involve more than fifty thousand dollars, rule S-7 retains the twenty-five offeree limitation contained in section 26(b)(9) of the state Act.⁵¹ The rationale for the retention of the offeree concept in this category of offering is that the purchaser limitation in small offerings is an experimental provision which should be tested and evaluated before the offeree concept is eliminated entirely in larger transactions.⁵²

In order to prohibit the types of abuses of the offeree limitation which occurred prior to the adoption of rule S-7, the rule, in addition, requires a short filing in offerings involving more than fifty-thousand dollars. Rule S-7(d) requires that the information contained in Form D-1⁵³ be filed with the Securities Division twenty days after the termination of the offering or twelve months after its commencement, whichever shall first occur. Form D-1 asks for certain general information about the issuer and requires that each officer or general or managing partner, of the issuer, as well as a majority of the board of directors of the issuer, list under oath the names, addresses and occupations of each offeree.⁵⁴ While this requirement is clearly more burdensome than the old exemption procedure under section 26(b)(9) of the Act, it is far less so than the filing requirement in the so-called "fair and equitable" states.⁵⁵

50. For example, under the old standards of section 26(b)(9) of the State Act, compliance with the twenty-five offeree limitation meant that issuers at least met the SEC's rule of thumb for the total number of permissible offerees under section 4(2) of the Act. Under rule S-7(b)(1), an issuer seeking to raise fifty thousand dollars or less can offer its securities to an unlimited number of persons. If the number is substantially greater than twenty-five, the issuer will qualify under rule S-7 for the state's private offering exemption, but might at the same time violate the registration provisions of the Securities Act of 1933. The Maryland Securities Commissioner, therefore, warns issuers and attorneys to consider the Securities Act of 1933 when designing an offering under rule S-7. See Maryland Securities Act Release No. 5 (Sept. 28, 1972).

51. Maryland Securities Rule S-7(b)(2).

52. Maryland Securities Act Release No. 5 (Sept. 28, 1972).

53. For the text of Form D-1 see Appendix B *infra*.

54. This provision will provide an obvious aid to enforcement of the exemption. If the Commissioner discovers, by complaint or otherwise, an offeree of securities of the registrant who is not listed on the affidavit, he can at that point, without the necessity for a lengthy and difficult investigation, determine that a violation has occurred.

55. In those states which permit the Commissioner to pass upon the merits of an offering to determine if it is "fair and equitable," the issuer must submit a filing prior

*Transferability, Investment Letters, Legends
and the Holding Period*

To comply with rule S-7(b)(i) or (ii), the conditions set forth in subsection (c) must also be met.⁵⁶ Subsection (c) prohibits general advertising of the offering and requires that the issuer obtain an investment letter from each purchaser, put a restrictive legend on each security sold and place stop-transfer instructions with transfer agents or note such instructions on the stock transfer books of the issuer. These provisions are designed to insure that the risks involved in the private offering remain with the initial purchasers and that the offering does not acquire the characteristics of a public distribution of securities.⁵⁷

The two-year holding period requirement is intended to restrict private offerings to those who purchase for investment only and to limit the risk to the initial purchaser of the securities. The Commissioner has stated that the holding period requirement will be interpreted consistently with the holding period criteria set forth in rule 144 under the Securities Act of 1933.⁵⁸ In keeping with the provisions of section 26(b)(9) of the state Act, institutional investors, as defined in section 26(b)(8) will not be counted in determining the number of purchasers or offerees under the rule.⁵⁹

Finally, the rule will operate on a prospective basis only, except that strict compliance with the provisions of section 26(b)(9) of the state Act will be required of all offerings in progress at the time of adoption of the rule.⁶⁰

to the commencement of the offering. Approval can therefore be delayed or denied entirely. *See, e.g.*, WIS. STAT. ANN. § 551.23(3)(d) (Supp. 1972-73).

56. Maryland Securities Rule S-7(c).

57. Maryland Securities Act Release No. 5 states in this regard:

It is essential that the offeror and/or issuer of the securities take careful precaution to assure that a public offering does not result . . . [from] resales of securities purchased in either of the transactions meeting the tests set forth in the new Rule. For, if in fact . . . purchasers do acquire the securities with a view to distribution, the seller assumes the risk of possible violation of the registration requirements of the Act and its consequent civil and criminal liabilities.

