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AVOIDING LIABILITY IN BEST EFFORTS OFFERINGS AND CLOSINGS UNDER RULE 10b-9



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I. Introduction

Private placement offerings usually are structured as best efforts, contingency offerings, meaning (1) that the underwriter or placement agent does not commit contractually to purchase or place any securities, and (2) that the actual closing, or sales of securities pursuant to the offering, is contingent on the occurrence of a particular event, most often the receipt of orders for a minimum aggregate amount of the securities by a certain offering expiration date. Best efforts contingency offerings facilitate capital raising because the brokers or others participating in the offering are not required to commit to purchase the securities in advance, and the purchasers know that their purchases will not be accepted unless the designated minimum amount of sales is achieved.

Out of the great number of best efforts offerings conducted each year, many fail to receive orders for the designated minimum level of subscriptions within the maximum offering period, and are unable to close under their original terms. A failure to close means that all investor funds must be returned, and the participants in a failing offering often will go to great efforts to try to find a way to close despite the lack of subscriptions. Many of the ways that are found involve misleading investors into believing that the designated minimum actually was met.

Both the SEC and FINRA have focused substantial enforcement efforts on closings of contingency offerings. FINRA has found substantial violations of Rule 15c2-4, which governs the handling of funds by broker-dealers in contingency offerings.¹ Unfortunately, however, the law applicable to such offerings has never been clear, and has been based on a partly unwritten body of interpretation regarding what constitutes a "bona fide" purchase of securities for purposes of the rules, what advance disclosure may be required regarding purchases by general partners or broker-dealers, and even what constitutes a contingency offering.

The purpose of this outline is to organize the written and unwritten law applied to contingency offerings and to suggest how contingency offerings should be structured to

¹ FINRA Notice to Members 98-4 (January 1998) ("In particular, members should note . . . that a broker/dealer affiliated with the issuer may only deposit investors' funds in an escrow account with a bank independent of the issuer and the broker/dealer; . . . that no person other than a bank may act as an escrow agent; and . . . that the member's attorney may not act as the 'agent or trustee' of a separate bank account.")

minimize the risk of violating the principal SEC rules that govern contingency offerings -- Rules 10b-9 and 15c2-4.

II. History — Rule 10b-9 and Rule 15c2-4

Offerings by entities that need a certain minimum level of funds to undertake operations, such as start-up stock offerings or real estate syndications, are usually structured as best efforts, contingency offerings, often referred to as "all-or-none," "part-or-none" or "minimum - maximum" offerings. In an all-or-none offering, all of the securities must be sold² within a specified period, and, if that condition is not met, those who subscribed for the securities will have all of their funds returned.

In a part-or-none, or minimum-maximum offering, a designated minimum amount of the securities must be sold within a specified time.³ If the minimum is sold within the designated period, subscribing investors must complete their purchases, and offering activities may continue, without any additional contingencies, for the duration of the offering period. On the other hand, if the minimum amount of sales is not met, subscribing investors must receive a full return of their funds and the offering is terminated.

The natural pressures to close offerings often lead to attempts by issuers to retain offering proceeds even though the required level of sales has not occurred. Also, prior to the adoption of Rule 15c2-4 (described below), broker-dealers participating in all-or-none or part-or-none offerings sometimes retained proceeds in their own hands beyond a reasonable period of time, thereby subjecting the proceeds to risk of loss. In either case, there was the risk that issuers ultimately would be capitalized with far less than the anticipated proceeds of the offering. The SEC responded in 1962 with the adoption of Rules 15c2-4 and 10b-9.

Rule 15c2-4⁴ makes it a "fraudulent, deceptive or manipulative act or practice" for purposes of Section 15(c)(2) of the Securities Exchange Act of 1934 (the "Exchange Act") for

² The contractual definition of "sale" for purposes of satisfying the contingency in an all-or-none or part-or-none offering may vary somewhat, but generally the relevant documents require a payment, in immediately available funds, of at least part of the purchase price, and a binding commitment to pay the remainder at a fixed time or times or on demand.

³ Another form of contingency offering is the "step" offering, in which additional groups of investors become obligated to complete their purchases as the level of sales in a particular offering moves from one designated level to the next. The "step" offering may be used, for instance, for a partnership which will purchase expensive equipment such as drilling rigs, and which requires a certain amount of funds to purchase each additional piece of equipment.

⁴ Rule 15c2-4 provides in full as follows:

It shall constitute a "fraudulent, deceptive, or manipulative act or practice" as used in Section 15(c)(2) of the Act, for any broker, dealer or municipal securities dealer participating in any distribution of securities, other than a firm commitment underwriting, to accept any part of the sale price of any security being distributed unless:

- (a) The money or other consideration received is promptly transmitted to the persons entitled thereto; or
- (b) If the distribution is being made on an "all-or-none" basis, or on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some

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any broker-dealer participating in a best efforts, contingency offering to accept any part of the sale price for the securities unless the broker-dealer either (i) promptly puts the funds in escrow and appoints as escrow agent a bank that has agreed in writing to make the appropriate transfer to the issuer or the investors upon the occurrence of the relevant contingency or (ii) promptly deposits the funds in a segregated bank account, with respect to which the broker-dealer acts as trustee or agent, and, upon the occurrence of the relevant contingency, promptly makes the appropriate transfer itself.⁵ Pursuant to Rule 15c3-1⁶ under the Exchange Act, broker-dealers

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further event or contingency occurs, (1) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred."

⁵ Interpretative letters, SEC enforcement proceedings, presentations by SEC staff members, and other materials shed some light on the technical requirements of Rule 15c2-4. In a 1983 enforcement proceeding, the SEC ruled that, although Rule 15c2-4, unlike Rule 10b-9, uses the phrase "distribution of securities," Rule 15c2-4 applies to both private placements and public offerings, so long as the offering meets the definition of "distribution" set forth in Rule 10b-6 under the Exchange Act. Baikie & Alcantara, Inc., Securities Exchange Act Release No. 19410 (January 6, 1983). Rule 10b-6, since replaced by Regulation M, defined "distribution" as any offering of securities, whether or not registered, that "...is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." Second, in an interpretive letter dated October 16, 1984 to Linda A. Wertheimer, Chairman, Subcommittee on Partnerships, Trusts and Unincorporated Associations, Federal Regulation of Securities Committee, American Bar Association, the SEC defined the term "prompt transmittal" as applied to escrow arrangements established in connection with contingency offerings of interests in direct participation programs. See FINRA Notice to Members 84-64 (November 26, 1984). The letter also addressed other payment mechanics for such escrow arrangements - in particular, the requirement that all checks representing offering proceeds be made to the order of the escrow agent, and not the broker-dealer. Third, in FINRA Notice to Members 84-7 (January 30, 1984), the SEC answered a number of frequently raised interpretative questions relating to Rule 15c2-4. For example, the SEC defined "receipt of offering proceeds" in the context of payment by check, defined "prompt deposit" as it applies to the use of segregated deposit accounts, and provided specifics as to who could act as the "agent or trustee" maintaining the segregated deposit account. Moreover, the Commission has held that a broker-dealer may not justify retention of an investor's funds on the ground that the investor had not submitted complete documentation; instead, the broker-dealer must promptly return funds to any investors not providing complete documentation. *In re Dillon Securities, Inc.*, SEC Rel. 34-31573 (December 8, 1992), 52 SEC Docket 2953. Finally, in an interpretative letter, the SEC stated that Rule 15c2-4 does not allow investment of offering proceeds in "money market funds, corporate equity or debt securities, repurchase agreements, bankers acceptances, commercial paper or municipal securities." *Investment Company Filing Guidance*, SEC Interpretative Letter dated January 11, 1990 (available December 2, 1992); see also, *FINRA Notice to Members 84-7* (January 30, 1984). Two presentations by an SEC staff member also shed some light on the SEC's interpretation of Rule 15c2-4. See Bergmann, "Contingency Offerings: Escrow Accounts and Related Issues," Broker-Dealer Compliance - A Compliance Conference for the Financial Services Industry (September 27, 1985); and Bergmann, "Some Compliance Considerations in Underwritings," Critical Current Legislative and Regulatory Issues Affecting Publicly Traded and Private Limited Partnerships (ABA Section of Corporation, Banking and Business Law, 1986 Annual Meeting) (July 15, 1986).

