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The problems encountered by the business community in raising capital for new or small businesses has spurned implementation of responsive policy and regulations by the Securities and Exchange Commission. As a result of input from a series of nationwide small business hearings, the S.E.C. has recently demonstrated its commitment to aiding capital raising needs. This was accomplished by creating an Office of Small Business Policy to respond to the effects of major new changes to the Securities Act of 1933 which seek to facilitate the process of capitalization of small business. Professor David H. Barber, of Brigham Young University's J. Reuben Clark Law School, examines the ramifications of these new provisions against the background of the 1933 Act's purpose and effect. Specifically, Professor Barber discusses consequences of recent changes adopting a less burdensome form for facilitating first-time offerings of securities, the creation of a new exemption from registration added by the 1980 Small Business Investment Act, and an exception permitting certain prior purchasers of restricted securities to sell their securities under the 1933 Act by utilizing simpler methods.

I. INTRODUCTION

Recently the Securities and Exchange Commission (S.E.C.) has adopted some new rules and procedures pursuant to the Securities Act of 1933[1] (1933 Act) which are designed to simplify small

1. 15 U.S.C. §§ 77a - 77b (1976).

business financing. These changes came after a series of nationwide small business hearings (Small Business Hearings) in which businessmen, broker-dealers, venture capitalists, lawyers, and accountants discussed the problems they have encountered in raising capital for new or small businesses.[2] This article will summarize these changes as well as review the advantages and disadvantages of these new provisions compared to other important provisions of the 1933 Act, which are typically relied upon by small businesses in raising capital.

The major changes in the 1933 Act which are of benefit to small businesses are: (1) the adoption of Form S-18[3] for registering first-time offerings of securities under the Securities Act of 1933; (2) the liberalization of procedures under Regulation A,[4] which is available for registering small public offerings of securities; (3) the adoption of rule 242,[5] a new exemption from registration for limited offerings; (4) the new section 4(6) of the 1933 Act,[6] which was added by the recently enacted Small Business Investment Incentive Act of 1980,[7] and (5) the liberalization of the S.E.C.'s rule 144, which permits those who have purchased "restricted securities" under some exemption to the registration provisions of the 1933 Act, to sell their securities without violating the Act, if they follow the specific, objective tests set forth in the rule.[8]

Perhaps even more important than these changes, the S.E.C. has also created an Offfice of Small Business Policy as a means of institutionalizing its concern for small business issues. It is expected that this office will carefully monitor the effect of the S.E.C.'s rules and regulations on small businesses, and that in the future, changes will be suggested with a view towards facilitating small business capital formation.

In order to proceed, it will be helpful to briefly review the struc-

2. *See* DIVISION OF CORPORATE FINANCE, SECURITIES AND EXCHANGE COMMISSION FILE NO. 57-734, SUMMARY OF COMMENTS RELATING TO SEC SMALL BUSINESS HEARINGS AND PROPOSED FORM S-18 (1980), [hereinafter cited as S.E.C. SMALL BUSINESS HEARINGS], and Securities Act Release No. 5914 (March 6, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,530, which announced the S.E.C.'s intention to hold public hearings regarding the effects of the rules and regulations on the ability of small businesses to raise capital.

3. 17 C.F.R. § 239.28 (1980); S.E.C. Release No. 6049, 15691 (April 3, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) § 82,046.

4. 17 C.F.R. § 230.251-.264 (1980).

5. 17 C.F.R. § 230.242 (1980); S.E.C. Release No. 6180 (January 17, 1980), [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) § 82,426.

6. Small Business Investment Incentive Act, Pub. L. No. 96-477, § 602, 94 Stat. 2275 (1980) (to be codified in 15 U.S.C. §§ 77d(b), *see* note 106 and accompanying text.

7. *Id.* §§ 77b(15), 77d(6).

8. 17 C.F.R. § 230.144 (1980).

ture and scope of the Securities Act of 1933 and state securities laws regulating the original distribution of securities.

II. THE SECURITIES ACT OF 1933—A CAPSULE REVIEW

There is a strong public interest in the regulation of securities and securities markets. There are two basic types of securities markets. One market is for the original distribution of securities. For example, if *Corporation XYZ* is formed and issues some of its common stock to the public, this issuance is an original distribution. The other market is for the continuous trading of outstanding securities, *i.e.*, securities already distributed may thereafter be bought and sold either with the help of a securities firm in the "over-the-counter" market, or informally in transactions between original purchasers and subsequent buyers.

In addition to regulating securities markets, the federal securities laws also regulate the activities of firms and individuals engaged in the business of buying and selling securities. These firms function both as "brokers" and "dealers." Most firms in the securities business function in both capacities and hence are referred to as "broker-dealers."

The two most important federal securities laws are the Securities Act of 1933,[9] which primarily regulates the original distribution of securities, and the Securities Exchange Act of 1934[10] (1934 Act), which primarily regulates the subsequent trading of securities, the markets in which securities are traded, and the parties involved in the trading. Companies that register their securities under section 12 of the 1934 Act[11] and file subsequent periodic reports with the S.E.C. are called "registered companies," or alternatively "reporting companies." The S.E.C. is the federal agency responsible for administering and enforcing the federal securities laws.

The 1933 Act regulates the original distribution of securities by an issuer[12] to the public. The distribution of securities, called an underwriting, involves moving the securities of the issuer through the underwriter.[13] It is the underwriter who arranges for deal-

9. *See* note 1 *supra*.
10. 15 U.S.C. § 78a-78k (1976).
11. *Id.* § 78l.
12. Section 2(4) of the 1933 Act, *id.* § 77b(4), defines an "issuer" to include "every person who issues or proposes to issue any security. . . ."
13. Section 2(11) of the 1933 Act, *id.* § 77b(11), defines an "underwriter" as (a)

ers[14] to purchase and distribute portions of the issue. The securities are then sold to initial investors, who in turn sell the securities to those purchasers who intend to hold the securities for investment. Of course, rather than going through an underwriter, an issuer may choose to sell its securities directly to the public.

Congressional inquiries into the stock market crash of the late 1920's determined that securities were often distributed to investors without any disclosure of facts relevant to the buyer's investment decision, and the remedies provided by state law for fraudulent practices in these transactions were inadequate. Enactment of the 1933 Act, therefore, had two major objectives.

The first and primary objective of the 1933 Act is to require that issuers disclose to investors all material investment information relating to the securities being offered. To accomplish this objective, the 1933 Act requires the issuer to file a registration statement with the S.E.C. prior to offering or selling its securities to investors.[15] This registration statement must contain all material investment information about the issuer and the issuer's securities. In addition, the issuer must prepare a prospectus meeting the requirements of the Act, *i.e.*, a digest of the most important information contained in the registration statement. This prospectus must also be filed with the S.E.C. *and* distributed to potential investors prior to or at the time of delivery of the issuer's securities.[16] The S.E.C. does not purport to pass on the quality of the investment or the merits of the securities being offered by the issuer, nor is its role to keep bad investments from being offered to the public. The S.E.C.'s sole purpose is to see that all relevant investment information is disclosed by the issuer. Therefore, the investment decision rests solely with the investor.

The second objective of the 1933 Act is to prevent fraud and misrepresentation in the interstate sale of securities. To accomplish this, the Act includes several liability provisions affording defrauded purchasers more liberal remedies than those that were formerly available under the common law.[17]

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persons who purchase securities from the issuer with a view toward public distribution of the issuer's securities, (b) persons who offer or sell securities for an issuer in connection with a distribution by the issuer, and (c) persons who "participate" in a distribution by the issuer.

14. Section 2(12) of the 1933 Act, *id.* § 77b(12), defines a dealer as "any person who, either full or part time, is engaged in the business of offering, buying, selling or otherwise dealing or trading as an agent, broker or principal in securities issued by another person."

15. *See* § 5 of the 1933 Act, *id.* § 77e.

16. *See* § 10 of the 1933 Act, *id.* § 77j.

17. Section 11 of the 1933 Act, *id.* § 77k, provides for liability for named per-

Since potential investors must be provided with all information about the issuer and the securities being offered necessary to assist them in making an intelligent investment decision, this, of course, includes relevant historical financial information, and the issuer may also include projections of future financial performance.[18] Other information which must be included relates to factors affecting the price or value of the securities being offered, facts making the securities offered a high risk, relevant facts about the management of the issuer, and many others.[19]

Once the registration statement has been filed, the S.E.C. staff examines the information disclosed in light of the disclosure requirements of the registration form used. Typically the staff will opine on the disclosures by way of a "comment" or "deficiency" letter. In the normal course of events, the issuer complies with the staff's comments by making amendments, the S.E.C. then de-

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sons of the issuer and others involved in the registration and underwriting process where the registration statement or prospectus misrepresents or fails to state a material fact. In addition, liability may arise under § 12(1) of the 1933 Act, *id.* § 771(1), where the seller of securities violates some provision of § 5 of the Act *e.g.*, makes an unlawful offer to a potential investor, or fails to deliver the required prospectus, etc. Also, § 12(2) of the 1933 Act, *id.* § 771(2), covers seller fraud or misrepresentation in the sale of securities in general, whether or not registration with the S.E.C. is involved. Furthermore, § 17 of the 1933 Act, *id.* § 77q, is a very braod anti-fraud provision, providing that it is unlawful for any person to offer or sell securities through use of any fraudulent device or scheme, *or* to obtain money or property by means of any untrue statement of a material fact or by any omission to state a material fact, *or* to engage in any practice which operates as a fraud on the purchaser.

