Rule 242 and Section 4(6) Securities Registration Exemptions: Recent Attempts to Aid Small Businesses

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RULE 242 AND SECTION 4(6) SECURITIES REGISTRATION EXEMPTIONS: RECENT ATTEMPTS TO AID SMALL BUSINESSES

In recent years small businesses experienced difficulty in raising capital necessary for growth and development because small businesses practically were foreclosed from the public capital market. From 1968 to 1969, 1056 companies with assets of less than $5 million made a public offering of securities. In contrast, only seventy-nine companies were able to make a public offering from 1978 to 1979.

The costs of government regulation imposed on businesses in the capital raising process explain part of the problem. Section 5 of the Securities Act of 1933 (1933 Act) requires an issuer making a public offering to file a registration statement with the Securities and Exchange Commission (SEC). The registration statement requires detailed disclosures about the issuer's business, financial history, and directors and executive officers. An issuer also must furnish each potential purchaser with a prospectus which gives detailed information about the issuer.

The basic purpose of the federal securities laws is to require issuers to disclose material information to investors so investors can make informed investment decisions. Preparing the disclosure documents, however, is a long and expensive process. Generally,
the disclosure documents take about six months to complete\(^9\) at a cost exceeding $200,000.\(^{10}\)

The 1933 Act exempts certain transactions and securities from the registration requirements of section 5.\(^{11}\) Accordingly, small qualifying businesses use the exemptions as a less costly alternative to full registration.\(^{12}\) Prior to 1980, only four exemptions were available to issuers: the private placement exemption under section 4(2)\(^{13}\) and rule 146;\(^{14}\) the "intrastate" offering exemption under section 3(a)(11)\(^{15}\) and rule 147;\(^{16}\) rule 240,\(^{17}\) which exempts offerings of up to $100,000; and Regulation A,\(^{18}\) which provides a simplified registration process. Many commentators, however, criticize the exemptions as ambiguous and unworkable or too limited in scope to provide small businesses with a means to raise significant amounts of capital.\(^{19}\)

In 1980, both the SEC and Congress took steps to remedy the problems small businesses faced in raising capital.\(^{20}\) In January,

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10. 126 Cong. Rec. S5373 (daily ed. May 14, 1980). The study by the National Association of Securities Dealers examined the expenses of firm commitment underwritings of registered offerings of first time to market companies. *Id.*

11. Section 3 of the 1933 Act exempts certain types of securities from the registration requirements. For example, it exempts any security issued by a savings and loan association. Securities Act of 1933, § 3, 15 U.S.C. § 77c (1976 & Supp. III 1979). In contrast, § 4 exempts certain transactions, such as private placements. *Id.* § 4, 15 U.S.C. § 77d(2).

12. Thomforde, *supra* note 9, at 4. If, however, an offering fails to meet the requirements of an exemption, the transaction violates §§ 5(a) and (c) of the Act. Securities Act of 1933, §§ 5(a), 15 U.S.C. §§ 77e(a), (c) (1976).


17. *Id.* § 230.240.

18. *Id.* § 230.251-263.


the SEC, pursuant to its rulemaking authority under section 3(b) of the 1933 Act, adopted rule 242,21 a new exemption to the registration requirements of the 1933 Act.22 Section 3(b) of the 1933 Act permits the SEC to exempt from registration any class of securities if the SEC finds that registration is unnecessary because of the small amount or limited character of the offering.23 Thus, rule 242 allows certain corporate issuers to raise $2 million per issue of securities within a six-month period.24 Although rule 242 permits an issuer to sell securities to an unlimited number of "accredited persons" and thirty-five other individuals,25 rule 242 does not specify what disclosures an issuer must make to accredited persons.26 Sales to individuals other than accredited persons, however, trigger rule 242's disclosure requirements.27

The accredited persons definition is the core concept of rule 242. Essentially, accredited persons are investors, such as large institutions, that do not need the protection of the securities laws,28 because large institutions possess the economic bargaining power to demand from the issuer information necessary to make an informed investment decision.29 Therefore, rule 242 does not require an issuer to provide accredited persons with specific disclosure documents.30

Department of Commerce estimates that 40% to 50% of the growth in the American economy is the result of innovations. Therefore, new and small businesses may account for as much as 25% of national economic growth. Id. Small businesses also create new jobs. A study by an economist from the Massachusetts Institute of Technology found that 52% of the net new jobs between 1960 and 1976 were created by firms with 20 or fewer employees. Id. at S13470. Moreover, small businesses sustain existing employment because they account for 55% of all existing jobs in the private sector. Id.


23. Id.


25. Id. § 230.242(e).

26. Id. § 230.242(f).

27. Id. See notes 118-47 & accompanying text supra for an explanation of the disclosure requirements.


30. Id. at 6362.
The same concept underlies the Small Business Issuers’ Simplification Act of 1980\(^{31}\) (1980 Act). The 1980 Act amends section 4 of the 1933 Act to provide a new exemption, section 4(6), that closely resembles rule 242.\(^{32}\) Section 4(6) exempts sales of up to $5 million in securities to “accredited investors,” provided the issuer does not use general advertising or solicit the public in connection with any transactions under the exemption.\(^{33}\)

This Note will compare rule 242 of the Securities and Exchange Commission with section 4(6) of the 1980 Act. It will trace the development of the accredited purchasers concept, note the differences in rule 242 and section 4(6), and assess the effectiveness of the two new exemptions in aiding small business capital formation.

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Section 4(6) and rule 242 also resemble § 202(41) of the American Law Institute’s proposed Federal Securities Code. Section 202(41) of the proposed Code exempts a “limited offering” from the Code’s “offering statement” requirement, the Code’s terminology for the Act’s registration statement. 1 ALI Fed. Sec. Code § 202(41)(B) (Official Draft 1980). Section 202(41) defines a limited offering as an offering in which the initial purchasers are institutional investors and not more than 35 in number. Id.

The Code’s definition of “institutional investors” includes banks; insurance companies; registered investment companies; funds, trusts, or other accounts subject to the investment discretion of a bank or insurance company; and controlling persons of institutional investors. Id. § 202(74)(A). The Code also gives the SEC the power to delete or include other classes of institutional investors on the basis of their financial sophistication, net worth, and amount of assets under their management. Id. § 202(74)(B). For example, large universities or labor unions may be better candidates for institutional investors status than some small banks. Id. § 202(74) (comment 1). See Cheek, Exemptions Under the Proposed Federal Securities Code, 30 Vand. L. Rev. 355 (1977) for a comparison of existing exemptions and exemptions in the proposed Code.


The Private Placement Exemption: Prelude to Rule 242 and Section 4(6)

Rule 242 and section 4(6) are "private offering" exemptions because they prohibit general advertising and place limitations on the number and kind of investors that can participate in the offering. In this respect, they are in the same family of exemptions as the private placement exemption under section 4(2) and rule 146. At the same time, however, rule 242 and section 4(6) respond to dissatisfaction with the private placement exemption as a means of small business capital formation by refining the concept that underlies the private placement exemption. Therefore, an understanding of the private placement exemption is critical to an analysis of rule 242 and section 4(6).

