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Marvin R. Mohny

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NOTES

REGULATION D: COHERENT EXEMPTIONS FOR SMALL BUSINESSES UNDER THE SECURITIES ACT OF 1933

In March of 1982 the Securities and Exchange Commission (SEC) adopted Regulation D¹ (Reg. D), which governs offerings exempt from registration under the Securities Act of 1933.² The SEC promulgated Reg. D to encourage capital formation among small businesses³ and to simplify the existing regulatory scheme.⁴ Additionally, the SEC intended the adoption of Reg. D by state securities administrators to create a uniform federal-state exemption framework.⁵

Reg. D is a series of six rules replacing three separate rules governing small, medium, and large offerings.⁶ By combining the for-

1. 47 Fed. Reg. 11,251, 11,262-66 (1982) (to be codified at 17 C.F.R. §§ 230.501-.506). The Appendix to this Note contains a chart summarizing Reg. D and comparing it to former exemptions. *See id.* at 11,259. *See also infra* note 66.

2. Securities Act of 1933, §§ 1-26, 15 U.S.C. §§ 77(a) - 77 (bbbb) (1976 & Supp. IV 1980).

3. 46 Fed. Reg. 41,791 (1981). As used in the Securities Act, "small business" means "any issuer whose total assets on the last day of its most recent fiscal year were \$2.5 million or less" and who conducts or proposes to conduct an offering of securities of less than \$5 million. DIV. OF CORP. FIN., OFFICE OF SMALL BUS. POLICY, U.S. SEC, INITIAL REGULATORY FLEXIBILITY ANALYSIS (for Reg. D) 4 (Autumn 1981) [hereinafter cited as IRFA]. The Small Business Administration's (SBA) definition of "small business," although roughly comparable, varies according to industry group and is based on annual sales and number of employees. PUBLIC COMM. DIV., U.S. SBA, FACTS ABOUT SMALL BUSINESS AND THE U.S. SMALL BUSINESS ADMINISTRATION 7-8 (Feb. 1981) [hereinafter cited as FACTS ABOUT SMALL BUSINESS].

4. 47 Fed. Reg. 11,251 (1982) (to be codified at 17 C.F.R. §§ 230.501-.506).

5. *Id.* at 11,252. "[T]he Commission, through its Division of Corporation Finance, has coordinated with the North American Securities Administrators Association ('NASAA') . . . to develop a basic framework of limited offering exemptions that can apply uniformly at the federal and state levels. Regulation D is intended to be the principal element of this framework." *Id.* (footnotes omitted).

6. *Id.* at 11,251, 11,252. Prior to Reg. D, Rule 240 governed offerings up to \$100 thousand; Rule 242 governed offerings up to \$2 million; Rule 146 governed offerings in excess of \$2 million. 17 C.F.R. §§ 230.240e, .242(c), .146 (1981). Under Reg. D, Rule 504 governs offerings up to \$500 thousand; Rule 505 governs offerings up to \$5 million; Rule 506 governs offerings without a dollar limit. 47 Fed. Reg. 11,266.

mer separate rules into one regulation with uniform terms and conditions, the SEC simplified the limited offering exemptions, making them internally consistent.⁷ The SEC's liberalization of registration and disclosure requirements in Reg. D, however, may sacrifice some investor protection.⁸

The SEC has modified the Securities Act several times recently to encourage capital formation among small entities.⁹ Because Reg. D is part of this trend, this Note begins by placing Reg. D in the larger context of securities registration requirements. This Note then analyzes the changes Reg. D makes in relation to previous exemption rules. Finally, this Note concludes by discussing potential problems in complying with the new regulation.

THE DEVELOPMENT OF LIMITED OFFERING EXEMPTIONS

The Securities Act of 1933 (the Act) makes unlawful the sale of any security not registered with the SEC.¹⁰ Issuers must file a registration statement disclosing certain information about the issuer, its business, and the securities being offered for sale.¹¹ The Act also makes unlawful the delivery of any security for sale not

7. 46 Fed. Reg. 41,791 (1981). Rule 501 contains uniform terms and definitions applicable to Rules 504-506, 47 Fed. Reg. 11,262-64 (1982) (to be codified at 17 U.S.C. § 230.501); Rule 502 contains general conditions, 47 Fed. Reg. 11,264-65 (1982) (to be codified at 17 U.S.C. § 230.502); Rule 503 provides a common notice of sales form to be used for offerings under Reg. D, 47 Fed. Reg. 11,265 (1982) (to be codified at 17 U.S.C. § 230.503).

8. For a discussion of investor protection, see *infra* notes 96-114 and accompanying text.

9. See 46 Fed. Reg. 41,791-92.

10. Securities Act of 1933, § 5(a)(1), 15 U.S.C. § 77e(a)(1) (1976).

11. *Id.* § 7, 15 U.S.C. § 77g.

The basic registration form, Form S-1, requires, among other things, a description of the company's business, its properties, material transactions between the company and its officers and directors, the plan for distributing the securities and the intended use of the proceeds, capitalization, competition, identification of officers and directors and their remuneration, and any pending legal proceedings In addition, there are also detailed requirements concerning financial statements, including the requirement that such statements be audited by an independent certified public accountant. The company must also provide any other information that is necessary to make the statements complete and not misleading, in addition to the information expressly required by the form.

accompanied by a prospectus¹² containing information required in the registration statement.¹³ If an issuer fails to comply with these requirements, a purchaser may demand return of his consideration and accrued interest.¹⁴

In drafting the Securities Act of 1933, Congress recognized that federal registration was unnecessary under certain circumstances.¹⁵ Thus, the Act exempts certain classes of securities,¹⁶ transactions by certain individuals not involved in the distribution process,¹⁷ and transactions not involving any public offering.¹⁸ Congress also empowered the SEC to adopt additional limited exemptions that are consistent with the public interest and investor protection.¹⁹ The registration exemptions are useful particularly for small businesses that cannot afford registration costs²⁰ and do not require

12. Securities Act of 1933, § 5(b)(2), 15 U.S.C. § 77e(b)(2) (1976).

13. *Id.* § 10(a)(1), 15 U.S.C. § 77j(a)(1). A prospectus actually contains the descriptive and financial information required in Part 1 of a registration statement. Certain exhibits and other information required in a registration statement are omitted from the prospectus. *See id.*

14. *Id.* § 12(1), 15 U.S.C. § 77l(1). The right to sue for rescission based on failure to provide a prospectus is limited to one year from the date of violation by § 13. *Id.* § 13, 15 U.S.C. § 77m.

15. *Id.* § 3, 15 U.S.C. § 77c. The registration exemptions apply to federal registration requirements only. The issuer still must comply with the securities law of each state in which the securities are offered for sale. *Id.* § 18, 15 U.S.C. § 77r. The issuer has separate federal obligations neither to deal fraudulently, *id.* § 17a, 15 U.S.C. § 77q(a), nor to provide misleading information, *id.* § 12(2), 15 U.S.C. § 77l(2).

16. *Id.* § 3(a), 15 U.S.C. § 77c(a).

17. Section 4(1) exempts "transactions by any person other than an issuer, underwriter or dealer." Sections 4(3) and 4(4) exempt transactions by brokers and dealers subject to certain conditions. *Id.* § 4, 15 U.S.C. § 77d.

18. Section 4(2) exempts "transactions by an issuer not involving any public offering." *Id.* § 4(2), 15 U.S.C. § 77d(2).

19. *Id.* § 3(b), 15 U.S.C. § 77c(b). The SEC's rulemaking authority under § 3(b) currently is limited to offerings up to \$5 million. *Id.* (Supp. IV 1980).

20. The costs of registering a small public offering are estimated to approximate 20% of the total offering price. Green & Brecher, *When Making a Small Public Offering Under Regulation A (with forms)*, 26 PRAC. LAW 25, 29 (Mar. 1, 1980). A recent study by the SEC reported that the average costs for small public offerings were \$200 thousand for an average issue of \$1.3 million. *See* U.S. SEC, RULE 242: A MONITORING REPORT ON THE FIRST SIX MONTHS OF ITS USE 53, Table 18 (Dec. 1980) [hereinafter cited as 242 REPORT]. The greatest portion of the cost is attributable to underwriter's fees and selling commissions. *Id.* In addition to the external cost of a public offering, the issuer also must undertake significant internal expenditures including management time, loss of some flexibility in directing the company, and increased liability. OFFICE OF SMALL BUS., OFFICE OF PUBLIC AFFAIRS, U.S. SEC & U.S. SBA, Q & A: SMALL BUSINESS AND THE SEC 3 (Mar. 1981). The issuer in a registered

access to a broad public market to sell their securities.²¹

*The Nonpublic Offering Exemption Of Section 4(2)*²²

The most widely used statutory exemption has been the nonpublic offering exemption of section 4(2).²³ This section permits an issuer to sell an unlimited amount of unregistered securities if the offering is not public.²⁴ The characteristics of a nonpublic offering, however, have been unclear. In 1935, the General Counsel for the SEC stated some significant factors in determining whether an issue of securities involves a public offering, including the number of offerees, the relationship of the offerees to the issuer and to each other, the manner of offering, the number of units in the offering, and the dollar amount of the offering.²⁵ The general counsel also stated that offerings to less than twenty-five persons presumably do not involve a public offering.²⁶

Until 1953, issuers believed that they complied with section 4(2) by limiting their offerings to twenty-five offerees.²⁷ In *SEC v. Ralston Purina Co.*,²⁸ however, the Supreme Court noted that the sec-

offering also must assume a continuous reporting obligation under the Securities Exchange Act which costs "from \$25,000 to in excess of \$100,000 per year." Taylor, *Equity Financing for the Small Business: A Layman's Guide*, 20 S. TEX. L.J. 253, 257 (1979).

21. The advantages of registration include access to a wider market of potential investors for the initial offering, greater flexibility for future financings, and an unrestricted secondary trading market for the company's shares. CAPITAL FORMATION, *supra* note 11, at 7. A small business, especially one that is locally owned, however, does not require the amount of funding that makes access to a broad market essential. Additionally, because investors are likely to be closely associated with the business, restricted access to a secondary trading market might not impair the attractiveness of the offering.

22. Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1976).

23. Thomforde, *Relief for Small Businesses: Two New Exemptions from SEC Registration*, 48 TENN. L. REV. 323, 325 (1981). Until the promulgation of Rule 146 in 1974, the only registration exemptions for an issuer were § 3(a)(11), Regulation A (Reg. A), and § 4(2). Because Reg. A, a short form registration statement, had a very low dollar ceiling, and § 3(a)(11), the intrastate offering, required that the issuer and all ultimate purchasers reside in the same state, § 4(2) was the most popular exemption.

24. Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1976).

25. 11 Fed. Reg. 10,952 (1935).

26. *Id.*

27. Coles, *Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review*, 58 MARQ. L. REV. 395, 435-36 (1975).

28. 346 U.S. 119 (1953). In *Ralston Purina*, the SEC sought to enjoin the sale of unregistered securities by an issuer as nonexempt under § 4(1) (now § 4(2)). *Ralston Purina* claimed that sales to "key employees," a select group including artists, clerks, veterinarians,

tion 4(2) exemption did not depend solely on the number of offerees.²⁹ The Court interpreted the exemption in light of the purpose of the Securities Act, which is to protect investors by assuring the availability of relevant information.³⁰ The Court held that even in a nonpublic offering each offeree must have "access to the same kind of information that the act would make available in the form of a registration statement."³¹

Following the *Ralston Purina* decision, issuers either limited nonpublic offerings strictly to persons with access to information comparable to that found in a registration statement, or provided such information in an offering memorandum.³² In 1971 and 1972, however, decisions by the United States Court of Appeals for the Fifth Circuit in *Hill York Corp. v. American International Franchise, Inc.*³³ and *SEC v. Continental Tobacco Co.*³⁴ created

and electricians, did not constitute a public offering. *Id.* at 121. In granting the injunction, the Supreme Court provided the judicial benchmark for interpreting the nonpublic offering exemption. The Court construed the § 4(1) exemption in light of the purpose of the Securities Act, noting that "[t]he design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions." *Id.* at 124. The Court stated:

The exemption, as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within § 4(1), e.g., one made to executive personnel who because of their position have access to the same kind of information that the act would make available in the form of a registration statement. Absent such a showing of special circumstances, employees are just as much a part of the investing "public" as any of their neighbors in the community.

Id. at 125-26 (footnotes omitted).

The Court further stated that "[t]he focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose." *Id.* at 127 (emphasis added).

Since the *Ralston Purina* decision, courts and the SEC have maintained that the availability of the nonpublic offering exemption depends on whether every offeree has available the same information as in a registration statement. *See, e.g.,* *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893 (5th Cir. 1977); 17 C.F.R. § 230.146 (1981) (SEC rule setting information requirements for nonpublic offerings). Such information may be supplied to offerees by the issuer, or it may be made available to the offeree through natural channels of access to the issuer. 545 F.2d at 906-07.

29. 346 U.S. at 125.

30. *Id.* at 124. *See also* *A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38 (1941).

31. 346 U.S. at 125.

32. *See* *Coles*, *supra* note 27, at 436.

33. 448 F.2d 680 (5th Cir. 1971). In *Hill York*, an offering made to a small number of

doubts about the application of section 4(2) to anyone other than company insiders.³⁵ Consequently, issuers urged the SEC to articulate objective standards for compliance with the exemption.³⁶

In 1974 the SEC promulgated Rule 146 as a safe harbor³⁷ under section 4(2).³⁸ Under Rule 146, an issuer could meet its disclosure obligation in a nonpublic offering by providing offerees with a disclosure document.³⁹ Unfortunately, Rule 146 did not create entirely objective standards because it required issuers to determine accurately the wealth or sophistication of every potential offeree, an inherently risky and subjective determination.⁴⁰ Further, full

attorneys and businessmen did not qualify for the § 4(2) exemption because the investors, although sophisticated, did not have available "the information requisite for a registration statement" *Id.* at 690.

34. 463 F.2d 137 (5th Cir. 1972). In *Continental Tobacco*, the court held that the issuer claiming an exemption from registration under § 4(2) must prove "that all of the offerees of Continental enjoyed a relationship with Continental making registration unnecessary." *Id.* at 161.

35. D. RATNER, *SECURITIES REGULATION* 248 (1980).

36. *Id.*

37. 17 C.F.R. § 230.146(b) (1981). A "safe harbor" is a rule clarifying a statute. Compliance with the rule is deemed compliance with the statute, and the issuer is safe from future interpretations that otherwise would expose him to liability. *Id.*

38. 17 C.F.R. § 230.146 (1981). The preliminary note 3 to the Rule states that "Rule 146 is designed to provide, to the extent feasible, objective standards upon which responsible businessmen may rely in raising capital under claim of the Section 4(2) exemption." *Id.*

39. *Id.* § 230.146(e)(1) (1981). Subsequent to the promulgation of Rule 146 in 1977, the Fifth Circuit modified its position in *Continental Tobacco* and held in *Doran v. Petroleum Mgmt. Corp.* that an issuer could qualify for the § 4(2) exemption if the issuer could show that offerees had access to or had been provided with the necessary information. 545 F.2d 893 (5th Cir. 1977).