In addition to actions for damages or rescission of the transaction by private parties pursuant to these liability provisions, violation of the registration and prospectus provisions of § 5 or of the antifraud provisions of § 17 may give rise to injunctive proceedings by the S.E.C. or to criminal liability. (Note that the courts are divided whether private parties may bring such actions pursuant to § 17.) Also, collateral participants in securities transactions, such as lawyers, finders, accountants, etc., may also be held liable under §§ 12 and 17 in certain circumstances for rendering substantial assistance in a fraudulent transaction.

18. *See* S.E.C. Release No. 6084 (July 5, 1979), [1979 Tansfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,117; note also that the S.E.C. has its own accounting regulations setting forth what the S.E.C. considers to be "generally acceptable accounting principles." *See* Regulation S-X, 17 C.F.R. § 210 (1980).

19. The drafter of a registration statement should look first of all to §§ 6 and 7 of the 1933 Act, 15 U.S.C. §§ 77b and 77g (1976), Schedule A, 15 U.S.C. § 77ae (1976) (governing the registration process) and Regulation C, 17 C.F.R. §§ 230.400-.494 (1980) which sets forth the rules that apply to the registration statement and prospectus. In addition, the S.E.C. has prescribed a number of forms for use in complying with the registration requirements. Form S-1, 17 C.F.R. § 239.11 (1980), is the general form used for the registration of securities by most manufacturing and commercial companies.

clares that the registration is "effective," and the selling of the securities commences.

There are extensive regulations concerning the issuer's conduct immediately prior to filing the registration statement, once filing with the S.E.C. has taken place, and after the S.E.C. has declared that the registration statement is effective and selling of the issuer's securities has begun.

The cost required for a registered offering is very great. Expenses include the S.E.C. registration fee, accounting and legal fees, printing costs, state filing fees, and insurance against securities act liabilities. The time required is also lengthy—generally at least six months for the full registration and selling process. Therefore, if issuers can avoid the registration process, they will make every effort to do so. Thus, an issue frequently encountered under the 1933 Act is whether a particular distribution of securities qualifies under one or more exemptions from registration. There are basically two types of exemptions: exemptions for *securities* and exemptions for *transactions*.

Section 3 of the 1933 Act[20] exempts certain types of *securities* from the registration requirement of section 5 of the 1933 Act;[21] *i.e.*, they may be sold and resold without ever being subject to registration.[22] The second type of exemption is for certain types of securities *transactions*. With such an exemption, the initial sale of the securities is not subject to section 5, but the later resale of the same securities by the purchaser might be. For example, if *XYZ Oil and Gas Venture* sells a limited partnership interest to *A*, an investor, under a transaction exemption, *XYZ* would not have to register the limited partnership interests. Still, if *A* later attempted to sell his interest to *B*, *A* would have to find another exemption *or* register the interest being sold. Even if the sale of the issuer's securities are sold pursuant to an exemption, the antifraud provisions of the Act remain fully applicable.

A. State laws

The 1933 Act preserves the power of the states to regulate securities transactions.[23] Every state has adopted some form of regulation, called "Blue Sky" laws, and every securities transaction aimed at raising capital for a small business may therefore be subject to the law of one or more of the states having contact with

20. 15 U.S.C. § 77c (1976).

21. *Id.* § 77e.

22. For example, section 3(a)(2) of the 1933 Act *id.* § 77c(a)2 (1976), exempts securities issued or guaranteed by the United States.

23. *See* § 18 of the 1933 Act, *id.* § 77s.

the transaction, as well as federal law. The consequences of failure to comply with state statutes are similar to those imposed by the 1933 Act.

There are basically four different types of regulatory systems that have been set up by state securities laws. First, some states simply prohibit fraud or misrepresentation in the purchase and sale of securities and provide civil and criminal sanctions for violations.[24] Second, other states require that issuers file with state authorities certain material information about themselves and the securities to be issued, *i.e.*, a notification requirement. After the passage of a stated period of time, the registered securities may then be issued. Civil and criminal sanctions for violations are provided in these statutes as well.[25]

Third, some Blue Sky laws go further and require the filing of comprehensive information, similar to a registration statement under the 1933 Act, and a review of the offered securities by state officials prior to issuance. A typical standard used in such a review is whether the securities are being offered on a "fair, just and equitable" basis.[26] This type of procedure is known as registration by qualification. Finally, other states permit securities registered under the federal laws to be issued without further processing by the state. This is known as registration by coordination.[27] Still other states use a combination of these methods.

State laws also normally provide for a number of exemptions from the registration or other qualification requirements. The exemptions may be based either on the type of securities transaction involved, or on the type of securities themselves. While the state law may be similar in many respects to the federal laws, some state laws may be different, at least in one very important respect: the state law may be more than a full disclosure law, similar to the 1933 Act. In some cases the state law permits the state administrators to address themselves to the issue of the fairness of the proposal offered to investors. Registration under state law can be very time-consuming and expensive. Some of the administrators' ideas and policies that have developed over the years as to what is "fair, just and equitable" may create some

24. *See, e.g.*, People v. Concord Fabrics, Inc., 83 Misc. 2d 120, 371 N.Y.S.2d 550 (1975).
25. UTAH CODE ANN. § 61-1-8 (1953).
26. *See* 2 BLUE SKY LAW RPTR. (CCH) § 70,555 (1961).
27. *See* Data Access Systems, Inc. v. State, 63 N.J. 158, 305 A.2d 427 (1973).

very burdensome restrictions on raising capital from among a state's residents and add significantly to the time and expense required to process a registration in the state.

The provisions of the statutes of the states where the small issuer wishes to offer securities are of great importance. The task of complying with these statutes is made even more difficult by the fact that each state has its own laws. Thus, the reader of this article should be aware that none of the developments relating to the 1933 Act which are discussed below obviates the need for compliance with the securities laws of the state.

B. *Form S-18*

The major problems for issuers using the S-1[28] form for registration under the 1933 Act are that the required disclosures are very extensive, the registration process is extremely time consuming, and registration is thus very expensive. In addition, many of those testifying at the Small Business Hearings felt that the disclosures required by Form S-1 were not relevant to small business offerings and have resulted in many duplicative or "boilerplate" disclosures.[29]

In response to these criticisms, the S.E.C. has adopted a new registration form, Form S-18.[30] This new form is a simplified means for small corporations to register up to five million dollars in securities during any twelve-month period, saving these businesses both time and money. As a matter of fact, according to a monitoring report issued by the S.E.C.'s Directorate of Economic and Policy Research, Form S-18 has quickly displaced Form S-1 as the principal means for small corporations to register initial public offerings of securities.[31]

At the present time, Form S-18 may only be used by certain domestic and Canadian *corporations*. U.S. companies using Form S-18 must have their principal business operations in the United States, and Form S-18 cannot be used by partnerships, limited partnerships, or other non-corporate issuers. S-18 cannot be used by issuers which are already part of the S.E.C.'s disclosure system by virtue of being required to file annual and other reports

28. 17 C.F.R. § 239.11 (1980).

29. SEC SMALL BUSINESS HEARINGS, *supra* note 2, at 59.

30. 17 C.F.R. § 239.28 (1980).

31. SECURITIES EXCHANGE COMMISSION, DIRECTORS OF ECONOMIC AND POLICY RESEARCH, FORM S-18: A MONITORING REPORT ON ITS USE IN 1979 at 2 (1980) [hereinafter cited as FORM S-18 MONITORING REPORT]. Heretofore, Form S-18 has not been available to a company with significant mining operations, but this was recently changed by the S.E.C. *See*, S.E.C. Release No. 6299 (March 18, 1981). [Current] Fed. Sec. L. Rep. (CCH) § 82,851. It is likely in the near future that Form S-18 will be amended to make it available to otherwise qualified oil and gas companies.

with the S.E.C. under the 1934 Act, *i.e.* the so-called "reporting companies." Also excluded are companies having or intending to have significant oil or gas operations, any insurance company which is exempt from the reporting requirements of the 1934 Act, any investment company, and any majority-owned subsidiary of a company which is excluded from using the form. Although it is possible that in future views of Form S-18 some of these restrictions on its use might be reconsidered.