Administrative and Judicial Interpretations of Section 4(2)

Section 4(2) of the 1933 Act provides that "transactions by an issuer not involving a public offering are exempt from registration." Although the language of section 4(2) is relatively simple, the distinction between a "private" and "public" offering remains elusive because the 1933 Act does not define "public" or "private." Soon after passage of the 1933 Act, the General Counsel of the SEC enumerated certain relevant factors for determining whether an offering was private: the number of offerees and their relationship to each other and the issuer, the number of shares offered, and the size and manner of the offering. At that time, however, commentators viewed the private placement as a question of mere numbers, concluding that any offering to less than twenty-five persons automatically was exempt from registration. The Supreme Court rejected the numbers theory in SEC v. Ralston Purina Co. In Ralston Purina, the Court held that the ap-

35. See notes 13-14 & accompanying text supra.
40. 346 U.S. 119 (1953). In SEC v. Ralston Purina Co., the issuer offered treasury stock to its "key employees," who included artists, clerical assistants, electricians, stock clerks, and stenographers. Id. at 120-21. The Supreme Court concluded that "[a]bsent a showing of
Applicability of section 4(2) depends on whether the particular class of persons affected needs the protection of the 1933 Act.\textsuperscript{41} Relying on the purpose of the 1933 Act, the Court noted that an offering to sophisticated investors, investors who can "fend for themselves," is a transaction "not involving any public offering."\textsuperscript{42} In particular, the Court referred to a House report that stated that the 1933 Act exempts transactions when no practical need exists for registration.\textsuperscript{43}

In \textit{Ralston Purina}, the Court also held that to qualify for the private placement exemption an issuer must show that all offerees have access to the same kind of information available in a registration statement.\textsuperscript{44} The Court noted that the General Counsel's 1935 opinion recognized that the relationship between an issuer and its offerees, and not the mere number of offerees, is an important factor in determining whether an offering is "private."\textsuperscript{45}

Although the Supreme Court in \textit{Ralston Purina} interpreted the statutory language of section 4(2), commentators contended that it failed to provide issuers with clear guidelines.\textsuperscript{46} They criticized the sophistication and access standards of \textit{Ralston Purina} because the standards were inherently vague and difficult to apply.\textsuperscript{47} In several decisions after \textit{Ralston Purina}, courts construed the sophistication requirement outlined in \textit{Ralston Purina}. In determining whether the offerees could fend for themselves, the courts examined the offerees' business experience, particularly in the issuer's business, and the offerees' general investment and stock market experience.\textsuperscript{48} No court, however, expressly considered the access requirement\textsuperscript{49} of \textit{Ralston Purina} until the decisions of the

\textsuperscript{41} Id. at 125.
\textsuperscript{42} Id.
\textsuperscript{43} Id. at 122.
\textsuperscript{44} Id. at 125-26.
\textsuperscript{45} Id. at 126 n.12.
\textsuperscript{46} See, e.g., Thomforde, supra note 9, at 16.
\textsuperscript{47} Id.
\textsuperscript{48} See, e.g., Garfield v. Stram, 320 F.2d 116 (10th Cir. 1963); Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959); Repass v. Rees, 174 F Supp. 898 (D. Colo. 1959).
United States Court of Appeals for the Fifth Circuit in *Hill York Corp. v. American International Franchies* and *SEC v. Continental Tobacco Co.* In *Hill York*, the court noted that the relationship between the issuer and the offerees should give the offerees "special advantages . . . substantially different from the status of members of the public at large to be able to obtain all necessary information about the issuer and its securities." In *Continental Tobacco*, the court held that an issuer cannot satisfy the access requirement simply by providing offerees with the same information that is required in a registration statement. Instead, each offeree must have a prior relationship with the issuer that gives him access to the necessary information, and the issuer must furnish him with that information.

**Rule 146: An Attempt to Provide Objective Criteria**

After *Continental Tobacco*, practitioners became concerned that the strict access standard enunciated by the court in *Continental Tobacco* effectively prohibited most private placements. By requiring both disclosure and access, the court placed a heavy burden on an issuer relying on the private placement exemption under section 4(2). Moreover, the case law under section 4(2) failed to provide issuers using the private placement with clear-cut standards to determine if an offeree was sophisticated and had access to the necessary information. Consequently, to provide issuers using the private placement exemption with more objective criteria, the SEC adopted rule 146. The SEC determined that, if an offering meets all of the requirements of rule 146, the offering is deemed to be "nonpublic."

Rule 146 permits an issuer to sell its securities to a maximum of thirty-five persons, excluding purchasers of more than $150,000 of

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50. 448 F.2d 680 (5th Cir. 1971).
51. 463 F.2d 137 (5th Cir. 1972).
52. 448 F.2d at 688 n.6.
53. 463 F.2d at 160.
54. Id. at 160-61.
55. See, e.g., Alberg & Lybecker, supra note 19, at 628.
56. 17 C.F.R. § 230.146, Preliminary Note 3 (1980).
57. Id. § 230.146.
58. Id. § 230.146, Preliminary Note 3.
Each offeree must have access to or be furnished with the kind of information that would be supplied in a registration statement. In addition, an issuer must have reasonable grounds to believe that each offeree or his representative can evaluate the merits and hazards of the investment. Thus, an issuer can sell its securities to an unsophisticated offeree, provided the unsophisticated offeree has an "offeree representative" who can evaluate the issue for him; however, an unsophisticated offeree must be able to "bear the economic risk of the investment." Finally, rule 146 prohibits an issuer from soliciting or advertising to offer or sell its securities.

Rule 146 also guides issuers by providing that "access can only exist by reason of the offeree's position with respect to the issuer." Rule 146 then defines "position" as "an employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate

59. Id. § 230.146(g).
60. Id. § 230.146(e). Rule 146 clearly abandons the Fifth Circuit's strict access standard espoused in Continental Tobacco. In 1977, the Fifth Circuit liberalized its own test and adopted a disjunctive test in Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977). The court in Doran noted that the Second and Fourth Circuits interpreted Ralston Purina to require either access or disclosure, but the court emphasized that Continental Tobacco was not inconsistent with that view. Id. at 905.

The court's interpretation of Continental Tobacco is strained because in Continental Tobacco the court said:

Continental did not affirmatively prove that all offerees of its securities had received both written and oral information concerning Continental, that all offerees of its securities had access to any additional information which they might have required or requested, and that all offerees of its securities had personal contacts with the officers of Continental.

463 F.2d at 160 (emphasis added).

In Doran, the court admitted that Continental Tobacco contained "additional language," but the court interpreted the language as "making clear that [in Continental Tobacco] no privileged relationship [existed] between the offerees and the issuer that might have compensated for the defendant's palpable failure to disclose." 545 F.2d at 907-08. The court noted further that the disjunctive nature of the test simply was not explicit in Continental Tobacco. Id. at 908. Thus, after the decision in Doran, the Fifth Circuit continued to apply the disjunctive test. See SEC v. Spence & Green, 612 F.2d 896, 902 (5th Cir. 1980).