⁶ Rule 15c3-1 provides in relevant part as follows:

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maintaining net capital of at least \$250,000 can choose between depositing the proceeds of the offering in a segregated deposit account or placing the proceeds into escrow, whereas those broker-dealers not maintaining a net capital position of at least \$250,000 must put the funds into escrow.

Rule 10b-9, adopted under Section 10(b) of the Exchange Act, makes it a "manipulative or deceptive device or contrivance" to represent:

1. that a security is being sold on an all-or-none basis, unless the security is part of an offering made on the condition that all or a specified amount of the consideration paid will be returned to the purchasers unless (A) all of the securities are sold at a specified price within a specified time and (B) the seller receives the total amount due him by a specified date; or
2. that a security is being sold on the basis of a contingency that a certain amount be sold, unless it is part of an offering made on the condition that all or a specified amount of the consideration paid will be returned to the purchasers unless (A) a specified number of units of the security are sold at a specified price within a specified time and (B) the total amount due to the seller is received by him by a specified date.⁷

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[(a)(2)(i)] A broker or dealer...shall maintain net capital of not less than \$250,000 if it carries customer or broker or dealer accounts and receives or hold funds or securities for those persons. A broker or dealer shall be deemed to receive funds, or to carry customer or broker or dealer accounts and to receive funds from those persons if, in connection with its activities as a broker or dealer, it receives checks, drafts or other evidences of indebtedness made payable to itself or persons other than the requisite.....escrow agent.....

[(a)(2)(vi)] A broker or dealer that...does not engage in any of the activities described in paragraphs (a)(2)(i) through (v) of this section shall maintain net capital of not less than \$5,000...]

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Rule 10b-9 provides in full as follows:

(a) It shall constitute a "manipulative or deceptive device or contrivance", as used in Section 10(b) of the Act, for any person, directly or indirectly, in connection with the offer or sale of any security, to make any representation:

(1) To the effect that the security is being offered or sold on an "all-or-none" basis, unless the security is part of an offering or distribution being made on the condition that all or a specified amount of the consideration paid for such security will be promptly refunded to the purchaser unless: (A) all of the securities being offered are sold at a specified price within a specified time, and (B) the total amount due to the seller is received by him by a specified date; or

(2) To the effect that the security is being offered or sold on any other basis whereby all or part of the consideration paid for any such security will be refunded to the purchaser if all or some of the securities are not sold, unless the security is part of an offering or distribution being made on the condition that all or a specified part of the consideration paid for such security will be promptly refunded to the purchaser unless: (A) a specified number of units of the security are sold at a specified price within a specified time, and (B) the total amount due to the seller is received by him by a specified date.

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The purpose of the two rules is to ensure (1) that in offerings with a minimum sales condition, investors' funds will not be at risk until the designated amount of proceeds has been deposited in the segregated deposit account or placed in escrow, and (2) that investors' funds will be promptly returned if the designated amount has not been received by the stated cut-off date.⁸ The purpose was summarized in the release proposing Rule 10b-9:

It is the purpose of the proposed rule to prohibit any person from making any representation to the effect that the security is being offered on an "all-or-none" basis unless it is clear that the amount due to the purchaser is to be refunded to him unless all of the securities being offered are sold and the seller receives the total amount due to him in connection with the distribution.⁹

The release adopting Rule 15c2-4 described the Commission's concern as follows:

Sometimes the issuer on whose behalf a distribution is being made is a comparatively new company, is making the public offering to raise the capital necessary to begin or expand its activities, and the failure to receive it will substantially impair its ability to continue in business or to conduct necessary operations. In some cases the "sale" becomes final only if all the securities are sold within a specified period of time; and the arrangement contemplates that the payments made by customers will be returned to them if the distribution is not completed in the required time. The failure of

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(b) This rule shall not apply to any offer or sale of securities as to which the seller has a firm commitment from underwriters or others (subject only to customary conditions precedent, including "market outs") for the purchase of all the securities being offered.

⁸ Rule 10b-9 and Rule 15c2-4 do not apply to all situations where investors have the right to a return of their subscriptions upon the occurrence of a particular event. *Becherer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 43 F.3d 1054 (6th Cir. 1995). In *Becherer*, an issuer selling undivided interests in a future hotel created two distinct escrow accounts - an "interim escrow account" and a "closing escrow account." The issuer used the interim escrow account for any funds received prior to the achievement or failure of the minimum sales condition. After achievement of the minimum sales condition, any funds in the interim escrow account, and all other funds representing the purchase price of the securities, would become part of a "closing escrow account." If the issuer did not complete construction of the hotel within the required period of time, the closing escrow account would terminate, and the funds would be returned to the investors. Although the issuer failed to complete the hotel on time, it did not return the funds to the investors. The investors sued, claiming violations of Rules 10b-9 and 15c2-4. The lower court ruled against the investors, and the appeals court affirmed. According to the appeals court, "[p]ut in context it is clear that the District Court was actually holding that the securities regulations apply to the interim escrow account and not to the closing escrow account. This interpretation is consistent with the plain language of the regulations, and the *Becherer* plaintiffs have provided us with no reasons and no authority to find that this interpretation is erroneous." *Becherer*, 43 F.3d at 1062.

⁹ Securities Exchange Act Release No. 6864 (July 30, 1962), [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,855. See also Securities Exchange Act Release No. 6905 (October 3, 1962), [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,869 (adopting the rule).

the underwriter or a participating broker-dealer to transmit the funds, or to maintain them so that they will be insulated from and not be jeopardized by his unlawful activities or financial reverses, could involve a fraud either upon the person on whose behalf the distribution is being made or upon the customer to whom the payment is to be returned if the distribution is not completed.¹⁰

Securities Exchange Act Release No. 11532,¹¹ the principal (and only substantial) interpretive release regarding Rules 10b-9 and 15c2-4, also emphasizes that the principal concern is that the designation "all-or-none" not be used unless actual receipt by the issuer of the full proceeds of the offering is required:

[O]ne of the primary purposes of the rule was to prohibit the designation "all or none" or "part or none" from being utilized where the underwriter is required only to get persons to agree to purchase the specified minimum securities within the specified period and is not required to collect full payment for such sales within the specified period.

Thus, the release states, an offering may not be considered sold for purposes of the representation "all-or-none" unless "all the securities required to be placed are sold in bona fide transactions and are fully paid for." The release goes on to indicate that "non-bona fide sales" are sales which are "designed to create the appearance of a successful completion of the offering, such as purchases by the issuer through nominee accounts or purchases by persons whom the issuer has agreed to guarantee against loss."

Whether an offering may be closed consistent with Rule 10b-9 is not always clear, in part because it is not always clear what sales are "bona fide." For many years, the best available guidance took the form of a few SEC staff-prepared seminar outlines,¹² one significant no-action letter¹³ and a few published articles.¹⁴ Over the last 20 years, as discussed below, various courts and the Commission attempted to set standards that go well beyond prior interpretations and that create significant risks for counsel in closing contingency offerings. Most recently, and as

¹⁰ Securities Exchange Act Release No. 6737 (February 21, 1962), [1961-64 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,825.

¹¹ (July 11, 1975), Fed. Sec. L. Rep. (CCH) ¶ 22,730.

¹² Scarff, "Developments in Trading Practices," Fourteenth Annual Institute on Securities Regulation, vol. 1, p. 435 (1982); Bergmann, "Contingency Offerings: Escrow Accounts and Related Issues," Broker-Dealer Compliance - A Compliance Conference for the Financial Services Industry (September 27, 1985); Bergmann, "Some Compliance Considerations in Underwritings," Critical Current Legislative and Regulatory Issues Affecting Publicly Traded and Private Limited Partnerships (ABA Section of Corporation, Banking and Business Law, 1986 Annual Meeting) (July 15, 1986).

¹³ Linda A. Wertheimer, 1986 SEC No-Act. LEXIS 2272 (April 29, 1986).

¹⁴ Robbins, *All-or-None Offerings*, 19 Rev. Sec. Reg. 59 (March 19, 1986); Robbins, *All-or-None Offerings: An Update*, 19 Rev. Sec. Reg. 181 (August 27, 1986); and Robbins & Little, *Closing Unsuccessful Offerings: The New Scope of Rule 10b-9*, 4 Insights 10 (May 1990).

discussed below, the D.C. Circuit has recognized the confusion caused by those decisions and has taken the first step toward turning the tide.