While it is restrictive as to whom may use it, Form S-18 is accommodating to needs of small business financing in another very important respect. Venture capitalists and sophisticated investors are usually unwilling to tie up their capital for long periods of time. Hence, in financing the new or young business, these investors want to be able to sell all or a portion of their securities holdings in the first public offering of the company. In adopting S-18, the Commission opened this "exit" for these investors by permitting existing shareholders to register up to $1.5 million of their securities for resale in the twelve-month period, so long as total sales of securities by both the issuer and its shareholders do not exceed the form's five million dollar ceiling.

The potential time and cost savings from use of Form S-18 can come from three areas: (1) Form S-18 calls for reduced textual disclosures as compared to Form S-1; (2) the financial statement disclosures are less burdensome; and (3) Form S-18 is the first full registration form that may be filed either in Washington D.C., *or* in the regional office of the S.E.C. for the state where the issuer's business is located.

As far as the text of the registration statement is concerned, many of the required narrative disclosure items set forth in Regulation S-K,[32] the Commission's standard disclosure regulation for preparation of the textual part of an issuer's registration statement and thus required in Form S-1,[33] are not required by Form S-18. For example, S-18's "Description of Business" item does not call for such commonplace S.E.C. disclosures as the risks attendant to government contracting or from foreign operations, and similarly, only unusual competitive risks need be disclosed. In addition, as a result of an amendment to the S.E.C.'s Form 10-K,[34]

32. 17 C.F.R. §§ 229.1-.20.12 (1980).
33. *Id.* § 239.11.
34. *Id.* § 249.310.

when an issuer on Form S-18 becomes a reporting company under the 1934 Act, the issuer is permitted to supply its Form S-18 prospectus in lieu of much of the more extensive narrative and financial information which would otherwise be required in its first annual report on Form 10-K. As a result of these and other changes, preparation of a registration statement under Form S-18 should not be as costly as preparing an S-1 registration.

As far as financial statements are concerned, S-18, like Form S-1, requires that the issuer prepare a consolidated balance sheet as of a date within ninety days prior to the filing date of the registration statement. This balance sheet need not be audited if an audited balance sheet for the issuer's most recently ended fiscal year is also included. However, under Form S-18, consolidated statements of income, sources, and applications of funds and other stockholder equity statements need only be provided for two fiscal years, instead of the required three fiscal years under Form S-1. Even more importantly, financial statements under Form S-1 must comply with the Commission's regulation S-X, which details the form and content of financial statements required to be filed in registration statements and reports under the 1933 Act and the 1934 Act. In some instances, these requirements differ from generally accepted accounting principles, which may add to the time and expense of accountants in preparing the registration statement. However, financial statements prepared for Form S-18 filings are exempted from the requirements of regulation S-X;[35] the financial statements need only be in accord with generally accepted accounting principles.

Thus far there appears to be some actual savings by using Form S-18 as compared to S-1 filings. For a sample analysis done by the S.E.C., it was determined that the average expense of initial public offerings done under Form S-18 as compared to those done under Form S-1 was $91,453 as compared to $106,188,[36] when considering printing, legal, accounting, and miscellaneous expenses, and excluding S.E.C. registration filing fees and Blue Sky expenses.

Another benefit to users of Form S-18 is that filing of the registration statement may be made in the regional office of the S.E.C. for the region where the issuer has or proposes to base its principal business operations. Alternatively, the issuer can file in the Commission's principal office in Washington, D.C. Those who take advantage of the regional office filing option may experience

35. *See generally id.* §§ 210.1-01 — 210.12-43.

36. FORM S-18 MONITORING REPORT, *supra* note 31.

a reduction in S.E.C. processing time.[37] This, of course, may result in additional savings to the issuer. It can also be a very valuable option to the lawyer who is not experienced in securities matters, since the staff of the S.E.C. may be closer and more available for consultation than would otherwise be the case.

Generally, the prospectus delivery requirements are substantially similar to those required with respect to Form S-1 which requires that a prospectus must be delivered before or concurrently with anything put in the mail to a possible purchaser, whether supplemental sales literature or a confirmation. Further, a preliminary prospectus must be mailed to all persons at least forty-eight hours prior to the time of mailing a confirmation. Similar to an S-1 offering, a preliminary prospectus and certain other prescribed methods of soliciting offers to buy or indications of interest can be utilized during the period between the filing date of an S-18 registration statement and the effective date, provided such efforts do not ripen into a sale prior to the effective date. The processing procedures used by the S.E.C. for an S-18 registration are similar to those employed for an S-1 offering.

Use of Form S-18 has been in an experimental period, with the S.E.C. analyzing its experience to determine how it works and what the effects are likely to be on the securities markets. Recently the Commission asked for public comment as to whether the five million dollar ceiling should be raised and whether the restrictions as to the nature of the issuers should be eliminated.[38]

C. *Regulation A Offering*

In addition to the other securities and securities transaction exemptions set forth in the 1933 Act, section 3(b)[39] of the Act permits the S.E.C. to exempt other security offerings from registration where the protection of the Act is not required and less than five million dollars in securities is involved in the offering. S.E.C. rule making under this section includes Regulation

37. *Id.* at 33. the median processing time of a Form S-18 filing was reported to be 32.5 business days, as compared to 124 business days for a comparable Form S-1 registration statement filed in Washington D.C.

38. S.E.C. Release No. 6274 (Dec. 23, 1980) [1981] 585 SEC. REG. & L. REP. (BNA). Even more recently the SEC abolished the restrictions relating to mining companies. *See* footnote 31.

39. 15 U.S.C. § 77c(b) (1976).

A,[40] rule 240[41] and rule 242.[42]

Regulation A was adopted by the S.E.C. pursuant to section 3(b) of the 1933 Act to allow small businesses to raise funds through a public offering without incurring all of the costs associated with an S-1[43] offering.[44] A recent change made by the S.E.C.

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40. 17 C.F.R. §§ 230.251-.264 (1980).

41. *Id.* § 230.240.

42. *Id.* § 230.242.

43. *Id.* § 239.11.

44. *Compare* Regulation B, 17 C.F.R. §§ 230.300-.346 (1980), which provides an exemption for offerings of undivided interests in oil and gas rights not exceeding $250,000. The exemption becomes effective within 10 days after the filing of an "offering sheet" with the S.E.C. This is a relatively short "question and answer" type form. The questions relate to such facts as the name of the tract, the name and address of the operator, the legal description of the tract, and the area of the tract in acres. Additional information asked for includes the identity of the driller; whether the driller is spending any of his own funds in drilling, completing, and placing the well in production; what assurances the purchaser of any interest has that the well will be drilled and completed; whether funds derived from the sale of the interest being offered will be used only for drilling, completing, and placing such well in production; and any other material facts relating to or affecting the interest offered. This "offering sheet" must also be given to all prospective offerees and actual purchasers.

For many years the exemption provided by Regulation B was utilized on a limited basis. The advent of the energy crisis, the decline in prices of common stocks, the increased average earnings of people in this country, and resulting higher average tax brackets have all contributed to an intensified interest in investments in oil and gas securities in recent years and a very significant increase in the use of Regulation B.

Historically, one the principal problems with use of the Regulation B exemption was that the offeror was not required to furnish the Commission with any evidence that he had notified the securities regulatory authorities of the states in which he intended to make offers pursuant to Regulation B and the proposed offering in that state. This deficiency was rectified in 1976 when the Commission amended Regulation B to require that the offeror must furnish the Commission with satisfactory assurance that a notification of the proposed offering has been furnished to the state securities administrator of each state in which the interests are proposed to be offered. 17 C.F.R. § 230.310(a) (1980).

As a result of significant abuse of the Regulation B exemption, the Commission and many of the state regulatory authorities have stepped up their enforcement activities in connection with these offerings. On January 8, 1976, for example, the S.E.C. issued a release entitled "Fraudulent Practices in Connection with Oil and Gas Fractional Interests." The release states in part:

> While a number of oil and gas fractional interest which are offered throughout the country are legitimate in their conception, business-like in their marketing and prudent in their operation, unscrupulous promoters have taken advantage of the investor attention to engage in a number of fraudulent marketing practices. As a result, the Commission and State authorities have within the past two years instituted an increasing number of enforcement actions. Accordingly the Commission wishes at this time to alert investors of some of the fraudulent marketing practices that have recently come to its attention. Exchange Act Release No. 1192 (Jan. 8, 1976) [1975-76 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 80,355.

The release goes on to list a number of precautions that investors should take in dealing with persons offering fractional undivided working interests in oil and gas leases and certain questions that the offeree should ask of anyone attempting to sell such securities. The release concludes by suggesting that anyone who be-has dramatically increased the usefulness of Regulation A in accomplishing its intended purpose. In 1978 the S.E.C. increased the maximum dollar amount which can be raised during a twelve-month period from $500,000 to $1.5 million.[45] In addition, control and non-control shareholders of the issuer may also make use of Regulation A in offering their securities to the public.[46]

One of the savings to a small business from a Regulation A offering comes from the fact that Regulation A permits use of a shortened registration statement. The information required to be disclosed is set forth in Schedule I of Form I-A[47] of the 1933 Act. These disclosure requirements are considerably less detailed than those required by either Form S-1 or Form S-18.[48] The offering circular, analogous to the prospectus under S-1, is not unlike the prospectus required by Form S-18.