61. 17 C.F.R. § 230.146(d) (1980).
62. Id. See Alberg & Lybeck, supra note 19, at 637-39, for a discussion of the offeree representative concept.
63. 17 C.F.R. § 230.146(d) (1980).
64. Id. § 230.146(c).
65. Id. § 230.146(e).
the merits and risks of the prospective investment."\textsuperscript{66}

An issuer, however, still may have difficulty determining whether an offering is private because rule 146 defines access subjectively. Under rule 146 an issuer must determine whether an offeree’s position gives him access to the necessary information. Moreover, rule 146 does not provide an issuer with any guidance in determining whether an offeree is sophisticated. The determination of sophistication may depend, as it did before rule 146 was promulgated, on any of the following factors: the complexity of the issuer’s business, organizational, and financial structure; the complexity of the offering; an offeree’s prior purchase of similar investments; or his management experience in similar businesses.\textsuperscript{67} Yet, rule 146 does not state whether any one of these factors is relevant. Thus, an issuer cannot rely on the availability of the private placement exemption even under the criteria of rule 146.

**PRIVATE PLACEMENT UNDER RULE 242 AND SECTION 4(6)**

*Accredited Persons under Rule 242*

The SEC recognized the difficulty in providing objective criteria for the private placement exemption when it adopted rule 146. The SEC realized that no rule can cover adequately all legitimate private offerings.\textsuperscript{68} Therefore, in providing a solution to the problems with the private placement exemption, the SEC promulgated a new exemption, rule 242.

In devising its new exemption, the SEC remodeled the sophistication and access requirements of the private placement exemption into definitive and objective standards. Rule 242 dispenses with subjective criteria by providing that an issuer that relies on rule 242 need determine only whether a purchaser fits into one of the three clearly defined categories of “accredited persons.”\textsuperscript{69} These categories include: institutional investors, which include banks, insurance companies, employee benefit plans, provided a plan fiduciary makes the decision to invest,\textsuperscript{70} and investment com-

\textsuperscript{66} Id.

\textsuperscript{67} Albert & Lybecker, supra note 19, at 635.

\textsuperscript{68} 17 C.F.R. § 230.146, Preliminary Note 1 (1980).

\textsuperscript{69} Id. § 230.242(a)(1).

\textsuperscript{70} The employee plan must meet the requirements of paragraphs (a) through (c) of rule
panies; purchasers of at least $100,000 of the issuer's securities; and the issuer's directors and executive officers.\(^7\)

By definition, accredited persons do not need the protection of the securities laws;\(^2\) as is the case with sophisticated offerees, accredited persons certainly can fend for themselves. Institutional investors, such as banks and insurance companies, meet the criteria for a sophisticated offeree because they carry out a large part of their business through investment in securities. An issuer's directors and executive officers also qualify as sophisticated offerees: they are employed by the issuer, they understand its business and financial structure, and their position with the issuer gives them access to necessary investment information.

In one respect, however, rule 242 is more liberal than rule 146. Rule 146 permits an issuer to sell its securities to unsophisticated but wealthy offerees, provided that the offerees have a representative who can evaluate the investment.\(^3\) Rule 242, however, includes in its definition of accredited persons purchasers of more than $100,000 of an issuer's securities.\(^4\) Such block purchasers may be wealthy and able to bear the risks of the investment, but they are not necessarily sophisticated. Although rule 242 requires block purchasers to pay with cash or a cash equivalent\(^5\) to ensure that such investors possess economic bargaining strength,\(^6\) rule 242 does not require them to have a representative. Payment restrictions, however, do not guarantee sophistication. Thus, by including block purchasers in its definition of accredited persons, rule 242 may sacrifice investor protection for the sake of small business capital formation.

\(^{16b-3}\) under the Securities Exchange Act of 1934. \textit{Id.} § 230.242(c).

71. \textit{Id.} § 230.242(a)(1). Rule 242 defines "executive officer" as the president; secretary; treasurer; any vice president in charge of a principal business function such as sales, administration, or finance; and any other person who performs similar policy-making functions for the issuer. \textit{Id.} § 230.242(a)(3).


73. 17 C.F.R. § 230.146(d) (1980).

74. \textit{Id.} § 230.242(a)(1)(ii).

75. \textit{Id.} A "cash equivalent" under rule 242 is either a full recourse obligation payable within 60 days of the first issuance of the securities or the cancellation of any indebtedness owed by the issuer to the purchaser. \textit{Id.}

Accredited Investors under Section 4(6)

Under the Small Business Issuers' Simplication Act of 1980, an issuer may avoid the registration process by selling its securities to "accredited investors."77 Not surprisingly, accredited investors are similar to accredited persons. The definitions, however, are not identical. As does rule 242, section 4(6) of the 1980 Act includes institutional investors in its definition of accredited investors, but section 4(6) excludes an issuer's directors and executive officers, and block purchasers from its coverage.78 The 1980 Act, however, also includes "business development companies," venture capital companies that elect to be exempt from the Investment Company Act of 1940,79 within its definition of accredited investors.80

78. Id. § 603, 94 Stat. 2294. In bill form, section 4(6) permitted sales to purchasers of at least $100,000 of an issuer's securities. S. 2699, 96th Cong., 2d Sess., 126 CONG. REC. 5375 (1980).

A venture capital company is a type of investment company that usually takes a controlling position in the investee company and actively participates in the investee's operations because of the size of the venture capital company's investment. A venture capital company also typically enters into transactions with the investee company because of its substantial involvement in the investee's corporate affairs. Federal Securities Laws and Small Business Legislation: Hearings on S. 1533, S. 1940, & S. 2699 Before the Subcomm. on Securities of the Sen. Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess. 355, 362-63 (1980) (memorandum of Ray Garrett, Jr., Paul H. Dykstra, & David F Heroy) [hereinafter cited as Hearings].


The amendment to the 1940 Act exempting business development companies is designed to remove the burdens of the 1940 Act on venture capital companies and in turn to facilitate small business capital formation. H.R. REP. No. 1341, supra note 1, at 21, U.S. CODE CONG. & Ad. News at 4803. A venture capital company must elect to be regulated as a business development company which is less regulated than an investment company under the 1940 Act. Id. at 22-27, U.S. CODE CONG. & Ad. News at 4804-09.

Many commentators contend that the SEC also should include venture capital companies within the definition of accredited persons under rule 242. 45 Fed. Reg. 6362, 6363-64
Both rule 242 and section 4(6) use the accredited persons concept to stimulate small business capital formation in a manner consistent with investor protection. Yet, rule 242 and section 4(6) are not identical exemptions because an accredited person may not be an accredited investor.

**Comparison of Rule 242 and Section 4(6)**

In addition to the differences in proper purchasers under rule 242 and section 4(6), the exemptions differ significantly in their definitions of proper issuers and in the maximum amount of permissible sales. Rule 242 and section 4(6) also differ in other respects. An issuer, therefore, must be familiar with the differences between rule 242 and section 4(6) so it can decide which exemption best fits its needs.

**Issuers**

Rule 242 is not available to all issuers; only "qualified issuers" can use this exemption. Under rule 242 the definition of a qualified issuer derives from a combination of restrictions taken from Form S-18 and Regulation A.