40. Under Rule 146, prior to making an offer, the issuer had to determine that every offeree either was sophisticated (defined as knowledgeable in financial and business matters), or able to bear the risk of the investment. 17 C.F.R. § 230.146(d)(1) (1981). An offer made to a single unqualified offeree caused the exemption under Rule 146 to be lost and presumably also violated § 4(2). 17 C.F.R. § 230.146, *prelim. n.3* (1981). The entire offering, therefore, was in violation of § 5, and every holder of the securities had a right to return them to the issuer for a refund of the issue price. Securities Act of 1933, § 12(1), 15 U.S.C. § 77l(1) (1976).

The Securities Act defines very broadly an offer to sell. See Securities Act of 1933, § 2(3), 15 U.S.C. § 77b(3) (1976). Almost any nonroutine communication regarding the issuer or its securities made without filing a registration statement may be construed as an offer to sell. 22 Fed. Reg. 8,359 (1957). The Rule 146 requirement that the issuer determine the offeree's qualifications prior to making an offer to sell imposed an unrealistic burden. See Coles, *supra* note 27, at 440.

compliance with Rule 146 was time-consuming and expensive.⁴¹ During the late 1970's pressure again mounted on Congress and the SEC to provide relief for businesses forced to choose between expensive disclosure and a risky exemption.

Recent Actions By Congress and the SEC

In the late 1970's, both Congress and the SEC recognized the importance of small businesses to the American economy,⁴² and the disproportionate impact of registration requirements on the ability of small businesses to raise capital.⁴³ Each rulemaking body, therefore, undertook specific actions to provide relief.

In 1975, the SEC promulgated Rule 240 to provide a new registration exemption for offerings of less than \$100 thousand by closely held issuers.⁴⁴ In 1978 and 1979, the SEC again aided small

41. Campbell, *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139, 1156.

42. A recent publication of the SBA reports that small nonfarm businesses account for 58% of U.S. business employment and 39% of the gross national product. Additionally, of the 13 million nongovernment jobs created between 1969 and 1976, 12 million were created by small businesses. See FACTS ABOUT SMALL BUSINESS, *supra* note 3, at 3-4. The SBA also reports that between 1952 and 1973, small firms "produced four times as many innovations per research and development dollar as medium-sized firms (defined as those with 1,000 - 10,000 employees)." *Id.* at 22.

43. In 1977, the Advisory Committee on Corporate Disclosure reported to the SEC that its "survey of publicly held companies indicates that the burden of reporting weighs more heavily on small than large companies." DIRECTORATE OF ECON. AND POLICY ANALYSIS, U.S. SEC, FORM S-18: A MONITORING REPORT ON THE FIRST EIGHTEEN MONTHS OF ITS USE 5 (Mar. 1981) [hereinafter cited as FORM S-18 REPORT].

Assuming that a large business's earnings are greater than those of a small business, and that the cost of compliance with identical government regulations is approximately equal, then the burden of compliance with identical government regulations is proportionately greater for the small business. Thus, the initial appearance of equal treatment in reality favors large companies. OFFICE OF CHIEF COUNSEL FOR ADVOC., U.S. SBA, BETTER FEDERAL TREATMENT FOR SMALL ENTITIES 2 (Dec. 1980). The fact that small businesses spend \$12.7 billion per year filling out federal, state, and local government forms indicates the magnitude of the problem. FACTS ABOUT SMALL BUSINESS, *supra* note 3, at 21.

Congress recognized that regulations often favor large entities and in 1980 passed the Regulatory Flexibility Act, which directed agencies to fit requirements to the scale of the entity regulated. Regulatory Flexibility Act of 1980, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified at 5 U.S.C.A. §§ 601-612 (West Supp. 1980)). For a discussion of the Regulatory Flexibility Act, see *infra* note 50 and accompanying text.

44. 17 C.F.R. § 230.240 (1981). Rule 240 allows issuers with less than 100 beneficial owners to sell up to \$100,000 in a limited offering free of federal disclosure requirements, provided that the issuer observes federal limitations on commissions, manner of offering, and

businesses by amending Rule 144 to increase liquidity of securities purchased in an exempt offering.⁴⁵ In 1979, Form S-18, a short form registration statement, became available for initial public offerings of \$5 million or less.⁴⁶ Also in 1979, the SEC established the Office of Small Business Policy within the Division of Corporation Finance to address the problems of small business issuers.⁴⁷ In 1980, the SEC promulgated Rule 242 which provided a \$2 million exemption with limited disclosure requirements⁴⁸ and introduced

resale. *Id.*

45. 17 C.F.R. § 230.144 (1981). Rule 144 provides a safe harbor for the resale of restricted securities when certain conditions are met regarding the availability of public information about the issuer, *id.* § 230.144(c), the compliance by the original purchaser with a minimum holding period, *id.* § 230.144(d), and the volume of sales by affiliates of the issuer, *id.* § 230.144(e). A purchaser reselling without registration or compliance with the exemption may be an underwriter as defined in § 2(11) and is subject to strict liability under § 12(1). *Id.* § 230.144, *prelim. n.2.*

In 1978, the SEC amended Rule 144 to permit sales directly to market makers. 43 Fed. Reg. 43,709, 43,711 (1978). In 1979, the SEC amended Rule 144 to permit nonaffiliates of the issuer to sell an unlimited amount of securities, provided the other conditions of the Rule were met. 44 Fed. Reg. 15,610, 15,612 (1979).

46. FORM S-18 REPORT, *supra* note 43, at 3. The SEC describes Form S-18 as follows:

In adopting Form S-18, the Commission departed from conventional disclosure practices in order to facilitate small business capital formation. The narrative portion of Form S-18, for example, calls for fewer disclosure items than does the more generalized Form S-1. The narrative items which are included in Form S-18, however, are generally consistent with the corresponding items in Form S-1.

Form S-18 also calls for the presentation of audited financial statements which correspond substantially to those required in offerings exempt from registration pursuant to Regulation A under the Securities Act of 1933 ("Regulation A"). Financial statements required by Form S-18 are to be prepared in accordance with generally accepted accounting principles and practices ("GAAP"). Form S-18 requires "(1) a consolidated balance sheet as of the date within 90 days prior to the date of filing the registration statement; and (2) consolidated statements of income, source and application of funds, and other stockholders' equity for the two fiscal years prior to the date of filing"

In addition, unlike Form S-1, which must be filed at the Commission's headquarters office (in Washington, D.C.), Form S-18 may be filed either at the headquarters office or at the regional office for the region in which the issuer conducts (or intends to conduct) its business operations.

Id. at 3-4 (footnotes omitted).

47. FORM S-18 REPORT, *supra* note 43, at 6.

48. 17 C.F.R. § 230.242 (1981). Rule 242 provided that certain American and Canadian corporations could raise up to \$2 million every six months in an exempt offering using Form S-18 as a disclosure document. *Id.* §§ 230.242(c), .242(f)(1)(i). For offerings made exclusively to accredited persons, however, the Rule did not require specific disclosures. *Id.* §

the concept of "accredited persons," certain investors to whom the SEC requires no specific disclosure.⁴⁹

In 1980, Congress enacted the Regulatory Flexibility Act⁵⁰ and the Small Business Investment Incentive Act.⁵¹ The Regulatory Flexibility Act (RFA) states that "uniform Federal regulatory and reporting requirements have in numerous instances imposed unnecessary and disproportionately burdensome demands including legal, accounting, and consulting costs upon small businesses, small organizations, and small governmental jurisdictions with limited resources"⁵² The RFA thus amends the Administrative Procedure Act⁵³ and requires all federal agencies to evaluate the impact of their regulations on small entities and consider alternative procedures to lessen the burden of compliance.⁵⁴

Through the Investment Incentive Act, Congress amended the

230.242(f)(1).

49. 242 REPORT, *supra* note 20, at 6. As defined in Rule 242(a)(1), accredited persons are commercial banks, insurance companies, certain employee benefit plans, registered investment companies, licensed small business investment companies, anyone purchasing \$100 thousand or more of the offered securities within a 60-day period, and any director or executive officer of the issuer. 17 C.F.R. § 230.242(a)(1) (1981).

50. Regulatory Flexibility Act of 1980, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified at 5 U.S.C. §§ 601-612 (West Supp. 1980)).

51. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980). In drafting the Investment Incentive Act, Congress clearly expressed concern for the adverse impact of securities regulations on the ability of small business to raise capital.

The Committee is well aware of the slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses, that has occurred in recent years. The importance of these businesses to the American economic system in terms of innovation, productivity, increased competition and the jobs they create is, of course, critical. Hence, the need to reverse this downward trend is of compelling public concern. Without doubt, the slowdown that has occurred is the product of many economic forces quite apart from the costs of securities regulation—taxes and inflation principal among them—and the Congress has been separately addressing all these factors in a wide variety of ways. But no undue cost should be shielded from scrutiny. As but one means of dealing with the more general problem, this Bill seeks specifically to reduce some of the costs of government regulation imposed on the capital-raising process, to the extent that it can be done without sacrificing necessary investor protection.

H.R. REP. No. 1341, 96th Cong., 2d Sess. 20, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 4800, 4802.

52. Regulatory Flexibility Act of 1980, § 2(a)(3), 94 Stat. 1164 (1980) (findings and purposes).

53. 5 U.S.C. §§ 551-559 (1976).

54. Regulatory Flexibility Act of 1980, § 1603, 15 U.S.C.A. § 603 (West Supp. 1981).

Securities Act in three ways to reduce the registration burden for small issuers. First, Congress added an exemption, section 4(6), which allows issuers to sell up to \$5 million in securities to accredited investors⁵⁵ without incurring specific disclosure obligations.⁵⁶ Second, Congress raised the ceiling under which the SEC may create exemptions from \$2 million to \$5 million.⁵⁷ Finally, Congress directed the SEC to work with state securities administrators to develop a consistent national scheme of securities regulation.⁵⁸

55. As defined by the Securities Act, an accredited investor is:

(i) a bank as defined in section 77c(a)(2) of this title whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13); an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which either a bank, insurance company, or registered investment adviser; or

(ii) 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 and regulations which the Commission shall prescribe.

15 U.S.C. § 77b(15) (Supp. IV 1980) (amending Securities Act of 1933, § 2, 15 U.S.C. § 77b(1)-(14) (1976)). Cf. 17 C.F.R. § 230.242 (1981) (definition of accredited person).

56. Section 4(6) provides that the provisions of § 5 shall not apply to transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 77c(b) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe.

15 U.S.C. § 77d(6) (Supp. IV 1980) (amending Securities Act of 1933, § 4(6), 15 U.S.C. § 77(d) (1976)).

57. By increasing substantially the § 3(b) ceiling from \$2 million to \$5 million, Congress intended to provide the SEC with greater flexibility to develop rules to meet the investment needs of small businesses. 45 Fed. Reg. 71,775, 71,776 (1980). See also Note, *Rule 242 and Section 4(6) Securities Registration Exemption: Recent Attempts to Aid Small Businesses*, 23 WM. & MARY L. REV. 73, 88 (1981).

58. Congress amended § 19 of the Securities Act of 1933 (codified at 15 U.S.C. § 77s) to add a new § 19(c) which provides in pertinent part: "The Commission is authorized to cooperate with any association of duly constituted representatives of State governments whose primary assignment is the regulation of the securities business within those States, and which, in the judgment of the Commission, could assist in effectuating greater uniformity in Federal-State securities matters." Omnibus Small Business Capital Formation Act of 1980,

The steps taken in the last decade by Congress and the SEC helped create a more favorable environment for financing small businesses.⁵⁹ Unfortunately, the result was a "patchwork quilt" pattern of registration exemptions.⁶⁰ Reg. D consolidates the scattered exemption rules and addresses the problems of small businesses.⁶¹

THE STRUCTURE OF REGULATION D

Reg. D consists of six rules numbered 501 through 506.⁶² Rules

§ 505, 15 U.S.C. § 77s(c)(1) (Supp. IV 1980).

Because issuers must comply with both federal and state securities laws, uniformity of laws will help relieve issuers of the burden of multiple filings. IRFA, *supra* note 3, at 4. Relaxing the federal rules without coordination with the states would be of limited benefit to the issuer.

59. The volume of initial public offerings (IPO's) fell precipitously after 1972, and "[o]nly since 1979 has the IPO volume shown signs of health Nevertheless, the recovery, which can be seen in a comparison of 1979 and 1980 IPO volume, has been dramatic. Overall volume in 1980 was nearly triple that in 1979 and the number of issues increased 260%." U.S. SEC & U.S. SBA, *THE ROLE OF REGIONAL BROKER-DEALERS IN THE CAPITAL FORMATION PROCESS: UNDERWRITING, MARKET-MAKING AND SECURITIES RESEARCH ACTIVITIES* 7, 10 (Aug. 1981) [hereinafter cited as *REGIONAL BROKER-DEALERS*].

Exempt issues also flourished. During 1979, 477 issuers filed notices of sales on Form 240 aggregating \$9,707,205. During 1980, 1,486 issuers filed notices of sales on Form 240 aggregating \$14,164,141. 46 Fed. Reg. 2,631, 2,635 (1981).

Rule 242 first became available to issuers in 1980. During the first six months of its availability, 64 issuers filed notices of intended sales aggregating \$38,058,704. *Id.* at 2,636. Moreover, the issuers using Rule 242 were "small when measured by their financial characteristics and number of employees." *Id.*

60. Thomforde, *supra* note 23, at 336.

61. 47 Fed. Reg. 11,251 (1982). "The objective of . . . Regulation D . . . is to coordinate the various limited offering exemptions and to streamline the existing requirements applicable to private offers and sales of securities thereby creating a more coherent pattern of exemptive relief, particularly as it relates to the capital formation needs of small business." IRFA, *supra* note 3, at 3.

62. 47 Fed. Reg. 11,251, 11,262-66 (1982) (to be codified at 17 C.F.R. § 230.501-.506). Six preliminary notes precede Reg. D and place it within the existing statutory scheme. *Id.* at 11,253. The preliminary notes provide that securities issued in reliance on Reg. D will be subject to the same general qualifications that apply to the existing filing exemptions under §§ 4(2) and 3(b).

Note 1 provides that compliance with Reg. D exempts an issuer from the registration requirements of § 5 of the Securities Act only. 47 Fed. Reg. 11,251, 11,262 (1982). Compliance with Reg. D, however, does not exempt an issuer from the anti-fraud provisions or the civil liability provisions of the Act.

Note 2 reminds issuers that Reg. D does not provide an exemption from compliance with the securities laws of the states. *Id.* An issuer therefore must comply with the separate registration requirements of each state in which its securities will be sold.

501 through 503 provide uniform terms and definitions, general conditions, and a uniform notice of sales form, Form D.⁶³ Rules 504 through 506 replace former rules 240, 242, and 146 respectively.⁶⁴ Rule 504 governs offerings up to \$500 thousand, Rule 505 governs offerings up to \$5 million, and Rule 506 governs offerings exceeding \$5 million.⁶⁵ Each of the former rules had its own definitions, conditions, and notice of sales form; thus, Reg. D simplifies and unifies the exemptions.

