

# CHAPTER THREE — SECURITIES LAW

## Small Business Financing Alternatives Under the Securities Act of 1933

BY ROY L. BROOKS

### TABLE OF CONTENTS

INTRODUCTION .....	544
I. PUBLIC FINANCINGS .....	554
A. <i>Intrastate Offerings</i> .....	554
B. <i>Rule 240</i> .....	558
C. <i>Regulation A</i> .....	561
D. <i>Rule 242</i> .....	566
E. <i>Form S-18</i> .....	570
II. PRIVATE PLACEMENT .....	573
A. <i>Manner of the Offering</i> .....	575
B. <i>Nature of Offerees</i> .....	576
C. <i>Availability of Information</i> .....	577
D. <i>Number of Purchasers</i> .....	577
E. <i>Advantages and Disadvantages</i> .....	578
III. SELECTION OF FINANCING DEVICES .....	579
A. <i>Capital Requirements</i> .....	580
B. <i>Regulatory Burden</i> .....	581
C. <i>Application of Proceeds</i> .....	582
D. <i>Prestige and Financial Contacts</i> .....	582
E. <i>Government Regulation versus Owner Control</i> .	583
F. <i>Resale Restrictions</i> .....	584
CONCLUSION .....	584
APPENDIX: SUMMARY OF CERTAIN FEATURES OF PUBLIC AND PRIVATE FINANCING DEVICES .....	586

# Small Business Financing Alternatives Under the Securities Act of 1933

BY ROY L. BROOKS\*

*The regulatory scheme of the Securities Act of 1933 impedes capital formation by small businesses. This article analyzes the nuances, strengths and weaknesses of various equity financing methods designed to alleviate part of the regulatory burden imposed on small businesses. It is argued that a choice among the financing devices should take place within the context of an enterprise's basic business and financial objectives and that, from the businessperson's perspective, the financing devices should be viewed as alternative means of effectuating those objectives.*

## INTRODUCTION

Small businesses<sup>1</sup> play a pivotal role in the United States' economy.<sup>2</sup> They provide<sup>3</sup> and create<sup>4</sup> more private employment

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<sup>1</sup> For the purpose of this article, small business means an unincorporated or incorporated form of business association (a) independently owned and operated (b) not dominant in its industry segment and (c) which qualifies as an issuer of securities under any Public or Private Financing device.

The Small Business Association (SBA), for the purposes of small business investment company assistance, currently defines a small business as one that is independently owned and operated, is not dominant in its field of operation, does not have assets exceeding \$9 million, does not have net worth in excess of \$4 million, and does not have average net income for the preceeding two years in excess of \$400,000. 13 C.F.R. §121.3-11 (1979). However, the SBA recently proposed a revision of its small business definition which would be based solely on the number of employees over a 12 month period, irrespective of income or assets. The number of employees would differ from industry to industry, with the maximum number set at 2500. 45 Fed. Reg. 15,442 (1980).

<sup>2</sup> SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORT, at iv (1978) [hereinafter cited as ANNUAL REPORT]. See also *Small Business and Society: Hearings Before the Select Committee on Small Business, United States Senate, 94th Cong., 1st Sess.* (1975); *Economic Problems of Small Business in the Midwest: Hearings Before the Select Committee on Small Business, United*

than any other business sector of the economy. As effective producers in such vital industries as construction,<sup>5</sup> services,<sup>6</sup> retailing and wholesaling,<sup>7</sup> they help to maintain competitive markets. Significantly, small enterprises account for over 40% of the Gross National Product<sup>8</sup> and nearly 50% of the private sector's output.<sup>9</sup>

Despite small businesses' substantial contributions to the economy, they have not flourished in recent years.<sup>10</sup> Perhaps the chief reason for poor business performance is inexperienced management.<sup>11</sup> Another reason is the high cost of long term

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*States Senate*, 94th Cong., 1st Sess. (1975). Nearly 90% of all United States' corporations are small corporations and virtually all of the sole proprietorships, which account for 75% of all United States businesses, are small businesses. U.S. SMALL BUSINESS ADMINISTRATION, *FACTS ABOUT SMALL BUSINESS AND THE U.S. SMALL BUSINESS ADMINISTRATION 3* (1979). [hereinafter cited as *FACTS*].

<sup>5</sup> Excluding farm workers, approximately 58% of all workers in the private sector are employed by small businesses and over 100 million Americans earn a living, directly or indirectly, from small businesses. *FACTS*, *supra* note 2, at 3.

<sup>4</sup> For example, between the years 1969 and 1976, 14 million Americans joined the civilian labor force. Of the 9 million new jobs provided during that period, 6 million were created by small businesses and 3 million were created by state governments. In contrast, the work force of the one thousand largest United States corporations remained at 16 million during this same period. *Id.* at 4.

<sup>5</sup> Nearly 80% of construction revenue is accounted for by small businesses. *Id.* at 2.

<sup>6</sup> Approximately 60% of revenue in the service industry is produced by small businesses and more than 30% of all small businesses are in the service industry. *Id.* at 3.

<sup>7</sup> Small businesses account for approximately 70% of all sales made by retailers and wholesalers and nearly 25% of all small businesses are in the retail trade industry. *Id.*

<sup>8</sup> *ANNUAL REPORT*, *supra* note 2, at iv; *FACTS*, *supra* note 2, at 2. Gross National Product, or GNP is the total amount of all goods and services produced in the economy. See P. SAMUELSON, *ECONOMICS* 179-80, 197, 243 (10th ed. 1976); A. ALCHIAN & W. ALLEN, *UNIVERSITY ECONOMICS* 529 (1972).

<sup>9</sup> *ANNUAL REPORT*, *supra* note 2, at iv; *FACTS*, *supra* note 2, at 2. Output in the private sector, excluding farm portions, is sometimes referred to as GBP, or Gross Business Product. GBP is GNP excluding government and farm portions. *FACTS*, *id.*

<sup>10</sup> See *ANNUAL REPORT*, *supra* note 2, at iv. Business failures, large and small, increased by 18% in 1977 as compared to a 6% increase in 1974. *FACTS*, *supra* note 2, at 2. Although an average of 250,000 new businesses, large and small, are started each year, today more than half of these businesses are likely to fail within the first 5 years. *FACTS*, *id.*

<sup>11</sup> It is estimated that "95% of all business failures are a direct result of poor

equity capital which places equity financing beyond the realm of practicality for many small businesses.<sup>12</sup>

Many factors can contribute to the cost of capital formation.<sup>13</sup> Prominent among them is the regulatory burden imposed on small issuers of securities by the Securities Act of 1933<sup>14</sup> (hereinafter referred to as the "1933 Act" or the "Act").<sup>15</sup>

management." *FACTS*, *supra* note 2, at 2.

<sup>12</sup> See *ANNUAL REPORT*, *supra* note 2, at iv-v. See also Haynsworth, *The Need for a Unified Small Business Legal Structure*, 33 *BUS. LAW.* 849 (1978).

<sup>13</sup> *E.g.*, inflation, inexperienced or inefficient management. See *ANNUAL REPORT*, *supra* note 2, at iv-v.

<sup>14</sup> 15 U.S.C. §§ 77a-77aa (1976), *as amended*, (Supp. II, 1978). In 1978, the Securities and Exchange Commission [hereinafter referred to as the "SEC" or "Commission"] conducted public hearings concerning the effects of the 1933 Act on the ability of small businesses to raise equity funds in the domestic capital markets. See *Sec. Rel. No. 5889* (Dec. 14, 1977). See also *Sec. Rel. No. 5914* (Mar. 6, 1978). Among the conclusions reached by the SEC in these hearings is that the cost and paper work involved in the offering of securities often overburdens small issuers. Others have concurred with this assessment. See, *e.g.*, Sargent, *The Federal Securities Law and Small Business*, 33 *BUS. LAW.* 901-15 (1978). See also note 171 and accompanying text *infra*.