Because Form S-18 is rule 242's disclosure document, the SEC included in rule 242 the same restrictions on issuers that are in Form S-18. Moreover, because rule 242 and Form S-18 are experimental and depart significantly from traditional disclosure concepts, the SEC proceeded with caution in making rule 242 and

(1980). Because they seek high risk investments, venture capital companies are an important source of small business financing. See generally H.R. Rep. No. 1341, supra note 1, U.S. Code Cong. & Ad. News at 4802. By including venture capital companies in the definition of accredited persons, the SEC would open new avenues for small business financing and investor protection would not be sacrificed because venture capital companies possess enough economic bargaining power to obtain necessary investment information.

82. Form S-18 is an alternative registration statement that is available for public offerings of up to $5 million in securities. Id. § 230.28 (1980).
83. Id. §§ 230.251-.263.
84. See note 86 infra.
Form S-18 available to all issuers.86 Thus, only certain corporate issuers can use rule 242 and Form S-18.87 Noncorporate entities such as limited partnerships must use other exemptions to raise capital. Rule 242 and Form S-18 also exclude investment companies and companies engaged in oil, gas, and mining operations.88

Regulation A also affects rule 242's definition of qualified issuer because rule 242 borrows from Regulation A its unworthy issuer concept.89 Unworthy issuers are businesses with a questionable securities background.90 For example, Regulation A and rule 242 exclude issuers that were convicted within the past five years of any crime or offense involving the purchase or sale of securities.91 The SEC believes such issuers should not receive the benefit of the less stringent disclosure requirements available under the exemption92 and considers the safeguard necessary to protect investors.93

Section 4(6), unlike rule 242, is available to any business entity.94 Any kind of business, whether a limited partnership or corporation, can use section 4(6) as a means of capital formation. Many commentators recommend that limited partnerships also be included in the definition of qualified issuer under rule 242.95 They argue that rule 242 forces new businesses to incorporate to take


Form S-18 calls for a narrative disclosure somewhat less extensive than Form S-1, the standard disclosure form. Id. at 10890. For a copy of Form S-18 see [1979] 3 SEC COMPLIANCE: FINANCIAL REP. & FORMS (P-H) ¶ 61307. Registrants that use Form S-18 have the option of filing in Washington, D.C. or in a regional office. Id. ¶ 61007.


88. Id. The SEC excluded oil, gas, and mining companies because it believes such offerings present unique disclosure problems. 43 Fed. Reg. 10888, 10890 (1978).

89. 17 C.F.R. § 230.252 (1980).

90. Id. § 230.242(a)(5)(V).


93. Bloomenthal, supra note 91, at 98.


advantage of rule 242 when the choice of business form should be
dependent on other considerations.\textsuperscript{97} Some commentators also con-
tend that rule 242 discriminates against oil and gas companies.\textsuperscript{98}

The SEC should be cautious, however, in expanding the defini-
tion of qualified issuer under rule 242. Rule 242 and section 4(6)
are not identical exemptions. By definition, accredited investors
under section 4(6) are sufficiently sophisticated to evaluate oil and
gas offerings or offerings made by a limited partnership. Under
rule 242, however, an ordinary investor may qualify as an accred-
ited person if he buys at least $100,000 of the issuer's securities.\textsuperscript{99}
Even though he qualifies as an accredited person, he may not un-
derstand the complexities of such an offering without the benefit of
full disclosure.

Both rule 242 and section 4(6) are designed specifically to aid
small business capital formation, but neither exemption places any
restrictions on the size of the issuer. In bill form section 4(6) re-
stricted use of the exemption to small issuers,\textsuperscript{100} but Congress ultim-
ately deleted the restriction on an issuer's size of operations.
Therefore, even though Congress and the SEC intended to aid
small businesses, neither section 4(6) nor rule 242 is limited exclu-
sively to small businesses.

\textit{Aggregate Sales Price}

Rule 242 permits an issuer to sell $2 million of its securities in a
six-month period.\textsuperscript{101} When the SEC adopted rule 242, section 3(b)
of the 1933 Act permitted the SEC to exempt up to $2 million per
issue of securities.\textsuperscript{102} Thus, in adopting rule 242, the SEC ex-
hausted its exemptive authority under section 3(b).

Prior to the adoption of rule 242, rule 240 and Regulation A
were the only existing section 3(b) exemptions. Rule 240 exempts

\begin{itemize}
\item \textsuperscript{97} \textit{Id.}
\item \textsuperscript{98} Bloomenthal, \textit{supra} note 91, at 98.
\item \textsuperscript{99} See note 71 & accompanying text \textit{supra}.
\item \textsuperscript{100} The bill defined a "small issuer" as any business entity that met two of the three
following criteria: total assets of less than $15 million, total gross revenues per year in each
of its last two fiscal years of less than $30 million, or less than 500 record holders. S. 2699,
\item \textsuperscript{101} 17 C.F.R. § 230.242(c) (1980).
\item \textsuperscript{102} Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) (Supp. III 1979).
\end{itemize}
$100,000 of securities issued within a twelve-month period.\textsuperscript{103} In comparison, an issuer can raise up to $4 million in a twelve-month period under two separate rule 242 offerings.\textsuperscript{104} Regulation A permits an issuer to sell up to $1.5 million of its securities,\textsuperscript{105} but the issuer still must register with the SEC even though the process is simplified.\textsuperscript{106}

Rule 242's disclosure provisions, however, are triggered only in certain instances.\textsuperscript{107} Thus, of the available section 3(b) exemptions, rule 242 significantly improves the ability of small issuers to raise capital pursuant to an exempted offering of securities.

Rule 242, however, requires an issuer to aggregate offerings under rule 242 with sales made under the other section 3(b) exemptions if the other section 3(b) offerings were made within six months of the rule 242 offering.\textsuperscript{108} Every sale of securities in reliance on Regulation A or rule 240 within the specified time period reduces the permissible amount of subsequent sales under rule 242. The following example illustrates how an issuer must aggregate offerings under rule 242:

If an issuer sold $500,000 of its securities on June 1, 1980 in reliance on [rule 242], $50,000 on September 1, 1980 pursuant to rule 240, and an additional $200,000 on October 1, 1980 pursuant to Regulation A, the issuer would be permitted to sell only $1,250,000 more until December 1, 1980, since until that date the issuer must count all three prior sales toward the $2,000,000 limit. However, if the issuer made its fourth sale under [rule 242] on December 1, 1980, the issuer could sell $1,750,000 of its securities, since the June 1, 1980 sale would not be within the preceding six months.\textsuperscript{109}

The SEC requires section 3(b) sales to be aggregated so that an

\textsuperscript{103} 17 C.F.R. § 230.240(e) (1980).
\textsuperscript{104} See note 101 & accompanying text supra.
\textsuperscript{105} 17 C.F.R. § 230.254 (1980).
\textsuperscript{106} Id. § 230.255.
\textsuperscript{107} See notes 118-34 & accompanying text infra.
\textsuperscript{108} 17 C.F.R. § 230.242(c) (1980). Rule 242 permits an issuer to exclude offerings of securities to employees under an employee stock option plan under Regulation A. Id. The Commission decided to exclude stock option plans because they are designed primarily to provide employees with additional compensation and an equity interest in the company, not to raise capital. 45 Fed. Reg. 6362, 6365 (1980).
\textsuperscript{109} 17 C.F.R. § 230.242(c), Note 1 (1980).
issuer does not use rule 242, Regulation A, and rule 240 to issue over $2 million of securities in a six-month period.\footnote{110} Otherwise, an issuer could use all three exemptions to sell $6.5 million of unregistered securities in a continuous offering over a twelve-month period. Arguably, an offering of that size approaches a public offering and should be registered.