III. Application - Rules 10b-9 and 15c2-4 in Practice

A. Purchases by the General Partner or Affiliates

1. Discretionary Purchases of Unsold Units

As a general matter, purchases by persons who have an interest in the completion of an offering may be considered “bona fide” sales for purposes of rule 10b-9.¹⁵ In the case of private offerings of partnership interests under Regulation D, the staff has approved such purchases by the general partner of the partnership making the offering where (i) the issuer has disclosed the possibility that the general partner may purchase limited partnership interests in order to meet the specified minimum; (ii) the maximum amount of the possible purchases is disclosed; and (iii) the purchases are made for investment rather than resale.¹⁶

The release cited above applied by its terms to private offerings only, and at least the requirement that purchases be made “for investment” could be read as limited to the private offering context.¹⁷ The staff has indicated, however, that it considers the position taken in the release to be fully applicable to public offerings,¹⁸ and the staff has confirmed in discussions that it believes specifically that purchases by the general partner or affiliates must be made *for investment* even in a public offering.

¹⁵ Naturally, such purchases may not be made by the issuer itself, where the effect would be to reduce the capital anticipated to be available to the issuer at the completion of the offering. Securities Exchange Act Release No. 11532 (July 11, 1975), Fed. Sec. L. Rep. (CCH) ¶ 22,730. In the situation generally presented, however, purchases by affiliates of the issuer would not affect the financial condition of the issuer.

There are also certain disclosure requirements which will apply whenever there is a possibility that an affiliate may purchase a substantial amount of securities. At a minimum, the offering document should describe the risk that such purchases may make it more difficult for unaffiliated investors to exercise whatever voting rights are provided by the documents, and should also indicate that such purchases may create an additional conflict of interest between the sponsor and unaffiliated investors, since the sponsor may have an interest in recovering its investment earlier than unaffiliated investors.

¹⁶ Securities Act Release No. 6455 (March 3, 1983), 17 C.F.R. § 231.6455, Fed. Sec. L. Rep. (CCH) ¶ 2380, at Question 79.

¹⁷ Note that Item 18(D) of Securities Act Industry Guide 5, Fed. Sec. L. Rep. (CCH) 3829, specifically contemplates resales, in a public offering, of securities purchased by the general partner or affiliates to meet the minimum in a real estate offering:

“If the General Partner or its affiliates intend to purchase interests, and such interests will be included in satisfying the minimum offering requirements, it should be disclosed whether such interests are intended to be resold, and if so, the period of time these interests will be held prior to being resold. Depending on the circumstances, such interests may be considered to be unsold allotments under Section 4(3) of the Act. (See Securities Act Release 4150.)”

¹⁸ Bergmann, “Contingency Offerings: Escrow Accounts and Related Matters,” n. 12 *supra*.

This position appears to blur together the concepts of "purchasing for investment" and "taking the risk of investment." The relevant question would appear to be not whether a purchase is made "for investment," since in a public offering no such requirement is imposed on any purchaser, but whether the purchase is "bona fide" for purposes of Rules 10b-9 and 15c2-4. Neither existing releases nor case law have taken the position that a sale must be "for investment" to be bona fide, so long as the general partner or affiliate is purchasing the securities on the same terms as other investors, for the same consideration, and without any guarantees against loss. He must, under the case law, take the risk of the investment. It remains unclear, however, to what extent the staff may consider purchases for resale by the sponsor or affiliates in a public offering to be inconsistent with Rules 10b-9 and 15c2-4.¹⁹

2. Loans or other commitments by the sponsor

The sponsor of a contingency offering may commit, at commencement of the offering, to purchase any securities remaining unsold at the conclusion of the offering. Similarly, the sponsor may wish to have a closing prior to receipt of the required minimum, at which the sponsor would lend the issuer the purchase price of the unsold securities, with repayment to come either from the proceeds of further sales or from conversion of the loan into the unsold portion of the offering.²⁰

In *Roger C. Hartman, Esq. (Urban Improvement Fund Ltd. - 1975)*,²¹ the staff indicated that where a sponsor of a contingency offering commits to purchase any unsold securities upon the closing of the offering, the offering should not be considered a contingency offering subject to Rules 10b-9 and 15c2-4, as the investors' funds would not be returned to them regardless of the success of the offering.

An offering such as that described in *Hartman*, however, still involves substantial risks for investors, including improper handling of funds by broker-dealers and diversion of funds by the issuer. Similarly, a sponsor's commitment to lend funds to the issuer can involve substantial risks relating to nonperformance or inadequate disclosure of the terms of the loan. In a

¹⁹ See, e.g., *Blinder, Robinson & Co., Inc.*, Release No. 34-23913 (December 19, 1986), 37 SEC Docket 332, discussed below, in which one of the activities criticized was the underwriter's continuation of the offering in order to resell the units it had purchased. See also, *William Jackson Blalock*, Release No. 35002 (1994), discussed below. In both cases, however, the defendants were alleged to have closed the offerings in such a manner as to fraudulently create the impression that an unsuccessful offering had in fact satisfied its contingency.

²⁰ The SEC staff position until 1985 had been that the sponsor of a limited partnership offering could loan funds to the partnership in order to meet the required level of sales, on the conditions (i) that the fact that the loan may be made and the maximum amount of the loan are disclosed and (ii) that by the terms of the offering, the general partner must make an irrevocable commitment, disclosed in the offering document, to purchase for investment any of the securities not sold to investors at the expiration date of the offering. (Scarff, "Developments in Trading Practices", fn. 12, at 473.) A more restrictive position was taken in a 1985 staff interpretive letter, *Timothy M. Horner, Esq.* (October 16, 1985), in which the staff concluded that an interim closing based on the conditions outlined above would not be acceptable because it (i) would allow a closing before satisfaction of the minimum sales condition and (ii) would allow a closing based on a commitment to purchase rather than an actual purchase.

²¹ [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) 80,396 (avail. November 3, 1975).

subsequent letter, *Linda A. Wertheimer*,²² the staff supplemented *Hartman* with the following requirements:

- (1) The sponsor must unconditionally agree that it will either purchase unsold interests for investment upon termination of the offering or loan the partnership all or a specified portion of the purchase price of the unsold interests (either at the Interim Closing or at the Termination Date), and must be able to demonstrate a present and continuing ability to satisfy its commitment;
- (2) If there is to be a closing prior to completion of the offering, the Specified Minimum must be sold in bona fide transactions prior to the interim closing;²³
- (3) The offering materials must contain full and fair disclosure of (i) the terms of the offering, including the extent and nature of the sponsor's commitment and its ability to satisfy such commitment; (ii) the risks associated with the sponsor's commitment;²⁴ (iii) the termination date of the offering; and (iv) the maximum level of potential purchases of securities or loans by the sponsor; and
- (4) Any purchases by the sponsor must be for investment and not resale, and the offering materials must so state.

²² 1986 SEC No-Act. LEXIS 2272 (April 29, 1986).

²³ Paragraph 2 of Part A contains a reference to the securities having been "fully paid for with customer funds that have cleared the banking system," but this should not be read to mean that the funds must have cleared the banking system by the Specified Date. The staff previously has indicated that subscriptions received by a selling broker on the last day of an offering period may be counted if the "prompt transmittal" guidelines of FINRA Notice to Members 84-64 are followed, the checks deposited in the escrow account clear the banking system, and the suitability of the investor has been determined.

²⁴ Disclosure of the risks associated with the general partner's commitment must of course depend on the facts of the particular offering. In many situations, the risks associated with substantial purchases of interests by the general partner will include the following:

- (1) As a holder of limited partnership interests, the general partner is likely to have interests which conflict with those of other limited partners. If the general partner is required to purchase a substantial number of limited partnership interests, it may have an interest in a sale or refinancing of the partnership's assets earlier than would the other investors.
- (2) Substantial purchases of limited partnership interests by the general partner may limit the ability of the other limited partners to exercise voting rights granted by the partnership agreement.
- (3) Substantial purchases of limited partnership interests by the general partner may limit the general partner's financial capacity to fulfill other financial obligations to or on behalf of the partnership.