As a result of the regulatory burden involved in equity financing, small businesses often must turn to high-interest loans from banks and other sources. The problem with debt financing and the advantage of equity financing is, as stated by one businessperson, "What you borrow . . . you have to pay it back . . . . When you go public, you don't have to pay it back. It gives a . . . [business] a chance to get ahead." *Wall St. J.*, Aug. 22, 1979, at 38, col. 6. Also, in times of rising interest rates commercial lenders often resort to credit-tightening policies, such as the refusal to extend loans to new ventures or to all but the most credit-worthy of borrowers, which tend to dry up funds otherwise available to small businesses. See, *e.g.*, *Wall St. J.*, Jan. 22, 1980, at 1, col. 6.

<sup>15</sup> The Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1976), *as amended*, (Supp. II, 1978) [hereinafter referred to as the "1934 Act"], can also have a heavy regulatory impact on the small issuer of securities. See Sargent, *supra* note 14, at 903. The 1934 Act mainly deals with trading in securities issued under the provisions of the 1933 Act. Virtually every conceivable aspect of securities trading is regulated by the 1934 Act: the SEC is established under the act to administer the securities laws (§ 4, 15 U.S.C. § 78(d), *as amended* (Supp. II, 1978) securities exchanges must register with the SEC (§ 6, 15 U.S.C. § 78(f) (1976)); some companies must register as a "listed" company and these companies and certain other issuers must register their securities with the SEC as well as file periodic reports with the SEC (15 U.S.C. §§ 78l, 78m (1976)); proxy solicitations in connection with registered securities must be filed with the SEC and insider-trading in such securities is restricted (15 U.S.C. §§ 78n, 79p (1976)); brokers and dealers who trade in the over-the-counter market or in municipal securities must register with the SEC as must national securities associations (15 U.S.C. §§ 78o, 78o-4, 78o-3 (1976)); margin

The 1933 Act has two basic objectives: full and fair disclosure to the investing public and the prohibition of fraud in securities transactions.<sup>16</sup> The disclosure requirements of the Act begin with Sections 7,<sup>17</sup> 6<sup>18</sup> and 5<sup>19</sup> thereof. The former requires the preparation<sup>20</sup> and the latter two mandate the filing<sup>21</sup> of a docu-

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requirements established by the Federal Reserve for loans by banks, brokers, dealers and others are enforceable through provisions of the 1934 Act (15 U.S.C. §§ 78g, 78h (1976)); and fraudulent trading practices are prohibited (15 U.S.C. §§ 78i, 78j (1976)). If a business files a registration statement under the 1933 Act, such as a Form S-1 or Form S-18, or has 500 or more of any class of equity security holders and more than \$1 million in total assets, it becomes committed to the periodic reporting requirements of the 1934 Act. See Sections 15(d), 12(g), 15 U.S.C. §§ 780(d), 781(g) (1976). The only other way for a business to become committed to the periodic reporting requirements of the 1934 Act is by trading its securities on a national exchange, which first requires registration of the securities for trading purposes with the SEC. See 15 U.S.C. § 781(a), (b) (1976). Since it is unlikely that a small business could meet the listing requirements of a national exchange, the possibility of incurring additional regulation through this corridor of the 1934 Act is remote. Finally, a small business will not likely be subjected to the proxy solicitation requirements and the tender offer requirements of the 1934 Act since those provisions only apply to securities registered under Section 12 of the 1934 Act. See 15 U.S.C. §§ 78m(d), 78n(a), 78p(a) (1976).

<sup>16</sup> SEC, *THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION* 2-3 (1974); Dean, *Twenty-five Years of Federal Securities Regulation by the Securities and Exchange Commission*, 59 COLUM. L. REV. 697, 699 (1959).

<sup>17</sup> 15 U.S.C. § 77g (1976).

<sup>18</sup> 15 U.S.C. § 77f (1976).

<sup>19</sup> 15 U.S.C. § 77e (1976).

<sup>20</sup> Information required to be disclosed in connection with securities issued other than by a foreign government is set forth in Schedule A. See 15 U.S.C. § 77aa (1976). The SEC has the authority to permit omissions and require additional information, 15 U.S.C. § 77g (1976), and has done so by prescribing various forms for registration statements. See 17 C.F.R. § 239 (1979).

The information required in Schedule A, and indeed more, is contained in Form S-1, the standard registration statement under the 1933 Act. See 17 C.F.R. § 239.11 (1979); [1980] 1 FED. SEC. L. REP. (CCH) ¶7121; [1980] 1 SEC. REG. (P-H) ¶4501. Along with supporting documentation, information contained in Form S-1 consists of two basic types: narrative disclosures and financial disclosures. These disclosures are supplemented by various other provisions of the 1933 Act. As to narrative disclosures, the most important supplements include Regulation S-K, 17 C.F.R. § 229 (1979); and, as to financial disclosures, Regulation S-X, 17 C.F.R. § 210 (1979), the Accounting Series Releases and the Staff Accounting Bulletins, see note 27 *infra*.

Taking into account these supplemental disclosures, Form S-1 typically consists of (1) the facing sheet, (2) the prospectus, which contains the information specified in Part I of the form, (3) the information called for by Part II, (4) the

ment with the SEC by any person<sup>22</sup> who sells<sup>23</sup> or offers to sell<sup>24</sup> a security<sup>25</sup> by any means of interstate commerce.<sup>26</sup> The prepa-

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undertaking to file reports, (5) the required signatures, (6) consents of experts, (7) financial statements, such as, a consolidated balance sheet, consolidated income statement, and consolidated funds statement, (8) exhibits and (9) any other information requested by the Commission's staff.

The prospectus, Part I of Form S-1, contains most of the information called for in Form S-1 and is the only part of the registration statement usually distributed to prospective investors. The prospectus normally contains information relative to the identity of the issuer, its location, capitalization, directors, underwriters, the general character of its business, the amount of the net proceeds of the offerings, a description of the securities being issued and of the underwriting of said securities.

The financial statements covering the most recent fiscal year must be audited by independent public accountants. However, statements for "stub" periods or fiscal periods between the end of the most recent fiscal year and the date of SEC filing, need not be audited. Despite this the underwriters might ask for a written opinion by the accountants to the effect that the unaudited statements were prepared in a manner consistent with the audited statements. See [1980] 1 FED. SEC. L. REP. (CCH) ¶ 7121; 17 C.F.R. § 229 (1979). For a more detailed discussion of Form S-1, see, e.g., Sec. Rel. No. 33-4936 (Dec. 9, 1968); C. ISRAELS & G. DUFF, WHEN CORPORATIONS GO PUBLIC 138-39, 177-253 (eds. 1962); Brooks, *Currency Translations in the Registration Statements of Foreign Issuers*, 35 BUS. LAW. 435, 442 (1980).

<sup>21</sup> The filing requirements for registration statements are detailed in Regulation C of the Act. Regulation C contains general instructions, *inter alia*, as to the proper form of the filing document, the number of copies required to be filed and printing requirements. It also specifies requirements as to the form and content of prospectuses, written consents, exhibits, amendments, withdrawals, certain disclosure items, place of filing, effective date and computation of fees. See 17 C.F.R. §§ 230.400-230.494 (1979).

<sup>22</sup> Section 2(2) of the Act defines "person" as any individual plus most unincorporated or incorporated forms of business. 15 U.S.C. § 77b(2) (1976).

<sup>23</sup> Section 2(3) of the Act defines "sell" to include any "contract of sale or disposition of a security or interest in a security for value". Preliminary negotiations or agreements between an issuer and underwriters or among underwriters in privity with the issuer are excluded from this definition. See 15 U.S.C. § 77b(3) (1976).

<sup>24</sup> Section 2(3) of the Act defines "offer to sell" to include any "attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The exclusion as to underwriting negotiations and contracts also applies, *id.*

<sup>25</sup> The term "security" is given a very broad definition under the 1933 Act. Section 2(1) of the Act defines security as, *inter alia*, any note, stock, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, transferable share or investment contract. 15 U.S.C. § 77b(1) (1976).