Furthermore, the SEC would have exceeded its exemptive authority under section 3(b) if it permitted sales of greater than $2 million of securities. Recently, however, in the Small Business Investment Incentive Act of 1980, Congress raised the section 3(b) ceiling to $5 million\footnote{111} to provide the SEC with increased flexibility in developing exemptions targeted at smaller issuers.\footnote{112} Consequently, section 4(6) incorporates the $5 million ceiling\footnote{113} and thus permits an issuer to sell over twice the aggregate amount of securities permitted under rule 242.\footnote{114}

\textit{Purchasers}

Even though section 4(6) permits an issuer to raise more capital than rule 242, an issuer must make certain tradeoffs if it decides to use section 4(6) instead of rule 242. Most notably, an issuer cannot sell its securities to ordinary investors under section 4(6).\footnote{115} Because rule 242 permits thirty-five ordinary investors to participate in the offering,\footnote{116} rule 242 provides for a more flexible means of capital formation than section 4(6). An issuer can use rule 242 to sell its securities to accredited persons and to ordinary investors, provided the number of ordinary investors does not exceed thirty-five.

\footnote{110. 45 Fed. Reg. 6362, 6365 (1980).}
\footnote{Rule 242 as originally adopted provided that "[t]he aggregate offering price of an issue of securities shall not exceed the amount allowed under section 3(b) of the Act" 17 C.F.R. § 230.242(c) (1980). The SEC amended rule 242 to maintain the $2 million ceiling after Congress increased the $3(b) ceiling to $5 million. 45 Fed. Reg. 71775, 71776 (1980).}
\footnote{112. S. Rep. No. 958, 96th Cong., 2d Sess. 44 (1980).}
\footnote{114. See note 111 \textit{supra}.}
\footnote{115. See notes 77-80 & accompanying text \textit{supra}.}
\footnote{116. 17 C.F.R. § 230.242(e) (1980).}
Both exemptions permit an issuer to sell its securities to an unlimited number of accredited purchasers.\(^{117}\) If an issuer wants to sell its securities only to accredited purchasers, its decision to use rule 242 or section 4(6) depends on its capital needs. If an issuer wants to sell only $2 million of its securities, it can use either exemption, but if an issuer wants to raise more than $2 million of capital, it can use only section 4(6).

**Disclosure**

**Disclosure to Investors**

Rule 242 and section 4(6) operate under the assumption that accredited purchasers do not need the protection of the securities laws because they will demand and receive from the issuer any information that they need to evaluate the issue.\(^{118}\) Accordingly, neither rule 242 nor section 4(6) requires an issuer to furnish an accredited purchaser with any information.

The SEC believes that this approach to disclosure is revolutionary,\(^{119}\) but its roots can be traced to rule 146. Under rule 146, each offeree must have access to or be furnished with certain information.\(^{120}\) Rule 146 defines access as an "employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer."\(^{121}\) Similarly, accredited purchasers under rule 242 and section 4(6) possess the economic bargaining power to demand information from the issuer. Rule 242 and section 4(6), however, relax the requirement of rule 146 that each offeree must have access to or be furnished with information and be sufficiently sophisticated to evaluate the merits and hazards of the investment.\(^{122}\) Under rule 242 and section 4(6), an accredited purchaser becomes, by definition, a proper purchaser.\(^{123}\) The exemptions assume that accredited purchasers have access to


\(^{118}\) See notes 68-72, 77-80 & accompanying text supra.


\(^{120}\) 17 C.F.R. § 230.146(e) (1980).

\(^{121}\) Id. (emphasis added).

\(^{122}\) Id. § 230.146(d).

\(^{123}\) See notes 69-71 & accompanying text supra.
the information by reason of their economic bargaining power and that they are sufficiently sophisticated to evaluate the investment.

Rule 146 also requires an offeree to have access to or receive information that would be supplied in a registration statement.\textsuperscript{124} Neither rule 242 nor section 4(6), however, specifies the kind of information an accredited purchaser must have access to or obtain from the issuer. Both exemptions assume accredited purchasers will obtain whatever information is necessary to make an informed investment decision. Thus, rule 242 and section 4(6) lessen the regulatory burden on small issuers because the exemptions do not dictate what information accredited purchasers must receive.

Unlike accredited purchasers, ordinary investors need the protection of the securities laws because they are financially unsophisticated and cannot fend for themselves. Because ordinary investors need protection and may purchase securities under rule 242,\textsuperscript{126} the SEC requires that they receive certain information.\textsuperscript{126} Thus, if an issuer sells to ordinary purchasers in a rule 242 offering, the issuer must furnish accredited and ordinary investors with "the same kind of information specified in Part I of Form S-18, to the extent material to an understanding of the issuer, its business, and the securities being offered."\textsuperscript{127} An issuer need not furnish investors with all of the information called for by Form S-18,\textsuperscript{128} but it must provide an ordinary investor with material information.\textsuperscript{129}

\begin{itemize}
\item \textsuperscript{124} 17 C.F.R. \textsect{230.146(e)} (1980).
\item \textsuperscript{125} See note 25 & accompanying text supra.
\item \textsuperscript{126} 17 C.F.R. \textsect{230.242(f)} (1980).
\item Section 202(41) of the proposed Federal Securities Code also permits sales to 35 ordinary investors. See note 32 supra. Unlike rule 242, however, the Code does not require an issuer relying on the limited offering to disclose to ordinary investors. See 1 ALI Fed. Sec. Code \textsect{202(41)} (Official Draft 1980). Yet, ordinary investors need the protection of the securities laws because they cannot fend for themselves. See SEC v. Ralston Purina Co., 346 U.S. at 125. In this respect, the Code's treatment of disclosure is revolutionary compared to the SEC's two-tier system under rule 242. The purchasers under a Code limited offering can be "thirty-five widows and orphans who are thoroughly unsophisticated strangers, and who are unable to bear the economic risk of their investment." Cheek, supra note 32, at 364.
\item \textsuperscript{127} 17 C.F.R. \textsect{230.242(f)(i)} (1980).
\item \textsuperscript{128} Form S-18's disclosure requirements are not as onerous as those of Form S-1. See note 86 supra.
\item \textsuperscript{129} An issuer relying on rule 242 may be subject to liability under the federal securities laws if it omits "material information." Rule 242 does not exempt an issuer from the antifraud provisions of the 1933 and 1934 Acts or from civil liability under \textsect{12(2)} of the 1933 Act. 17 C.F.R. \textsect{230.242}, Preliminary Note 1 (1980).
\end{itemize}
The materiality standard provides small issuers with some flexibility, but the standard may lead to interpretive problems. The standard, in effect, may relegate issuers to the time consuming task of determining the meaning of "material." As a result, issuers simply may give to their purchasers all of the information required by Form S-18. Nevertheless, the SEC seeks to improve small business capital formation in a manner consistent with investor protection, and ordinary investors will not be harmed by too much, instead of too little, information.