Regulation A does not require that financial statements of the issuer be certified by an independent public accountant as is required with respect to those in a Form S-18 or Form S-1 offering. Neither does the regulation require that the financial statements be prepared in accordance with the Commission's Regulation S-X.[49] Regulation A does require income statements, statements of changes in financial condition and of other stockholders' equity

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lieves that he may have been victimized should contact either the state securities commission of his state or the nearest Commission regional office. Usually, the Regulation B exemption will not qualify with the states for registration by coordination. Thus, the offeror must find an exemption under state law or register in each state where the offering is sold. Form S-10, 17 C.F.R. § 239.17 (1980), is the basic form required for registration of certain types of oil and gas interests or rights, where the amount if beyond the $250,000 limitation of Regulation B.

45. S.E.C. Release No. 5977 (September 11, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,710. Shortly after this change, Congress amended section 3(b) to raise the ceiling to five million dollars. Still, Regulation A remains at $1.5 million.

46. Any one control person may issue no more than $100,000 worth of securities in a one-year period. The affiliate must have the permission of the issuer to make such an issuance, and all amounts issued by an affiliate count toward the ceiling amount of $1.5 million during any one twelve-month period. *See* rule 254, 17 C.F.R. § 230.254 (1980).

47. *Id.* 249.1a. The existing structure of Regulation A calls for the filing of a "notification" of Form I-A, and exhibits to that form which include, among other matters, an offering circular prepared in accordance with Schedule I of Form I-A. The S.E.C. has made a new proposal, designated the "offering statement," which would substitute a procedure calling for a single document consisting of three parts. The Commission also asked for public comment. *See* Securities Act Release No. 6275 (December 23, 1980), [1981] § 85 SEC. REG. & L. REP. (BNA).

48. 17 C.F.R. § 239.28 (1980).

49. *Id.* §§ 210.1 — 210.12 (1980).

for the last two fiscal years, and a balance sheet, to be prepared in accordance with generally accepted accounting principles.

Like an S-18 registration, the prospective issuer must file the Regulation A offering circular with the S.E.C.'s regional office for the state in which its business operations are or will be conducted. The offering circular undergoes a staff review similar to the one given the prospectus in a regular S-1 registration. Delivery requirements relating to the Regulation A offering circular are substantially the same as those for an S-18 offering.

Efforts to condition the market during the waiting period heretofore could not be utilized. But the Commission has recently amended Regulation A so as to allow a preliminary offering circular to be used during the waiting period in a fashion similar to a preliminary prospectus in a S-18 offering.[50] One result of this change will probably be an increase of participation by underwriters in Regulation A offerings.

Several characteristics not found in other S.E.C. small business provisions make Regulation A particularly valuable in certain situations. First, the regulation has few limitations as to the nature of the issuers which may use it.[51] A second advantage is that financial statements need not be audited.[52] A third advantage is that completion of a securities offering under Regulation A does not automatically cause the issuer to become subject to the periodic reporting requirements of the 1934 Act.[53] The fourth advan-

50. Rule 256(a) and (i), *id.* § 230.256 (1980); S.E.C. Release No. 6075 (June 1, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) § 82,101. The offering, however, must be sold through one or more underwriters who are broker-dealers registered under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a - 78k (1976), each of whom must sign a consent and certification to the effect that it will keep accurate records of persons to whom the preliminary offering circular is sent.

51. United States and Canadian issuers with their principal business operations or proposed operations in the United States or Canada may use Regulation A, 17 C.F.R. §§ 230.251-.264 (1980). Similar to Form S-18, *id.* § 239.28 (1978) Regulation A is not available for offerings by investment companies, offerings by certain issuers barred because of prior misconduct of associated individuals, or for offerings of fractional undivided interests in oil and gas rights. However, unlike Form S-18, it may be used by partnerships, limited partnerships, oil exploration ventures, and reporting companies under the 1934 Act. *See* Rule 252(a) and (b), *id.* § 230.252 (1980).

52. This apparent advantage, in fact, may be illusory. Many states require audited financials, and if an underwriter is used to sell the offering, most underwriters will insist that the financial statements be audited.

53. Through operation of section 15(d) of the 1934 Act, 15 U.S.C. § 780 (1976), issuers in registered offerings, such as those on Form S-1, 17 C.F.R. § 239.11 (1980), or Form S-18, *id.* § 239.28, will become reporting companies under the 1934 Act, 15 U.S.C. §§ 78a - 78k (1976), if they are not already, and consequently, will be required to file annual reports on Form 10-K, 17 C.F.R. § 249.310 (1980), and other periodic reports prescribed by the S.E.C. However, an issuer under Regulation A generally will be required by section 12(g) of the 1934 Act, 15 U.S.C. § 78 1 (g)

tage of the Regulation A offering is its reduced expense.[54] And finally, there is no section 11 liability for offerings made pursuant to Regulation A.[55]

An obvious disadvantage of Regulation A compared to an S-18 offering is the limit of $1.5 million in a twelve-month period.[56] Another possible disadvantage of Regulation A is that some states will not accept Regulation A registrations by coordination, which means that the issuer using Regulation A to comply with federal securities laws might have to file separate documents with such states.

D. *Rule 242*

Registration of securities, even under Form S-18 or Regulation

(1976), to register as a reporting company *only* at such time as it has five-hundred shareholders and one million dollars in assets.

54. Unfortunately, the average cost of a Regulation A offering has never been systematically surveyed to know that this advantage really exists.

55. Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1976), imposes absolute liability on the issuer for misrepresentations, and liability on a large number of the participants in the registration process, including the principal officers, all directors, the underwriters, and named experts who fail to carry the burden of proof with respect to their so-called "due diligence" defense. *See* §§ 11(a) and (b) of the 1933 Act, *id.* §§ 77k(a) and 77k(b). The plaintiff can recover under section 11 without proving reliance as to certain market purchases and as to certain classes of defendants, without regard to privity with the seller. *See* § 11(a) of the 1933 Act, *id.* § 77k(a).

Liability with respect to misrepresentations in connection with a Regulation A offering must be predicated on section 12(2) of the 1933 Act, *id.* § 77l(2) or on the general liability provision of rule 10b-5, 17 C.F.R. § 240.10b-5 (1980), adopted under the 1934 Act. Section 12(2) requires a degree of privity, *see* Wilko v. Swan, 127 F. Supp. 55 S.D.N.Y. (1955), limits prospective defendants, and does not impose absolute liability on the issuer. Those including the issuer, who are subject to liability under section 12(2) do, however, have to carry the burden of proof on the issue of due care, and reliance is not an aspect of the plaintiff's case.

For a plaintiff to recover under rule 10b-5, "scienter" must be proved, Ernst & Ernst v. Hochfelder, 425 U.S. 986 (1976), although many courts are accepting reckless conduct and/or knowledge of all of the relevant facts as the equivalent to scienter. *See* Bailey v. Meister Brau, Inc., 535 F.2d 982 (7th Cir. 1976).

56. In view of the recent amendment to section 3(b) of the 1933 Act, 15 U.S.C. § 77 c(b) (1976), increasing the ceiling up to five million dollars from the previous two million dollar level, it is likely that the S.E.C. in the near future will increase the dollar amount of securities that can be sold pursuant to Regulation A, 17 C.F.R. §§ 230.251-.264 (1980). As evidence of this intention, the S.E.C. has recently asked for public comment on certain of the key exemptions for small businesses. With respect to Regulation A, the Commission says that it is considering raising the ceiling to an amount other than the current $1.5 million, possibly to three million dollars, and requiring certified financial statements for at least one year. *See* S.E.C. Release No. 6274 (December 23, 1980), [1981] 585 SEC. REG. & L. REP. (BNA).

A, is very expensive. Thus, small businesses usually seek financing under one of the other exemptions from registration, most frequently the "private placement" exemption. However, during the S.E.C. hearings, the private placement exemption, provided in section 4(2) of the 1933 Act,[57] and the S.E.C.'s rule 146[58] thereunder, were criticized as being unduly difficult for small businesses to comply with.[59] Rule 242,[60] a new exemption from registration for limited offerings which do not involve a general solicitation or advertising, is designed to address some of the problems which small businesses have encountered in using the private placement exemption.

By way of background, the registration requirements of section 5 of the 1933 Act apply only to an offering of securities that is made to the "public." Therefore, transactions by an issuer that constitute a "private" offering of securities are exempt from registration. The basic private offering exemption is contained in section 4(2) of the Act. Whether or not an offering is "private" under section 4(2) and hence exempt, is a question of fact in each case, with the burden of proof on the party claiming the exemption. The following factors have been considered by the courts in determining whether a given offering is private.