On some occasions, the SEC and the courts have had difficulty in determin-

ration and filing of the standard disclosure document (hereinafter referred to as the "registration process") can be very complex,<sup>27</sup> time-consuming<sup>28</sup> and costly.<sup>29</sup>

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ing whether a security has been offered or sold. *See, e.g.*, Sec. Rel. No. 33-5382; Sec. Rel. No. 33-5347; *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *Los Angeles Trust Deed & Mortgage Exchange v. SEC*, 285 F.2d 162 (9th Cir. 1960) *cert. denied* 366 U.S. 919 (1961). *See also* Lipton & Katz, "Notes" Are (Are Not?) Always Securities—A Review, 29 BUS. LAW. 861 (1974); Lipton & Katz, "Notes" Are Not Always Securities, 30 BUS. LAW 763 (1975).

<sup>26</sup> Section 2(7) of the Act defines "interstate commerce" as "trade or commerce in securities or any transportation or communication relating thereto among the . . . [states or territories of the United States] or between any foreign country . . . [and any state or territory of the United States]." 15 U.S.C. § 77b(7) (1976). An act performed in interstate commerce is the constitutional basis upon which the securities laws are established. *See, e.g.*, *United States v. Re*, 336 F.2d 306 (2d Cir.) *cert. denied* 379 U.S. 904 (1964). For more detailed discussion, *see, e.g.*, McCauley, *Intrastate Securities Transactions under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959).

<sup>27</sup> The registration process is complex because it brings together different professionals (lawyers, accountants, investment bankers, businesspersons and government officials) with different perspectives on corporate finance. For example, an investment banker may wish to view the registration statement as a selling document because he or she has the responsibility of marketing the securities. In contrast the SEC views the registration statement as a disclosure document since it is charged with protecting the investing public from fraud. In drafting the registration statement, the lawyer must attempt to reconcile both perspectives. Even though the SEC has quite a powerful role in the registration process, the fact remains that if the investment banker feels that language in the registration statement paints an unreasonably negative picture of the company, the deal will not go forward and the company is unable to obtain funds. For a discussion of the role of the investment banker in the registration process, *see* *U.S. v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953).

The detail and unstable nature of the provisions comprising the regulatory scheme also contribute to the complexity of the registration process. The lawyer must comply with a myriad of Congressional and administrative rules, regulations, schedules and guides which together constitute the "law" governing the registration process. Additionally, this "law" is constantly changing and counsel must keep abreast of these changes or face potential liability.

The lawyer must also learn the investment banker's profession (i.e., markets and investments) and the accountant's profession as these disciplines are very much reflected in the registration statement. The latter discipline is perhaps the heart of disclosure for it is the financial statements, especially the income statement, which are most important to a prospective investor. Since many accountants are unfamiliar with the SEC's accounting requirements as set forth in Regulation S-X, the Accounting Series Releases (hereinafter referred to as "ASR") and the Staff Accounting Bulletins (hereinafter referred to as "SAB"), accountants seem to have the most difficulty of all the professionals in

However, a number of exemptions from the standard disclosure and registration requirements are available to small businesses.<sup>30</sup> Section 3(a) of the Act<sup>31</sup> exempts certain securities

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moving through the registration process. The SEC accounting standards are published in 17 C.F.R. § 210 (1979)(Regulation S-X). For more detailed information concerning the complexity of the registration process, see, e.g., C. ISRAEL & G. DUFF, *supra* note 20, at 43-8, 65-119, 149-76. Schneider & Manko, *Going Public: Practice, Procedure and Consequences*, 15 VILL. L. REV. 283 (1970) revised and updated in RULES AND REGULATIONS OF THE SECURITIES AND EXCHANGE COMMISSION (Bowne, 1978) [revised and updated version hereinafter referred to as *Going Public*].

<sup>28</sup> The registration process is time-consuming primarily because of the many drafting sessions required to engender a disclosure document that complies with the regulatory scheme. It usually takes two to three months from the first drafting session to the closing of the deal, which is when the company actually receives its funds. This timetable assumes that everything runs smoothly in terms of the drafting sessions and the SEC's review of the registration statement. Rarely is this the case, however, since any number of things can go wrong. Problems of rule interpretation may arise between the issuer and SEC reviewer, and drafting problems may arise between the underwriters and the accountants. Small companies going public and any company which does not offer securities frequently may require a longer timetable because of a lack of familiarity with the ever-changing regulatory scheme. In addition, after the registration statement has been filed, the SEC usually requires that it be amended to incorporate specific comments that it may have about certain disclosures within the document or the many exhibits which often accompany the document. Even large companies do not expect the SEC to approve the first filing of the registration statement.

Some time must also be spent on the deal prior to the first drafting session. The businessperson must spend a period of time negotiating the terms of the offering with the investment banker. This will require, *inter alia*, the banker to do a detailed analysis of the company and its industry. See, e.g., C. ISRAEL & G. DUFF, *supra* note 20, at 8-12, 43-4, 121-24, 149-52.

<sup>29</sup> The major expenses involved in the registration process include underwriters' compensation (which today can range from 7% to 10% of the offering price), legal fees (which today can range between at least \$50,000 and \$100,000 for a first offering of several hundred thousand or several million dollars), accounting fees (which today can be between at least \$40,000 to \$75,000 if there have been no prior audits of financial statements and new accountants are engaged at the time of the offering) and printing expenses (which today can range between at least \$35,000 and \$100,000). See *Going Public, supra* note 27, at 20-23; P. SAMUELSON, *ECONOMICS* 107 (1976). In addition, the filing of each registration statement will cost the issuer 1/50th of 1% of the maximum aggregate offering price of the securities, with a minimum cost of \$100. 15 U.S.C. § 77f(b) (1976). In 1976, the average total expense of a first public offering ran to \$202,000 per offering with the highest being \$700,000. *Going Public, supra* note 27, at 22, n.13.

<sup>30</sup> See Appendix: Summary of certain features of Public and Private Financ-



from the registration requirements of the Act<sup>32</sup> and Section 4 of the Act<sup>33</sup> provides registration exemption for certain securities transactions.<sup>34</sup> In addition, the SEC is empowered under Section 3(b)<sup>35</sup> to promulgate rules and regulations which exempt specific securities from registration.<sup>36</sup>

Although a security or securities transaction may be exempted from standard disclosure or registration, issuers are not exempt from compliance with relevant Blue Sky laws.<sup>37</sup> In addition, the

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ing Devices, *infra*, for a table detailing the key elements and requirements of the major financing devices.

<sup>31</sup> 15 U.S.C. § 77c(a) (1976).

<sup>32</sup> For example, government and bank securities, (§ 3(a)(2)), commercial paper maturing in nine months (§ 3(a)(3)), securities issued by charitable organizations (§ 3(a)(4)), securities issued by thrift institutions (§ 3(a)(5)), carrier offerings governed by the Interstate Commerce Act (§ 3(a)(6)), securities issued by a receiver or trustee-in-bankruptcy with court approval (§ 3(a)(7)), securities issued in issuer exchange offers (§ 3(a)(9)) and intrastate offerings of securities (§ 3(a)(11)). The latter exemption, which is more like an exempted transaction, is discussed in detail at notes 55-89 and accompanying text *infra*.

<sup>33</sup> 15 U.S.C. § 77d (1976).

<sup>34</sup> The exempted transactions are: (1) transactions by nonprofessionals, meaning persons other than an issuer, underwriter (defined in 15 U.S.C. § 77(d)(1976) as a person who participates in an issuer distribution of securities with a view to reselling for profit) or dealer (§ 4(1)); (2) transactions not involving a public offering (§ 4(2)); (3) transactions by a dealer not prohibited by § 4(1) of the Act (§ 4(3)); (4) transactions by brokers in execution of customer orders (§ 4(4)); and (5) certain real estate transactions (§ 4(5)). The Private Placement Exemption (§ 4(2)) is discussed in detail at notes 244-296 and accompanying text *infra*.

<sup>35</sup> 15 U.S.C. § 77c(b)(1976) *as amended* (Supp. II, 1978).

<sup>36</sup> The SEC's authority to exempt securities is currently limited to offerings not exceeding \$2 million. 15 U.S.C. § 77c(b)(1976). Rule 240, discussed at notes 90-120 and accompanying text *infra* and Rule 242, discussed at notes 177-215 and accompanying text *infra*, are based on Section 3(b) powers.