B. Changes in Offering Terms

Rules 10b-9 and 15c2-4 have been interpreted to require a high degree of specificity in the terms of an offering. A change in a material term of an offering is in effect a termination of the offering as originally made, and requires that investors' funds be returned. The staff has taken the position that any of the following changes in the terms of an offering subject to Rules 10b-9 and 15c2-4 is in effect a termination of the offering as to all previous investors and requires that all proceeds be returned to the investors:

- (1) Extension of the offering period.
- (2) Change in the offering price.
- (3) Change in the minimum purchase required of investors.
- (4) Change in the amount of proceeds necessary to release proceeds in escrow.
- (5) Change in the application of proceeds.²⁵

The staff has permitted offerings to be extended beyond the initial offering period only if the following procedure is followed:

- (1) A reconfirmation offer must be made to all subscribers prior to the specified expiration date. The reconfirmation offer must disclose the extension and any other material information necessary to update the prospectus disclosure in order to permit subscribers to make an informed new investment decision.
- (2) The reconfirmation offer must be structured so that the subscriber affirmatively elects to continue his investment and those subscribers who take no affirmative action will have their subscriptions returned.
- (3) In order to comply with the requirement of Rule 15c2-4 that funds held in escrow pending a stated event or contingency be promptly returned if the stated event or contingency does not occur, the reconfirmation offer must be made far enough in advance of the initial expiration date so that a subscriber who does not reconfirm will have his funds returned promptly after the initial expiration date.²⁶

²⁵ Bergmann, "Contingency Offerings: Escrow Accounts and Related Issues," *supra*, note 5; Scarff, "Developments in Trading Practices," *supra*, at 471 (extension of offering period); *Tucson Hotel Associates* (March 12, 1985) (staff interpretive letter re extension of offering); *Reliance Trust Company* (July 25, 1985).

²⁶ Securities Act Release No. 6455 (March 3, 1983), Fed. Secs. L. Rep. (CCH) ¶ 2380, at Question 80; Scarff, "Developments in Trading Practices," *supra*, at 471-472. Bergmann, "Contingency Offerings:
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The same procedure would apply in a public or private offering. In a public offering, the offering may proceed by post-effective amendment rather than a new registration statement, although in any case but an extension of the offering period, funds must actually be returned to investors prior to the reconfirmation offer. *See, e.g., Tucson Hotel Associates* (March 12, 1985). Inattention to the expiration date of an offering has been held sufficiently reckless to constitute a violation of Rules 10b-9 and 15c2-4. *See SEC v. Electronics Warehouse*, 689 F. Supp. 53 (D. Conn 1988).²⁷

In a FINRA Consent issued in April 2012 (European American Equities, FINRA Case #2009020941102), for example, the placement agent for a minimum-maximum contingency private placement offering of securities extended the deadline and amended the price and terms of the offering when no subscriptions had been received by the initial expiration date. As of the amended contingency deadline, investors subscribed to the offering, but in an amount less than the stated minimum contingency. When the amended contingency deadline passed, the placement agent did not return the funds. Instead, it further extended the deadline and changed the offering terms. After finally meeting the contingency, the firm closed the offering and disbursed funds from the escrow account. FINRA concluded that the placement agent willfully violated Rule 10b-9 by failing to obtain the consent of the investors who subscribed to the offering prior to the amended contingency deadline before extending the offering deadline, and failing to return investor funds when the contingency deadline expired and when the firm made changes to the offering. The placement agent was censured and fined.

C. Duty to Update Disclosure

Practitioners have often argued that there is no duty to provide updated substantive disclosures to investors who have executed subscription documents in a contingency offering, since those investors already have made the commitment to invest. This position was squarely rejected by the Fifth Circuit in *Banc One Capital Partners Corporation v. Kneipper*, CCH Fed. Secs. L. Rptr. ¶ 98,935 (1995), in which the court found that promoters had a duty to provide subscribing investors with information the promoters obtained after execution of the subscriptions. The information related to the funding concerns which underlie the typical minimum sales condition - in particular, the promoters failed to inform subscribing investors of arrangements that had the effect of reducing substantially the contributions of two significant investors.

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Escrow Accounts and Related Matters," *supra* note 5, indicates that "extension of the offering period is the only situation involving a change in the terms of the offering in which the staff deems such a reconfirmation procedure to be appropriate," but provides no reason why more should be required in the case of, for example, a change in the minimum purchase required of investors. The staff specifically has refused to permit the reconfirmation procedure where the sponsor proposed to reduce the level of minimum subscriptions required for closing. *Tucson Hotel Associates* (March 12, 1985).

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Extension of an offering period after the minimum amount of subscriptions has been received within the disclosed period would not violate Rule 10b-9 and therefore would not require compliance with these procedures. *In the Matter of Erik W. Chan*, 73 SEC Docket 727-54 (Sept. 14, 2000).

D. What Sales May Be Counted; "Last Day Sales"

Rules 10b-9 and 15c2-4 require both that the specified amount of securities be "sold" within a specified time and that the total amount due to the seller be received by him by a specified date. Where funds are received by a selling broker on the last day of the offering period, but not deposited in escrow on that day, may they be counted toward the required minimum? The staff has indicated that they may be counted,²⁸ so long as the "prompt transmittal" guidelines of FINRA Notice to Members 84-64 are followed, but this does not mean that the escrow may be released immediately.

All checks deposited in the escrow account must have cleared the banking system and represent immediately available funds for the securities to be "fully paid" within the meaning of Securities Exchange Act Release No. 11532.²⁹ A broker may not substitute its own funds for those of a customer whose check has been dishonored.³⁰ It is clearly contrary to Rules 10b-9 and 15c2-4 to close on the basis of checks which the broker knows will not be honored.³¹ Further, to the extent that the offering requires a suitability determination (or, in the case of an offering under Regulation D, an accreditation determination) by the managing broker-dealer or sponsor, subscriptions may not be counted until the suitability of the investor has been determined.³²

E. Discount Purchases

"Discount purchases" – that is, purchases made at reduced or waived brokerage commissions – have presented special problems under Rule 10b-9, because all investors are not purchasing on the same terms to meet the required minimum. The SEC staff at one time took the position that purchases by persons entitled to purchase securities net of brokerage commissions must be at the full purchase price, with a rebate of the commissions after closing.

In the *Linda A. Wertheimer* letter cited above, the staff substantially modified its position, announcing that in offerings subject to Rules 10b-9 and 15c2-4, the issuer may offer to sell securities on special terms, such as full or partial waiver of commissions or volume discounts, as long as (a) such varied terms are offered uniformly to persons in a certain specified class or classes, and (b) such terms are fully disclosed in the offering materials. Although the letter does

²⁸ Bergmann, "Contingency Offerings: Escrow Accounts and Related Issues," *supra*, note 5.

²⁹ See *Chris Anderson* (March 29, 1984) (staff interpretive letter).

³⁰ See *Roald George Gregerson*, 46 SEC 387 (1976). See also, *SEC v. Leonard S. Sands*, (C. Dist. Cal. August 10, 1996), 62 SEC Docket 2410, Rel. No. LR-15046 (Sept. 16, 1996) (violation of Rule 10b-9 found where chairman of issuer purchased a \$1 million interest for which the check originally received in payment had been returned one month after the closing).

³¹ *SEC v. Manor Nursing Center*, *supra*. In *SEC v. First Pacific Bancorp*, No. 96-56687 (9th Cir. April 28, 1998), the appeals court upheld sanctions against a bank holding company, its chairman and a related entity for actions related to an offering in which the required minimum of \$1.5 million was met by \$500,000 diverted from an offering by a related entity, a \$1 million bad check and \$188,000 in actual proceeds.

³² Bergmann, "Contingency Offerings: Escrow Accounts and Related Issues," note 5, *supra*.

not state explicitly that such sales may be counted in determining whether a designated minimum sales level has been met, the staff informally has confirmed that they may.

F. Refunds

On failure of the minimum sales condition, Rules 10b-9 and 15c2-4 require that "all or a specified amount" of investors' funds be promptly returned.³³ See *SEC v. Electronics Warehouse*, 689 F. Supp. at 65. If less than all of an investor's funds may be refunded, the minimum amount that will be refunded must be stated in the offering memorandum.

The risks to which investors' funds may be subject should not include the form of investment of the escrow account. Offerings made through FINRA member broker-dealers are required to comply with FINRA Notice to Members 84-7 (January 30, 1984)³⁴ with respect to investment of escrow accounts. To the extent that an offering is not required to, and does not comply with the investment guidelines, there should be an appropriate risk factor dealing with risk of loss of the proceeds.

G. Purchases by Affiliates of the Issuer or Others Interested in the Success of the Offering; the "Corroboration Theory"

One of the most troubling, and troublesome topics under Rule 10b-9 has been the question when purchases of securities by affiliates of the issuer may be considered to be "bona fide," and therefore counted in reaching the designated minimum level of proceeds.