Maryland Securities Act Release No. 5 (Sept. 28, 1972).

58. Rule 144 was adopted in SEC Securities Act Release No. 5223 (Jan. 11, 1972); *See also* Maryland Securities Act Release No. 5 (Sept. 28, 1972).

59. Since the purpose of the Maryland Securities Act is to protect investors, and since institutional investors are otherwise exempt by virtue of section 26(b)(8) of the State Act, an offer or sale to this class of investors does not affect the issuer's offeree or purchaser count.

60. Maryland Securities Act Release No. 5 (Sept. 28, 1972).

CONCLUSION: OPERATION OF THE RULE

Rule S-7 should have a salutary effect, both from an enforcement point of view and from the perspective of issuers who wish to insure that a private placement does not violate the registration provisions of the state Act. The guidelines are clear and, with the possible exception of the definition of "sophisticated investor," there is little room for inconsistent administrative interpretations. Most important, however, is the opportunity offered by the rule to small businesses which found compliance under the old standards difficult or confusing. If the limited offering provision for amounts below fifty thousand dollars is a success, it may be possible to eliminate the offeree concept entirely.

APPENDIX A

RULE S-7

(a) *Definitions*

The following definitions shall apply for the purposes of this Rule.

(1) "Offeror" includes the issuer, any agent or employee of the issuer and any other person, who for and/or on behalf of the issuer or for himself, offers to sell, sells or solicits an offer to buy a security or an interest in a security for value.

(2) "Offeree" includes any person to whom has been directed an offer to buy or a solicitation of an offer to buy a security or an interest in a security for value.

(3) "Person" includes an individual, a corporation, a partnership, an association, a joint stock company, a trust, an unincorporated organization, or association, a government, or a political subdivision of a government.

(4) "Sophisticated investor" means a person: (i) who, by virtue of his net worth or financial experience or by virtue of his representation by an advisor, is able to evaluate a prospective investment solely on the basis of information respecting the investment presented to him by the offeror and who therefore understands the implications of the special risks of the investment, or concerning the issuer which registration under the Act would provide and who is able to fend for himself in evaluating investment matters.

(5) "Related Person" includes the officers and directors, or general and managing partners, of the issuer, their spouses, parents, brothers, sisters, and children.

(6) "General Advertising" includes any written or printed communication or any oral communication (made by means of public communications media or otherwise); provided, however, that "General Advertising" shall not include a disclosure document, such as a confidential offering memorandum or disclosure statement respecting the issue of a security, or such other documents or oral communications relating to the sale of a security as are required to consummate the sale thereof, if such documents are delivered or oral communications made by the offeror of the security directly to an offeree thereof or to an advisor of such offeree.

(7) The "Act" means the Maryland Securities Act.

(8) The "Rule" means this Rule.

(9) The "Commissioner" means the Securities Commissioner of the State of Maryland.

(b) *Conditions To Be Met*

A sale of, offer to sell, or solicitation of an offer to buy securities shall be exempt from registration under the Act, pursuant to Section 26(b)(9) thereof only if such sale, offer, or solicitation shall be made in:

Transaction Involving Not More Than \$50,000

(1) A transaction with respect to which: (i) the offeror offers for sale, solicits an offer to buy, or sells securities with respect to which the total consideration received or sought to be received by the offeror shall not exceed \$50,000; and (ii) all securities offered for sale or for which solicitations of an offer to buy were made by the offeror are sold of record and/or beneficially to not more than twenty-five persons in this state; and (iii) all persons who purchase securities offered for sale or for

which solicitations of an offer to buy were made by the offeror are sophisticated investors and/or related persons; and (iv) the requirements set forth in sub-section (c) of this Rule are satisfied or; in,