Reg. D encourages capital formation among small businesses by expanding the concept of accredited investors and raising dollar ceilings of exemptions.⁶⁶ Thus, the new regulation increases the opportunity for issuers to make securities offerings with less burdensome disclosure requirements.⁶⁷ For offerings made only to accred-

Note 3 states that attempted compliance with Reg. D does not serve as an election. *Id.* Failure to comply exactly with the requirements of Reg. D does not violate the registration requirements of the Act provided the issue qualifies under another exemption.

Note 4 cautions that the exemption from federal registration requirements under Reg. D exempts only the issuer. *Id.* A purchaser reselling securities purchased in a Reg. D offering without registration or an exemption may be considered as participating in a distribution and become strictly liable as an underwriter, as defined in § 2(11) of the Act. Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11) (1976).

Note 5 provides that these rules may be used for business combinations. 47 Fed. Reg. 11,251, 11,262 (1982).

Note 6 provides that any offering may lose its exempt status, even though in technical compliance with the rule, if it is part of a scheme to evade the Act's registration requirements. *Id.*

63. 47 Fed. Reg. 11,251, 11,262-65 (1982) (to be codified at 17 C.F.R. §§ 230.501-503).

64. *Id.* at 11,266 (to be codified at 17 C.F.R. §§ 230.504-506, replacing 17 C.F.R. §§ 230.240, .242, .146 (1981)).

65. 47 Fed. Reg. at 11,266.

66. Reg. D encourages issuers to make offerings with reduced disclosures. The most significant changes made by Reg. D are:

- a) increasing the offering ceiling to \$500,000 under Rule 504 and to \$5 million under Rule 505, 47 Fed. Reg. 11,251-52 (1982);
- b) expanding the definition of accredited investors relative to former Rule 242 and § 4(6), *id.* at 12,253;
- c) extending the accredited investor concept to offerings in excess of \$5 million, *id.* at 11,252;
- d) permitting noncorporate issuers to make offerings with reduced disclosures to nonaccredited investors, *id.* at 11,258;
- e) excluding accredited investors from the 35 purchaser limitation of Rules 505 and 506, *id.*;
- f) eliminating the offeree qualification test for large offerings, *id.*; and
- g) permitting issuers to pay sales commissions for offerings under Rule 504, *id.*

67. *Id.* at 11,258.

ited investors⁶⁸ and for small offerings made under Rule 504,⁶⁹ Reg. D requires no specific disclosures. For offerings made under Rule 505, qualified issuers may provide information on a short form disclosure document.⁷⁰ For offerings under Rule 506, information comparable to full registration must be provided only if nonaccredited investors participate.⁷¹

Accredited Investors

Accredited investors are purchasers who can "fend for themselves," and to whom the issuer has no specific disclosure obligations.⁷² Although the accredited investor concept was not introduced into the Securities Act until 1980,⁷³ the SEC has expanded the concept tremendously in Reg. D, extending it to offerings by partnerships and to offerings exceeding \$5 million.⁷⁴

The accredited investor concept in Reg. D benefits issuers in numerous ways. First, the expanded concept makes Reg. D exemptions more advantageous to issuers than exemptions under the prior rules. Rule 146 did not contain an accredited investor concept. Rule 242 contained a narrower definition of "accredited per-

68. *Id.* at 11,264 (to be codified at 17 C.F.R. § 230.502(b)(1)(i)).

69. *Id.*

70. *Id.* (to be codified at 17 C.F.R. § 230.502(b)(2)(i)(4)). When nonaccredited investors participate in an offering under Rules 505 and 506, the issuer assumes disclosure obligations to all purchasers. *Id.* (to be codified at 17 C.F.R. § 230.502(b)(1)(ii)). Companies required to report under the Securities Exchange Act of 1934 must provide all purchasers with the information required to be filed under that Act. *Id.* (to be codified at 17 C.F.R. § 230.502(b)(2)(ii)). The disclosure obligation for non-Exchange Act companies varies according to the amount of the offering. *Id.* (to be codified at 17 C.F.R. § 230.502(b)(2)(i)). Additionally, all issuers must describe any written information that they have provided to accredited investors and make it available to purchasers upon request. *Id.* at 11,265 (to be codified at 17 C.F.R. § 230.502(b)(2)(ii)).

71. *Id.* at 11,264-65 (to be codified at 17 C.F.R. § 230.502(b)(2)(i)(B)).

72. Note, *supra* note 57, at 82.

73. See 17 C.F.R. § 230.242(a)(1) (1981). The accredited investor concept in Rule 242 was an experiment, testing whether exempt offerings without specific disclosure requirements to certain types of investors could be consistent with investor protection. 45 Fed. Reg. 6,362 (1980).

74. Rule 242 permitted issuers to make offerings of up to \$2 million every six months, but the Rule was limited to American and Canadian *corporate* issuers. 17 C.F.R. § 230.242(a)(5), (c) (1981). Section 4(6) had an offering ceiling of \$5 million, but permitted no participation by nonaccredited investors. Securities Act of 1933, § 4(6), 15 U.S.C. § 77d(6) (Supp. IV 1980).

sons" and limited its application to offerings of \$2 million or less.⁷⁵ Additionally, because Reg. D excludes accredited investors in determining the number of purchasers of an offering,⁷⁶ distribution may be much broader under Reg. D than under Rules 242 or 146.⁷⁷

Another advantage of Reg. D's interpretation of the accredited investor concept is that an issuer may make offerings pursuant to Rule 506 to accredited investors in unlimited dollar amounts without incurring any specific disclosure obligations.⁷⁸ Therefore, in an offering made exclusively to accredited investors, an issuer may avoid some of the printing and accounting costs of preparing certified financial statements, and some of the legal fees associated with preparing a federal disclosure document.⁷⁹ If any nonaccredited investors participate, however, the issuer assumes significant disclosure obligations to all purchasers.⁸⁰ Consequently, an issuer seeking the least costly method of making an offering should limit exempt offerings exclusively to accredited investors.

Reg. D defines eight categories of accredited investors.⁸¹ Only three of these categories existed under Rule 242, each of which has been expanded. The category of accredited institutional investors under Rule 242 was comprised of banks, insurance companies, registered investment companies, and other financial institutions.⁸² Reg. D expands this category to include business development companies as defined by the Investment Company Act.⁸³ To be accredited under Reg. D, however, a business development company must provide significant managerial assistance to the issuer.⁸⁴ The

75. 17 C.F.R. § 230.242(c) (1981).

76. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)(1)(iv)).

77. See *infra* notes 272-75 and accompanying text for a discussion of calculating the number of purchasers.

78. 47 Fed. Reg. 11,251, 11,264 (to be codified at 17 C.F.R. § 230.502(b)).

79. For offerings registered on Form S-18, for instance, legal, printing, and accounting fees comprise 95% of the total issuance cost. Of this total, legal fees account for 48%, accounting fees for 23%, and printing costs for 24%. The savings, therefore, in an unregistered offering made solely to accredited investors is likely to be significant. FORM S-18 REPORT, *supra* note 43, at 29, Table 7.

80. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(1)(ii)).

81. *Id.* at 11,262-63 (to be codified at 17 C.F.R. § 230.501(a)(1)-(8)).

82. 17 C.F.R. § 230.242(a)(1) (1981).

83. 47 Fed. Reg. 11,251, 11,262 (1982) (to be codified at 17 C.F.R. § 230.501(a)(1)). See also Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(48) (Supp. IV 1980).

84. Unlike Rule 242(a)(1), Reg. D includes business development companies as accredited

class of accredited institutions now also includes Employee Retirement Income Security Act⁸⁵ (ERISA) plans with assets over \$5 million.⁸⁶ Previously, only ERISA plans with a financial institution as the plan fiduciary had an accredited status.⁸⁷ The Commission modified this definition to give accredited status to large plans with internalized investment responsibility.⁸⁸

Under Reg. D, directors, executive officers, and general partners of the issuer are accredited investors.⁸⁹ Rule 242 did not allow general partners of an issuer to be accredited investors. Because Reg. D removes this limitation, the general partners of issuers and the directors, executive officers, and general partners of a general partner of issuers also are accredited investors.⁹⁰ These insiders do not need the protection of a registration statement because their positions provide them with access to information about the issuer and the securities offered.

Reg. D contains a third category of accredited investor which originated in Rule 242. Rule 242 defined purchasers of \$100 thousand or more as accredited persons because they possessed sufficient economic leverage with the issuer to demand any necessary information.⁹¹ The purchaser, however, had to discharge his payment obligation within sixty days.⁹² The SEC modified this requirement in Reg. D to permit payment by installments.⁹³ Purchasers who commit to pay \$150 thousand within five years are accredited investors if their total commitment is less than twenty

investors "to encourage the contributions venture capitalists may make to the capital formation process by investing in and providing managerial assistance to small, growing businesses." 46 Fed. Reg. 41,791, 41,796 n.17 (1981).

85. An ERISA plan is an "employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974." 47 Fed. Reg. 11,251, 11,262 (to be codified at 17 C.F.R. § 230.501(a)(1)).

86. 47 Fed. Reg. 11,251, 11,262 (1982) (to be codified at 17 C.F.R. § 230.501(a)(1)). *See id.* at 11,254 (discussing ERISA plans as accredited investors).

87. 17 C.F.R. § 230.242(a)(1)(i) (1981).

88. 47 Fed. Reg. 11,251, 11,254 (1982).

89. *Id.* at 11,262-63 (to be codified at 17 C.F.R. § 230.501(a)(4)).

90. *Id.*

91. 17 C.F.R. § 230.242(a)(1)(ii) (1981). *See generally* Note, *supra* note 57, at 89.

92. 17 C.F.R. § 230.242(a)(1)(ii)(1981).

93. Purchases made by installment payments do not extend the sales period of an offering for purposes of integration or the filing requirements of Form D. 47 Fed. Reg. 11,251, 11,254 n.13 (1982).

percent of their net worth.⁹⁴ Presumably, the minimum purchase requirement guarantees that these investors have access to information, and the twenty percent floor assures they are able to bear the risk of the investment. Because wealthy natural persons have less restrictive alternative means of accreditation, this category will be comprised primarily of private businesses.⁹⁵

The five new categories of accredited investors introduced in Reg D consist of two categories of natural persons and three categories of institutions. The new categories of natural persons are controversial because natural persons previously could not be accredited investors unless they also had access to information as insiders or they purchased \$100 thousand worth of an issue within sixty days.⁹⁶ Under the new regulation, natural persons are accredited investors if they have a net worth of at least \$1 million⁹⁷ or have income in excess of \$200 thousand for each of the past two years.⁹⁸ Wealthy individuals, therefore, may be accredited investors even if they invest less than \$150 thousand in an unregistered offering and lack access to information. By not requiring specific disclosures to these investors under Reg. D, the SEC seems to violate the access requirements of *Ralston Purina*.⁹⁹ Affluent but financially unsophisticated individuals also may invest more than twenty percent

94. *Id.* at 11,263 (to be codified at 17 C.F.R. § 230.501(a)(5)).

95. See *infra* notes 266-72 and accompanying text for a discussion of the \$150 thousand purchaser category.

96. See 17 C.F.R. § 230.242(a)(1) (1981). These new categories open a tremendous source of private financing to issuers without imposing specific disclosure requirements by equating personal wealth with financial sophistication and access to information. These categories also potentially deprive many wealthy but unsophisticated investors of the protection of the Securities Act. The caveat of SEC Commissioner Loomis prior to the adoption of the Small Business Investment Incentive Act of 1980 still is appropriate: "[R]emoving investor protections too broadly or precipitously could ultimately have negative effects on the ability of small businesses to raise capital if investor dissatisfaction results in lost confidence in the securities." *Small Business Investment Incentive Act of 1979: Hearings on H.R. 3991 Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 96th Cong., 2d Sess. 35 (1979) (statement of Phillip A. Loomis, Jr., Commissioner, SEC). For a discussion of access to information for accredited investors, see *infra* notes 97-110 and accompanying text.

97. 47 Fed. Reg. 11,251, 11,263 (to be codified at 17 C.F.R. § 230.501(a)(6)).

98. *Id.* at 11,263 (to be codified at 17 C.F.R. § 230.501(a)(7)). Accredited investors also must reasonably expect to earn more than \$200 thousand in the current year. *Id.*

99. See *supra* note 28 and accompanying text for a discussion of the *Ralston Purina* holding.

of their wealth without the ability to bear the risk of their investment. Formerly, Rule 146 protected investors by requiring issuers to ascertain an investor's financial sophistication and his ability to bear the risk of loss.¹⁰⁰ Reg. D sacrifices much of this protection to facilitate capital formation.¹⁰¹

The three new categories of institutions defined as accredited investors are: (1) entities wholly owned by accredited investors;¹⁰² (2) private business development companies¹⁰³ as defined in the Investment Advisors Act;¹⁰⁴ and (3) tax exempt organizations with assets in excess of \$5 million.¹⁰⁵ Entities that are wholly owned by accredited investors have accredited status because their investment decisions are made by persons for whom formal disclosure is unnecessary.¹⁰⁶ Private business development companies are accredited investors if they participate in management because they

100. 17 C.F.R. § 230.146(d)(2)(i), (ii) (1981).

101. Accredited natural persons are likely to be the primary source of financing for small businesses. A recent SBA study reports that the median investment size for informal investors is between \$10 thousand and \$25 thousand. W. WETZEL, JR., & C. SEYMOUR, *INFORMAL RISK CAPITAL IN NEW ENGLAND* 16 (1981) [hereinafter cited as *INFORMAL RISK CAPITAL*]. Small informal investments, however, have greater than average risk. The SBA reports that 55% of businesses that fail do so within the first five years. *FACTS ABOUT SMALL BUSINESS*, *supra* note 3, at 3. Small businesses are likely to obtain financing through informal offerings, however, because small businesses have less capacity to finance growth through retained earnings and depreciation than do mature corporations. *REGIONAL BROKER-DEALERS*, *supra* note 59, at 7. Small businesses are also at a disadvantage in bank borrowings, 1 SBA *ANNUAL REP.* 7, Table 2 (1980), and may not have audited financial statements for the benefit of investors. See 46 Fed. Reg. 41,791, 41,801 (1981).

The presumption underlying the two categories of natural persons is that wealthy individuals do not need the protection provided by a registration statement. This presumption is tenuous. Investor protection should require the issuer to determine that wealthy individuals also are sophisticated, at least until the SEC can demonstrate with a high degree of certainty that wealth alone assures financial sophistication and access to needed financial information.

102. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(a)(8)).

103. *Id.* (to be codified at 17 C.F.R. § 230.501(a)(2)). This category of accredited investors differs from the business development companies included in Rule 501(a)(1), which must elect not to be regulated under the Investment Company Act of 1940. Private business development companies generally will be smaller in size, yet they must provide the issuer with "significant managerial assistance" as defined in § 2(a)(47) of the Investment Company Act of 1940. *Id.* at 11,251, 11,254.

104. Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to -20 (1976 & Supp. IV 1980).

105. 47 Fed. Reg. 11,251, 11,262 (1982) (to be codified at 17 C.F.R. § 230.501(a)(3)).

106. *Id.* at 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(1)(i)). To require disclosure to an entity owned entirely by accredited investors would unnecessarily burden the issuer because none of the beneficiaries need formal disclosure. See *id.*

have access to information about the issuer. Granting accredited status to business development companies enables small businesses to benefit from the companies' managerial expertise without the burden of preparing disclosure documents.¹⁰⁷

Large tax exempt organizations are considered accredited investors because they are similar to the financial institutions covered by Rule 242.¹⁰⁸ Large tax exempt organizations presumably make sophisticated financial decisions and can bear the investment risk. Like nondisclosure to wealthy individuals, however, not requiring specific disclosures to these investors also may violate the *Ralston Purina*¹⁰⁹ holding, because such organizations may not have access to necessary information.¹¹⁰

Expanding the accredited investor concept, then, significantly increases the ability of small businesses to raise capital in exempt offerings. By expanding the categories of accredited investors, however, the SEC created the possibility that large amounts of securities may be sold to wealthy yet financially unsophisticated persons who lack access to information comparable to that given in a registration statement.¹¹¹ Nevertheless, the rules defining accredited in-

107. Poor management causes 92% of all small business failures. FACTS ABOUT SMALL BUSINESS, *supra* note 3, at 3. Issuers now are more likely to reap the benefit of outside managerial assistance, because Reg. D includes private business development companies within its definition of accredited investors. 47 Fed. Reg. 11,251, 11,262 (to be codified at 17 C.F.R. § 230.501(a)(2)). Professional venture capital companies often are not interested in small offerings, *see* INFORMAL RISK CAPITAL, *supra* note 101, at 32; therefore, this category of accredited investors may be comprised primarily of small consulting teams offering management assistance and investing less than \$150 thousand.

108. 47 Fed. Reg. 11,251, 11,262 (1982) (to be codified at 17 C.F.R. § 230.501(a)(3)). As first proposed, this category of accredited investors was limited to college and university endowment funds with assets exceeding \$25 million. 46 Fed. Reg. 41,791, 41,803 (1981). Upon further consideration, however, the SEC decided to enlarge the category and lower the minimum assets requirement to \$5 million. 47 Fed. Reg. 11,251, 11,254 (1982).

109. *See supra* notes 28-30 and accompanying text.

110. Access to information depends on "position" relative to the issuer, not on income and wealth of the purchaser. 17 C.F.R. § 230.146(e) (1981). Large charities which do not purchase a significant part of an exempt offering may be in no position to insist upon specific disclosures. Presumably, however, large charities are both sophisticated and able to bear the risk. These factors alone do not provide protection without access as specified under the *Ralston Purina* standard. *See supra* notes 28-30 and accompanying text.

111. Of the eight categories of accredited investors, only insiders, 47 Fed. Reg. 11,251, 11,262 (1982) (to be codified at 17 C.F.R. § 230.501(a)(4)), business development companies, *id.* (to be codified at 17 C.F.R. § 230.501(1)(2)), and \$150 thousand purchasers, *id.* (to be codified at 17 C.F.R. § 230.501(5)), hold a position relative to the issuer which would pro-

vestor status do not exempt issuers from the anti-fraud¹¹² or civil liability¹¹³ provisions of the Securities Act, or from state disclosure requirements.¹¹⁴ Thus, the necessity of compliance with these provisions and requirements may mitigate possible risk to investors.

Offerings to \$500 Thousand - Rule 504

Rule 504 of Reg. D replaces Rule 240. Neither rule specifies the information that an issuer must disclose in an offering, but Rule 504 raises the Rule 240 offering ceiling from \$100 thousand to \$500 thousand.¹¹⁵ Because issuers making offerings for under \$500 thousand primarily are issuers for whom the cost of compliance with federal disclosure requirements imposes an unreasonable burden,

vide access to information. Financial institutions, *id.* (to be codified at 17 C.F.R. § 230.501(a)(1)), and large charities, *id.* (to be codified at 17 C.F.R. § 230.501(3)), presumably are both sophisticated and able to bear the risk. Affluent individuals, *id.* at 11,263 (to be codified at 17 C.F.R. §§ 230.501(a)(6)-(7)), in most instances may be presumed able only to bear the risk and not to have financial sophistication.

112. Section 17(a) of the Securities Act of 1933 provides that:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Act of 1933, § 17(a), 15 U.S.C. § 77(2)(a) (1976).

113. Section 12(2) of the Securities Act of 1933 provides in part that any person who: offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1976).

114. Securities Act of 1933, § 18, 15 U.S.C. § 77r (1976). *See also supra* note 62.

115. Compare 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(1)(i)) (referring to Rule 504) with 17 C.F.R. § 230.240(e) (1981) (referring to Rule 240).

the SEC believes that an exemption from registration for such small offerings is appropriate.¹¹⁶

As under Rule 240, state securities law primarily would govern offerings under Rule 504.¹¹⁷ Consequently, many small and growing businesses may acquire initial financing by complying with state disclosure requirements alone.¹¹⁸ State securities administrators can regulate small offerings efficiently because they are familiar with the circumstances of local issuers and can respond to their inquiries quickly.¹¹⁹ Presumably, investors also will be protected by their own familiarity with issuers of small offerings.¹²⁰ Offerings

116. This belief is supported by a recent SBA financed independent study that reported: The severe effects of cost-inefficient federally mandated financial disclosure are most pronounced among smaller firms. It is generally acknowledged that the costs of compliance with reporting requirements are both large in absolute terms and relatively more burdensome for smaller companies. For instance, in a study prepared for the SEC and Congress, the Advisory Committee on Corporate Disclosure reported that the costs involved in preparing and filing a Form 10-K are typically on the order of \$2.41 per \$100,000 of sales for 'large' (sales in excess of \$1 billion) companies, \$3.21 per \$100,000 of sales for 'medium' (sales of \$100 million to \$1 billion) companies, and \$121.41 per \$100,000 of sales for 'small' (sales of less than \$100 million) firms; for Form 10-Q, the annual costs per \$100,000 of sales are comparable: \$1.08 for large companies, \$2.56 for medium companies, and \$123.48 for small companies. So the smallest firms and their shareholders bear the highest proportionate costs, first because the costs are relatively larger by any financial measure, and second because the costs are divided among fewer owners. This inequity is particularly unfortunate considering the fragile financial situation of many small companies and the importance of the small business sector as a major source of new jobs, new markets, new products, new industries, and technical and commercial innovations.

A.E. OSBORNE ASSOCIATES, *ASSET SIZE AND ALTERNATIVE POLICY CRITERIA IN SECURITIES REGULATION 2-3* (Dec. 1981) (footnotes omitted) [hereinafter cited as OSBORNE STUDY].

117. Depending on the requirements of each state in which the issue is sold, the resulting burden on issuers may be more or less comparable to federal regulation. By removing the requirement for federal registration, the Rule eliminates the hardship of duplicate requirements when unnecessary to protect investors. IRFA, *supra* note 3, at 4. The SEC agreed with the commentators that a need existed for a *de minimis* exemption from federal regulation. 46 Fed. Reg. 41,791, 41,801 (1982).

118. 47 Fed. Reg. 11,251-52 (1982). "Because of the small amount of the offering and the likelihood that sales will occur in a limited geographic area, the Commission and NASAA [North American Securities Administrators Association] believe that greater reliance on state securities laws is appropriate." *Id.*

119. A recent SEC study on the use of Form S-18 indicates that agency response time to issuer filings has decreased due to regional report filing. FORM S-18 REPORT, *supra* note 43, at 38. A similar efficiency should exist for filings with the states.

120. Compare 47 Fed. Reg. 11,251-52 (1982) with 39 Fed. Reg. 2353 (1974) (investor pro-

made in states requiring that a registration statement be filed and that a prospectus be delivered are exempt from federal restrictions on the manner of offering and resales as well as from disclosure.¹²¹

In addition to raising the \$100 thousand ceiling to \$500 thousand, Rule 504 modifies Rule 240 in other significant aspects. Rule 504 removes the Rule 240 prohibition against paying commissions for solicitation of offers and sales.¹²² Consequently, small businesses seeking to raise capital now can seek the assistance of securities professionals experienced in structuring exempt offerings.¹²³ Solicitation also is beneficial to the issuer because the connection made between the small issuer and the clients of a broker-dealer significantly expands the issuer's market.¹²⁴ Unlike Rule 240, Rule 504 is limited to issuers not required to report under the Securities Exchange Act of 1934,¹²⁵ instead of to issuers with fewer than 100 beneficial owners. This new standard relates directly the disclosure requirements of the Securities Act to the size and ability of the issuer to comply without incurring unreasonable expense.¹²⁶ These

tection in intrastate offerings).

121. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(b)(1)). When the state requires delivery of prospectus and registration, the SEC assumes the existence of adequate investor protection. 46 Fed. Reg. 41,791, 41,801 (1981). If the states exempt offerings made under Rule 504, the federal restrictions on resale and manner of offering still apply because investors have not received a prospectus. Commentators contend, however, that when states require delivery of a prospectus, the federal exemption of Rule 504 should be increased above \$500 thousand to reflect the additional protection of investors. Letter from ABA to SEC (Nov. 11, 1981) (Public File # S7-891) (commenting on proposed Reg. D).

122. 47 Fed. Reg. 11,251-52 (1982).

123. If the disclosure proves to be inadequate and the issuer becomes insolvent, sales through a securities professional also create the possibility that a purchaser may recover damages from the broker. See Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1976).

124. Small businesses rely primarily on regional broker-dealers to manage their offerings as was documented recently in a joint study by the SBA and SEC. See generally REGIONAL BROKER-DEALERS, *supra* note 59. During the period from 1972-1980, regional broker-dealers managed 79% of reported initial public offerings. *Id.* at ii. Regional broker-dealers also served as the leading market-makers for secondary sales. *Id.* Small issuers also will probably rely on regional broker-dealers in making exempt offerings.

125. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976 & Supp. IV 1980). An issuer is an Exchange Act company for purposes of Reg. D if required to file periodic reports pursuant to § 13 or § 15(d) of the Securities Exchange Act. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)). Exchange Act companies have filed a registration statement pursuant to either § 15(d) of the Securities Exchange Act of 1934 or the Securities Act of 1933, or have more than 500 shareholders and more than \$1 million in assets. 15 U.S.C. § 78(g)(1)(B).

126. Under Rule 240, a qualified issuer could be a large company with audited financial

changes demonstrate that the SEC conceived Rule 504 particularly to assist the capital formation needs of small businesses.¹²⁷

Investment companies¹²⁸ cannot make offerings under Rule 504 regardless of their size.¹²⁹ Investment companies are excluded because they are separately regulated under the Investment Company Act of 1940¹³⁰ which contains its own registration exemptions.¹³¹ Including investment companies under Rule 504 might subject them to inconsistent obligations.¹³² Similarly, companies required to file specific disclosure documents under the 1934 Act,¹³³ should not be permitted to make offerings under Rule

information provided the company had fewer than 100 owners. 17 C.F.R. § 230.240(f) (1981). A recent study reports that "the number of shareholders appears to bear very little relationship to asset size." OSBORNE STUDY, *supra* note 116, at 7. By limiting Rule 504 to companies that are not required to provide information under the Securities Exchange Act, the SEC creates a more direct relationship between the small issue disclosure exemption and the issuer's ability to provide information. See 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(a)).

127. Rule 504 requires only that sales made pursuant to § 3(b) or in violation of § 5(a) be aggregated toward the \$500 thousand limit. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(a), (b)(2)). Rule 240 required the aggregation of every unregistered offering but did not aggregate sales to certain company insiders. 17 C.F.R. § 230.240(b)(ii) (1981). Therefore, the impact of this change is uncertain. See *infra* notes 195-99 and accompanying text.

128. An investment company is one which:

- (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
- (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
- (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Investment Company Act of 1940, § 3(a), 15 U.S.C. § 80a-3(a) (1976).

Rules 504 and 505 exclude these issuers because the Investment Company Act of 1940 regulates them separately, and because they have available a special \$500 thousand exemption under Regulation E of the Securities Act of 1933. 46 Fed. Reg. 41,791, 41,801 n.36 (1981).

129. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(a)).

130. 15 U.S.C. §§ 80a-1 to -64 (1976 & Supp. IV 1980).

131. See *supra* note 128. In addition to the \$500 thousand exemption under Regulation E, investment companies with fewer than 100 owners have a nonpublic offering exemption under the Investment Company Act § 3(c), 15 U.S.C. § 80a-3(c) (1976).

132. See 46 Fed. Reg. 41,791, 41,801 n.36 (1981).

133. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-kk (1976 & Supp. IV 1980).

504.¹³⁴ Reg. D requires that Exchange Act issuers provide purchasers with their Exchange Act documents.¹³⁵

Offerings to \$5 Million - Rule 505

Rule 505 replaces Rule 242 and provides disclosure standards for medium-sized offerings not warranting full registration and disclosure. Rule 505 increases the \$2 million per six month ceiling of Rule 242 to \$5 million per year.¹³⁶

For an offering under Rule 505 involving nonaccredited investors, issuers required to report under the Exchange Act must provide purchasers with their Exchange Act documents.¹³⁷ Companies not reporting under the Exchange Act must provide investors with the same information as specified in Part One of Form S-18, the short form registration statement.¹³⁸ If Form S-18 is not available to the issuer, then the issuer must disclose the information required by Part One of the registration statement that the issuer is entitled to use.¹³⁹

Additionally, the issuer must present audited financial statements for the most recent fiscal year if they are available without unreasonable effort and expense.¹⁴⁰ The cost of preparing audited

134. The SEC must regulate disclosure consistently with public interest. Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) (1976). Reducing disclosure costs for small businesses is in the public interest because it facilitates capital formation. If the issuer already has prepared information, however, the burden of disclosure is slight and the duty to protect the investor makes exclusion of Exchange Act issuers from specific disclosure obligations inappropriate. See 46 Fed. Reg. 41,791, 41,801 (1981). Under Reg. D, the disclosure obligation for Exchange Act companies does not vary with the amount of the offering. 47 Fed. Reg. 11,251, 11,265 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(ii)).

135. 47 Fed. Reg. 11,251, 11,265 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(ii)).

136. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.505).

137. *Id.* at 11,251, 11,264 (to be codified at 17 C.F.R. § 230.502(b)(2)(ii)(A)).

138. *Id.* (to be codified at 17 C.F.R. § 230.502(b)(2)(i)(A)). Only American and Canadian corporations that previously have not made a registered offering may use Form S-18, excluding companies with significant oil and gas operations. 17 C.F.R. § 239.28(a)(1)-(5) (1981). The SEC plans to make Form S-18 available to more issuers, but probably will maintain its limitation to first time issuers of less than \$5 million. 46 Fed. Reg. 41,791, 41,794 (1981). For a discussion of Form S-18, see *supra* note 46.

139. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(i)(A)).

140. The standard for determining what is unreasonable effort and expense is not clear, but presumably depends on surrounding facts and circumstances. One commentator reported that a first time audit would cost \$25 thousand and take 45 days to complete. Letter from Pillsbury, Madison, Sutro to SEC (Oct. 26, 1981) (commenting on Reg. D) (public file

financial statements can be a significant burden to a relatively young or closely-held company that previously neither has sought external funding nor kept audited financial statements.¹⁴¹ The SEC is of the opinion, however, that allowing unaudited statements to be used as disclosure documents under Rules 505 and 506 is inconsistent with investor protection.¹⁴² If the cost of providing audited financial statements is unreasonable, issuers other than limited partnerships may provide financial statements for which only the balance sheet has been audited within 120 days prior to the offering.¹⁴³ Limited partnerships may supply investors with financial statements prepared for federal income tax purposes if obtaining audited financial statements would be unreasonable,¹⁴⁴ but the partnership's financial statements must be reported by a certified or an independent public accountant.¹⁴⁵

Prior to Reg. D, an issuer could make an offering of less than \$1.5 million pursuant to Rules 242, 146, or Reg. A.¹⁴⁶ Rule 146 and Reg. A each used the Reg. A offering circular, comparable in detail to Form S-18,¹⁴⁷ as a disclosure document for offerings under \$1.5 million.¹⁴⁸ Under Rule 242 a qualified issuer could make offerings of up to \$2 million using Form S-18 as a disclosure document.¹⁴⁹ Rule 505, therefore, does not change the disclosure burden signifi-

S7-891).

141. A recent SEC report indicated that the mean accounting fee for an issue under Rule 242 was approximately 10% of the total cost of the offering. See 242 REPORT, *supra* note 20, at 56. With Form S-18, the mean accounting fee comprised 23% of total offering costs. FORM S-18 REPORT, *supra* note 43, at 29.

142. 46 Fed. Reg. 41,791, 41,798 (1981).

143. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(ii)(2)(A)).

144. *Id.*

145. *Id.*

146. Reg. A currently has a \$1.5 million ceiling, 17 C.F.R. § 230.254(a)(1)(i) (1981); Rule 146 had no ceiling, 17 C.F.R. § 230.146 (1981); Rule 242 permitted sales of \$2 million every six months. 17 C.F.R. § 230.242(c) (1981).

147. The public accounting firm of Deloitte, Haskins & Sells stated in a letter to the SEC that the specific information requirements of Form 1A and Form S-18 are "almost identical." Letter from Deloitte, Haskins & Sells to SEC (Oct. 5, 1981) (public file # S7-891).

148. Rule 256 requires the use of Schedule I of Form 1A as an offering circular for Reg. A. 17 C.F.R. § 230.256(g) (1981). Amended Rule 146 allows use of the Reg. A disclosure document for offerings below \$1.5 million. 17 C.F.R. § 230.146(e)(1)(ii)(d) (1981).

149. 17 C.F.R. § 230.242(f) (1981). Unlike offerings made under Reg. A or Rule 146, Form S-18 provides no waiver of the requirement to provide certified financial statement information even in cases of undue hardship. See *supra* note 46.

cantly for these issuers. Rule 146 and Reg. A were more flexible than Rule 505, however, because they permitted use of unaudited financial statements in cases of unreasonable effort or expense.¹⁵⁰ Rule 242 was less flexible because it did not allow an issuer to present only an audited balance sheet if auditing costs were unreasonable.¹⁵¹ Prior to Reg. D, Rule 146 governed exempt offerings between \$2 million and \$5 million.¹⁵² Rule 146 required disclosure in more detail than did Form S-18, but still permitted an issuer to avoid the cost of auditing.¹⁵³

Investment companies and "unworthy issuers," those with questionable securities records as defined by Reg. A, may not use Rule 505.¹⁵⁴ Conspicuously absent, however, are the prohibitions included in Rule 242 on use by partnerships, foreign corporations, and companies with significant oil and gas operations.¹⁵⁵ Successful use of limited disclosure requirements under Rule 242 led the SEC to make Rule 505 more widely available to small businesses regardless of organization form.¹⁵⁶

Offerings Exceeding \$5 Million - Rule 506

Offerings either in excess of \$5 million or by issuers unable to use Rules 504 and 505 may be exempt under Rule 506. Prior to Reg. D, Rule 146 covered exempt offerings in excess of \$5 mil-

150. Compare 17 C.F.R. § 230.146(e)(1)(b)(2) (1981) and 17 C.F.R. § 230.256 (Schedule I (11)) (1981) with 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(A)) (discussing requirements for providing audited financial statements).

151. 17 C.F.R. § 230.242(f)(1)(i) (1981). Rule 242 requires that the financial statements for the issuer's most recent fiscal year be audited.

152. After 1980, exempt offerings up to \$5 million could be made under § 4(6), but only to accredited investors (institutions). Securities Act of 1933, § 4(6), 15 U.S.C. § 77d(6) (Supp. IV 1980). Rule 147 also provides a narrow exemption without a dollar ceiling when the issuer and all participants reside in the same state. 17 C.F.R. § 230.147(a) (1981).

153. See *supra* note 46 (discussion of form S-18). Rule 146 required the issuer to provide "the same kind of information that is specified in Schedule A of the Act," which is equivalent to a full registration statement. 17 C.F.R. § 230.146(e)(1) (1981).

154. Rule 505 excludes "unworthy issuers," as defined by Rule 252 of Reg. A. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.505(b)(2)(iii)). These issuers have participated in questionable securities practices within the preceding five years. 17 C.F.R. § 230.252(c)-(f) (1981).

155. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.505(a), (b)(2)(iii)); 17 C.F.R. § 230.242(a)(5) (1981).

156. 46 Fed. Reg. 41,791, 41,801 (1981). The inclusion of limited partnerships will be valuable, especially for real estate developments and oil and gas ventures. *Id.*

lion.¹⁵⁷ Rule 506 has several advantages over Rule 146 for issuers. Most significantly, in Rule 506 the SEC extended the accredited investor concept to large offerings. Consequently, Rule 506 allows more investors to participate in an exempt offering,¹⁵⁸ and enables an issuer to raise unlimited amounts of capital without specific disclosure requirements. Under Rule 146, only persons with access to information could purchase securities without receiving specific disclosures.¹⁵⁹

Like Rule 146, the issuer under Rule 506 must evaluate the financial sophistication of nonaccredited investors.¹⁶⁰ The issuer's duty, however, is less burdensome than under Rule 146, which required the issuer to evaluate the wealth or sophistication of each prospective offeree.¹⁶¹ By requiring evaluation of purchasers alone, Rule 506 eliminates the primary source of uncertainty for issuers of large exempt offerings.¹⁶² Rule 146 also required the issuer to determine that every purchaser either was financially sophisticated or had a purchaser representative,¹⁶³ and could bear the economic risk of the investment.¹⁶⁴ Under Rule 506, the issuer must deter-

157. 17 C.F.R. § 230.146 (1981) (excluding exempt offerings under Rule 147, 17 C.F.R. § 230.147 (1981)). See *infra* notes 253 & 254 for a discussion of the limitations of Rule 147.

158. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.506(b)(2)). See *infra* notes 174-85 and accompanying text for a discussion of calculating the number of purchasers.

159. 17 C.F.R. § 230.146(e)(1)(i) (1981).

160. Rule 506, unlike Rule 146, does not require issuers to evaluate offeree qualifications. 47 Fed. Reg. 11,251, 11,258 (1982) (to be codified at 17 C.F.R. § 230.506). Rule 506, however, requires the issuer to evaluate *purchaser* sophistication. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.506(b)(2)(ii)). Rule 505 protects purchasers indirectly without requiring a purchaser sophistication test by prohibiting unworthy issuers from offering securities under that Rule. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.505(b)(2)(iii)).

161. 17 C.F.R. § 230.146(d)(2) (1981).

162. The requirement of ascertaining every *offeree's* wealth and sophistication under Rule 146 created uncertainty by making the exemption contingent on subjective evaluation of offeree qualifications made prior to each offer. For a discussion of offeree qualifications under Rule 146, see *supra* note 40 and accompanying text.

163. A purchaser representative is an investment advisor with the ability to evaluate the risk of a financial investment, employed by an investor as his representative for a given offering. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.501(b)). Reg. D's definition of "purchaser representative" is the same as Rule 146's definition of "offeree representative," with the word "purchaser" substituted for the word "offeree." See 17 C.F.R. § 230.146(a)(1) (1981).

164. 17 C.F.R. § 230.146(d) (1981). Rule 506 retains this protection, at least indirectly, by requiring the issuer reasonably to believe that purchasers either are sophisticated or have a

mine whether each purchaser is financially sophisticated or has a purchaser representative, not whether a purchaser can bear possible economic loss. Such an evaluation provides more certainty than the evaluation required under Rule 146.¹⁶⁵

As in Rule 505, when nonaccredited investors participate in an offering under Rule 506, Exchange Act company issuers must provide all investors with the documents filed under that act.¹⁶⁶ Non-Exchange Act issuers must provide all investors with the same kind of information described in Part One of whatever registration form the issuer is entitled to use.¹⁶⁷ Most issuers under Rule 506 must provide information on a form more detailed than Form S-18 under Rule 505, which is limited to certain issuers who have never made a registered offering.¹⁶⁸ Although this provision is identical to that contained in Rule 146,¹⁶⁹ the SEC's recent simplification of the basic registration forms has lessened the issuer's disclosure burden.¹⁷⁰ If both accredited and nonaccredited investors participate, the issuer, on request, must provide to nonaccredited investors a summary of all written information given to accredited investors.¹⁷¹

purchaser representative. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.506(b)(2)(ii)). This requirement encourages issuers to make offerings under Rule 506 through broker-dealers who qualify as purchaser representatives and who have an independent duty to determine the suitability of their clients' investments. 46 Fed. Reg. 41,791, 41,799 (1981).

165. Compare 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.506(b)(2)(ii)) with 17 C.F.R. § 230.146(d)(2) (1981) (purchaser qualification requirements).

166. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(B)(ii)).

167. *Id.* (to be codified at 17 C.F.R. § 230.502(b)(2)(B)).

168. Because Regulation T, 12 C.F.R. § 220.1-.130 (1981), prohibits the use of installment sales for offerings not exempted by § 4(2) of the Securities Act of 1933, 15 U.S.C. 77d(2) (1976), issuers desiring to use installment payments for an offering of less than \$5 million might use Form S-18 under Rule 506, if they are not Exchange Act companies. 12 C.F.R. § 220.7(a)(2) (1981). Most issuers under Rule 506, however, must provide information on a form more detailed than Form S-18, which is used for offerings under Rule 505.

169. 17 C.F.R. § 230.146(e)(1) (1981).

170. 47 Fed. Reg. 11,449-57 (1982) (to be codified at 17 C.F.R. § 239.11-13). See also *id.* at 11,380, 11,382-83 (1982).

171. 47 Fed. Reg. 11,251, 11,265 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(iv)). This provision has two problems. First, compliance will be difficult because the transfer of information between an accredited investor and an issuer occurs on numerous occasions over a long period of time. To ask the issuer to summarize formally all written communications and disclose the summary to nonaccredited investors may be unreasonably

If possible, financial statements under Rule 506 must be audited, which may increase the expense to some issuers.¹⁷² Issuers that cannot provide audited financial statements have the same alternatives as under Rule 505. Limited partnerships may provide the financial statements prepared for their federal tax return if accompanied by an auditor's report. All other issuers may provide financial statements with only balance sheets audited.¹⁷³

General Limitations on Offerings

The Number of Purchasers

The issuer reasonably must believe that no more than thirty-five purchasers participate in an offering under Rules 505 and 506.¹⁷⁴ This is the same number of purchasers permitted under Rules 146 and 242.¹⁷⁵ For offerings under Rule 504, an unlimited number of purchasers may participate.¹⁷⁶ This expands the limits of Rule 240,

burdensome.

Second, this provision presents a strong incentive for the issuer not to include both accredited and nonaccredited investors in the same offering to avoid doubling his disclosure obligations. In an offering sold to both accredited and nonaccredited investors, the issuer must disclose to all purchasers not only the information provided to accredited investors, but also the information that the rule requires him to disclose to nonaccredited purchasers.

The issuer also must provide to each purchaser an opportunity to ask questions and receive answers concerning the offering. *Id.* at 11,265 (to be codified at 17 C.F.R. § 230.502(b)(2)(v)). This provision probably can be satisfied by noting the opportunity in an offering memorandum.

172. Because Exchange Act companies already have audited financial statements, the issuers most affected by this requirement will be investment companies and unworthy issuers that are excluded from using Rule 505. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. §§ 239.505(a), (b)(2)(iii)). The auditing requirements do not create an excessive hardship for non-Exchange Act companies using Rule 506 because the cost is spread over the larger dollar amount of the offering.

173. *Id.* at 11,264-65 (to be codified at 17 C.F.R. § 230.502(b)(2)(i)(B)).

174. *Id.* at 11,266 (to be codified at 17 C.F.R. §§ 230.505(b)(2)(ii), .506(b)(2)(i)). Presumably, an issuer reasonably believing that a sale is to only 35 purchasers does not forfeit the exemption automatically if that number is exceeded.

175. 17 C.F.R. §§ 230.146(g), .242(e) (1981).

176. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)). Because the 35-purchaser limitation does not apply to offerings under Rule 504, state laws determine the limits of distribution for Rule 504 offerings. No offering under Reg. D, however, may be offered so widely that it violates the prohibition against public offerings required in Rule 502, *id.* at 11,265 (to be codified at 17 C.F.R. § 230.502(c)), unless made exclusively in states that require the filing of a registration statement and the delivery of a prospectus. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.504(b)). The filing of such information with the

which excluded issuers having more than one hundred beneficial owners.¹⁷⁷

Reg. D excludes accredited investors from the thirty-five purchaser limit,¹⁷⁸ thereby increasing the potential number of actual purchasers relative to former Rules 242 and 146. Rule 242 excluded "accredited persons" from the thirty-five purchaser limit, which is a narrower concept than "accredited investor."¹⁷⁹ Rule 146 excluded \$150 thousand purchasers, which also is a narrower concept than "accredited investors."¹⁸⁰ Each of the rules excludes persons closely identifiable with other purchasers, such as spouses and controlled organizations.¹⁸¹ Prior rules, however, excluded organizations controlled by purchasers from the thirty-five purchaser limit only if the purchaser owned one hundred percent of the organization's equity.¹⁸² Reg. D excludes controlled organizations from the number of purchasers when a purchaser's interest exceeds fifty percent.¹⁸³ This modification further increases the potential number of actual purchasers for an offering under Reg. D.¹⁸⁴ Excluding certain actual purchasers from the calculation of the purchaser limit does not discharge the issuer's duty to meet other requirements of Reg. D with respect to these purchasers.¹⁸⁵

state is sufficient protection. *Id.*

177. 17 C.F.R. § 230.240(f) (1981).

178. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)(1)(iv)).