If a rule 242 issuer is a reporting company under the 1934 Act,\(^\text{130}\) it can use the documents required by the 1934 Act to satisfy the disclosure requirements under rule 242.\(^\text{131}\) Thus, 1934 Act companies using rule 242 may furnish investors with the company's annual report or a proxy statement,\(^\text{132}\) which furnishes investors with the information necessary to evaluate the security.

Rule 242 also attempts to insure that ordinary investors receive the same information as accredited purchasers. An issuer must answer an offeree's questions about the terms and conditions of the transaction.\(^\text{133}\) In addition, an issuer must furnish ordinary purchasers with a brief description of any information it furnishes to accredited persons if the ordinary investor requests the information in writing prior to the date of his purchase.\(^\text{134}\)

**Disclosure to the SEC**

Rule 242 also requires an issuer to make certain disclosures to the SEC on Form 242.\(^\text{135}\) Form 242's reporting requirements are minimal in comparison with the detailed disclosures required by Form S-18. The SEC requires an issuer to report on Form 242 so the SEC can analyze the effectiveness of rule 242 as a means of small

\(^{130}\) Under the Securities Act of 1934, a "reporting company" is any company required to register with the SEC because it either trades its securities on a national securities exchange, § 12(a), or has total assets of over $1 million and at least 500 shareholders, § 12(g)(1). 15 U.S.C. §§ 78l(a), (g)(1) (1976).


\(^{132}\) Id.

\(^{133}\) Id. § 230.242(f)(2).

\(^{134}\) Id. § 230.242(f)(3).

\(^{135}\) Id. § 230.242(f).
business capital formation.\textsuperscript{136} The SEC also plans to monitor its experiment by randomly sampling offering materials to examine the kind and quality of disclosures made to ordinary investors.\textsuperscript{137}

An issuer need not obtain prior SEC approval of offering materials,\textsuperscript{138} but it must file a notice of sale on Form 242 with the SEC ten days after the first sale, ten days after completion of the offering, and every six months unless the offering is completed prior to that time.\textsuperscript{139} Form 242 requires an issuer to furnish information about the issuer's business, the proposed offering, capital structure, and other section 3(b) offerings being made by the issuer.\textsuperscript{140} The form is relatively simple to prepare because it asks issuers questions in a multiple-choice format.\textsuperscript{141} The most detailed question requires a brief description of the issuer's business and contemplates a response of only three or four lines.\textsuperscript{142}

Section 4(6) also requires an issuer to file a notice of sale with the SEC on forms prescribed by the SEC.\textsuperscript{143} Consequently, shortly after Congress enacted section 4(6), the SEC adopted Form 4(6) to provide the SEC with information about the effectiveness of section 4(6) as a means of small business capital formation.\textsuperscript{144} Form 4(6) is substantively similar to Form 242, although the SEC deleted certain items inapplicable to a section 4(6) offering.\textsuperscript{145} For example, the SEC deleted questions regarding sales to ordinary investors because ordinary investors cannot participate in a section 4(6) offering.\textsuperscript{146} The filing requirements are similar to those under rule 242: an issuer must file Form 4(6) ten days after the first sale, ten days after the final sale, and every six months until it files a final notice.\textsuperscript{147}

\textsuperscript{137} Id.
\textsuperscript{138} Id.
\textsuperscript{139} 17 C.F.R. \textsection 230.243(h) (1980).
\textsuperscript{141} See id.
\textsuperscript{142} See id.
\textsuperscript{144} 45 Fed. Reg. 75182 (1980). The SEC adopted Form 4(6) on an interim basis pending public comment. Id.
\textsuperscript{145} Id. at 75182-83.
\textsuperscript{146} Id. at 75183.
\textsuperscript{147} Id.
Ban on Advertising

Both rule 242 and section 4(6) prohibit an issuer from publicly soliciting or advertising the sale of its securities. Rule 242 defines "general advertising or solicitation" as including, but not limited to, "any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over the television or radio." Section 4(6) does not have its own definition of advertising or solicitation. Presumably, the definition of advertising under rule 242 applies under section 4(6).

The ban on advertising limits an issuer's promotional sales activities and attempts to ensure that investors are not misled by sales literature that does not have SEC approval. The prohibition, however, effectively may limit participating investors to those persons already known by the issuer.

Resale Restrictions

The SEC places certain restrictions on the resale of securities acquired in a rule 242 offering. Apparently, section 4(6) also restricts the resale of securities. An issuer using rule 242 must inform each purchaser of the securities that the purchaser can resell only pursuant to a registration statement or an exemption from registration. A rule 242 issuer also must place a legend on the stock certificates stating that the securities are not registered and setting forth the restrictions on resale.

Resales of rule 242 securities must be registered because section 5 of the 1933 Act applies to all sales of securities, unless an exemption is available for the transaction, and rule 242 is not available

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149. 17 C.F.R. § 230.242(d) (1980).
150. Cf. Thomforde, supra note 9, at 11 (rule 240).
151. 17 C.F.R. § 230.242(g) (1980).
153. 17 C.F.R. § 230.242(g) (1980).
154. Id.
155. "It shall be unlawful for any person to offer to sell or offer to buy any security, unless a registration statement has been filed as to such security. " Securities Act of 1933, § 5(c), 15 U.S.C. § 77e(c) (1976) (emphasis added).
as an exemption for resales.\textsuperscript{156}

Section 4(1) of the 1933 Act, which exempts "transactions by any person other than an issuer, underwriter or dealer,"\textsuperscript{157} would seem to exempt all resales by purchasers in a rule 242 offering, but the result is not that well-defined. Section 2(11) of the 1933 Act deems certain purchasers to be issuers or underwriters.\textsuperscript{158} Under section 2(11) an "underwriter" includes any person who sells a security for an issuer in connection with a distribution, and an "issuer" includes a controlling person.\textsuperscript{159} Because rule 405 defines "control" as the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of [the issuer] whether through the ownership of voting securities, by contract, or otherwise,"\textsuperscript{160} directors, executive officers, and large shareholders participating in a rule 242 offering may be issuers under section 2(11) of the 1933 Act. Moreover, any person selling a security for a controlling person becomes an underwriter under section 2(11).\textsuperscript{161} Thus a sale of a rule 242 security by a controlling person or his agent is not exempt from the registration requirement of section 5 of the 1933 Act.