Transaction Involving More Than \$50,000

(2) A transaction with respect to which: (i) the offeror offers for sale, solicits an offer to buy, or sells securities with respect to which the total consideration received or sought to be received by the offeror shall exceed \$50,000; and (ii) offers for sale or solicitations of offers to buy made by the offeror of the securities are directed to not more than twenty-five offerees in this state during any period of twelve consecutive months; and (iii) all offerees of the securities offered for sale or for which solicitations of an offer to buy were made by the offeror are sophisticated investors and/or related persons; and (iv) the requirements set forth in sub-sections (c) and (d) of this Rule are satisfied; or in

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(3) A transaction with respect to which the Commissioner has, upon application to him, expressly withdrawn, or further conditioned or waived the provisions of this sub-section, or otherwise varied the terms hereof in accordance with the provisions of Section 26(b)(9) of the Act.

(c) Advertising Prohibition and Investment Restrictions

No offer for sale, solicitation for offer to buy or sale of securities for which an exemption is claimed under sub-sections (b)(1) or (b)(2) of the Rule shall be exempt from the registration provisions of the Act unless in connection with such offer, solicitation or sale—

(1) General Advertising is not utilized or employed in any manner;

(2) The offeror procures from each purchaser of its securities a representation that he has purchased the securities for investment purposes only and not for resale;

(3) All securities sold bear a conspicuous restrictive legend setting forth the restrictive character of the security; and,

(4) The issuer transmits appropriate stop-transfer instructions respecting such securities to the transfer agent, and if there be no transfer agent, the issuer duly notes such stop-transfer instructions on its stock transfer books.

(d) Form D-1 Filing Requirement

With respect to each transaction involving more than \$50,000, the information required by Form D-1 shall be filed with the Maryland Division of Securities not later than twenty (20) days after completion of the offering or within twelve months of the commencement of the offering, whichever shall first occur.

(e) Two Year Holding Period

All securities sold in reliance upon this Rule shall not be sold or otherwise transferred for a period of at least two years from the date of issue of such securities, unless such sale or other transfer shall be exempt from the registration provisions of the Act pursuant to the exemptions provided in Section 26(b) thereof including Section 26(b)(9); provided, however, that in the event such sale or other transfer shall be made pursuant to Section 26(b)(9) of the Act, such sale or other transfer shall comply in all respects with the provisions of this Rule other than this sub-section (e).

(f) *Institutional Investors*

For the purpose of determining the number of purchasers under section (b) (1) or the number of offerees under section (b) (2) of this Rule, institutional investors, as defined in Section 26(b) (8) of the Act, shall not be counted.

APPENDIX B

FORM D-1

This form must be filed with the Division of Securities for a transaction involving more than \$50,000.00 (the "Transaction") and for which an exemption from the registration provisions of the Act is claimed under Section 26(b) (9) and Rule S-7(b) (ii) thereunder.

1. _____
(Name of Issuer)
2. _____
(Name of Offeror, if other than issuer, and if all or part of the money received in the Transaction is received for said Offeror)
3. State the type of business in which the issuer is engaged.
4. State the dollar amount raised or sought to be raised by the Transaction.
5. State the following information: The names, employment positions and offices with the issuer, home and business addresses of all officers, directors, general or managing partners, and persons who own of record, or beneficially own, 10 per cent or more of the outstanding shares of any class of equity security of the issuer.
6. State whether any of the persons named in Item No. 5 has ever been convicted of a crime, adjudicated a bankrupt or made a general assignment for the benefit of creditors or been a principal of any company which was reorganized in bankruptcy, adjudicated a bankrupt or made a general assignment for the benefit of creditors, or whether any or such persons or companies has been the subject of a civil or criminal proceeding instituted by a State or Federal Securities Agency. If answer is "yes," explain fully.
7. State the names, home and business addresses and occupations of each person to whom an offer of the securities has been directed pursuant to the Transaction.

The following affirmation shall appear at the end of the form filed with the Division in compliance with the provisions of Rule S-7(b) (ii).

There shall follow under such affirmation the signatures of all officers and general or managing partners of the issuer and a majority of the Board of Directors of the issuer.

"We do solemnly declare and affirm under the penalties of perjury that to the best of our knowledge the contents of the foregoing document are true and correct."

Signed: _____