179. 17 C.F.R. § 230.242(a)(1) (1981).

180. 17 C.F.R. § 230.146(g)(2)(d) (1981).

181. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)); 17 C.F.R. §§ 230.146(a)(1), .240(f), .242(e)(2) (1981).

182. 17 C.F.R. §§ 230.146(a)(1), .240(f), .242(e)(2) (1981).

183. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)(1)(ii)). For a discussion of the uncertainties involving accredited investors and purchasers, see *infra* note 275 and accompanying text.

184. Clients of a broker-dealer must be counted separately. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)(2)). All members of an organization formed solely to invest in a limited offering also must be counted, unless all of the owners are accredited. *Id.*

185. *Id.* In an offering not made exclusively to accredited investors, for instance, even if an investor does not count toward the 35-purchaser limit, the issuer still must provide all investors with the required information. *Id.* at 11,264 (to be codified at 17 C.F.R. § 230.502(b)(1)(ii)). The issuer also must inform all purchasers of resale restrictions on the securities. *Id.* at 11,265 (to be codified at 17 C.F.R. § 230.502(d)).

Integration and Aggregation

Integration and aggregation are related but distinct principles that may disqualify an offering of securities from an exemption under Reg. D.¹⁸⁶ Integration allows combination of separate sales of securities into one offering when the securities have sufficiently similar characteristics.¹⁸⁷ Aggregation automatically combines the dollar amounts of certain offerings, limiting the amount of securities that an issuer may sell under a particular exemption.¹⁸⁸

An issuer of an exempt offering faces two dangers from integration. One exemption may be lost through integration of sales that were intended to qualify under an incompatible exemption.¹⁸⁹ Additionally, integration may cause an offering to exceed the exemption's dollar limitation.¹⁹⁰ Under traditional criteria for integration,¹⁹¹ the issuer wanting to make an exempt offering could not be

186. The SEC stated:

Based on its experience with rule 242, the Commission is aware that in computing the aggregate offering price issuers frequently misunderstand the interaction of the concepts of aggregation and integration as applicable under rules 504(b)(2)(i) and 505 (b)(2)(i). Aggregation is the principle by which an issuer determines the dollar worth of exempt sales available directly under section 3(b) of the Securities Act. Integration is a principle under which an issuer determines overall characteristics of its offerings.

47 Fed. Reg. 11,251, 11,258 n.31.

187. *Id.*

188. *Id.* The aggregation rules prevent an issuer from exceeding the \$5 million ceiling of Rule 505 by combining § 3(b) exemptions. 47 Fed. Reg. 11,251, 11,266 (to be codified at 17 C.F.R. § 230.505(b)(2)(i)). Although Reg. D requires no specific disclosures for intrastate offerings and large offerings made solely to accredited investors, Rules 504 and 505 do not require aggregation of these offerings because these offerings are not § 3(b) exemptions. *Id.*

189. For example, an issuer may not exempt part of an issue as an intrastate offering and part of the same issue as a nonpublic offering. See I L. Loss, *SECURITIES REGULATION*, 591-96 (1961).

190. For example, if an issuer integrates two sequential offerings of \$3 million pursuant to Rule 505, both offerings lose the exemption because they exceed the \$5 million limit. For this reason, Reg. D has a uniform safe harbor of six months. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(a)).

191. Traditionally, the following five factors helped to determine whether separate sales of securities were part of a single issue:

- a) whether the sales are part of a single plan of financing;
- b) whether the sales involve issuance of the same class of securities;
- 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.

27 Fed. Reg. 11,316-17 (1962), *reprinted in* 47 Fed. Reg. 11,251, 11,264 (1982).

certain that a prior offering had come to rest.¹⁹² Reg. D provides a safe harbor from integration for any offers or sales of securities more than six months before or after a given offering.¹⁹³ Rules 146 and 242 contained comparable safe harbor provisions, but Rule 240 did not contain the provision.¹⁹⁴ Thus, an issuer may make an exempt offering under Rule 504 with greater certainty than under Rule 240.

Aggregation involves different rules. In calculating the dollar amount of an offering under Rules 504 and 505, the issuer must include all sales during the preceding twelve months under section 3(b)¹⁹⁵ or in violation of section 5.¹⁹⁶ Rule 240 contained more restrictive aggregation rules, requiring aggregation of all securities sold without registration.¹⁹⁷ Rule 240, however, excluded from aggregation sales made to promoters, directors, officers and full-time employees of the issuer.¹⁹⁸ Rule 504 does not exclude from aggregation sales to these persons because of the significant increase in the offering ceiling.¹⁹⁹

192. Because subsequent resales by purchasers from the issuer could be interpreted as part of the original distribution, under the traditional rules an issue could continue far beyond the final transaction in which the issuer was a party. The safe harbor under Rule 502 reduces this uncertainty by terminating an issue for integration purposes at the date of last sale or offer "by or for the issuer." 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(a)).

193. *Id.*

194. 17 C.F.R. § 230.146(b)(1) (1981), 17 C.F.R. § 230.242(b) (1981); 17 C.F.R. § 230.240 (1981).

195. Section 3(b) of the Securities Act authorizes the SEC to create limited offering exemptions for issues of securities within its \$5 million ceiling. Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) (Supp. IV 1980). Reg. A, Rule 504, and Rule 505 are the current § 3(b) exemptions, although offerings made under Rules 240 and 242 may require aggregation until June 30, 1983 (twelve months after the rescission of those rules).

196. Section 5 requires registration of nonexempt securities. Securities Act of 1933, § 5, 15 U.S.C. § 77e (1976). Consequently, an issuer of unregistered securities under Rules 504 and 505 need not aggregate sales made under an exemption other than § 3(b). 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 47 C.F.R. §§ 230.504(b)(1), .505(b)(2)).

In proposed form, Reg. D also aggregated certain sales made by predecessors or affiliates of the issuer as defined in proposed Rule 501(j). 46 Fed. Reg. 41,791, 41,804 (1981). The SEC deleted these definitions from the final regulation. Reg. D does not require *aggregation* of these sales. The sales by predecessors and affiliates may be *integrated*, however, and the closeness of the affiliate's relationship with the issuer is a factor for consideration. 47 Fed. Reg. 11,251, 11,253 (1982).

197. 17 C.F.R. § 230.240(e) (1981).

198. *Id.* n.(3)(b)(ii).

199. 46 Fed. Reg. 41,791, 41,800 (1981). The SEC's inclusion of sales to insiders in the

The aggregation rules for Rule 242 were slightly less restrictive than those for Reg. D. Rule 242 did not aggregate sales under section 3(b) to certain employee benefit plans or sales in violation of section 5.²⁰⁰ In addition, Rule 242 only aggregated sales during the preceding six months, consistent with its offering ceiling of \$2 million every six months.²⁰¹ Rule 505 aggregates over a twelve month period, having raised the offering ceiling to \$5 million a year.²⁰²

Limitation on Manner of Offering

Consistent with former Rules 240, 242, and 146, Reg. D prohibits an issuer from offering securities by general solicitation or public advertising.²⁰³ Neither the issuer nor his selling agent may advertise the securities publicly or offer the securities at any seminar to which the attendees are invited through the public media.²⁰⁴ The manner of offering limitations in Reg. D are simpler than under Rule 146 because the issuer has no duty to evaluate the qualifications of offerees prior to the offer.²⁰⁵ Reg. D permits the issuer to offer the securities to anyone provided that the issuer observes the

total issue amount for Rule 504 is inconsistent with its policies of capital formation and investor protection. First, such inclusion effectively limits the stated increase in the exemption ceiling relative to Rule 240. Second, when insiders participate in an offering with outsiders, the outsiders' investment has more safety, not less. Third, insiders are accredited investors who do not need the disclosure protection of the Act. Fourth, insiders probably are state residents and particularly subject to state control. Arguably, therefore, sales to insiders should not reduce the amount of outside financing available to an issuer under Rule 504.

200. 47 Fed. Reg. 11,251, 11,258 n.32 (1982).

201. 17 C.F.R. § 230.242(c) (1981).

202. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.505(b)(2)).

203. Rule 502(c) states:

Except as provided in § 230.504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Id. at 11,265 (to be codified at 17 C.F.R. § 230.502(c)).

204. Issuers would benefit, however, if the SEC issued some objective guidelines defining general solicitation. Until such time, issuers should request interpretive letters from the SEC. 47 Fed. Reg. 11,251, 11,261 (1982).

205. For a discussion of the issuer's duty under Rule 146, see *supra* notes 39 & 40 and accompanying text.

limitations on the number and qualifications of ultimate purchasers and does not solicit in a public manner.²⁰⁶

Limitations on Resale

Only the issuer is exempt from registering the securities under Reg. D; subsequent transfer of the securities by purchasers is unlawful absent registration or another available exemption.²⁰⁷ This restriction applies even to resales between accredited investors.²⁰⁸

The issuer must take the following steps to insure that purchasers observe restrictions on resale:

- 1) make a reasonable inquiry to determine that the purchaser acquires the securities for himself or on behalf of another;
- 2) make written disclosure to each purchaser that the securities are unregistered and may not be resold without registration or exemption; and
- 3) place an appropriate legend on each stock certificate.²⁰⁹

These provisions mirror those of Rules 240 and 242.²¹⁰ Rule 146 further required that the issuer place stop-transfer instructions with the stock transfer agent to ensure the observation of the resale restriction.²¹¹ Although the SEC still advises using stop-transfer instructions, they are not required for an offering exempt under Reg. D.²¹²

206. The limitations on manner of offering under Rule 504 are waived, however, for offerings made exclusively in states that require the filing of a registration statement and the delivery of a prospectus. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(b)(1)).

207. Rule 144 provides an exemption for resale of restricted securities if the resale is not a distribution. Three criteria for determining whether the resale constitutes a distribution are the existence of adequate current public information about the issuer, the original purchaser's holding period, and the impact of the transaction on the trading market. 17 C.F.R. § 230.144 prelim. note (1981). A purchaser reselling without registration or compliance with an exemption may be an underwriter as defined in § 2(11) and subject to strict liability under § 12(1). Securities Act of 1933, §§ 2(11), 12(1), 15 U.S.C. §§ 77b(11), 77l(1) (1976).

208. Because accredited investors can fend for themselves, less reason exists to restrict securities for resale to accredited investors than to nonaccredited investors. For a discussion of policy regarding resales to accredited investors, see *infra* notes 276-79 and accompanying text.

209. 47 Fed. Reg. 11,251, 11,265 (1982) (to be codified at 17 C.F.R. § 230.502(d)).

210. 17 C.F.R. §§ 230.240(g)(1)-(3), .242(g)(1)-(3) (1981).

211. 17 C.F.R. § 230.146(h)(3) (1981).

212. 46 Fed. Reg. 41,791, 41,799 (1981).

Filing Form D

To qualify for the exemptions, Reg. D requires the issuer to file a notice of sales form, Form D, with the SEC within fifteen days after the first sale of securities.²¹³ The issuer then must file Form D every six months during the course of the offering and within thirty days after the completion of the offering.²¹⁴ Additionally, the issuer must provide the SEC, on request, with copies of any information furnished to nonaccredited investors under Rule 505.²¹⁵

Issuers use Form D to report offerings made pursuant to Reg. D and section 4(6).²¹⁶ The new form replaces Forms 240, 242, 146, and 4(6).²¹⁷ Form D is similar to Form 242, with the additional requirement that the issuer disclose the states in which securities are offered.²¹⁸ All forms require the issuer to answer specific questions about the exempt offering.²¹⁹ Form D, however, requires more information than did Form 146,²²⁰ and filing Form D is a condition precedent to an exemption, unlike Form 240.²²¹ Thus, Reg. D increases an issuer's filing burden for very large and very small offerings. The SEC plans to modify Form D after monitoring Reg. D's effectiveness as a capital forming device.²²²

SUMMARY AND OBSERVATIONS

The goal of Reg. D is to lower the cost of equity financing for small businesses in a manner consistent with investor protection. The cost of equity financing will decrease because a broader class of issuers may make exempt offerings in increased dollar amounts

213. 47 Fed. Reg. 11,251, 11,265 (1982) (to be codified at 17 C.F.R. § 230.503(a)(1)).

214. *Id.* (to be codified at 17 C.F.R. § 230.503(a)(2), (3)).

215. *Id.* (to be codified at 17 C.F.R. § 230.503(d)).

216. *Id.* at 11,267 (to be codified at 17 C.F.R. § 239.500).

217. Previously, Rules 240, 242, and 146 and § 4(6) each had separate forms. Form 146 was due at the time of first sale, 17 C.F.R. § 239.146 (1981), Forms 242 and 4(6) were due no later than 10 days after first sale, *id.* §§ 239.242, .246, and Form 240 was due no more than 10 days after the close of the first month in which a sale was made, *id.* 239.240.

218. The purpose of this requirement is to check the effectiveness of efforts to promote federal and state coordination of filing exemptions. 46 Fed. Reg. 41,791, 41,799 (1981).

219. 17 C.F.R. §§ 239.146, .240, .242, .246 (1981); 47 Fed. Reg. 11,251, 11,267 (1982) (to be codified at 17 C.F.R. § 239.500).

220. 17 C.F.R. § 239.146 (1981).

221. 17 C.F.R. § 230.240(h)(2) (1981).

222. 46 Fed. Reg. 41,791, 41,800 (1981).

and with reduced disclosure obligations to a broader class of investors. The SEC accomplished this result by extending the concept of accredited investors²²³ and by raising the ceilings on limited offering exemptions.²²⁴ These actions are consistent with investor protection because the SEC has not reduced the issuer's disclosure obligation to nonaccredited investors.²²⁵ In fact, if nonaccredited investors participate in an offering under Rule 506, the disclosure burden actually exceeds that of former Rule 146.²²⁶ Thus, increased disclosure burdens may force issuers to exclude nonaccredited investors from large offerings under Rule 506.²²⁷

The consolidation of terms and conditions into one regulation has many salutary effects. Unlike prior rules,²²⁸ Reg. D is internally consistent, which simplifies the federal exemption framework. The new regulation also increases an issuer's certainty that exemption qualifications have been met. Moreover, consistency and certainty should assist courts in interpreting securities regulations and exemptions. Despite its many advances, however, Reg. D creates or leaves unresolved several problems.

Problems of Statutory Authority

The SEC's statutory authority for extending the accredited investor concept to offerings in excess of \$5 million is unclear. The

223. See *supra* notes 72-114 and accompanying text.

224. See *supra* notes 115, 116, 136 & 157 and accompanying text.

225. Rules 504, 505, and 506 generally require the same disclosure as Rules 240, 242 and 146. The requirements for preparing audited financial statements in Reg. D, however, are slightly more restrictive than Rule 146 and slightly less restrictive than Rule 242. 47 Fed. Reg. 11,251, 11,264-65 (1982) (to be codified at 17 C.F.R. § 230.502(b)); 17 C.F.R. §§ 230.240(b), .242(f) (1981).