1. The Investor's Need for the Protection of the 1933 Act.

For many courts, the primary question is whether, given the circumstances of the offering, potential investors need the protection of the registration provisions of the Act.[61] In answering this question, the basic issue is the sophistication of the persons to whom the offering is made, *i.e.*, are they knowledgeable enough to ask the right questions, capable of demanding and getting the information they need to make an intelligent investment decision, and able to bear the risk of the investment?

2. Access to Investment Information.

Sophistication by itself is not enough. The investor must also have access to all information material to a decision, *i.e.*, the same information that would have been included in a registration statement.

3. Receipt of Material Information.

Some courts have held that mere access to material information is not enough; the issuer must actually distribute to its offerees the same type of material information as would otherwise be in a

57. 15 U.S.C. § 77d(2) (1976).
58. 17 C.F.R. § 230.146 (1980).
59. *See* S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2, at 146.
60. 17 C.F.R. § 230.242 (1980).
61. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

registration statement, as well as provide access to any additional information the offerees request.[62]

4. Number of Offerees.

The concept of a private offering also seems to imply that the number of offerees and purchasers will be small. The more sophisticated the offerees, the more offerees there can be. On the other hand, even one unsophisticated offeree will destroy the exemption. Still, no matter how sophisticated the offerees, when the number gets very large, the offering is likely to be deemed public and subject to registration.[63] Each case must be decided on its own facts.

5. Other Relevant Factors.

There may be several other relevant factors that may affect a decision on whether an offering qualifies for the 4(2) exemption. The dollar value of the offering is a factor because the larger the offering the more "public" it looks. The number of shares involved and the relationship between the offerees must be considered because the more unrelated and diverse, the more public the offering. Finally, the manner in which the offering is made is important because the more public the means used, the more likely the offering will be held to be public.[64]

6. Investment Intent of Buyers.

If an issuer initially issues securities to five sophisticated investors in a private offering, but the five original investors immediately sell to ninety new investors, should the private offering exemption continue to apply or has the offering now arguably become a "public distribution"? In a normal securities distribution, dealers often sell to initial investors who intend to hold only for a short time and then take a profit by early sale once the newly issued securities move up in price. Since a "distribution" has occurred only when the securities finally come to rest in the hands of those investors who intend to hold them for a substantial period of time, the intent of the original purchasers in buying the securities is very important in determining whether the private exemption should apply. Whether the original purchasers took for investment or for further distribution is a question of fact. In

62. *See* SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).
63. *See* Hill York Corp. v. American Int'l Franchisers, 448 F.2d 680 (5th Cir. 1971).
64. *Id.*

determining such intent, several factors are considered by the courts: whether the purchasers have signed letters stating their investment intent, whether a restrictive legend has been placed on the stock certificates to the effect that the certificates cannot be transferred without the issuer's permission, and the length of time the original investors hold the securities before transfer. Because of the frequent confusion and ambiguity in determining whether an investor had the required "investment intent" required to establish a private offering, the S.E.C. adopted rule 144,[65] which specifies an objective set of criteria for establishing such intent. If these factors are met, then original purchasers in a private offering of securities may resell without violating the Act.

After spending an inordinate amount of time analyzing and resolving issues concerning alleged private offering sales under section 4(2),[66] such as whether the number of offerees of purchasers was too large for a private offering, the S.E.C. adopted rule 146.[67] Both section 4(2) and rule 146 apply only to offerings by issuers; they are not available to secondary offerings by control persons. Rule 146 reduces some of the criteria for a private offering to objective terms. As a result, many courts have referred to the terms of rule 146 in determining the elements of section 4(2).[68] In order to qualify a private offering under rule 146 all of the following conditions must be met.

1. Method of Offering.

Securities may not be sold through any form of general advertising or solicitation, including newspaper, magazines, television, public seminars or meetings, letters, or written notices. However, seminars, meetings or written communications may be used if the offerees are first qualified as to sophistication or their ability to bear the risk of investment.[69]

2. Qualified Offerees and Purchasers.

Prior to making any *offer*, the issuer must have reasonable grounds to believe and must believe (a) the offeree is sufficiently sophisticated in financial and business matters to evaluate the risk of the investment, or (b) the offeree can bear the economic

65. 17 C.F.R. § 230.144 (1980).
66. 15 U.S.C. § 77d(2) (1976).
67. 17 C.F.R. § 230.146 (1980).
68. *See, e.g.*, Doran v. Petroleum Management Corporation, 545 F.2d 893 (5th Cir. 1977). Note that rule 146, 17 C.F.R. § 230.146 (1980), is not exclusive; issuers may still attempt to qualify under section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1976), if they can't meet the requirements of rule 146.
69. 17 C.F.R. § 230.146(c) (1980).

risk of the investment. Prior to making any *sale*, the issuer must have reasonable grounds to believe and must believe (a) the offeree or the offeree together with his representative are sufficiently sophisticated in financial matters to evaluate the risk of investment, and (b) the offeree is able to bear the economic risk of the investment.[70] The requirements relating to the ability to bear the economic risk and that of sophistication are not defined in the rule. The rule has been sharply criticized for requiring that the issuer make subjective determinations of these matters.[71] The critics have indicated that the ambiguity and uncertainty of these terms make full compliance a time consuming and expensive procedure because of the need for extensive documentation.[72] Moreover, commentators have stated that the *offeree* qualification provision is not cost-justified and is unnecessary for investor protection since there is still the requirement that all *purchasers* be qualified.[73]

3. Access to Information.

Each offeree must have access to the same kind of information included in a registration statement. That is, the offeree must have an employment, family, or economic position with respect to the issuer sufficient to enable him to obtain such information, *or* the issuer must actually give the offeree the same information normally included in a registration statement, and offerees must be able to ask the issuer questions and obtain any additional information they desire.[74] Reporting companies may generally satisfy the information requirements with certain of their recent periodic reports, proxy statements, or recent Securities Act registration statements. Also, to make it easier on small businesses, rule 146 provides that for offerings under $1.5 million that the dis-

70. 17 C.F.R. § 230.146(d) (1980). An "offeree representative" is a person not affiliated with the issuer in any way, who is sophisticated in financial and business matters and who either alone, or together with other offeree representatives or the offerees can evaluate the merits and risks of the prospective investment. *Id.* § 230.146(a)(1).

71. *See* S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2, at 148. It has been suggested by the critics that a qualification provision based on an objective standard of wealth be adopted. *Id.* at 162.

72. *See* Thumfurde, *Exemptions from SEC Registration for Small Businesses*, 47 TENN. L. REV. 1 (1979); and Carney, *The Perils of Rule 146*, 8 U. TOL. L. REV. 343 (1977).

73. S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2, at 146.

74. 17 C.F.R. § 230.146(1) (1980).

closures can approximate those required for a Regulation A offering, which would mean that the financial statements could be unaudited.

The disclosure standards of rule 146 have met with criticism, particularly as they relate to small companies not reporting under the 1934 Act. At least one critic has suggested that the costs of the effort necessary to satisfy the information requirements of the rule may actually be defeating one of the purposes of the exemption, which presumably is to avoid the cost of registration where the expense is not justified by the benefits to the public.[75] Also, several commentators at the Small Business Hearings favored relaxing and specifically defining the disclosure requirements for institutional investors. Generally it was noted, for example, that institutional investors are usually in a position of being able to demand the information they desire and that this level of information is usually such that relaxing the disclosure requirements of the rule would have no adverse impact on the securities markets.[76] This was the rationale behind adopting the "accredited investor" concept in rule 242,[77] discussed infra, and the later statutory exemption granted to "accredited investors" in section 4(6) of the 1933 Act,[78] also discussed infra.[79]

4. Number of Purchasers.

There can be no more than thirty-five purchasers in any offering made in reliance on the rule.[80] There are several exclusions, however. An important one is that any cash purchaser of $150,000 or more is not counted. Critics of this provision have suggested that a reduction in the $150,000 amount to $100,000 or even $50,000 would attract a broader group of sophisticated investors.[81]

5. Investment Intent.

The issuer must exercise reasonable care to assure that each purchaser does not intend to resell his securities, which are "re-

75. Carney, *Exemptions from Securities Registration for Small Issuers: Shifting from Full Disclosure—Part I: The Private Offering Exemption, Rule 146 and an End to Access for Small Issuers*, 10 LAND AND WATER L. REV. 507 (1975).

76. S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2, at 151.

77. 17 C.F.R. § 230.242 (1980).

78. Pub. L. No. 96-477, § 602, 94 Stat. 2275 (1980) (to be codified in 15 U.S.C. § 77d(6). *See* note 106 *infra* and accompanying text.