The underlying purpose of Rules 10b-9 and 15c2-4, as stated in their adopting and interpretive releases, is to prevent offerings made on a minimum sales condition from closing if the issuer will not receive the required amount of funds by the stated cut-off date. The core decisions applying the rule all involved schemes designed to create the false appearance that the issuer has received the amount of proceeds necessary to satisfy the minimum sales condition.³⁵

For example, in *SEC v. Manor Nursing Center*, 340 F. Supp. 913 (S.D.N.Y. 1971), *modified*, 458 F.2d 1082 (2d Cir. 1972), the issuer and selling shareholders in a public all-or-none stock offering received the proceeds of the offering even though, at the time of the closing,

³³ Investors' funds must be returned to them directly, unless the investors authorize otherwise. Return of investors' funds to brokerage accounts without their consent was found to be a violation of Rule 15c2-4. *In the Matter of Richard Harriton*, 72 SEC Docket 506-3 (April 20, 2000).

³⁴ See also, *Investment Company Filing Guidance*, SEC interpretive letter dated January 11, 1990 (available December 2, 1992).

³⁵ See, e.g., the recent SEC enforcement action *In the matter of National Partnership Investments Corporation*, 64 SEC Docket 2024, Rel. No. 33-7425 (June 25, 1997), finding a 10b-9 violation where the placement agents, in order to meet the designated minimum for the offering, arranged for another partnership to release capital contributions and borrow funds in order to pay a construction contractor, which did not have sufficient assets to qualify as an investor in the pending offering but used the money to partially fund a subscription to the pending offering. The co-placement agents "knew or should have known that the final subscription did not come from a bona fide investor. Each was, therefore, a cause of the violations. . . ."

all of the purchasers' checks had not cleared and the number of shares purchased did not equal the number offered. Certain of the selling shareholders then reinvested offering proceeds to buy unsold shares "in an effort to make it appear that the issue had been sold." 340 F. Supp. at 918. After the closing, checks for over half the proceeds bounced. The checks delivered by the underwriter to the selling shareholders in turn bounced, whereupon the issuer paid out to the selling shareholders the proceeds it had received. The court described the scheme as "a 'bootstrap operation' to give the underwriting a facade of completeness." 340 F. Supp. at 924.³⁶

Similarly, in 1982, in *SEC v. Blinder, Robinson & Co., Inc.*,³⁷ the issuer and underwriter of an all-or-none stock offering committed a portion of the proceeds in advance of the closing to obtain a bank loan to purchase additional shares, and obtained funds from the escrow account prior to the closing of the offering. The underwriter then engaged in substantial trading activity in the stock, all without an actual closing of the offering ever taking place.

Although the scheme in *Blinder, Robinson* clearly violated Rule 10b-9, the court, in dictum, expanded the scope of the rule by stating that investors in an all-or-none offering by a new company are entitled to assume that the offering will succeed only if their investment judgment is corroborated by enough other investors to satisfy the minimum sales condition:

[I]n an "all or none" offering of securities by a new company, whether all the securities have been sold to the public in bona fide transactions is of particular importance because the "all or none" contingency is the investors' principal protection. Each investor is comforted by the knowledge that unless his judgment to take the risk is shared by enough others to sell out the issue, his money will be returned.³⁸

The quoted language appears to have been based at least in part on the decision in *A.J. White & Co. v. SEC*,³⁹ a 1977 case involving a public part-or-none offering. In *A.J. White & Co.*, two principals of the issuer arranged for loans from a bank to employees of the issuer and certain acquaintances of the principals on the understanding that the employees and acquaintances would use the loans to purchase stock and then quickly re-sell the stock, repaying the loans with the proceeds of the stock sales. The court found that the scheme rendered misleading the portions of the prospectus dealing with the method of distribution:

³⁶ This sort of scheme has by no means fallen out of favor. In *SEC v. First Pacific Bancorp*, No. 96-56687 (9th Cir. April 28, 1998), the appeals court upheld sanctions against a bank holding company, its chairman and a related entity for actions related to an offering in which the required minimum of \$1.5 million was met by \$500,000 diverted from an offering by a related entity, a \$1 million bad check and \$188,000 in actual proceeds.

³⁷ *SEC v. Blinder, Robinson & Co., Inc.*, 542 F. Supp. 468 (D. Colo. 1982); *aff'd* [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,491 (10th Cir. 1983), *cert. denied*, 105 S. Ct. 783 (1985).

³⁸ 542 F.Supp. at 476.

³⁹ 556 F.2d 619 (1st Cir. 1977), *cert. denied*, 434 U.S. 969 (1977).

The knowledge that the minimum amount has been sold to bona fide investors may be a very important matter to the other investors. Particularly in cases such as this, an offering of shares in a new company, one of the investors' major concerns will be whether the price they are paying for the securities is a fair market price. The inability of the underwriter to sell the specified minimum to bona fide investors may well indicate that the market judges the offering price to be too high. *Thus, to declare an offering completed through non-bona fide sales financed through bank loans, where the purported investors have not made an investment decision backed with their own money, may significantly mislead the legitimate investors as to a crucial factor in their decision.*⁴⁰

The quoted language of *A. J. White*, while describing fraudulent conduct, should not be read to interpret Rule 10b-9. In fact, the court went on to state as follows:

[I]t would be a very serious violation of the representations of the issuer and underwriter to the subscribers to declare such an offering sold when the minimum amount had not been realized. See generally Rule 10b-9 17 C.F.R. § 240.10b-9.... *This is not such a case, however, for here the minimum amount of funds was received by the issuer.*⁴¹

Blinder, Robinson's "corroboration" theory, with its concept of investor "comfort," gives Rules 10b-9 and 15c2-4 far more content than ever appeared in their adopting and interpretive releases, and could lead to the conclusion that even where securities are purchased by persons taking the risk of the investment, the fact that the purchasers are affiliated with the issuer (or otherwise lack independent judgment) might result in a failure of the minimum sales condition. For example, in assessing whether the minimum sales condition has been met, would the issuer have to ignore purchases by an underwriter for discretionary accounts?⁴² Similarly, in a private offering of real estate limited partnership interests, would substantial purchases by the seller of the real estate to be acquired cause a failure of the minimum sales condition? Is the answer different if the purchases are made by officers of the sponsor who, under the terms of the offering, are able to purchase units net of commissions?

The *Blinder, Robinson* "comfort" language, extending as it does far beyond the stated purposes of Rules 10b-9 and 15c2-4, appears to prove too much, and should not be the basis for incorporating into the two rules a vague requirement relating to investor assurance, yet

⁴⁰ *Id.* at 623 (emphasis added).

⁴¹ *Id.* (emphasis added).

⁴² This question was raised, but not decided, by Administrative Law Judge Regensteiner in his Initial Decision in *Rooney, Pace, Inc.*, Administrative Proceeding File No. 3-6332 (May 24, 1985), at n. 24 (citing *Blinder, Robinson*).

references to that reasoning have become increasingly common in SEC staff interpretations, in SEC and FINRA opinions and in reported cases.⁴³

In *C. Brock Lippitt*, Release No. 34-23495 (August 4, 1986), 36 SEC Docket 277, three principals (and 75% owners) of the underwriter of a part-or-none stock offering purchased sufficient unsold shares to satisfy the minimum sales level required for a closing. The money to purchase the stock was drawn from a firm account,⁴⁴ and at the closing held immediately thereafter the firm received compensation in excess of the purchase price of the shares. "Thus," the Commission stated, "in effect, payment for those purchases was made with the firm's underwriting compensation, compensation it was not entitled to receive unless the minimum amount of the offering had been sold."

This statement falls somewhat short of reasoned argument. There was no allegation that the principals did not provide good funds to the escrow account, or that the payment received from the offering was necessary to cover the check written to purchase the units. What, then, was the basis for the Commission's conclusion that the purchases violated Rule 10b-9?