226. Like Rule 146, Rule 506 requires the issuer to disclose to nonaccredited investors the same information required in a registration statement. 17 C.F.R. § 230.146(e)(1) (1981); 47 Fed. Reg. 11,251, 11,264-65 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(B)). Unlike Rule 146, however, Rule 506 requires that at least the issuer's balance sheet be audited. 47 Fed. Reg. 11,251, 11,264-65 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(B)).

227. Sales to any nonaccredited investors obligate the issuer to provide disclosure documents to every investor. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(1)(ii)). In addition, the issuer must catalog and disclose any information provided to accredited investors to nonaccredited investors participating in the same offering. *Id.* at 11,265 (to be codified at 17 C.F.R. § 230.502(b)(2)(iv)). To avoid this increased cost in a large offering, issuers must exclude nonaccredited investors.

228. 17 C.F.R. §§ 239.146, .240, .242 (1981).

SEC promulgated Rule 506 pursuant to the SEC's power to define "nonpublic offering" under section 4(2).²²⁹ By extending the accredited investor concept to Rule 506, however, the SEC authorizes issuers to sell large amounts of unregistered securities without requiring specific disclosure to investors who may lack access to information.²³⁰ This results in a definition of "nonpublic offering" that is inconsistent with case law interpreting section 4(2).²³¹

Assuming that section 4(2) does not authorize the SEC to extend the accredited investor concept to Rule 506, the validity of the SEC's action must rest on another statutory provision. Section 2(15) authorizes the SEC to expand the definition of accredited investors.²³² Prior to Reg. D, however, only section 4(6) contained the term "accredited investor," and that section had a \$5 million ceiling.²³³ The SEC's own rulemaking authority also has a \$5 million limit under section 3(b).²³⁴ Arguably, unless section 19(c)²³⁵ gives the SEC the power to extend the accredited investor concept to offerings exceeding \$5 million, the SEC acted without authority. Issuers making large offerings under Rule 506 to accredited investors without making disclosures similar to a full registration statement, therefore, may risk judicial denial of the registration exemption.²³⁶

Problems of an Unsafe Harbor

Reg. D states that an offering not in compliance with Reg. D

229. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.506(a)).

230. For a discussion of accredited investors' access to information, see *supra* notes 96-111 and accompanying text.

231. For a discussion of judicial precedents interpreting § 4(2), see *supra* note 28 and accompanying text.

232. Securities Act of 1933, § 2(15), 15 U.S.C. § 77b(15) (Supp. IV 1980). See *supra* note 55.

233. *Id.* § 4(6), 15 U.S.C. § 77d(6) (Supp. IV 1980). See *supra* note 56.

234. *Id.* § 3(b), 15 U.S.C. § 77c(b) (Supp. IV 1980).

235. Securities Act of 1933, § 19(c), 15 U.S.C. § 77s(c) (Supp. IV 1980) (quoted *supra* note 58). Section 19(c) requires cooperation between federal and state agencies to develop a national system of securities regulation. *Id.*

236. Alternatively, courts may use Rule 506 as they did Rule 146 to interpret § 4(2). See *supra* note 39. Using Rule 506 instead of Rule 146 to interpret § 4(2), however, is less consistent with case law. Rule 506 neither requires the issuer to evaluate offeree qualifications nor ensures that every purchaser has access to information or receives specific disclosures. For a discussion of case precedents, see *supra* note 28 and accompanying text.

provisions may nevertheless qualify under another exemption;²³⁷ however, this may be a false promise. Rule 506²³⁸ permits sales to accredited investors without specific disclosures²³⁹ and eliminates the issuer's duty to determine the qualifications of offerees.²⁴⁰ Current case law under section 4(2), however, requires an issuer to make specific disclosures to every offeree not having independent access to information, and to evaluate the wealth or sophistication of every potential offeree.²⁴¹ Thus, an issuer ignoring offeree qualifications or relying on the accredited investor concept may sacrifice his ability to rely on section 4(2).²⁴²

Reg. A is the only alternative section 3(b) exemption generally available for offerings failing to satisfy Rules 504 and 505.²⁴³ Reg. A, however, has a ceiling of \$1.5 million.²⁴⁴ Sales below that amount will not be exempted because the offering did not satisfy the Reg. A disclosure requirements by filing with the SEC.²⁴⁵ Thus, offerings that fail to comply with Rules 504 and 505 may not have a residual exemption under section 3(b).

Section 4(6),²⁴⁶ enacted by Congress in 1980, should serve as a residual exemption for offerings up to \$5 million made solely to accredited investors. The SEC may have intended that result because section 4(6) and Reg. D use the same definition of accredited

237. See *supra* note 62.

238. Rule 506(a) provides that: "Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act." 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.506(a)).

239. 47 Fed. Reg. 11,251, 11,264 (1982) (to be codified at 17 C.F.R. § 230.502(b)(1)(i)).

240. 47 Fed. Reg. 11,251, 11,258 (1982).

241. For a discussion of the disclosure requirements under § 4(2), see *supra* note 28 and accompanying text.

242. See *supra* note 236.

243. 17 C.F.R. § 230.251-264 (1981). Rules 240 and 242 also were § 3(b) exemptions, 17 C.F.R. §§ 230.240(b), .242(b) (1981), but were rescinded effective June 30, 1982, 47 Fed. Reg. 11,251, 11,261 (1982).

244. 17 C.F.R. § 230.254(a) (1981).

245. 17 C.F.R. § 230.251-264 (1981). Although technically an exemption promulgated under § 3(b), Reg. A provides a short form registration statement, Form 1-A, which must accompany all offerings under Reg. A. 17 C.F.R. §§ 230.255, .256 (1981). Form 1-A is similar to Form S-18. 47 Fed. Reg. 41,791, 41,794 (1981).

246. Securities Act of 1933, §4(6), 15 U.S.C. § 77d(6) (Supp. IV 1980).

investors²⁴⁷ and the same notice of sales form.²⁴⁸ Section 4(6), however, does not cover sales to nonaccredited investors or sales in excess of \$5 million.²⁴⁹ If an issuer under Reg. D sells more than \$5 million or sells to nonaccredited investors, he must comply completely with Rules 501 through 506 or rely solely on the narrow intrastate offering exemption of section 3(a)(11)²⁵⁰ and Rule 147.²⁵¹ Because an issuer loses the Reg. D exemption for even an inadvertent failure to comply with any of its terms, the lack of a residual exemption could be very risky for the issuer.²⁵²

Problems Related to Accredited Investors

Reg. D does not specify exactly what information an issuer must disclose in an offering sold only to accredited investors. The SEC could aid issuers by describing the standard of proof required to defend successfully against suit by an accredited investor claiming inadequate disclosure.²⁵³ If issuers must prove that they made disclosures comparable to a registration statement to every accredited investor, the only value of the expanded concept in Reg. D is to increase the number of potential purchasers under Rules 505 and 506.²⁵⁴ Because Reg. D does not provide an exemption from the civil liability and anti-fraud provisions of the Act, issuers otherwise exempt from specific federal disclosure obligations under Rules 504

247. 47 Fed. Reg. 11,251, 11,253 n.11 (1982).

248. 47 Fed. Reg. 11,251, 11,267 (1982) (to be codified at 17 C.F.R. § 239.500).

249. Securities Act of 1933, § 4(6), 15 U.S.C. § 77d(6) (Supp. IV 1980).

250. Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1976).

251. 17 C.F.R. § 230.147 (1981). To qualify for the registration exemption under Rule 147, the issuer must be incorporated in that state, the issuer's primary business location must be in that state, all purchasers must be state residents, and nearly all proceeds must be used in the state. *Id.* Unless Reg. D offerings intentionally are limited to one state, the utility of Rule 147 as a residual exemption is doubtful.

252. Rules 504-506 provide that exempt offerings must satisfy *all* the conditions of Rules 501-503. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. §§ 230.504(b)(1), .505(b)(1), and .506(b)(1)).

253. If an investor alleges inadequate disclosure in the purchase or sale of a security, the issuer has the burden of showing that he fulfilled the required disclosures. *See, e.g., Lively v. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971).

254. Because Rules 505 and 506 exclude accredited investors from the 35-purchaser limitation, the expanded use of the accredited investor concept increases the potential distribution of offerings under these rules. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)(1)(iv)). Rule 506 also exempts the issuer from having to consider an offeree's sophistication. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.506(b)(2)(ii)).

through 506 may be subject to substantial disclosure obligations under sections 12 and 17 of the Securities Act of 1933,²⁵⁵ or under Rule 10b-5²⁵⁶ promulgated under section 10b of the Securities Exchange Act of 1934.²⁵⁷ Until the SEC clarifies issuers' disclosure obligations to accredited investors, a prudent issuer will provide all investors with a detailed offering memorandum to reduce the issuer's potential liability and to avail itself of the residual exemption of section 4(2).²⁵⁸

Reg. D contains other ambiguities concerning the concept of accredited investors, particularly the categories of natural persons.²⁵⁹ The proposed regulation defined an individual's "income" as adjusted gross income reported on a federal personal income tax return.²⁶⁰ The final regulation does not define "income" and does not provide clear measurement guidelines for determining an individual's wealth.²⁶¹ The SEC rejected the concept of self-certification, in which an investor certifies to the SEC as to his or her own net worth, sophistication, and financial experience, as being inconsis-

255. Securities Act of 1933, §§ 12, 17, 15 U.S.C. §§ 77l, q (1976).

256. 17 C.F.R. § 240.10b-5 (1981). Rule 10b-5 provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

257. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1976).

258. *See supra* notes 237-42 and accompanying text.

259. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. 230.501(a)(5)-(7)).

260. 46 Fed. Reg. 41,791, 41,803 (1981).

261. 47 Fed. Reg. 11,251, 11,255 (1982). The SEC suggests that income may be determined by computing

individual adjusted gross income (assuming that had been reported on a federal tax return) increased by any deduction for long term capital gain under section 1202 of the Internal Revenue Code (the "Code"), any deduction for depletion under section 611 *et seq.* of the Code, any exclusion for interest under section 103 of the Code, and any losses of a partnership allocated to the individual limited partner as reported on Schedule E of Form 1040 (or any successor report).

Id. The SEC has offered no other guidance in the matter.

tent with investor protection.²⁶² Unfortunately, the SEC did not indicate the method of wealth determination that would be acceptable. Additionally, without clear guidelines, wealthy foreign investors who do not file federal income tax returns and wealthy Americans who shelter a substantial amount of their taxable income may have difficulty demonstrating their accredited investor status.²⁶³

The use of income and wealth criteria to define natural persons as accredited investors undermines the rationale for making natural persons \$150 thousand purchasers. A natural person qualifies as an accredited investor based on wealth if he has a net worth of \$1 million, or if he has a net worth of \$750 thousand and is willing to invest \$150 thousand.²⁶⁴ Thus, millionaires may invest as much or as little as they wish in an exempt offering, thereby providing them with a less risky investment, and giving issuers a valuable source for capital formation. Persons with assets of \$750 thousand, however, must invest twenty percent of their wealth.²⁶⁵ An understandable reluctance on the part of the latter group of investors to risk so significant a portion of their wealth probably will render this category meaningless.

Realistically, the \$150 thousand purchaser category serves only to define a method by which private companies may be accredited,²⁶⁶ thereby highlighting Reg. D's unequal treatment of large organizations. Reg. D includes nonprofit institutions that have more than \$5 million in assets as accredited investors.²⁶⁷ Private

262. 46 Fed. Reg. 41,791, 41,795 n.15 (1981).

263. 47 Fed. Reg. 11,251, 11,255 (1982).

264. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(a)(5)-(6)). An investor's net worth must exceed \$750 thousand for \$150 thousand to represent less than 20% of his assets. 47 Fed. Reg. 11,251, 11,255 (1982).

265. Rule 501(a)(5) requires natural persons who are not millionaires to invest 15-20% of their net worth in an exempt offering to be accredited as \$150 thousand purchasers. 47 Fed. Reg. 11,251, 11,255 (1982). This requirement will discourage persons with assets of \$750 thousand from participating in an offering limited to accredited investors, although presumably they are not significantly less able than millionaires to protect themselves.

266. Financial institutions, business development companies, large nonprofit organizations, and natural persons are accredited without a minimum purchase requirement. *Id.* at 11,262-63 (to be codified at 17 C.F.R. § 230.501(a)(1)-(4), (6)-(8)). Because they are excluded from the income and wealth tests, other kinds of private companies are accredited only if they purchase at least \$150 thousand and are worth at least five times their investment. *Id.* at 11,263 (to be codified at 17 C.F.R. § 230.501(a)(3)).

267. *Id.* at 11,262 (to be codified at 17 C.F.R. § 230.501(a)(3)).

businesses are not accredited, however, unless they are wholly owned by accredited investors²⁶⁸ or are willing to purchase \$150 thousand in unregistered securities.²⁶⁹ If private corporations could qualify as accredited investors based on their income and wealth, the \$150 thousand purchaser category would be unnecessary.²⁷⁰

Other Problems

Reg. D creates uncertainty in its rules for counting the number of purchasers,²⁷¹ and in its manner of offering limitations.²⁷² One question Reg. D does not answer is whether the spouse, close relatives, and controlled organizations of an accredited investor are included in determining the number of purchasers.²⁷³ Furthermore, although thirty-five nonaccredited investors are allowed to participate in the sale,²⁷⁴ Reg. D leaves unanswered how many offerees an issuer may contact without violating the prohibition against general solicitation and advertising.²⁷⁵ This uncertainty forces an is-

268. *Id.* at 11,263 (to be codified at 17 C.F.R. § 230.501(a)(8)).

269. *Id.* (to be codified at 17 C.F.R. § 230.501(a)(5)).

270. The \$150 thousand test was a standard of access to information adopted from Rule 242. 47 Fed. Reg. 11,251, 11,254 (1982). The SEC abandoned the strict access requirement, however, in defining the new categories of accredited investors based on wealth. For a discussion of the access provisions under Reg. D, see *supra* notes 90-111 and accompanying text. Because natural persons and other institutions must meet less restrictive standards to be considered accredited, the SEC could abandon the \$150 thousand purchaser category if private businesses of sufficient income and wealth were defined as accredited investors.

271. *Id.* at 11,251, 11,263 (to be codified at 17 C.F.R. § 230.502(e)).

272. *Id.* at 11,265 (to be codified at 17 C.F.R. § 230.502(c)).

273. Rules 505 and 506 exclude accredited investors from the 35-purchaser limitation. 47 Fed. Reg. 11,251, 11,263 (1982) (to be codified at 17 C.F.R. § 230.501(e)(1)). Yet Rule 502 includes accredited investors as purchasers for disclosure requirements. *Id.* at 11,264 (to be codified at 17 C.F.R. § 230.502(b)(1)(ii)). Because Rule 501(e) also excludes parties closely related to purchasers from counting in the 35-purchaser limitation, *id.* at 11,263 (to be codified at 17 C.F.R. § 230.501(e)(1)(i)(ii)), an issuer cannot be certain whether parties closely related to accredited investors may be excluded. This uncertainty is a potential trap for issuers seeking to comply with the 35-purchaser limit.