Section 19(a) (15 U.S.C. § 77s(1976)) gives the SEC authority, *inter alia*, to promulgate rules and regulations that provide for disclosure exemption in varying degree. Form S-18, discussed at notes 216-243 and accompanying text *infra*, is based on the SEC's Section 19(a) powers. To a lesser extent, Regulation A, discussed at notes 121-176 and accompanying text *infra*, is also founded on Section 19(a). See 17 C.F.R. § 230.240 (1979).

<sup>37</sup> Blue Sky laws refer to state statutes which regulate the distribution of securities within that particular state. The process of complying with relevant Blue Sky requirements is considerably less difficult than satisfying the requirements of the 1933 Act. See C. ISRAELS & G. DUFF, *supra* note 20 at 119. For further details on Blue Sky laws, see, e.g., [1980] 1 SEC. REG. (P-H) ¶ 1201 *et. seq.*; [1980] 1 BLUE SKY L. RPT., (CCH) ¶ 4901 *et. seq.*; CAL. CORP. CODE §§ 25000-25801 (West Cum. Supp. 1980); L. LOSS & E. COWETT, BLUE SKY LAWS

antifraud provisions of the securities laws are still applicable.<sup>38</sup>

The resale of securities issued in an original nonexempted or exempted offering may not be transacted without registration of a disclosure document covering such securities.<sup>39</sup> Such secondary offerings are not required to be registered if exempted by a pro-

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(1958); Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287 (1959).

<sup>38</sup> The basic liability provisions under the 1933 Act are Sections 11 and 12. Section 11 gives an injured buyer of securities a cause of action for material misstatements or omissions in the registration statement against every person who signed the registration statement, every accountant or other professional (including lawyers) named in the registration statement as having prepared or certified any report used in connection with the registration statement, every person who served as a director of the corporation at the time the registration statement was filed and every underwriter. Section 12 makes any person who offers to sell or sells an unregistered security by means of a misleading prospectus or oral communication liable to an injured buyer of such security. The standard of proof under Sections 11 and 12 is negligence, *Johns Hopkins University v. Hutton*, 422 F.2d 1124 (4th Cir. 1970); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955). Section 13 of the 1933 Act provides that the action must be brought within one year of the time the violation is or should have been discovered. For further discussion of the liability features under the 1933 Act, see, e.g., *Kaiser-Fraser Corp. v. Otis & Co.*, 195 F.2d 838 (2nd Cir.) cert. denied 344 U.S. 856, (1952); *Escott v. Bar Chris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968); *Globus v. Law Research Service, Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968); Folk, *Civil Liabilities under the Federal Securities Acts: The Bar Chris Case*, Part I, 55 VA. L. REV. 1 (1969); *ABA National Institute on the Bar Chris Case*, 24 BUS. LAW. 523 (1969); Comment, *Bar Chris: Due Diligence Refined*, 68 COLUM. L. REV. 1411 (1968).

Where the security or transaction is exempted from the registration process, the liability provisions of the Sections 12(2) and 17 of the 1933 Act are still applicable. See 15 U.S.C. §§ 771(2), 77q(1976). In addition, a defrauded purchaser of securities is given a right to seek damages from the seller under the provisions of Section 10b and Rule 10b-5 of the 1934 Act. 15 U.S.C. § 78j(b)(1976); 17 C.F.R. § 240.10b-5 (1979). See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.) cert. denied 343 U.S. 956 (1952). See also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Rule 10b-5 is virtually identical to Section 17(a) of the 1933 Act relative to fraudulent sales of securities. Although the Supreme Court has not ruled on whether an implied cause of action exists under Section 17(a), in light of the express remedies provided in Sections 11 and 12, *Blue Chip Stamps*, 421 U.S. at 734, n.6, some lower courts have held that an implied action exists under Section 17(a). See, e.g., *Barnes v. Peat, Marwick, Mitchell & Co.*, 332 N.Y.S.2d 281 (Sup. Ct. 1972).

<sup>39</sup> See Section 5 of the Act, discussed at notes 19-26 and accompanying text *supra*. See also 17 C.F.R. § 230.144 (1979) (Prel. Note 1).

vision of the Act.<sup>40</sup> Most small resales are exempted<sup>41</sup> and Section 4(1) of the Act<sup>42</sup> exempts large resales by a seller who did not purchase directly from an issuer or who is not otherwise deemed to be a controlling shareholder.<sup>43</sup> Secondary offerings of securities by control persons and of "restricted securities"<sup>44</sup> may be transacted without registration<sup>45</sup> if the provisions of Rule 144 are satisfied<sup>46</sup> or if the resale is otherwise exempted.<sup>47</sup>

The regulatory framework of the 1933 Act can easily discourage small business equity capital formation.<sup>48</sup> However, the cost of such capital engendered by the burden of the regulatory system can be minimized by a basic understanding of the system's structural limitations and by an intelligent exploitation of the system's benefits.

Accordingly, the purpose of this article is to introduce small businesses and their counsel to the nuances, strengths and weaknesses of various financing devices provided in the 1933 Act. Part I<sup>49</sup> of the article discusses various devices of Public Financings<sup>50</sup> and Part II<sup>51</sup> explores features of a major Private Financ-

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<sup>40</sup> See Section 3 and 4 of the Act discussed at notes 31-36 and accompanying text *supra*. See also 17 C.F.R. § 230.144 (1979)(Prel. Notes 1, 2).

<sup>41</sup> See Section 4(1), 4(3), (4) of the Act cited in note 34 *supra*.

<sup>42</sup> See Section 4(1) of the Act cited in note 34 *supra*.

<sup>43</sup> Section 4(1) of the Act does not exempt transactions by an issuer, dealer or underwriter. See note 34 *supra*. Under Section 2(11), a person in a control relationship with an issuer is deemed to be an issuer for purposes of the Section 4(1) exemption. See 15 U.S.C. § 77b(11)(1976). Whether a seller of stock is a control person, or an affiliate, is a question of fact. Directors, high level officers and holders of 10% of the issuers' voting securities may be deemed to be control persons. See *American Standard*, [1972] 1 FED. SEC. L. REP. (CCH) ¶ 79,071.

<sup>44</sup> "Restricted securities" are securities issued in a Private Placement transaction, a Rule 242 or a Rule 240 transaction. See 17 C.F.R. § 230.144(a)(3)(1979) *as amended*, 45 Fed. Reg. 6,362, 6,367 (1980).

<sup>45</sup> Sales under Rule 144 can be transacted through brokers and if so transacted, can be exempted from registration pursuant to Section 4(4). See 17 C.F.R. § 230.144(g)(1979).

<sup>46</sup> The main problem created for resellers by Rule 144 is the requirement that the securities cannot be transferred for a period of two years. For a discussion of Rule 144 see notes 292-296 and accompanying text *infra*.

<sup>47</sup> 17 C.F.R. § 230.144(j)(1979); Sargent, *supra* note 14, at 908.

<sup>48</sup> See Sargent, *supra* note 14, at 903.

<sup>49</sup> Notes 55-243 and accompanying text *infra*.

<sup>50</sup> For a definition of Public Financings, see note 54 and accompanying text *infra*.

<sup>51</sup> See notes 244-296 accompanying text *infra*.

ing device,<sup>52</sup> the Private Placement. In Part III,<sup>53</sup> the article analyzes the economic and financial factors inherent in a financing decision. The article concludes with the assessment that ultimately the choice among the financing devices must be predicated upon the enterprise's business objectives.

## I. PUBLIC FINANCINGS

Public Financings can be viewed as equity capital formation through a public distribution of an issuer's securities. This part of the article analyzes various financing methods, or devices, established for the purpose of effectuating a Public Financing without full compliance with the registration process.

Public Financing devices considered in this article include Intrastate Offerings, Rule 240, Regulation A, Rule 252<sup>54</sup> and Form S-18. The order in which these financing devices are presented roughly accords with the relative degree of regulation inherent in each device. Those devices farthest removed from the registration process are analyzed first.