79. There is evidence that the S.E.C. is considering adopting a unified concept of "accredited investor" in section 4(6) of the 1933 Act, *id.* § 77d, rule 242, 17 C.F.R. § 230.242 (1980), and incorporating such a concept in Rule 146, 17 C.F.R. § 230.146(g) (1980). *See* Securities Act Release No. 6274 (Dec. 23, 1980), [1981] 585 SEC. REG. & L. REP. (BNA).

80. 17 C.F.R. § 230.146(g) (1980).

81. S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2 at 135.

stricted securities," i.e., that the original purchasers purchase with "investment intent".[82] This rule specifies the actions the issuer must take, including placing a legend on the stock certificates and issuing stop transfer instructions to the issuer's stock transfer agent, to assure that purchasers are not taking with a view to redistribution. Rule 144, which establishes objective criteria for permitting resales without violating the investment intent requirement, discussed above in connection with 4(2), is also applicable to investor resales under rule 146.

6. Notification to the S.E.C.

Finally, the issuer must notify the S.E.C. when it makes use of the rule.[83]

Another important element in determining whether the requirements for a private offering have been met under either section 4(2) or rule 146 is whether the offering in question should be regarded as part of a larger offering made or to be made; that is, whether two or more offerings should be considered as "integrated" as parts of the same offering. This issue arises because small businesses are typically in a perpetual search for capital, and in order to avoid the securities laws they may divide what is essentially one offering into what appears to be two or more offerings. Here again, there are several factors to be considered: whether (a) the different offerings are part of a single plan of financing, (b) the offerings involve issuance of the same class of security, (c) the offerings are made at or about the same time, (d) the same type of consideration is to be received, and (e) the offerings are made for the same general purpose.[84] Thus, for example, in the case of limited partnership offerings of fractional undivided interests in separate oil and gas properties, where all properties are contiguous to each other, and are subdivided for the purpose of creating many small offerings, and where the promoters must constantly find new investors for each new venture, the S.E.C. might well argue that all of the smaller offerings should be integrated into one offering. Although the term "offering" is not defined in rule 146, the rule does provide a safe harbor for integration purposes; that is, the rule has a provision for objective

82. 17 C.F.R. § 230.146(h) (1980).
83. 17 C.F.R. § 230.146(i) (1980).
84. S.E.C. Release No. 4552 (1962).

determination that all of the conditions for separate offerings have been met and that no integration will occur.[85]

There is one final criticism of rule 146 that should be mentioned. It has been suggested that a substantial compliance clause should be added to rule 146 to preclude a purchaser from rescinding a sale on the basis of technical non-conformity with the rule's requirements.[86] And finally, it has been suggested that a right of rescission should only be provided to those purchasers with whom the rule's requirements were not met, rather than to all investors in the offering.[87]

Rule 242[88] is a reaction to the above mentioned criticisms of the private offering exemption and rule 146. The rule 242 exemption combines certain elements of rule 146, Regulation A,[89] and Form S-18[90] into an exemption for issues of a qualified corporate issuer seeking to raise not in excess of two million dollars in a six-month period in a private placement. The rule incorporates the novel concept that offerings made solely to certain "accredited investors" need not be accompanied by any mandated written disclosures. The rule was adopted pursuant to the S.E.C.'s authority under section 3(b) of the 1933 Act.[91] It was effective on February 25, 1980.

Rule 242 permits certain qualified U.S. or Canadian *corporate* issuers to offer and sell up to two million dollars in securities in a single offering.[92] Like Form S-18, the rule is presently not available to partnerships and other legal but non-corporate forms of ownership. Also excluded are investment companies, companies engaged in significiant oil, gas, or mining operations, and companies barred from use of Regulation A because of prior misconduct of associated persons.[93]

85. Rule 146, 17 C.F.R. § 230.146 (1980), permits the issuer to exclude consideration of any sales made six months prior to and six months subsequent to the subject offering if there have been no offers and sales of the same or a similar class of securities by the issuer during the six month period preceding or immediately following the rule 146 offering. If there are offers of the same class of securities during the six month periods, then normal integration principles apply. *See* rule 146 (b), *id*.

86. S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2, at 157.

87. *Id*. at 158.

88. 17 C.F.R. § 230.242 (1980).

89. *Id*. §§ 230.251-.264.

90. *Id*. § 239.28.

91. 15 U.S.C. § 77c(b) (1976).

92. 17 C.F.R. § 230.242(c) (1980). The S.E.C. has asked for public comment on whether the $2 million ceiling should be removed. *See* S.E.C. Release No. 6274 (December 23, 1981), [1981] 585 SEC. REG. & L. REP. (BNA).

93. The primary reason for the issuer restrictions is that rule 242 is in the nature of an experiment representing a significant departure from traditional disclosure concepts; therefore, the Commission wanted to gain experience with the less

One material difference between rule 242 and Form S-18 and Regulation A is that the offering price ceiling in rule 242 is computed on a six-month basis rather than on a twelve-month basis. Also, for the purposes of calculating the two million dollar ceiling, an issuer must include all securities sold during the six-months immediately prior to commencement of the offering in reliance on all section 3(b) exemptions such as other rule 242 sales, sales pursuant to the exemptions afforded by rule 240 or Regulation A. However, sales of securities pursuant to certain employee plans made pursuant to Regulation A are not included, nor are those under Regulation B.[94] Also, the securities of an "affiliate" which became such within the preceding twelve months, and securities issued by a "predecessor"[95] must be included in the calculations.

Although rule 242 and rule 146 are similar in some respects, they are different in several important areas. For example, rule 146 has no limits on the amount that can be raised in the offering, whereas a rule 242 offering is presently limited to raising two million dollars in a six-month period. An important difference in rule 242's favor is that it dispenses with the subjective "offeree suitability" standards of rule 146 by creating an objective class of persons called "accredited persons." This class is defined to include: (1) banks, certain insurance and investment companies; (2) employee benefit plans that are subject to Title I of ERISA and advised by either a bank, insurance company, or registered investment advisor; (3) persons who pay cash or a cash equivalent for at least $100,000 of the securities offered (compare rule 146's requirements of $150,000), and (4) directors and execu-

complex type of offerings. The above issuers represent the same ones that can use Form S-18 17 C.F.R.S. 239.28 (1980). This was believed by the S.E.C. to be important since the disclosure document required to be given to non-accredited investors must include the Form S-18 information; however, in the future the S.E.C. may not limit rule 242, *id.* § 230.242 to the same issuers as use Form S-18. As a matter of fact, it is probably that in the near future that both Form S-18 and rule 242 will be liberalized with respect to the issuers that may use them. *See* S.E.C. Release No. 6274 (December 23, 1980), [1981] 585 SEC. REG. & L. REP. (BNA), asking for public comment on whether or not to remove the issuer qualifications on both Form S-18 and rule 242, and S.E.C. Release No. 6300 (March 19, 1981) [Current] Fed. Sec. L. Rep. (CCH) § 82,852 (proposing that rule 242 be amended so as to permit its utilization by a mining company).

94. 17 C.F.R. §§ 230.300-.346 (1980); *see* 17 C.F.R. § 230.242(c) (1980).

95. *See* 17 C.F.R. § 230.242(a) (1980). Note that Regulation A, 17 C.F.R. §§ 230.251-.264, has similar provisions concerning the inclusion of the securities of affiliates and predecessors.

tive officers of the issuer.[96] Sales are permitted to an unlimited number of accredited investors and to thirty-five additional non-accredited investors.[97] The fact that there is a limitation in rule 242 to "accredited investors" and a limited number of non-accredited investors will be a decisive factor in determining in many cases whether to rely on rule 242 or Regulation A, which has no limitations on the number of purchasers.

The disclosure process depends on the status of the purchasers and on whether the issuer is a reporting company under the 1934 Act. If the offering is made exclusively to accredited persons, the rule does not specify what, if any, information must be furnished. If, however, the offering is made to both accredited and non-accredited persons, then accredited persons as well as non-accredited persons must be furnished with the same kind of information as specified in part I of form S-18, to the extent it is material to an understanding of the issuer, its business and the securities being offered. It is provided, however, that the specified financial statements need to be *certified* only for the issuer's last year. This information must be furnished in writing.[98] A reporting company may satisfy the disclosure requirements by furnishing purchasers its most recent annual report, a definitive proxy statement, and all other reports or documents required to be filed by it since the filing of the annual report.[99] Also, the issuer must give non-accredited persons a description of any information furnished in writing to accredited investors and the opportunity to view such information if they want to. Finally, the issuer must give all offerees prior to sale the opportunity to obtain reasonably available additional information necessary to verify the information furnished.[100]

Securities acquired in a rule 242 offering are "restricted securities" and cannot be sold without registration or resort to an exemption, such as rule 144. Therefore, the issuer must take appropriate care to assure that purchasers are not "underwriters." The issuer must make reasonable inquiry to assure that

96. 17 C.F.R. § 230.242(a)(1) (1980).

97. 17 C.F.R. § 230.242(1) (1980).