Organizations must be wholly owned by accredited investors, however, to be themselves accredited. *Id.* at 11,263 (to be codified at 17 C.F.R. § 230.501(a)(8)). Therefore, an issuer that sells securities to an organization controlled by accredited investors who do not own 100% of the equity in the organization, assumes specific disclosure obligations to every participant in the offering. *Id.* at 11,264 (to be codified at 17 C.F.R. § 230.502(b)(1)(ii)).

274. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.505(b)(2)(ii)).

275. The SEC notes that:

pursuant to the accredited investor concept in Regulation D, offerings could theoretically be made to an unlimited number of accredited investors. The

suer to choose between limiting the offering or risking loss of the exemption.

The SEC also must address certain issues regarding Reg. D's limitations on resale. An accredited investor cannot resell restricted securities to other accredited investors without registration or qualifying for an exemption.²⁷⁶ Presumably, however, accredited investors are no less able to protect themselves after a security is issued than before, and a resale limitation unnecessarily restricts a valuable secondary market for the stock.²⁷⁷ To increase the marketability of exempt offerings, the SEC should adopt a provision similar to that in S-18 and allow a certain fraction of the offering amount to be reserved for resale to accredited investors.²⁷⁸

A different resale problem involves uncertificated securities. Because Reg. D eliminates the issuer's duty to issue stop-transfer instructions and now requires labelling on the share certificate, nothing gives notice of the stock's restricted status to the subsequent purchaser of an uncertificated security.²⁷⁹ The SEC should require stop-transfer instructions if uncertificated securities are involved.

The SEC should explain why only Rule 505 excludes unworthy issuers.²⁸⁰ Such issuers pose a greater danger to investors under Rule 504 which requires no disclosure, and under Rule 506 which has no offering ceiling. For consistency and investor protection, the SEC should require an unworthy issuer to obtain specific approval from the SEC before using any Reg. D exemption.

Another inconsistency is the Reg. D requirement that an issuer

Commission cautions issuers, however, that depending on the actual circumstances, offerings made to such large numbers of purchasers may involve a violation of the prohibitions against general solicitation and general advertising.

46 Fed. Reg. 41,791, 41,799 n.30 (1981).

276. *Id.* at 11,265 (to be codified at 17 C.F.R. § 230.502(d)).

277. In some cases, however, accredited investors may not be able to protect themselves as well in a secondary purchase because they do not have direct access to the issuer. The new categories of accredited investors, however, do not require such access to the issuer in an initial transaction. For a discussion of access under Reg. D, see *supra* note 110 and accompanying text.

278. Form S-18 allows issuers to reserve \$1.5 million of the \$5 million ceiling for resale without full registration or compliance with an exemption. 17 C.F.R. § 239.28(d) (1981).

279. 46 Fed. Reg. 41,791, 41,799 (1981).

280. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.505(b)(2)(iii)). Rule 505(b)(2)(iii), however, provides that an unworthy issuer may be permitted to use the Rule 505 exemption upon a showing of good cause. *Id.*

evaluate purchaser sophistication only under Rule 506. Because Rule 506 requires more disclosure than Rules 504 and 505, purchasers of offerings under the latter rules need greater sophistication.²⁸¹ The only apparent incentive for an Exchange Act issuer to make an offering pursuant to Rule 505 is to avoid the duty to evaluate the qualifications of purchasers;²⁸² this motive does not serve Reg. D's purposes.

The new requirements for audited financial statements under Rules 505 and 506 could work an undue hardship on certain small issuers because those rules do not allow a complete waiver of auditing when expense is unreasonable. Requiring issuers to bear greater costs in preparing financial reports under Rules 505 and 506 than previously under Reg. A and Rule 146 is contrary to the SEC's overall objectives in promulgating Reg. D.²⁸³

Finally, the SEC should decide whether to apply federal restrictions on the manner of offering and resale in states that do not require the delivery of a prospectus.²⁸⁴ Such a requirement is in-

281. Purchasers in Rule 504 and Rule 505 offerings need more financial sophistication because less comparability exists among the financial reports of non-Exchange Act companies which do not have to file reports in a federal format. In addition, investments in small businesses are riskier than investments in large companies. For a discussion of risk, see *supra* note 101.

In the proposed Rule 502, the SEC considered additional investor protection by requiring that all commissions be paid to registered broker-dealers. The SEC eliminated this requirement because it was inconsistent with state laws regulating the payment of commissions. 47 Fed. Reg. 11,251, 11,256 (1982). Indirectly, however, by imposing a purchaser sophistication test, the SEC encourages issuers of large offerings to sell through brokerage houses which would qualify as purchaser representatives. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.506(b)(2)(ii)). This provides additional protection for investors of large offerings "since a registered broker-dealer, pursuant to its suitability obligations, must make a determination as to whether participation in the offering is appropriate for each investor." 46 Fed. Reg. 41,791, 41,799 (1981).

282. Except for the purchaser qualification test, Exchange Act companies must meet an identical disclosure burden under Rules 505 and 506. 47 Fed. Reg. 11,251, 11,264-65 (1982) (to be codified at 17 C.F.R. § 230.502(b)(2)(ii)). The SEC promulgated Rule 505 under § 3(b) and Rule 506 under § 4(2). *Id.* at 11,266 (to be codified at 17 C.F.R. §§ 230.505(a), .506(a)). Exchange Act issuers, however, would make offerings under Rule 505 to avoid the restrictive judicial interpretations of § 4(2) as a residual exemption. For a discussion of judicial interpretations of § 4(2) see *supra* notes 28 & 39 and accompanying text.

283. The SEC intends that Reg. D will decrease the burden on small issuers consistent with investor protection. 47 Fed. Reg. 11,251, 11,252 (1982). Increasing the reporting requirements for exemptions without allowance for hardship increases offering costs, and may preclude issuers from selling to nonaccredited investors.

284. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(b)(1)).

consistent with the belief that federal regulation is inappropriate for offerings below \$500 thousand. For Reg. D to benefit small issuers most effectively, federal and state exemptions must coincide.²⁸⁵ If state statutes are more restrictive, Reg. D will have little effect.²⁸⁶ Similarly, if federal regulations unnecessarily intrude on state systems, the federal regulations negate the benefit of the state exemptions. Moreover, imposing the federal restrictions on offerings otherwise exempt under Rule 504 constitutes a trap for the unwary issuer who expects to rely on the provisions of his state's securities laws.²⁸⁷

CONCLUSION

Reg. D generally should accomplish the SEC's objectives of simplifying the federal exemption framework and encouraging capital formation in the small business sector.²⁸⁸ Whether Reg. D becomes

285. An offering under Rule 504 must comply with the provisions of Rules 501-503, except that such an offering is exempt from the disclosure requirements of Rule 502. *Id.* at 11,264 (to be codified at 17 C.F.R. § 230.502(b)(1)(i)). If the states in which the securities are offered require no registration of the offering or delivery of a prospectus, the federal restrictions on manner of offering and resale still apply. *Id.* at 11,266 (to be codified at 17 C.F.R. § 230.504(b)(1)). This conflicts with the terms of the intrastate offering exemption which has no offering or resale limitations. 17 C.F.R. § 230.147 (1981). Each state can protect its own investors in small offerings without requiring issuers to comply piecemeal with federal requirements. Requiring the SEC to police small offerings that are otherwise exempt from federal disclosure requirements is inefficient and potentially misleading to small issuers.

286. The issuer derives only a limited benefit from more relaxed federal rules because it still must comply with the more restrictive state rules. 47 Fed. Reg. 11,251, 11,262 *prelim.* n.2 (1982). The cost to the issuer of preparing information generally will depend on the most restrictive set of laws with which it must comply.

287. The apparent effect of Rule 504 is to make offerings below \$500 thousand by non-Exchange Act companies governed largely by state law; however, federal anti-fraud and civil liability still apply. 47 Fed. Reg. 11,251, 11,258, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(a)). An unsophisticated issuer easily could neglect to follow residual federal requirements on manner of offering, resales, and filing notice of sales. Such inadvertent failure to comply with all of the federal requirements causes the issuer to lose the Rule 504 exemption and suffer liability for violating § 5 of the Act. 47 Fed. Reg. 11,251, 11,266 (1982) (to be codified at 17 C.F.R. § 230.504(b)). This is an excessively harsh result, particularly because filing the notice of sales form was not a condition precedent under Rule 240. 17 C.F.R. § 230.240(h)(2) (1981).

288. The Commission understands that, following its adoption of regulation D, the NASAA [North American Securities Administrators Association] Subcommittee will recommend adoption by NASAA of modifications to its uniform limited offering exemption to provide for a uniform exemptive system. This sys-

a uniform federal-state exemption scheme depends on the willingness of state securities administrators to follow the SEC mandate of unification.

In Reg. D, the SEC apparently has shifted its emphasis in regulating exempt offerings in three ways. First, regulatory policy has shifted to focus directly on the ability of the issuer to provide information without undue hardship.²⁸⁹ By excluding Exchange Act companies from using Rule 504, and by tiering the disclosure obligations of other issuers according to the amount of the offering, the SEC demonstrated its intent to assist small businesses through lenient disclosure provisions.²⁹⁰ Second, regulatory emphasis has shifted from protecting offerees to protecting purchasers only,²⁹¹ based on the presumption that an investor not purchasing suffers no legal harm.²⁹² Finally, by expanding the definition of accredited investors, the SEC has equated wealth with sophistication and with access to information.²⁹³ Under Reg. D, issuers have no duty

tem will endorse rule 505 with certain additional terms as one option, and rules 505 and 506 with no changes as a second option.

The additional terms that NASAA is expected to consider involve the following: (1) Restriction on transaction related remuneration; (2) Disqualification of issuers and other persons associated with offerings on the basis of state administrative orders or judgments; (3) Qualification of investors based on the suitability of the investment; and (4) Requirements for filing of the notices of sales.

.....

An official policy guideline of NASAA represents endorsement of a principle which NASAA believes has general application. NASAA has no power to enact legislation, promulgate regulations, or otherwise bind the legislatures or administrative agencies of its members.

47 Fed. Reg. 11,251, 11,253 & n.10 (1982).

289. For a discussion of the new emphasis on the issuer's ability to make disclosures, see *supra* note 126 and accompanying text.

290. Letter from Mr. Marshall J. Parker, Acting Chief Counsel for Advocacy, SBA, to Mr. George A. Fitzsimmons, Secretary, SEC (May 27, 1981) (discussing proposed size definitions of "small business").

291. For discussion of offeree protection requirements under prior rules, see *supra* note 40 and accompanying text.

292. The Supreme Court, in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), supported such reasoning by holding that "one asserting a claim for damages based on a violation of Rule 10b-5 must be either a purchaser or seller of securities." *Id.* at 749.

293. Prior to Reg. D, there were two general categories of accredited investors: persons with access to information, and financial institutions. 17 C.F.R. § 230.242(a)(1) (1981). Financial institutions presumably did not invest without adequate disclosures, and persons with access to information did not need separate disclosures.

Reg. D introduces wealth as a standard for being an accredited investor. 47 Fed. Reg.

to determine whether sufficiently wealthy investors are sophisticated or to supply them with specific information.²⁹⁴ This is potentially the most beneficial provision of Reg. D for small issuers, yet it sacrifices some of the investor protection available under Rule 146 and *Ralston Purina*.²⁹⁵

Reg. D leaves many questions unanswered, and raises additional problems. It achieves a precarious balance between investor protection and capital formation, and might sacrifice too much of the former to benefit the latter. The SEC has been developing innovative solutions to the problems of small businesses, as evidenced by its energetic rulemaking during the past decade. With Congress, the SEC may act again to improve the climate for the nation's small businesses. Presently, however, Reg. D is a significant step toward a properly balanced and unified exemption framework.

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11,251, 11,262-63 (1982) (to be codified at 17 C.F.R. § 230.501(a)(3), (6), (7)). The Commission, therefore, must presume wealthy people will not invest without information, specific disclosures are necessary to protect only investors with limited resources.

294. If the issuer reasonably believes that potential investors are accredited, it has no specific disclosure obligation and does not have to make a purchaser sophistication test under Rule 506. *Id.* at 11,251, 11,266 (to be codified at 17 C.F.R. § 230.506(b)(2)(ii)).

295. *See supra* note 28. The new definitions of accredited investors provide issuers with access to a tremendous amount of equity financing without specific disclosure requirements. Wealthy persons are not necessarily financially sophisticated, however, and Reg. D does not ensure that they will have access to information about the issuer. For a discussion of access, *see supra* note 110 and accompanying text. One must question whether the SEC has met its duty to act consistently with the protection of investors. *See Securities Exchange Act of 1934*, § 2, 15 U.S.C. § 78(b) (1976).

APPENDIX—FORMER EXEMPTIONS COMPARED WITH REGULATION D

RULE	\$ CEILING	ISSUER QUALIFICATIONS	NUMBER OF PURCHASERS ACCREDITED UNACCREDITED	DISCLOSURE REQUIREMENTS ACCREDITED UNACCREDITED	FINANCIAL STATEMENTS	PURCHASER QUALIFICATIONS	COMMISSIONS ON SALES	ADVERTISING	RESALES	AGGREGATION
240	100,000	Issuers with less than 100 owners	State laws control	State laws control	State laws control	State laws control	Not allowed	Not allowed	Restricted	All unregistered offerings within prior 12 months.
504	500,000	Issuers that are not Exchange Act companies or Investment Companies.	State laws control	State laws control	State laws control	State laws control	Allowed	Allowed if state requires registration & prospectus. Otherwise, no.	Unrestricted in states requiring registration & prospectus. Otherwise restricted.	All §3(b) offerings and all offerings violating §3(a) within prior 12 months.
242	2 million (6 months)	American & Canadian corporations except investment companies and issuers with significant oil & gas operations.	Unlimited	35 excluding accredited investors and parties closely related to purchasers.	Unspecified	Part 1 of Form S-18 for non-Exchange Act co's. Others use Exchange Act reports.	2 years' recent year information. Most recent year audited.	None	Allowed	All §3(b) offerings within prior 6 months.
505	5 million	Anyone but investment companies and unworthy issuers defined by Reg. A.	Unlimited	Same as 242 (with broader definition of accredited investor).	Unspecified	Same as Rule 242.	2 years' recent year information. Most recent year audited unless unreasonable. Otherwise, balance sheet only may be audited.	None	Allowed	Same as Rule 504.
146	Unlimited	Unlimited	Not Applicable	35 excluding \$150,000 purchases & parties closely related to purchasers.	Not Applicable	Part 1 of registration statement for non-Exchange Act companies. Others use Exchange Act reports.	3 years' Information. Auditing not required if unreasonable.	Offerees must be sophisticated or rich. Purchasers must be sophisticated or rich with a sophisticated representative. Purchaser must be sophisticated or have a sophisticated representative. No offeree qualifications or purchaser wealth test.	Allowed	Not applicable
506	Unlimited	Unlimited	Unlimited	Same as Rule 505.	Unspecified	Same as Rule 146.	3 years' recent year information. Most recent year audited if not unreasonable. Otherwise, balance sheet only may be audited.	Allowed	Not allowed	Not Applicable