### A. Intrastate Offerings

Section 3(a)(11) of the 1933 Act<sup>55</sup> exempts from the registration process any security which is issued exclusively intrastate by a resident of the state of issuance doing business therein.<sup>56</sup> The exemption is intended to provide local unincorporated or incorporated business associations<sup>57</sup> with a means for raising an unlimited amount of funds<sup>58</sup> from local sources.<sup>59</sup>

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<sup>52</sup> Private Financings, as used in this article, are nonpublic offerings of equity securities. See Section 4(2) of the 1933 Act discussed at note 34 *supra*. In a broader sense, Private Financings could embrace many forms of private business borrowings, such as commercial bank loans and credit from suppliers. Private borrowings are beyond the scope of this article.

<sup>53</sup> See notes 297-333 and accompanying text *infra*.

<sup>54</sup> See note 207 and accompanying text *infra*.

<sup>55</sup> 15 U.S.C. § 77c(a)(11)(1976).

<sup>56</sup> 15 U.S.C. § 77c(a)(11)(1976). Although the exemption is contained in Section 3 of the 1933 Act, the exemption is transactional; the securities themselves are not exempt unless offered as part of an intrastate transaction. See 39 Fed. Reg. 2353 (1974); 26 Fed. Reg. 9158 (1961).

<sup>57</sup> Compare Section 3(a)(11), 17 U.S.C. § 77c(a)(11)(1976), with Section 2(1), (4), 17 U.S.C. § 77b(1), (4) (1976).

<sup>58</sup> Section 3(a)(11) seeks to protect the investing public by restricting offerings to persons within the same locality as the issuer. See 39 Fed. Reg. 2354

Rule 147<sup>60</sup> provides objective standards (a so-called "safe harbor") upon which an issuer may rely to establish compliance with Section 3(a)(11).<sup>61</sup> The rule is nonexclusive; therefore, an issuer may rely upon the common law and SEC interpretations<sup>62</sup> in lieu of Rule 147 to demonstrate compliance with Section 3(a)(11).<sup>63</sup>

Under Rule 147, at the time of the offering the issuer must be both a resident of and doing business within the state in which the issue is offered and sold.<sup>64</sup> The issuer is deemed to be a resident of the offering state if it is incorporated,<sup>65</sup> organized,<sup>66</sup> has its principal office<sup>67</sup> or its principal home in such state.<sup>68</sup> The

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(1974). Local investors, by reason of their proximity to the issuer's residence, are presumed to be familiar with the issuer; consequently, imposition of a dollar ceiling on local financings would not be a significant contribution to investor protection. *See id.* In addition, as is the case with all exemptive offerings, purchasers are protected by the antifraud provisions of the securities laws. *See* note 38 and accompanying text *supra*. In contrast, the Section 3(b) exemptions attempt to provide for investor protection by imposing dollar ceilings on exempted transactions, *see* note 34 and accompanying text *supra*.

<sup>59</sup> 17 C.F.R. § 230.147 (1979) (Prel. Note 3).

<sup>60</sup> *Id.* at § 230.147.

<sup>61</sup> *Id.* § 230.147 (Prel. Note 3).

<sup>62</sup> For an analysis of compliance with Section 3(a)(11) without resort to Rule 147 *see, e.g.*, Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969); 39 Fed. Reg. 5353 (1974); 26 Fed. Reg. 9158 (1961); Owen, *The Private Offering and Intrastate Exemptions Under the Securities Act of 1933*, in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 165 (H. Wander & W. Grienberger eds.) (ABA 1968); Bloomenthal, *The Federal Securities Act Intrastate Exemption: Fact or Fiction?*, 15 WYO. L. J. 121 (1961); McCauley, *Intrastate Securities Transactions under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959).

<sup>63</sup> 17 C.F.R. § 230.147 (1979) (Prel. Note 1). For a comparative analysis of Rule 147 and the common law, *see* 39 Fed. Reg. 5353 (1974).

<sup>64</sup> 17 C.F.R. § 230.147(c)(1979).

<sup>65</sup> *Id.* at § 230.147(c)(1)(i).

<sup>66</sup> This feature applies to unincorporated associations which are required to organize under the laws of a state. *Id.* For example, the limited partnership is a statutory creation. *See* Uniform Limited Partnership Act, 8 U.L.A. 1 (1916). *See generally* H. HENN, AGENCY, PARTNERSHIP, AND OTHER UNINCORPORATED BUSINESS ENTERPRISES (1972).

<sup>67</sup> This feature relates to unincorporated associations which are not usually required to organize under the laws of a particular state. *Id.* at § 230.147(c)(1)(ii). The general partnership is not a statutory creation, although much of its law is codified. *See* Uniform Partnership Act, 7 U.L.A. 1 (1914). *See generally* H. HENN, *supra* note 66 at 1-295.

<sup>68</sup> This provision applies to individuals doing business as sole proprietors. 17 C.F.R. § 230.147(c)(1)(iii)(1979).

doing business requirement is met if the issuer's principal office is within the offering state,<sup>69</sup> and the 3-tier 80% test is met. Under the 3-tier 80% test, the issuer's generation of consolidated gross revenues,<sup>70</sup> location of consolidated assets,<sup>71</sup> and application of net proceeds<sup>72</sup> must be within the offering state.

As in the case of the issuer, the offerees and purchasers must also be residents of the offering state.<sup>73</sup> With an incorporated or unincorporated association, residence is determined by either the situs of the principal place of business or the owners' principal homes. If the association is not formed for the sole purpose of purchasing shares, its residence is determined by the former standard.<sup>74</sup> Otherwise, the latter standard is determinative.<sup>75</sup> In the case of an individual offeree or purchaser, residence is the situs of the individual's principal home.<sup>76</sup> An offer or sale of any part of the issue to a single non-resident of the offering state will destroy the exemption for the entire issue.<sup>77</sup>

The only specific disclosure requirement imposed on the issuer by Rule 147 is that purchasers be informed in writing of certain resale restrictions.<sup>78</sup> Securities purchased in an Intrastate Offering may not be resold during a distribution pursuant to the exemption and for a period of nine months from the date of the final exemptive distribution, unless the purchaser in the secondary market is a resident of the offering state.<sup>79</sup> The issuer must place a legend on the face of the securities reciting these restrictions,<sup>80</sup> provide for appropriate stop transfer notations,<sup>81</sup> and obtain a written representation from each purchaser as to the pur-

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<sup>69</sup> *Id.* at § 230.147(c)(2)(iv).

<sup>70</sup> *Id.* at § 230.147(c)(2)(i).

<sup>71</sup> *Id.* at § 230.147(c)(2)(ii).

<sup>72</sup> *Id.* at § 230.147(c)(2)(iii).

<sup>73</sup> *Id.* at § 230.147(d).

<sup>74</sup> *Id.* at § 230.147(d)(1).

<sup>75</sup> *Id.* at § 230.147(d)(2), (3). In essence, the association is stripped of its status as an entity for purposes of determining its residence.

<sup>76</sup> *Id.* at § 230.147(d)(2).

<sup>77</sup> *Id.* at § 230.147(b)(1).

<sup>78</sup> *Id.* at § 230.147(f)(3). Intrastate securities are not defined as "restricted securities" for purposes of Rule 144 but other restrictions on resale may be applicable. See notes 39-47 and accompanying text *supra*.

<sup>79</sup> *Id.* at § 230.147(e).

<sup>80</sup> *Id.* at § 230.147(f)(1)(i).

<sup>81</sup> *Id.* at § 230.147(f)(1)(ii).

chaser's residency.<sup>82</sup>

Rule 147 does not restrict solicitation and advertisement within the offering state.<sup>83</sup> In addition, the aggregation rules are inapplicable to Intrastate Offerings.<sup>84</sup>

Under limited circumstances, an Intrastate Offering may be deemed to be part of, or integrated with, a larger securities offering in which the issuer is or was engaged.<sup>85</sup> The effect of transac-

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<sup>82</sup> *Id.* at § 230.147(f)(1)(iii).

<sup>83</sup> *Id.* at § 230.147.