98. 17 C.F.R. § 230.242(f) (1980). Note that because Regulation A, *id.* §§ 230.251-.264, does not require audited financials, issuers may find rule 242, *id.* § 230.242 less advantageous when non-accredited persons are involved in the transaction and when obtaining audited financials is onerous.

99. The issuer must also furnish such additional material as may be necessary to keep the information furnished from being misleading. *See* rule 242(f)(ii), 17 C.F.R. § 230.242 (1980). Although not specifically alluded to by the rule, presumably this would include for a reporting company subsequent material developments not reflected in its filed reports.

100. *Id.*

they are purchasing for their own account, informing purchasers of restrictions on resale, and placing an appropriate legend on the certificate.[101] Also, the exemption is not available for securities offered by anyone other than the issuer; hence, it is not available for secondary distributions by control persons.[102] As a further control of the scope of the offering, the rule provides that no advertising can be used, nor may any general solicitation be made in connection with the offering.[103]

As with other exemptions to the 1933 Act, the written offering materials given to investors need not be filed with, nor are they reviewed by the S.E.C. However, for monitoring purposes, the S.E.C. has required that issuers undertake to furnish copies of offering materials upon request. Furthermore, the rule does require that an issuer file a form 242 with the Commission no later than ten days after the first sale, no later than ten days after the completion of the offering, and until final notice has been filed, every six months after the first sale. This form calls for considerable statistical information concerning the issuer, but in the form of multiple choice responses which permits the most appropriate box to be checked. In addition, it calls for brief narrative information concerning the issuer, including a brief description of the issuer's business, proposed use of the proceeds, and itemization of expenses of the offering. Information from which it can be determined whether the exemption is available must also be disclosed.[104]

Similarly to rule 146, all sales which are part of the same "issue" must meet all the conditions of rule 242 in order for the rule to be available. Also, a "safe-harbor" rule similar to that provided pursuant to rule 146 is available under rule 242.[105]

101. 17 C.F.R. § 230.242(g) (1980).

102. *Id.* § 230.242(b) (1980).

103. *Id.* § 230.242(d) (1980).

104. *Id.* § 230.242(f) (1980).

105. *Id.* § 230.242(b) (1980). For the purpose of determining which securities constitute a single issue, sales of securities occurring more than six months prior to the commencement of an offer of securities pursuant to the rule, or any time after six months from the completion date of the issue, shall not be considered part of the same issue, if, during neither of the six month periods there were no offers or sales of securities by or for the issuer of the same class as those offered or sold under rule 242, other than offers or sale of securities pursuant to any section 3(b) exemption of the 1933 Act, 15 U.S.C. § 77c(b) (1976), or pursuant to an employee plan. Otherwise, the normal rules with respect to integration apply.

E. *Section 4(6) of the 1933 Act*

A new section 4(6) was added to the 1933 Act by the Small Business Investment Incentive Act of 1980.[106] This section, related conceptually to section 4(2), rule 146, and rule 242, provides an exemption from the 1933 Act's registration requirements for transactions involving offers and sales of securities by an issuer solely to one or more "accredited investors," but no offers or sales may be made to non-accredited investors. However, the aggregate offering price can not exceed the amount allowed under section 3(b) of the Act,[107] currently five million dollars. There is no limitation on the number of accredited investors to whom sales can be made. Still, no advertising or public solicitation is permitted in connection with such transactions. Any issuer relying on the exemption must file with the S.E.C. a notice of sales made pursuant to the section. Securities sold in reliance of section 4(6) are "restricted securities," in that resales must be made pursuant to an effective registration statement or a valid exemption from registration, such as rule 144. Like rule 242, section 4(6) obviates the rule 146 problem of the subjective qualifying of offerees and purchasers by defining objectively in section 2(15) of the 1933 Act[108] an "accredited investor":

> (1) a bank; insurance company; registered investment company or a business development company as defined in Title I of the Small Business Investment Incentive Act of 1980; a small business investment company licensed by the Small Business Administration; or an employee benefit plan subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA); and
>
> (2) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules which the Commission shall prescribe.

Therefore, unless the S.E.C. expands the definition of "accredited investor" by rule, the only investors that can purchase securities sold in reliance on the exemption are the institutional purchasers specified in the statute.[109]

As with rule 242, there is no requirement that accredited investors be given any specific disclosure information by the issuer. There is no safe-harbor provision for integration problems relating to issuances under section 4(6), although the S.E.C. is cur-

106. Pub. L. No. 96-477 § 602, 94 Stat. 2275 (1980) (to be codified in 15 U.S.C. § 77d(b). *See* note 6, *supra*.

107. 15 U.S.C. § 77c(b) (1976).

108. *Id.* § 77b(15) (1976).

109. Note that the list of accredited investors under section 2(15) of the 1933 Act, *id.*, is somewhat different than the list under rule 242, 17 C.F.R. § 230.242 (1980).

rently considering adding such a provision to its rules.[110]

F. Two Other Exemptions Commonly Used by Small Businesses

In addition to Form S-18 registration, the private offering exemption in section 4(2) and rule 146, the section 3(b) exemptions discussed above, and the new section 4(6), there are two other exemptions from registration that should be mentioned here since small businesses frequently rely on them in raising capital.

1. Rule 240.[111]

This rule is a section 3(b) transaction exemption exempting issuers from the registration provisions of the 1933 Act, provided that the following criteria are met:

(a) No more than $100,000 in securities of the issuer are sold in reliance on the rule in a twelve-month period. Other sales of the issuer made without registration, securities issued by affiliates of the issuer, and securities issued by partnerships with the same or affiliated general partners, are included in calculating this total;

(b) There is no general advertising or general solicitation involved;

(c) No commission or similar solicitation is paid for soliciting buyers;

(d) Both immediately before and after the offering, the securities of the issuer are beneficially owned by fewer than one-hundred people;

(e) A notice on Form 240 is filed with the S.E.C. concerning the offering, although failure to file the form the first time the rule is relied on will not result in loss of the exemption.

Note that there are presently no required disclosures that must be made pursuant to the rule.

The securities offered pursuant to rule 240 are restricted securities. Hence, the rule imposes upon the issuer the duties of making a reasonable inquiry as to the investment objectives of the purchasers, informing the purchasers of the restrictions that exist on resale, and placing an appropriate legend on the stock certificates so that resale is prevented.

110. *See* S.E.C. Release No. 6274 (December 23, 1980), [1981] 585 SEC. REG. & L. REP. (BNA).
111. 17 C.F.R. § 230.240 (1980).

There have been several important criticisms of the rule. For example, the $100,000 per year limit is believed to be too low. Furthermore, the rule has been criticized for narrowing its application by including the offerings of affiliated companies of the issuer and others. Finally, the prohibition against the payment of a sales commission has been sharply criticized since the promoters of small companies are often unsophisticated and may need the help of professionals.[112]

In response to these criticisms, the Commission is considering comment on the possibility of raising the rule 240 ceiling and adding minimum disclosure standards.[113]

2. The Intrastate Offering Exemption

Securities offered and sold only to persons residing within a single state, by an issuer that is also a resident of and doing business in that state, or by a corporation, incorporated by and doing business within the state, are exempt from registration under section 5 of the 1933 Act[114] pursuant to section 3(a)(11) of the Act.[115] This exemption is designed to facilitate the raising of local capital for local businesses. The exemption is permitted on the grounds that local investors will be adequately protected both by their proximity to the insurer and by state regulations. The exemption is a transaction exemption, and securities sold under it may have to be registered when offered in a secondary distribution.

Over the years, considerable uncertainty surrounded the meaning of some terms of the intrastate exemption. For this reason, the S.E.C. adopted rule 146,[116] providing specific criteria which, if followed, ensure that the issuer qualifies for the intrastate offering exemption. Of course, if an issue does not qualify under rule 147, the issuer may still rely on the general terms of section 3(a)(11).

To qualify under the basic exemption of section 3(a)(11), the following requirements must be met:

1. The entire issue of securities must be offered and sold to residents of one state. A single offer to a nonresident will destroy the exemption.[117] Thus, resales to non-residents may not be made

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112. *See* S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2, at 135.

113. *See* S.E.C. Release No. 6274 (December 23, 1980).

114. 15 U.S.C. § 77d (1976).

115. *Id.* § 77c(a)(11).

116. 17 C.F.R. § 230.147 (1980).

117. *See* S.E.C. Release No. 4434 (1961). Also, the issuer must be careful not to lose the exemption through integration of an attempted intrastate offering with other interstate offerings of the same type of securities. *See, e.g.*, Hillsborough Invest. Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960).

until after the original distribution to residents is complete, i.e., "has come to rest." Therefore, to secure the exemption the issuer must demonstrate that each resident purchased the securities with investment intent.[118]

2. The issuer, the offerees, and the purchaser must reside within one state. The intrastate exemption requires that the issuer, the offerees, and the purchasers all be residents of the same state.