The Commission first stated that "[i]t is well established that undisclosed purchases by underwriters or their affiliates, arranged for the purpose of closing an unsuccessful 'all-or-none' or 'part-or-none' offering, are fraudulent." The Commission then asserted (citing *A. J. White and Blinder, Robinson*) that "[t]he 'all-or-none' and 'part-or-none' contingencies have been called the 'principal protection' of investors. They guarantee each investor that his money will be refunded unless other public investors share his view that the risk he is taking is worthwhile, and that the price he is paying is fair. Here applicants frustrated the legitimate expectations of investors by closing the . . . offering although the required minimum had not been sold to the public."⁴⁵

The Commission's reasoning provided little guidance for underwriters and counsel. Absent other factors, is it a "legitimate expectation" of investors that the underwriter and its affiliates will buy no securities in an offering subject to a minimum sales condition? What about other parties, such as lawyers, accountants and real estate brokers, who also have compensation interests in the offering? If they can buy some, but not enough to "frustrate . . . legitimate

⁴³ Thus, for example, the staff indicated in a 1985 interpretive letter under Rule 10b-9 that satisfaction of the "Specified Sales Level" in an all-or-none or part-or-none offering "indicates that the offering was priced fairly". *Timothy M. Horner, Esq.* (October 16, 1985). See also, Bergmann, "Contingency Offerings: Escrow Accounts and Related Issues," *supra*, note 5.

⁴⁴ In its appeal brief to the D.C. Circuit, the SEC staff alleged that the money was taken from a "special Account for the Exclusive Benefit of Customers." *Svalberg v. SEC*, No. 86-1674; *Lippitt v. SEC*, No. 86-1708, filed September 4, 1987.

⁴⁵ The cases cited in support of this conclusion are not helpful to the Commission. In *SEC v. Commonwealth Chemical Securities, Inc.*, 410 F. Supp. 1002 (S.D.N.Y. 1976), *aff'd in pertinent part*, 574 F.2d 90 (2d Cir. 1978), the underwriters had arranged for nominee purchases without good funds; in *A.J. White & Co. v. SEC*, the court based its decision in part on Rule 10b-5 and focused on representations in the prospectus other than the ones dealing with the existence of a minimum sales condition; in *Blinder, Robinson*, the escrow was blatantly broken before the minimum was reached. No case had held, other than in dictum, that purchases by an underwriter in an all-or-none offering violate the minimum sales condition.

expectations," what amount is too much? What if the offering documents specifically seek to limit or to eliminate any such "expectation?"

The *Lippitt* decision did not provide any clear guidance for future cases. The Commission appears to have concluded that it was wrong for the brokers to subscribe for an amount of shares that was less than the commission that they would earn. One might conclude that if the purchases by the underwriter had been substantially greater in amount than the commissions it would receive, the Commission would have been much less likely to have condemned them, since the purchases would not have been funded wholly by the commissions. Is the "legitimate expectation" of the investor that if the underwriter purchases, he will not purchase very much, or is it instead that if he purchases, he will purchase in excess of his compensation? The former is less significant to the offering, but arguably funded out of compensation; the latter has a more material effect on the offering, but the underwriter has invested his own funds and is not relying on his compensation from the offering to pay for the securities.

One might suggest that this portion of the *Lippitt* decision was wrongly decided, and represented the first example of the dangers inherent in the "corroboration" or "comfort" doctrine. As pointed out earlier, the test which should govern decision making under Rules 10b-9 and 15c2-4 is whether the issuer will receive the required amount of funds by the stated cut-off-date. In *Lippitt*, the principals of the underwriter appear to have made bona fide purchases of the shares with good funds. The transactions did result in the principals having invested a substantial portion of their underwriting commission in the securities, but this should prove irrelevant for purposes of Rules 10b-9 and 15c2-4, since the issuer did not guarantee the underwriters against subsequent loss on their investment.⁴⁶

Unfortunately, *Svalberg v. SEC*,⁴⁷ the 1989 opinion of the D.C. Circuit affirming the Commission's order in *Lippitt*, raises even greater uncertainties and risks. The court accepted

⁴⁶ The Commission's decision soon after *Lippitt*, in *C. E. Carlson, Inc.*, CCH Fed. Secs. L. Rep. ¶ 84,036 (September 11, 1986), *aff'd*, CCH Fed. Secs. L. Rep. ¶ 93,800 (10th Cir. 1988), presented a much clearer case of violation. In *Carlson*, a part-or-none stock offering, the broker-dealer arranged for short-term loans to parties who would receive payments from the proceeds of the offering, to enable those persons to purchase shares to meet the minimum proceeds required for an initial closing. They then received payments from the proceeds of the offering in excess of their investment, and repaid the short-term loans. The Commission stated that the conditions of the offering had not been met by the last-minute purchases. While the reasoning is not clearly stated, it appears that the decision that the purchases were not "bona fide" rests principally on the fact that the related parties who made the purchases knew that they would receive a payment of more than their investment if the offering closed. The opinion notes that "last-minute purchases, financed by loans from persons with an interest in the offering's success and ultimately by the offering's proceeds, were arranged by Carlson to give the appearance of a successful offering. Respondents were the chief beneficiaries of Carlson's fraudulent scheme."

It is open to question whether the Commission would have reached the conclusion that the purchases were fraudulent if the purchases had been in amounts substantially in excess of the compensation expected to be received by the purchasers, or if no loans had been made. The opinion also noted that the prospectus did not state that insider purchases could be used to meet the minimum. In affirming the Commission's decision, the Tenth Circuit emphasized the investor expectations issue, concluding that "in combination these steps defeated the part or none disclosure in the prospectus."

⁴⁷ *Svalberg v. SEC*, 876 F.2d 181 (1989).

petitioners' arguments that their purchases were bona fide purchases for investment and were relatively small in amount compared to the offering as a whole. Nevertheless, citing *A.J. White's* "fair market price" language, the court concluded that the purchases were fraudulent because the minimum shares had not been sold *to the public*:

The all-or-nothing provision serves not only to ensure that the issuing firm has sufficient funds to complete its project, but also to give investors some reasonable indication that they are paying a fair market price for their investment....It is not seriously disputed that petitioners purchased the SanAnCo stock for the purpose of closing the underwriting; indeed, petitioners' briefs basically admit as much. . . . The mere fact that petitioners retained their stock rather than selling it immediately did not ameliorate the damage done outside investors who lost an assurance that a given number of other *outside investors* shared their assessment of the stock's value. *Even if petitioners purchased the stock partially as an investment and partially to close the offering, this still distorted the information available to the public about the quality of the offering.* A principal who purchases with mixed motives may be willing to pay more than a reasonable price to ensure the success of the offering; whereas outside investors normally will buy the stock *only* for *bona fide* investment reasons. In this case, petitioners acted to create a false impression that the required minimum number of shares had been sold to the public; therefore, their purchases of SanAnCo with a purpose of closing the underwriting simply cannot be viewed as *bona fide* investments. (emphasis added).

It is also clear that petitioners' failure to inform investors that stock could be purchased by persons associated with the underwriter is "material" to the charges against them.

The court then went on to dismiss petitioners' argument that the purchase of only seven percent of the minimum offering was too small to be material:

Petitioners' stock purchases were made in the face of what they believed to be a deteriorating market; their actions were material because they purchased the final unsold block of securities with a purpose and effect of *closing* what appeared to be a weak underwriting. *No matter the amount of stock petitioners purchased, shareholders clearly would consider it "important" that principals were acting on their own to close what appeared to be a weak underwriting.* (emphasis added).

The court's decision finds a violation of FINRA's Rules of Fair Practice, rather than addressing Rule 10b-9 or Rule 15c2-4 specifically, but there can be little doubt that the court's reasoning would apply equally to an action under the two rules. In fact, in *William Jackson*

Blalock,⁴⁸ the SEC cites *Svalberg* as support for a finding that purchases by a broker-dealer enabling four contingency offerings to meet their respective minimum sales conditions violated Rule 10b-9. The offering materials had indicated that "organizers, directors and officers and, in one case, their affiliates" would purchase in the offering. The Commission found most compelling in this case the broker's lack of investment intent and the distorting effect of the late closings on the market:

The pattern of each of the purchases, coming on — or immediately prior to — the day of each IPO closing, supports the inference that the purpose of the purchases was to close the offerings. We also note that some of the shares were quickly resold to Atlanta Securities, which, in turn, resold them to retail customers. This fact further suggests that *Blalock* did not have any investment intent in purchasing these shares.

In a footnote, the Commission then went on to state, citing *Svalberg*, that the lack of investment intent would not have been required in order to find a violation:

Even if we were to find that Blalock made these purchases with mixed motives for investment and to close the offering, those purchases distort the information available to the public about the quality of the offering. A principal . . . may be willing to pay more than a reasonable price to ensure the success of the offering; whereas outside investors normally will buy the stock only for investment reasons. (emphasis added).