<sup>84</sup> *Id.* at § 230.147. The aggregation rules are of two basic types, both of which usually apply only where a dollar ceiling is imposed on a transaction. *See generally* 17 C.F.R. § 230.254(a)(1)(1979); 44 Fed. Reg. 54,258, 54,263 (1979). *Cf.* 44 Fed. Reg. 21,562, 21,568 (1979). The first rule provides that certain securities sold by the issuer during a specific period of time are to be included in calculating the aggregate dollar ceiling applicable to a prospective exemptive offering. *See* 17 C.F.R. § 230.240(e)(1979). Usually, securities offered pursuant to a Section 3(b) exemption within one year of the date of a proposed Section 3(b) transaction are aggregated. For example, offerings pursuant to Rule 240, Regulation A and Rule 242 are aggregated for the purpose of calculating the dollar ceiling in a proposed Regulation A offering if such offerings occur within the same 12-month period. 17 C.F.R. § 230.254(a)(1)(1979). Rule 242, unlike other devices to which Section 3(b) aggregation rules apply, provides for such aggregation during six-month periods rather than 12-month periods. *See* note 184 and accompanying text *infra*. Compliance with Section 3(b) aggregation rules merely requires the issuer to keep track of all its exemptive offerings within the specified period. *See, e.g.*, 17 C.F.R. § 230.240(e)(1979).

In addition to Section 3(b) aggregation, the applicable dollar ceiling of a proposed transaction may be affected by resale aggregation. Where a purchaser of an issue resells the securities for profit within a short period after the primary transaction, the differential between what the issuer received as consideration from its purchaser and what such purchaser received as consideration from its transferee will be taken into account by the SEC in determining whether the issuer exceeded the applicable dollar limitation. Unless expressly excluded by a provision in an applicable rule or regulation, resale aggregation would seem to apply to all transactions involving a dollar ceiling imposed by Congress. *Cf.*, In the Matter of Lewisohn Copper Corp., 38 S.E.C. 226, 235 (1958) (the statutory limitation on the amount of securities which may be offered would be meaningless if resale aggregation was not applicable).

<sup>85</sup> *See* note 86 *infra*. Rule 147(b)(2) provides a "safe harbor" from normal integration rules. In substance, any offering of securities under the 1933 Act which takes place either six months before or six months after an Intrastate Offering will not be deemed to be part of such Intrastate Offering, provided that the securities issued in such Intrastate transaction are not of the same or similar class of securities issued in other offerings within the six-month periods. *See* 17 C.F.R. § 230.147(b)(2)(1979). Similar safe harbors are provided in connection with Rule 242 and Private Placement financings. *See* notes 186 & 287 *infra*.

tion integration is to add new and unanticipated dimensions to each individual transaction deemed to be part of the integration. This in turn may affect the availability of one or more of the transactions if, after giving affect to the integration, such transactions do not meet their respective requirements.<sup>86</sup>

The Intrastate Offering can be of tremendous benefit to a business whose operations are local in character. The issuer is able to raise an unlimited amount of funds from local sources while avoiding the regulatory burden normally attendant upon capital formation.<sup>87</sup> The fact that the device is available to most forms of business<sup>88</sup> adds to its glitter.

The Intrastate Offering's only major drawback is that it cannot be employed by small growing businesses with significant interstate operations, or which desire to cultivate interstate financial and business relations.<sup>89</sup> These businesses will have to look to other exemptive financing devices for capital formation.

### B. Rule 240

Rule 240<sup>90</sup> is a Section 3(b)<sup>91</sup> financing device. It is intended to enable a closely-held corporation<sup>92</sup> to raise not more than

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<sup>86</sup> For example, if the issuer has made a Rule 242 offering within six months of an Intrastate Offering, the offerings may be deemed to be part of the same offering, the result of which could be a violation of the provisions of either or both devices. The question of integration is determined on a case-by-case basis with reference to the timing and characteristics of the offerings. See Sec. Rel. No. 33-4552; Sec. Rel. No. 33-4434. Where issuers plan successive offerings of securities, the safe harbors from integration should be used. See note 85 *supra*. The financings should be structured in a manner similar to the safe harbors if a safe harbor is not otherwise provided for a particular device. See generally Sargent, *supra* note 14 at 912; *Going Public*, *supra* note 27, at 26.

<sup>87</sup> See notes 27-29 and accompanying text *supra*.

<sup>88</sup> See note 57 and accompanying text *supra*.

<sup>89</sup> See note 77 and accompanying text *supra*.

<sup>90</sup> 17 C.F.R. § 230.240 (1979).

<sup>91</sup> See notes 35-36 and accompanying text *supra*.

<sup>92</sup> Both immediately before and after a Rule 240 offering, the issuer, after making reasonable inquiry, must have reasonable grounds to believe that the beneficial owners of its outstanding securities do not exceed 100 persons. 17 C.F.R. § 230.240(f)(1979). See also note 94 *infra*. However, some securityholders may be counted as a single securityholder; e.g., relatives of a securityholder sharing the same home as the securityholder or the beneficial equityholders of an unincorporated or incorporated association not formed for the sole purpose of acquiring securities offered in the Rule 240 transaction. *Id.* at § 230.240(f)(1)-(3). Thus, the actual number of beneficial owners can legitimately



\$100,000 on an annual basis outside of the registration process.<sup>93</sup>

A transaction under Rule 240 is restricted in numerous ways. Each purchaser must be a beneficial owner of the securities being offered.<sup>94</sup> The total number of eligible purchasers together with the total number of the issuer's beneficial owners may not exceed 100 after consummation of the transaction.<sup>95</sup> General solicitation and advertisement<sup>96</sup> as well as the payment of remuneration are prohibited.<sup>97</sup>

On the other hand, Rule 240 does not require the issuer to disclose any specific information to offerees or purchasers.<sup>98</sup> However, with the exception of the first offering,<sup>99</sup> each offering must be accompanied by the filing of a notification form with the SEC.<sup>100</sup> Securities issued in a Rule 240 transaction are

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exceed 100 persons.

<sup>93</sup> *Id.* at § 230.240(e).

The exemption is justified on grounds that the small dollar ceiling and the overall limited character of the offering substantially diminish the benefits of registration to the public. *See* 40 Fed. Reg. 6484 (1975). Under these circumstances, it is perhaps more efficient to resolve transactional abuses through remedial rather than preventative measures. *See* note 38 and accompanying text *supra*.

<sup>94</sup> This is in contrast to a buyer of record, such as a broker who purchases and sells securities held in his or her own name for the account of his client. Conceivably, a person, Mr. A, who desires to obtain title to, say, 100 shares of XYZ Corporation's common stock could instruct 10 different brokers or other intermediaries who would deal directly with the broker to purchase 10 shares each from XYZ Corporation without revealing the true identity of the beneficial purchaser, Mr. A. Once purchased, the shares could be held in the names of the 10 brokers or intermediaries, each of whom would be a record holder of 10 shares of XYZ Corporation common stock for the account of a single person, Mr. A. Rule 240(f) requires the issuer to take some sort of affirmative action to assure that Mr. A will in fact be the beneficial owner, not any of the actual purchasers. Otherwise, the transaction could actually engender more than 100 beneficial shareholders of the corporation if, for example, at the time of the transaction the corporation has 99 beneficial shareholders. *See* note 95 and accompanying text *infra*.

<sup>95</sup> *Id.* at § 230.240(f), discussed in note 92 *supra*.

<sup>96</sup> *Id.* at § 230.240(c). This prohibition would seem to apply to all forms of such communications, such as publications, distributions and broadcasts, regardless of content. *Cf. id.* at § 230.256(c).

<sup>97</sup> *Id.* at § 230.240(d).

<sup>98</sup> However, purchasers of the securities must be provided with information concerning resale restrictions. *See* note 103 *infra*.

<sup>99</sup> 17 C.F.R. § 230.240(h)(2)(1979).

<sup>100</sup> The notification form is Form 240. *Id.* at § 230.240(h)(1).

defined as "restricted securities,"<sup>101</sup> hence Rule 144 resale restrictions apply.<sup>102</sup>

The issuer must exercise reasonable care<sup>103</sup> to assure that no purchaser of its securities is buying with the intention of reselling for profit after the transaction.<sup>104</sup> The purpose of this requirement is to guard against any secondary underwriting of the offering.<sup>105</sup>

Finally, Section 3(b) aggregation rules<sup>106</sup> apply to Rule 240 offerings.<sup>107</sup> Resale aggregation rules<sup>108</sup> probably apply as well.<sup>109</sup> The integration rules<sup>110</sup> are expressly applicable to Rule 240 transactions.<sup>111</sup>

The fact that Section 3(b) aggregation rules and the integration rules are applicable to Rule 240 financings should not necessarily discourage the use of Rule 240 or other exemptive devices in multiple financings in a single year.<sup>112</sup> Multiple exempted financings in a single year may help to mitigate a major drawback of Rule 240, the \$100,000 ceiling.<sup>113</sup>

Rule 240 can benefit small corporations which need to raise a limited amount of funds. The exemption from the registration process<sup>114</sup> can reduce much of the regulatory burden associated

<sup>101</sup> See note 44 *supra*.