A person who purchases securities with a view toward their distribution also becomes an underwriter under section 2(11).\textsuperscript{162} Therefore, rule 242 requires an issuer to make a reasonable inquiry to determine whether a purchaser is acquiring the securities for himself or for other persons.\textsuperscript{163} A non-controlling shareholder who wishes to resell then must demonstrate that he did not purchase the securities with an intent to distribute,\textsuperscript{164} but rather with a view

\textsuperscript{158} The section 4(1) exemption has its broadest application in day-to-day securities transactions on exchanges and in over-the-counter markets. See Barton, Public Resales of Restricted Securities in Reliance Upon Section 4(1) of the Securities Act of 1933, in \textit{Sales and Resales of Restricted Securities} 387, 387-88 (1979).
\textsuperscript{160} Id.
\textsuperscript{161} 17 C.F.R. § 230.405 (1980).
\textsuperscript{162} See note 160 & accompanying text supra.
\textsuperscript{164} 17 C.F.R. § 230.242(g)(1) (1980).
to holding them for investment. The shareholder is not required to hold the securities indefinitely, but a definitive test does not exist to determine when and under what circumstances a shareholder can sell without becoming an underwriter. The shareholder also must show that his resale is not a distribution. The 1933 Act, however, does not define "distribution." Thus, distinguishing between an ordinary trading transaction and a distribution often is difficult.

As a result of the difficulty in applying section 4(1) of the 1933 Act, the SEC adopted rule 144 to provide objective criteria to determine whether a shareholder is an underwriter. Rule 144 requires a shareholder to hold restricted securities for at least two years prior to resale and places a ceiling on the dollar amount of the restricted securities resold. Additionally, the resale must be made by a broker or a market maker without soliciting buy orders. If a controlling or non-controlling shareholder complies

165. Thomforde, supra note 9, at 38-39.
166. Id. at 39.
167. If the transaction is classified as a distribution, the shareholder is considered an underwriter and is not exempt from the registration requirements of the 1933 Act. See notes 157-58 & accompanying text supra.
170. When the SEC adopted rule 242, it amended rule 144 to provide that securities acquired in a rule 242 offering are restricted securities. 45 Fed. Reg. 6362, 6367 (1980). Securities acquired in a rule 240 offering are also restricted securities. 17 C.F.R. § 230.144(a)(3) (1980).
171. 17 C.F.R. § 230.144(d) (1980).
172. Id. § 230.144(e). A shareholder relying on rule 144 can sell, during a three-month period, either one percent of the outstanding securities of the issuer of the class being sold or the average weekly trading volume during the preceding four weeks, whichever is greater. Id. This limitation applies to the sales of restricted and nonrestricted securities by controlling shareholders and to the sales of restricted securities by noncontrolling shareholders. Id.

A noncontrolling shareholder may sell an unlimited amount of restricted securities if they are listed for trading on a national exchange or quoted in the National Association of Securities Dealers electronic interdealer quotation system for stocks traded over the counter (NASDAQ) and the noncontrolling shareholder has held the securities for at least three years. Id. If they are not listed, the shareholder may sell an unlimited number of securities only if the issuer is subject to the reporting requirements of the 1934 Act and he has held the securities for four years. Id.
173. Id. § 230.144(f).

Section 3(a)(38) of the 1934 Act defines a "market maker" as:

any specialist permitted to act as a dealer, any dealer acting in the capacity of
with the requirements of rule 144, the SEC considers the transaction as one that does not involve an underwriter, and therefore the resale is exempt from the registration requirements of the 1933 Act.

Several commentators contend that the limitations of rule 144 prevent the resale of restricted securities of small issuers. Brokers may refuse to accept a purchaser's sell order because finding a buyer may not be economically feasible. Moreover, an organized market probably does not exist for a small issuer's securities. Therefore, a selling broker could not sell a small issuer's securities without violating rule 144's prohibition against solicitation.

Under rule 144 an issuer must be registered under section 12(g) of the Securities Exchange Act of 1934 or the issuer must satisfy the "other public information" requirement of rule 144. A company with at least five hundred shareholders and over $1 million in assets must file under section 12(g). An issuer with fewer shareholders and less assets, however, need not file under section 12(g), but the issuer must satisfy the other public information requirement of rule 144. The issuer must make certain information available on an ongoing basis to security holders, market makers, brokers, financial statistical services, and other interested parties.

175. See, e.g., Campbell, supra note 19, at 1153.
176. Id.
177. Id.
178. Id.
180. 17 C.F.R. § 230.144(c) (1980).
182. 44 Fed. Reg. 46752, 46755 (1979). To satisfy the other public information requirement, an issuer must make the following information publicly available:

(i) The exact name of the issuer and its predecessor (if any); (ii) the address of its principal executive offices; (iii) the state of incorporation, if it is a corporation; (iv) the exact title and class of the security; (v) the par or stated value of the security; (vi) the number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year; (vii) the name and address of the transfer agent; (viii) the nature of the issuer's business; (ix) the
An issuer cannot satisfy the requirement simply by providing the requisite information to the selling shareholder's broker.\textsuperscript{183} The requirement, therefore, further impedes the use of rule 144 by an investor in a small issuer. A small issuer rarely can afford to compile and distribute periodic reports to such a large number of interested parties. Thus, unless the issuer is registered under section 12(g) of the 1934 Act, an investor cannot satisfy the requirements of rule 144.

An issuer, however, can comply with rule 144's information requirements by voluntarily filing under section 12(g) of the 1934 Act,\textsuperscript{184} but this option is not an attractive alternative for a small issuer.\textsuperscript{185} A small issuer uses rule 242 as an alternative to the expensive and time-consuming process of making a public offering because it wants to avoid reporting requirements.

Because of restrictions placed on the resale of restricted securities, a rule 242 security is not a liquid security. Therefore, the 1980 Act, in bill form, attempted to provide accredited investors with a more liquid investment by amending section 4(1) of the 1933 Act to permit accredited investors to resell their securities only to other accredited investors.\textsuperscript{186}

nature of products or services offered; (x) the nature and extent of the issuer's facilities; (xi) the name of the chief executive officer and members of the board of directors; (xii) the issuer's most recent balance sheet and profit and loss retained earnings statements; (xiii) similar financial information for such part of the 2 preceding fiscal years as the issuer or its predecessor has been in existence; (xiv) whether the broker or dealer or any associated person is affiliated, directly or indirectly, with the issuer and (xvi) whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

184. Id.
185. Thomforde, supra note 9, at 42.

For purposes of this paragraph, any accredited investor who acquired a security in a transaction to which section 4(6) applies and who sells such security for his own account or in a fiduciary capacity shall not be deemed to be an underwriter under section 2(11) with respect to such transaction if such sale is made
Under the proposed amendment accredited investors would not have been required to comply with rule 144. Instead, accredited investors would have been permitted to make immediate and frequent resales to other accredited investors.\textsuperscript{187} Congress, however, deleted the amendment to section 4(1) of the 1933 Act from the bill even though permitting resales between accredited investors conforms with the purpose of section 4(6).\textsuperscript{188} The amendment would have made securities acquired in a section 4(6) transaction a more attractive investment because of their greater liquidity, and it would have given small issuers relief from the resale restrictions of rule 144. Moreover, accredited investors do not need the protection of a registration statement or other public information because accredited investors can obtain any information that they need about the issuer and its business, whether in an initial offering or in a subsequent resale. Nonetheless, even though Congress deleted the amendment, a section 4(6) purchaser, as a rule 242 purchaser, apparently may resell his securities if he meets the requirements of rule 144.\textsuperscript{189}