The *Lippitt* and *Blalock* decisions require substantial analytical effort to define exactly what the Commission will consider to be fraudulent activity. Unfortunately, to the extent that that analysis has been performed by the Commission, it is not revealed by the decisions. We are left in most cases with a mixture of facts and a general citation to the "comfort" language of *A. J. White* and the 1982 *Blinder, Robinson* decision. Other SEC decisions under 10b-9 are cited in the margin.⁴⁹

⁴⁸ 1994 SEC LEXIS 3677 (1994), *aff'd*, 1996 U.S. App. LEXIS 23847 (11th Cir. 1996).

⁴⁹ See, e.g., *In the matter of National Partnership Investments Corporation*, 64 SEC Docket 2024, Rel. No. 33-7425 (June 25, 1997), discussed above; *James Capel Inc.*, 1995 SEC LEXIS 996 (April 26, 1995) (offering improperly closed by broker-dealer taking shares in lieu of 5% underwriting commission and by broker-dealer buying 30,000 additional shares, as well as by counting sales that had not yet been completed and by funding purchases with loans from the issuer.); see also, *Robert Weston*, 1994 SEC LEXIS 2958 (September 28, 1994). See also *SEC v. Leonard Sands* (C. Dist. Cal. Aug. 20, 1996), 62 SEC Docket 2410 (Sept. 16, 1996) (Chairman of issuer violated Rule 10b-9 by purchasing a \$1 million interest for which the check originally given in payment was returned one month after the closing).

In *Glassier & Co.*, Release No. 34-29244 (May 29, 1991), 48 SEC Docket 1551, the underwriter of a part-or-none offering continued an offering past the designated closing date although the requisite minimum had not been sold, and closed the offering by means of insider purchases funded by loans that were repaid from the proceeds of the offering. In an order affirming FINRA sanctions, the Commission cited to *Blinder, Robinson*, *Svalberg* and *Carlson*, among other cases, in stating that "[t]he 'all-or-none' and 'part-or-none'

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In what may be the first sign of a long-needed reappraisal of the increasingly vague standards that have developed under the “corroboration theory,” the D.C. Circuit Court of Appeals in 2004 refused to uphold an SEC finding that an officer of a broker-dealer had willfully aided and abetted a violation of 10b-9 by assisting in transactions later determined to have violated Rule 10b-9.

In *Howard v. SEC*,⁵⁰ the SEC had found that Howard, an officer of James Capel Inc. (“JCI,” or, with affiliates, the “Capel Group”), a broker-dealer, had violated Rule 10b-9 in connection with the closing of two private offerings by a company called New Europe Hotels, N.V. In the first, a contingency offering, the required minimum had not been sold as the offerings neared their termination dates. JCI arranged the apparent sale of the minimum (1) by taking 100,000 shares in lieu of the fee it would have received for serving as the worldwide selling agent, and purchasing an additional 55,650 shares, (2) by purchasing shares in the offering that were immediately resold to a client,⁵¹ and (3) by causing New Europe to deposit funds into a bank account in the amount of fees owed to a real estate developer, IDG, which account IDG used as collateral for loans that were used to purchase shares in the offering. Further, full payment was not made for one-third of the shares sold in the offering until several weeks after the closing, apparently because of incorrect wiring instructions. Howard participated in the first three actions, and assisted in JCI’s efforts to account for and collect the funds that were not accounted for at the closing. In all cases, Howard believed that his and JCI’s actions had been approved by counsel for the offering, Rogers and Wells. Howard then assisted with a

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contingencies have been called a ‘principal protection’ of investors. They guarantee each investor that his money will be refunded unless other public investors share his view that the risk he is taking is worthwhile, and the price he is paying is fair.” 48 SEC Docket at 1556 (footnotes omitted).

In *Rooney, Pace Inc.*, Release No. 34-23763 (October 31, 1986), 36 SEC Docket 1133, the underwriter of an all-or-none offering created the appearance of a successful offering by, among other things, entering an unauthorized order for a corporation despite lack of authorization from the company’s board of directors, and entering unauthorized orders for two customers who were subsequently assured that they would be “out” before too long and would make a profit. As the Commission noted, this type of misconduct falls squarely within the prohibitions of Release No. 34-11532 and case law.

In *Blinder, Robinson & Co., Inc.*, Release No. 34-23913 (December 19, 1986), 37 SEC Docket 332, the underwriter of an all-or-none offering had engaged in “a deliberately deceptive sales campaign,” but still was required to arrange fraudulent orders to give the appearance that the offering was fully sold. Among other things, the issuer agreed to buy certificates of deposit as consideration for a bank extending credit to a third party to buy a large block of units in the offering, and a salesman arranged for another bank loan to one of his customers from a bank which was anxious to maintain good relations with the issuer. Finally, the broker-dealer bought the last 10% of the offering, an amount equal to approximately 96% of its anticipated brokerage commission, with the proceeds of a bank loan which was repaid at closing the next day out of the commission, “making it clear that the loan was simply a premature commission payment.” 37 SEC Docket at 334. The broker-dealer then continued its distribution activities in an effort to sell the securities it had purchased.

⁵⁰ 376 F.3d 1136; 2004 U.S. App. LEXIS 15771; Fed. Sec. L. Rep. (CCH) P92,891 (July 30, 2004)

⁵¹ Howard became aware near the end of the offering period that an investment company, for which JCI served as a sub-advisor, was interested in purchasing shares. JCI elected to purchase the 30,000 shares for which it had an indication of interest and, shortly after the closing of the offering, resold the shares to the investment company.

second offering, in which no disclosure was made of the violations alleged by the SEC to have occurred in the first offering.

The SEC had concluded that “the minimum subscription of 2,000,000 shares in the part-or-none offering was reached by improperly counting (1) shares the Capel Group purchased for itself, (2) shares JCI purchased for an aftermarket sale to the European Warrant Fund, and (3) shares IDG purchased with bank loans using as collateral the fees New Europe Hotels advanced,” none of which were bona fide transactions for purposes of Rule 10b-9. (376 F.3d at 1140.) The SEC also determined that 10b-9 had been violated when the offering was closed without payment having been received for one-third of the shares. The SEC found that Howard had, through his reckless conduct, aided and abetted the primary wrongdoing by JCI and the Capel Group.

Howard did not dispute the existence of the primary violations, but argued that he had acted in good faith, in reasonable reliance on counsel, and that there had not been “red flags” that would have warned him that JCI’s actions were violations of Rule 10b-9.⁵² The Court refused to accept that Howard’s lack of awareness that the described transactions were unlawful constituted recklessness on his part:

The minimum subscription of 2,000,000 shares was improperly reached when someone - not Howard decided to count the purchases by the Capel Group, JCI, and IDG Development Corporation. What dangers were so obvious that Howard should have known of them? What red flags should have alerted him? The SEC’s opinion mentions none regarding the Rule 10b-9 violations. *Instead, it finds him reckless for not knowing all the legal requirements of a part-or-none offering and for not disclosing to investors what he did not know - that Rule 10b-9 would be violated when the closing took place.*⁵³

The Court reviewed the language of Rule 10b-9 and of the principal interpretive release, both of which are quoted above, and noted that “Neither Rule 10b-9, nor the SEC’s contemporaneous explanation of it, mention sales to insiders or persons affiliated with the offeror or whether - as occurred here - these sales may be counted toward the minimum.” (*Id.* at 1144.)

The Court noted that the Commission’s decision had cited to the 2003 version of this outline (the “2003 Outline”)⁵⁴ for the proposition that “it is well established that purchases by underwriters or their affiliates arranged for the undisclosed purpose of closing an unsuccessful part-or-none offering are fraudulent.” (*Id.* at 1145.) The Court noted, however, that the 2003

⁵² The Court noted that it was undisputed that “‘Howard did not know that his role was part of an overall activity that was improper,’ he ‘believed that the lawyers had been consulted,’ and he did not have a ‘high conscious intent.’” (*Id.* at 1142.)

⁵³ 376 F.3d at 1144 (emphasis added).

⁵⁴ Robert B. Robbins, *Structuring Best Efforts Offerings and Closings Under Rule 10b-9*, SH067 ALI-ABA 297, 299 (2003) (available on Westlaw).