<sup>102</sup> See notes 44-47 and accompanying text *supra*.

<sup>103</sup> Reasonable care includes making reasonable inquiry to assure that the purchaser is not buying the securities as a beneficial owner with a view to selling them for a profit after the transaction, 17 C.F.R. § 230.240(g)(1)(1979) [hereinafter referred to as "underwriting restrictions"]; informing the purchaser of the underwriting restrictions, *id.* at § 230.240(g)(2); and placing a legend on the certificates concerning the underwriting restrictions. *Id.* at § 230.240(g)(3).

<sup>104</sup> *Id.* at § 230.240(g).

<sup>105</sup> See note 103 *supra*. An underwriting of the offering would bring more public investors into contact with the securities. See note 26 *supra*. This would tend to militate against the limited character of the exemption and could possibly upset the balance struck between the competing values of investor protection and capital formation. See note 93 *supra*.

<sup>106</sup> See note 84 *supra*.

<sup>107</sup> 17 C.F.R. § 230.240(e)(note 3(a))(1979).

<sup>108</sup> See note 84 *supra*.

<sup>109</sup> *Cf.* In the Matter of Lewisohn Copper Corp., 38 S.E.C. 226, 235 (1958).

<sup>110</sup> See notes 85-86 and accompanying text *supra*.

<sup>111</sup> 17 C.F.R. § 230.240 (Prel. Note 6)(1979).

<sup>112</sup> See notes 84-86 and accompanying text *supra*.

<sup>113</sup> See note 93 and accompanying text *supra*.

<sup>114</sup> See note 93 and accompanying text *supra*.

with corporate financings.<sup>115</sup>

The low dollar ceiling of Rule 240 would hardly satisfy the primary financial needs of most small businesses on an annual basis. On the other hand, Rule 240 may be adequate by itself to provide emergency funding or to facilitate the purchase of a particular asset, such as a small computer or some other type of small, income-producing asset.<sup>116</sup> Further, in view of the special character of a Rule 240 transaction, a low dollar ceiling is probably necessary.<sup>117</sup>

Another major disadvantage of Rule 240 is the restrictions it places on the resale market. The purchaser of a security issued under Rule 240 may not sell the security without first registering it with the SEC,<sup>118</sup> unless Rule 144 resale restrictions are met.<sup>119</sup> This type of restriction on transferability can discourage investors.<sup>120</sup>

Rule 240 is not the only financing device which can facilitate limited interstate capital formation. Regulation A may be more useful to many business organizations because of its flexible dollar limitations, in spite of the fact that it entails greater SEC control than Rule 240.

### C. Regulation A

Regulation A<sup>121</sup> is designed to provide a simple and relatively inexpensive means by which small businesses can raise limited amounts of needed capital.<sup>122</sup> Most domestic small businesses,

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<sup>115</sup> See notes 28-30 and accompanying text *supra*.

<sup>116</sup> The unincorporated form of business association would probably make good use of Rule 240 but, ironically, the rule is only available to an incorporated entity. See note 92 and accompanying text *supra*. For a detailed discussion of the relative advantages and disadvantages of doing business in the corporate as opposed to the unincorporated form, see, e.g., R. HAMILTON, CORPORATIONS 7-37 (1976); H. HENN, CORPORATIONS 65-11 (1974); W. CARY, CORPORATIONS 15-21 (1969). Notwithstanding such considerations, there may be no need for a business to incorporate in order to raise \$100,000 in an interstate, exempted transaction because Regulation A provides for such financing by unincorporated businesses. See notes 123-126 and accompanying text *infra*.

<sup>117</sup> See note 93 *supra*.

<sup>118</sup> See note 39 and accompanying text *supra*.

<sup>119</sup> See note 102 and accompanying text *supra*.

<sup>120</sup> For further discussion, see notes 292-296 and accompanying text *infra*.

<sup>121</sup> 17 C.F.R. § 230.251-264 (1979).

<sup>122</sup> 43 Fed. Reg. 41,383, 41,384 (1978). The policies of investor protection and capital formation are balanced through the regulation of the size of the offering

incorporated or unincorporated,<sup>123</sup> have access to this important financing device.<sup>124</sup>

Like Rule 240, Regulation A was promulgated pursuant to the SEC's Section 3(b) powers.<sup>125</sup> However, unlike Rule 240, Regulation A is hybrid; it provides a complete exemption from the registration process where the maximum annual aggregate offering price does not exceed \$100,000<sup>126</sup> and a partial filing exemption<sup>127</sup> for aggregate offerings not in excess of \$1.5 million in any given year.<sup>128</sup>

For the purpose of computing these dollar ceilings, the SEC will apply Section 3(b)<sup>129</sup> and resale aggregation rules.<sup>130</sup> In addition, Regulation A offerings are subject to integration.<sup>131</sup>

Regulation A offerings are not restricted as to the number or character of purchasers.<sup>132</sup> However, general publication, distribution or broadcast solicitation and advertisement in connection with an offering are prohibited.<sup>133</sup> The solicitation and advertisement restrictions do not preclude an issuer from making public announcements about the offering as long as such communications contain no more than the issuer's name,<sup>134</sup> a brief descrip-

and limited disclosure requirements. However, the dollar ceiling and the market's reaction to certain disclosure features of the regulation have done little to promote capital formation. See notes 170-175 and accompanying text *infra*.

Unlike the Intrastate Offering or Rule 240, Regulation A basically attempts to balance the competing policies from a preventative rather than a remedial perspective. Limited disclosure rather than remedial litigation is the central safeguard against securities abuse in Regulation A transactions. The preventative approach to investor protection is strongest where application of the registration process is plenary, involving both standard disclosure and registration. See notes 20 and 21 *supra*. It is open to question whether these policies are best balanced from a preventative or remedial approach.

<sup>123</sup> 17 C.F.R. § 230.253(a)(1)(1979).

<sup>124</sup> *Id.* at § 230.252.

<sup>125</sup> *Id.* at § 230.251. See notes 35-36 and accompanying text *supra*.

<sup>126</sup> *Id.* at § 230.254(a)(1)(ii). Compare note 140 *infra*.

<sup>127</sup> See note 21 *supra*.

<sup>128</sup> 17 C.F.R. § 230.254(a)(1)(ii)(1979).

<sup>129</sup> *Id.* at § 230.254(a)(1).

<sup>130</sup> See note 84 *supra*.

<sup>131</sup> See Sec. Act. Rel. No. 33-4552. Neither the aggregation nor integration rules should create serious problems in the selection or use of financing devices. See notes 84-86 and accompanying text *supra*.

<sup>132</sup> See 17 C.F.R. § 230.251-264 (1979).

<sup>133</sup> *Id.* at §§ 230.256(c), 230.257(b).

<sup>134</sup> *Id.* at §§ 230.256(c)(1), 230.257(b)(1).

tion of the securities being offered<sup>135</sup> and of the character and location of the issuer's properties,<sup>136</sup> a general description of the issuer's business<sup>137</sup> and, in the case of offerings not exceeding \$100,000, the names of persons available to provide additional information to prospective purchasers.<sup>138</sup>

The issuer must notify the SEC of its intent to engage in a Regulation A financing.<sup>139</sup> Such notification must be filed with the SEC on Form 1-A within 10 days of the initial offering.<sup>140</sup>

Securities issued pursuant to a Regulation A financing are not restricted.<sup>141</sup> Hence, securities acquired in a Regulation A transaction may be resold without the limitations imposed by Rule 144.<sup>142</sup> However, other restrictions on resale may be applicable.<sup>143</sup>

Disclosure under Regulation A<sup>144</sup> is achieved through the preparation and distribution of an offering circular.<sup>145</sup> The document requires disclosure of, *inter alia*, information concerning the issuer's incorporation or organization (as the case may be),<sup>146</sup> a tabulation on a per share or other unit basis of the offering price, the underwriting discounts or commissions and the proceeds to the issuer or other recipient thereof;<sup>147</sup> a description of the underwriting process being used to market the securities,<sup>148</sup> a description of the issuer's business,<sup>149</sup> including the nature of

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<sup>135</sup> *Id.* at §§ 230.256(c)(2), 230.257(b)(2).