3. The issuer must be "doing business" within the same state. In addition, since the purpose of the exemption is to finance local business, the issuer must also be "doing business" in the state. The "doing business" requirement is judged by (1) whether the issuer is doing a majority of its business in the state and (2) whether the proceeds of the offering will be used in the state.[119]

Because intrastate offerings need not be reported to the S.E.C., the Commission has little control over such offerings. This fact, plus uncertainty over the meaning of certain broad terms and conditions of the general section 3(a)(11) exemption (such as the definition of "doing business") gave rise to numerous violations of the intrastate offering exemption. Consequently, the S.E.C. adopted rule 147,[120] which provides the following specific, objective criteria for determining what is exempt under section 3(a)(11):

1. Offerees and purchasers must be residents of a single state. The rule specifies what shall be deemed the resident of various types of organizations and for individuals. The investment intent requirement is given an objective standard that for a period of nine months from the date of the last sale by the issuer, all resales must be made to persons residing in the state of the offering. The rule also is specific about the actions the issuer must take as precautions against interstate offers and sales, including placing a legend on the stock certificates and issuing stop transfer instructions to the transfer agent.

2. The issuer must also be a resident of the same state. The

118. For a discussion concerning "investment intent" in connection with the private offering exemption and rule 146, *see* notes 43-60 *supra* and accompanying text.

119. *See, e.g.*, SEC v. MacDonald Investment Co., 343 F. Supp. 343 (D. Minn. 1972).

120. 17 C.F.R. § 230.147 (1980).

rule specifies objective criteria for determining the issuer's residence.

3. The issuer must be "doing business" in the same state. The rule also sets forth objective criteria for making determinations whether the issuer is "doing business" in the state. The issuer is doing business in the state if: (a) eighty percent of its consolidated gross revenues are derived from the operation of a business or property located there or from the rendering of services within the state; (b) eighty percent of its consolidated assets are held there; (c) eighty percent of its proceeds from the securities transaction in question are to be used in the issuer's operations within the state; and (d) the issuer's principle office is located there.

There exists a substantial body of criticism of the intrastate offering exemption and rule 147. For example, critics have suggested that the eighty percent tests in rule 147 for "doing business" are too arbitrary and too restrictive to be practical. Also, the requirement that all *offers* must be made to residents has been criticized as too restrictive in that it does not allow for inadvertent, but good faith mistakes.[121]

Finally, while the intrastate exemption provides an exemption from registration under the federal securities laws, it should be noted that many states have registration requirements that are substantially similar to what the issuer would have been required to do under the 1933 Act.

G. Revisions to Rule 144[122]

The Commission has also recognized the importance of the fact that venture capitalists will invest in start-up companies only if they have reasonable assurance that at some point in time they will be allowed to resell the "restricted" securities acquired in connection with exempt financing. While rule 144 requires that such restricted securities be held for not less than two years, the Commission during 1978 liberalized rule 144. First, the Commission effectively doubled the amount that can be offered pursuant to rule 144 by making the quantitative limitations on resale operative during each three-month period rather than each six-month period. Second, in the case of securities listed on an exchange, the Commission changed the quantitative limit of the average weekly trading volume during the immediately preceding four calendar weeks or one percent of the outstanding shares of the ap-

121. *See, e.g.*, S.E.C. SMALL BUSINESS HEARINGS, *supra* note 2, at 111; Note, *The One-Two Combination: Will Federal and State Securities Regulation Knock Out Small Business?* 14 TUL. L.J. 132 (1978).

122. 17 C.F.R. § 230.144 (1980).

propriate class, to whichever is the greater, rather than whichever is the lesser, as was previously the case. Third, the Commission provided a similar alternative as to over-the-counter securities, quoted over the National Association of Securities Dealers' System (NASDAQ), which previously could not utilize such a trading alternative. Finally, the Commission allowed market-makers to effectuate rule 144 transactions as principals directly with the selling shareholder.[123] In addition, anyone who has *not* been an affiliate of the issuer for at least ninety days may now resell under rule 144 restricted securities held by him for three years without regard to the quantitative limitations of the rule, if such securities are listed or quoted on NASDAQ. The holding period for unlimited sales under rule 144 is four years for unlisted securities not quoted on NASDAQ, but the relaxed limitations are applicable only if the issuer is a reporting company.[124]

III. SUMMARY

The chart which follows summarizes the features of the main provisions relied upon in the 1933 Act by small businesses. What is also readily apparent from the comments made in the body of the article is that this area of the securities law is changing very rapidly and that frequent amendments to the chart will have to be made to keep it current.

123. *See* S.E.C. Release No. 5979 (September 15, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) § 81,710.
124. *See* S.E.C. Release No. 6032 (March 15, 1979) [1979 Transfer Binder] FED. SEC. L. REP. (CCH) § 81,992.

Comparison Chart For Securities Exemptions for Small Businesses

Comparison Item	Interstate Offering	Regulation A	Form S-18
(1) Aggregate Sales Price	Unlimited.	\$1.5 million/12 month period. Sales of affiliates, predecessors, estates of persons owning the issuer's securities, securities sold in violation of section 5 of the 1933 Act, and promotional stock of unseasoned companies are included in the ceiling amount.	Up to \$5 million/12 months for issuers; \$1.5 million for existing shareholders as part of \$5 million.
	No, but see state regulations.	No.	No.
(3) Manner of Offering	Offers and sales cannot be made to non-residents of the state. See also state regulations.	General solicitation is possible; also limited pre-effective solicitation of offers.	General solicitation possible; also limited pre-effective solicitation of offers.
(4) Excluded Issuers	None.	Only available to U.S. or Canadian issuers with principal business operations in U.S. or Canada. Can't be used by investment company, or for fractional undivided interests in oil and gas rights, nor by companies where associated persons have been guilty of misconduct.	Available only to qualified U.S. and Canadian corporations. Not available to partnerships; companies with significant oil, gas or mining interests; no reporting companies, investment companies; insurance companies.
(5) Nature of Offerees	Residents of same state, where issuer resides and does business.	No limitations.	No limitations.
(6) Information Requirement	Yes. See state regulations.	Yes. See Schedule I of form I-A notification document and offering circular more limited than form S-1. Unaudited financials. Filed in S.E.C. regional office.	Form S-18 registration statement and prospectus; more limited than form S-1; audited financials. May be filed in S.E.C.'s regional office.
(7) Opportunity for Questions	Not usually. See state regulations.	No.	Yes, of sales made.
(8) Resales Restricted	Yes.	No.	No.
(9) Report of Sales	Not usually. See state regulations.	No.	No.
(10) Nature of Purchasers	Residents of same state.	No limitations.	No limitations.
(11) Number of Purchasers	No limitations.	No limitations.	No limit.
(12) Integration of Offerings by the Same Issuer	Yes. Use five prong test. Safe-harbor rule if rule 147 is used.	Yes. Securities sold under another exemption to the 1933 Act may be integrated for calcul;ating the \$1.5 million limit.	For purposes of computing the five million dollar ceiling, the price of all securities of the issuer sold within one year of the offering (1) in violation of section 5(a) of the 1933 Act or (2) pursuant to other S-18 offerings as included. So is price of S-18 offerings by other shareholders, up to a total of \$1.5 million permitted.

Comparison Item	Section 4(2)	Rule 146	Rule 242	Rule 240	Section 4(6)
(1) Aggregate Sales Price	No limitation.	Unlimited.	$2,000,000/6 mos. (including all section 3(b), prior affiliate and predecessor sales).	$100,000/12 mos. (including all sales of exempt securities).	$5,000,000 per offering.
(2) Commission Prohibition	No.	No.	No.	Yes.	No.
(3) Manner of offering	No general solicitation or general advertising.	No general solicitation or general advertising.	No general solicitation or general advertising.	No general solicitation or general advertising.	
(4) Excluded Issuers	None.	None.	Non-U.S. or Canadian; limited partnerships; corporations with significant oil and gas or mining operations; investment companies. Only corporations qualify.	None.	None.
(5) Nature of Offerees	Sophisticated, knowledgeable and able to find for themselves.	Must be capable of evaluating the merits and risks of prospective investment and/or be wealthy.	Not regulated.	Not regulated.	Accredited investors.
(6) Information Requirement	Information called for by Schedule A of the 1933 Act.	Must furnish (unless offeree has access via economic bargaining power): (1) $1,500,000 offerings - information may be limited to schedule I (Reg. A); (2) other offerings: (a) reporting companies must use recent form S-1 or form 10, definitive statement and recent periodic reports. (b) non-reporting companies must give information that would be required to be included in the registration statement.	(1) Non-accredited purchasers: (a) reporting companies - most recent annual report, definitive proxy statement and recent periodic reports; (b) non-reporting companies - information required by part I of form S-18 to the extent the information is material (2) accredited purchasers: no specific requirement unless both accredited and non-accredited purchasers involved and then all purchasers are required to be furnished same information.	None.	No specific requirements.