Integration

Both rule 242 and section 4(6) structure their requirements on a per issue basis.\textsuperscript{190} Even if an issue qualifies for a rule 242 or section 4(6) exemption, the issuer need not use the rule 242 or section 4(6)\textsuperscript{191} exemption. An issuer may claim the availability of another applicable exemption if it wishes,\textsuperscript{192} but an issuer cannot use two exemptions for the same issue.\textsuperscript{193} Because, however, the 1933 Act and the exemptions from the Act do not define the term "issue," the SEC uses the integration doctrine to determine if a series of

\textsuperscript{187} Id.
\textsuperscript{188} Id. \textit{Id.}
\textsuperscript{189} Id. \textsuperscript{187} \textit{Id.}
\textsuperscript{190} \textit{Id.}
\textsuperscript{191} Rule 242 permits a qualified issuer to raise $2 million of capital per issue, while section 4(6) allows an issuer to raise $5 million of capital per issue. \textit{Id.} 
\textsuperscript{192} \textit{Id.}
\textsuperscript{193} \textit{Id.}
transactions is an issue. The integration doctrine assures that an issuer does not divide a distribution that should be registered as one issue into smaller, exempt offerings. Consequently, if the SEC integrates two offerings that, taken together, fail to meet the requirements of an exemption, such as rule 242 or section 4(6), the exemptions are invalid and the transactions violate section 5 of the 1933 Act.

In applying the integration doctrine, the SEC looks at the facts and circumstances surrounding the offering to determine the substance, and not the form, of the transaction. The SEC does not apply precise rules, but considers the following factors to be relevant:

(a) whether the sales are part of a single plan of financing;
(b) whether the sales involve issuance of the same class of security;
(c) whether the sales have been made at or about the same time;
(d) whether the same type of consideration is received; and
(e) whether the sales are made for the same general purpose.

195. See generally L. Loss, SECURITIES REGULATION 575-80, 591-96, 674-76 (2d ed. 1961); Thomforde, supra note 9, at 13-15.
197. Id., Thomforde, supra note 9, at 13.

The proposed Federal Securities Code defines "offering" by incorporating the traditional integration factors. Section 202(110)(A) of the Code provides that:

(i) offers of securities of different classes are separate offerings; and (ii) offers of securities of the same class by or for the account or benefit of the same person (whether the issuer or any other person) are separate offerings only if they are substantially distinct on the basis of such factors as the manner, time, and purpose of the offers, the offering price, and the kind of consideration.

1 ALI FED. SEC. CODE § 202(110)(A) (Official Draft 1980).

Although the Code seems to consider different classes of securities as separate offerings, the comments indicate that the differences between two nominally separate classes must be substantial. Id. § 202(110), comment (1)(a). Accordingly, the Code defines a "class of securities" as "all securities of an issuer that are of substantially similar character and whose holders enjoy substantially similar rights." Id. § 202(20).

The definition of "offering" under the Code is broader than the current definition of "issue" because the Code's definition applies to both initial sales by an issuer as well as resales of securities in the secondary market. Id. § 202(110), comment (1)(c).
Rule 242’s Qualified Safe Harbor

An issuer using rule 242 or section 4(6) may want to use other exemptions for other offerings over the course of a year, but an issuer cannot predict whether the SEC will integrate two arguably separate offerings. Because application of the integration doctrine depends on how the SEC views the issues, the integration doctrine may pose a problem to an issuer who presents offerings under different exemptions.

Consequently, rule 242 attempts to remedy this dilemma by providing a “qualified safe harbor” from the application of the integration doctrine. Under the qualified safe harbor of rule 242, sales of securities occurring more than six months prior to the commencement of a rule 242 issue, and sales occurring at any time after six months from its completion date, will not be integrated with the rule 242 offering. The safe harbor, however, is “qualified” because it applies only if an issuer does not offer or sell securities of the same or similar class during either six-month period, other than offers or sales pursuant to another section 3(b) exemption or an employee stock plan. If an issuer offers other exempt securities during the six-month period before and after a rule 242 offering, the SEC may integrate the offer with the rule 242 offering depending on the facts and circumstances of the transactions. Thus, an issuer must be wary of the application of the integration doctrine with respect to any offers or sales that do not qualify for the rule 242 safe harbor.

Rule 242’s qualified safe harbor provides an issuer with some guidance in structuring its offerings because sales that meet its requirements are “safe” from the integration doctrine. Moreover, the safe harbor allows an issuer to combine the use of rule 242 with Regulation A, rule 242, and the other section 3(b) exemptions, provided the aggregate offering price does not exceed $2 million in a six-month period.

201. Id.
203. See notes 108-10 & accompanying text supra.

Rule 146 has a safe harbor provision similar to rule 242’s, but does not permit any sales during the six-month “window-periods.” See 46 Fed. Reg. 2631 (1981).
Although section 4(6) does not provide a safe harbor from the integration doctrine, the SEC has rulemaking authority under the 1980 Act.\textsuperscript{204} Thus, to provide issuers using section 4(6) with greater certainty about application of the integration doctrine, the SEC proposed a safe harbor rule under section 4(6) similar to rule 242's qualified safe harbor.\textsuperscript{205}

\textbf{Conclusion}

Rule 242 and section 4(6) significantly improve the ability of small businesses to raise capital. Although they do not have the same statutory source, they both operate under the assumption that accredited purchasers possess the economic bargaining power to demand any information that they may need to make an informed investment decision. Prior to the adoption of rule 242 and section 4(6), an issuer had to choose between using a simple but limited exemption such as rule 240 or a hazardous but more flexible exemption such as rule 146. Under rule 242 and section 4(6) an issuer can have both simplicity and flexibility.

Both exemptions solve the problems with rule 146 by providing an issuer with objective criteria as to whether it qualifies for the exemption. An issuer using either rule 242 or section 4(6) simply must determine whether a particular purchaser fits into the definition of accredited person or investor. The issuer need not guess as to the offeree's sophistication.

Nonetheless, the exemptions differ in that rule 242's definition of accredited purchasers encompasses more types of investors than section 4(6). Unlike section 4(6), rule 242 permits sales to block purchasers and an issuer's executive officers and directors. Nevertheless, wealthy block purchasers may not be sophisticated enough.

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to fend for themselves. In this respect, rule 242 may sacrifice investor protection for the sake of small business capital formation.

Rule 242 and section 4(6) differ in other respects. Section 4(6) permits an issuer to raise $5 million per issue of securities, while rule 242 limits an issuer to $2 million per issue. Additionally, section 4(6) makes no provision for disclosure because under section 4(6) an issuer can sell to only accredited investors. Conversely, rule 242 includes some disclosure provisions because ordinary investors may qualify as accredited purchasers under rule 242.

The new exemptions are not without their shortcomings. Rule 242 may not protect sufficiently block purchasers, and by placing restrictions on the resale of securities acquired in the original offering rule 242 and section 4(6) may hinder capital formation in small businesses. Despite these shortcomings, rule 242 and section 4(6) are welcome additions to the regulatory scheme. Moreover, the regulatory framework is not static. The SEC and Congress can amend the new exemptions depending upon their success in improving small business capital formation.

Susan E. Satkowski