Outline had emphasized the lack of clarity created by decisions as to what constitutes a “bona fide” purchase in a contingency offering. The court reviewed the development of the “corroboration theory” and quoted the outline as arguing that “given the vagueness of the ‘corroboration’ or ‘comfort’ standard, it should not be surprising that in recent years it has become increasingly difficult for practitioners to define the circumstances in which Rule[] 10b-9 ... applies. The difficulties are greatest ... in the case of purchases, or undertakings to purchase, by affiliates of the issuer.” (*Id.* at 1146.) Given the uncertainties created by the case law, the court agreed with Howard that there were not danger signals or red flags so obvious that he should have noticed them.

As we understand the SEC's position, the purchases by the Capel Group and JCI were not in themselves illegal. The illegality arose in counting these shares toward the 2,000,000 minimum and closing the offering on that basis without informing the investors that these shares would be counted toward the minimum. *Nothing on the face of Rule 10b-9 deals with transactions of this sort.* While the SEC's 1975 release spoke of the need for “bona fide” sales, the non-bona fide transactions it mentioned - purchases by the issuer through nominee accounts or purchases by persons whom the issuer guarantees against loss, see 1975 WL 163128, at *1 - do not appear to be of the sort facing us here. And the Robbins article states that there are ‘many cases in which it is permissible for the sponsor or affiliates to purchase unsold interests in an all-or-none offering . . .’⁵⁵

The court found that Howard could not have been extremely reckless when he had substantial reason to believe that the transactions, which are not specifically prohibited in Rule 10b-9, had been approved by competent counsel. “In this case, rather than red flags, Howard encountered green ones, as outside and inside counsel approved transactions and counted sales that, the SEC later determined, should not have been counted under a rule whose language was silent on the subject.” (*Id.* at 1147) The court remanded, however, for additional fact-finding on the issue of Howard’s involvement in the closing which occurred without payment having been received for one-third of the shares.

The *Howard* decision did not challenge the SEC’s findings that JCI’s actions had been primary violations of 10b-9. The decision is significant, however, for its conclusion that the case law that has created the “corroboration theory” is too vague to provide clear guidance for future behavior. The case law, not the least of which is the D.C. Circuit’s own *Svalberg* decision, has created a thick fog of risk that surrounds nearly all decisions by affiliates of the issuer or other offering participants to purchase shares in a contingency offering. Under the *Svalberg* language, even an otherwise bona fide purchase for investment could be characterized as fraud if it could be seen as having been motivated, even in part, by the desire to help close a weak offering. *Howard* is a warning that the Commission and the courts have gone too far in finding violations under Rule 10b-9 without the articulation of any clear guidelines, and an indication that the

⁵⁵ *Id.* at 1146 (emphasis added).

courts may be less willing in the future to accept broad application of the “corroboration theory.”⁵⁶

H. FINRA and NYSE Enforcement and SEC Comment Letters

FINRA has devoted substantial attention to violations of Rules 10b-9 and 15c2-4 by broker-dealers. The FINRA Sanction Guidelines⁵⁷ provide that for violations of Rule 15c2-4, the recommended sanctions are a fine of \$1,000 - \$10,000 and, in egregious cases, suspension of the firm “with respect to any or all activities or functions and/or responsible individual in any or all capacities for up to 30 business days.” For violations of Rule 10b-9, the recommended sanctions are a fine of \$5,000-\$50,000 and, in egregious cases, suspension of the firm and/or individual for up to two years and a requirement that the firm conduct a rescission offer. The principal considerations in imposing sanctions are

1. Amount of commissions and/or other underwriting compensation retained by respondent.
2. Whether respondent was affiliated with the issuer or other entity to which customer funds were released.
3. Whether subscription funds were released from escrow before the contingency occurred.
4. For Rule 15c2-4 violations, the extent to which customer funds were exposed to risk or loss.

For Rule 10b-9 violations:

5. Extent of failure to satisfy the contingency described in the prospectus or offering circular.
6. Whether respondent used non-bona fide sales to give the false appearance that the contingency was satisfied.

The New York Stock Exchange also has taken enforcement action for violation of Rule 10b-9. In *J.J.B. Hilliard*,⁵⁸ the member firm consented to a censure and a \$1 million fine for conduct that included violations of Rule 10b-9 and Rule 15c2-4 where, following an alteration of material terms of a contingency offering because minimum subscription requirements were not met, the member firm failed to provide investors with notice of their right to elect a refund, and improperly released investment funds from escrow.

⁵⁶ The *Howard* court did not criticize its prior decision in *Svalberg*, but noted that “Although *Svalberg* does not specifically address Rule 10b-9, Robbins laments that this decision “raises even greater uncertainties and risks” for securities professionals.” *Id.* at 1146, n. 15.

⁵⁷ <http://www.finra.org/Industry/Enforcement/SanctionGuidelines/SG/P011491>

⁵⁸ NYSE Hearing Board Decision 07-68 (May 16, 2007).

H. Special Issues Involving Crowdfunding

Title III of the JOBS Act amends Section 4 of the Securities Act to create a new exemption for offerings of “crowdfunded” securities. Specifically, the JOBS Act amends Section 4 of the Securities Act to exempt issuers from the requirements of Section 5 of that Act when they offer and sell up to \$1 million in securities, provided that individual investments do not exceed certain thresholds and the issuer satisfies other conditions in the JOBS Act, some of which will require rulemaking by the SEC.

One of these conditions is that issuers use the services of an intermediary that is either a broker registered with the SEC or a “funding portal” registered with the SEC. A funding portal is defined as a crowdfunding intermediary that does not: (i) offer investment advice or recommendations; (ii) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (iii) compensate employees, agents, or others persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (iv) hold, manage, possess, or otherwise handle investor funds or securities; or (v) engage in such other activities as the SEC, by rule, determines appropriate.

The SEC must adopt rules governing funding portals before permitting anyone to register with the SEC as a funding portal. The JOBS Act, however, imposes certain legal obligations on crowdfunding intermediaries, including a requirement that the intermediaries, among other things, ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest.

This requirement should be assumed to carry with it all of the accumulated case law and interpretations of Rule 10b-9. In other words, crowdfunding issuers and intermediaries will likely be found to have violated Rule 10b-9 and the requirements of the JOBS Act if they close on a crowdfunding offering without having received full payment for all securities required to meet the minimum condition of the offering within the time period specified in the offering. In addition, the accumulated case law regarding what constitutes “bona fide” sales should be applicable to crowdfunding offerings to the same extent as all other contingency offerings.

J. Drafting the Private Placement Memorandum to Lessen Risk of 10b-9 Liability

Notwithstanding the *Howard* decision, practitioners must recognize that the overwhelming weight of authority in SEC decisions and case law has now adopted the “corroboration theory” as a basis for liability under Rule 10b-9. The cautious practitioner must take steps in the drafting of private placement memoranda to limit the potential application of the SEC decisions and case law to purchases by a broad range of persons who have an interest in the success of the offering.

We therefore consistently have urged that offering documents in contingency offerings include disclosures designed to eliminate, to the extent possible, expectations that investors might otherwise have that all of the offered securities will be purchased by unaffiliated investors exercising independent investment judgment. Such disclosures might include the following:

Shares may be purchased by the affiliates of the issuer or other parties with a financial interest in the offering

Shares may be purchased by the affiliates of the issuer, or by other persons who will receive fees or other compensation or gain dependent upon the success of this offering. Such purchases may be made at any time, and will be counted in determining whether the required minimum level of purchases has been met for the closing of the offering. *[Indicate maximum amount of the offering that may be purchased by such persons.]*

Investors therefore should not expect that the sale of sufficient shares to reach the specified minimum, or in excess of that minimum, indicates that such sales have been made to investors who have no financial or other interest in the offering, or who otherwise are exercising independent investment discretion.

The sale of the specified minimum, while necessary to the business operations of the issuer, is not designed as a protection to investors, to indicate that their investment decision is shared by other unaffiliated investors. Because there may be substantial purchases by affiliates of the issuer, or other persons who will receive fees or other compensation or gain dependent upon the success of the offering, no individual investor should place any reliance on the sale of the specified minimum as an indication of the merits of this offering. Each investor must make his own investment decision as to the merits of this offering.

We are not aware of this language having been addressed by the Commission or by any court, but we believe that its inclusion is a reasonable precaution against the event of purchases by persons interested in the offering being attacked under the corroboration theory.