<sup>136</sup> *Id.* at §§ 230.256(c)(4), 240.257(4).

<sup>137</sup> *Id.* at §§ 230.256(c)(3), 230.257(b)(3).

<sup>138</sup> *Id.* at § 230.257(b)(5).

<sup>139</sup> *Id.* at § 250.255(a).

<sup>140</sup> *Id.* at § 250.255(a). Where the aggregate offering price does not exceed \$100,000 in any given year, the issuer must file information called for in Schedule I of Form 1-A, with the exception of financial statements, as an exhibit to the notification form. 17 C.F.R. § 230.257(a)(1979). Schedule I is discussed in notes 146-159 and accompanying text *infra*.

<sup>141</sup> See note 44 *supra*.

<sup>142</sup> See notes 44-47 and accompanying text *supra*.

<sup>143</sup> See notes 39-43 and accompanying text *supra*.

<sup>144</sup> The disclosure requirements apply to offerings exceeding \$100,000 in a single year. See note 126 and accompanying text *supra*.

<sup>145</sup> 17 C.F.R. § 230.256 (1979). The offering circular is published as Schedule I to Form 1-A, 21 Fed. Reg. 5739-5747 [hereinafter cited as Schedule I]; [1980] 1 SEC. REG. (P-H) ¶4102.

<sup>146</sup> See Schedule I, *supra* note 145, Item 2.

<sup>147</sup> See Schedule I, *supra* note 145, Item 3(a).

<sup>148</sup> See Schedule I, *supra* note 145, Item 5.

<sup>149</sup> See Schedule I, *supra* note 145, Items 8A-8C.

its product lines and principal markets,<sup>150</sup> the location and general character of its fixed assets<sup>151</sup> and its plans for commercial application of new inventions;<sup>152</sup> information concerning the officers, directors and persons controlling the issuer,<sup>153</sup> including the interests (by security holding or otherwise) of each such person<sup>154</sup> and the aggregate annual remuneration of the three highest paid officers of the issuer;<sup>155</sup> and financial statements which include a balance sheet, income statement and a funds statement,<sup>156</sup> the latter two covering the last two full years of the issuer's business.<sup>157</sup>

The financial statements for the issuer's latest fiscal year need not be certified, unless the issuer is already required to file certified financial statements for such fiscal year.<sup>158</sup> However, such financial statements and uncertified financial statements for all other periods must be prepared in accordance with generally accepted accounting principles<sup>159</sup> (hereinafter referred to as "GAAP").

An offering circular must be furnished to each prospective purchaser prior to the mailing of the confirmation of sale.<sup>160</sup> If, however, the issuer files periodic reports pursuant to Section 13(a) or Section 15(d) of the 1934 Act,<sup>161</sup> the offering circular may be delivered at the time of confirmation of the sale.<sup>162</sup>

One of the major benefits of Regulation A is its general availability. All forms of business associations are eligible issuers under Regulation A.<sup>163</sup> Despite the general availability of Regu-

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<sup>150</sup> See Schedule I, *supra* note 145, Item 8(a).

<sup>151</sup> See Schedule I, *supra* note 145, Item 8C(b).

<sup>152</sup> See Schedule I, *supra* note 145, Item 8C(c).

<sup>153</sup> See Schedule I, *supra* note 145, Item 9.

<sup>154</sup> See Schedule I, *supra* note 145, Item 9(c).

<sup>155</sup> See Schedule I, *supra* note 145, Item 9(b).

<sup>156</sup> See Schedule I, *supra* note 145, Items 11(a), (b).

<sup>157</sup> See Schedule I, *supra* note 145, Item 11(b).

<sup>158</sup> See Schedule I, *supra* note 145, Item 11. See also 43 Fed. Reg. 41,383, 41,384 (1978). If an issuer is committed to periodic reporting under the 1934 Act, it is probably already required to file certified financial statements. The manner in which a small business may become subjected to such regulation is discussed in note 14 *supra*.

<sup>159</sup> See Schedule I, *supra* note 145, Item 11.

<sup>160</sup> 17 C.F.R. § 230.256(a)(2)(1979).

<sup>161</sup> See note 14 *supra*.

<sup>162</sup> 17 C.F.R. § 230.256(a)(2)(1979).

<sup>163</sup> See notes 123-124 and accompanying text *supra*.

lation A, its dollar ceilings may discourage prospective users of the device.<sup>164</sup> It is probable that neither \$100,000 nor \$1.5 million can completely satisfy the annual financial needs of most small businesses today.<sup>165</sup> Therefore, the dollar ceilings often constitute a significant limitation on Regulation A financings.

Theoretically, transaction costs attendant to a standard public offering<sup>166</sup> should not be as great for Regulation A offerings exceeding \$100,000 annually. The reason is that the latter's narrative and financial disclosures<sup>167</sup> are not as extensive as Form S-1 requirements<sup>168</sup> and the disclosure document need not be filed with the SEC.<sup>169</sup>

However, prior to the 1978 amendment to Regulation A,<sup>170</sup> the regulation did not live up to its promise of providing an inexpensive means of capital formation for small businesses.<sup>171</sup> The offering circular often was as "full blown" as a Form S-1 registration statement<sup>172</sup> because underwriters frequently required standard rather than less-than-standard narrative and financial disclosures.<sup>173</sup> Considering the potential liability arising from the disclosure document,<sup>174</sup> it seems reasonable that underwriters would prefer the maximum possible disclosures for an issuer lacking substantial size and reputation within the financial

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<sup>164</sup> *But see* note 116 and accompanying text *supra*.

<sup>165</sup> Most of the Regulation A offerings in 1978 were between \$400,000 and \$500,000. However, the dollar ceiling for Regulation A offerings was raised from \$500,000 to \$1.5 million in September of 1978. *See* ANNUAL REPORT, *supra* note 2, at 103.

<sup>166</sup> *See* notes 27-29 *supra*.

<sup>167</sup> *See* notes 144-159 and accompanying text *supra*.

<sup>168</sup> *See* note 20 *supra*. *See also*, *Going Public*, *supra* note 27, at 24.

<sup>169</sup> *See* notes 127-128 and accompanying text *supra*. Form S-1 is a filing document as well as a disclosure document. *See* notes 20-21 and accompanying text *supra*.

<sup>170</sup> *See* note 165 *supra*.

<sup>171</sup> The cost of a Regulation A financing could go as high as \$100,000, or 20% of the old dollar ceiling of \$500,000.

Consequently, the number of issuers using Regulation A declined steadily from 1,087 in 1972 to 213 in 1977. Sec. Rel. No. 33-5915. The increase in the dollar ceiling in 1978 has resulted in a concomitant increase in the number of Regulation A issuers. For the first half of 1979, the number of Regulation A users increased 40% over the number of users during the first half of 1978. *See* note 14 *supra*.

<sup>172</sup> *See* *Going Public*, *supra* note 27, at 25.

<sup>173</sup> *Id.* at 24-25; 43 Fed. Reg. 41,384 (1978).

<sup>174</sup> *See* note 38 *supra*.

community.<sup>175</sup>

Small issuers may nevertheless find the cost of capital formation under Regulation A to be acceptable. As long as marginal increases in the dollar ceiling exceed marginal increases in transaction costs, the cost of capital will remain low on a percentage basis.<sup>176</sup>

As an alternative to Regulation A, an issuer may wish to consider Rule 242. Indeed, where the financial needs of the business exceed \$1.5 million in a single year, the issuer has little choice but to consider the rule in lieu of the regulation.

#### D. Rule 242

Rule 242<sup>177</sup> is the most recent major financing device adopted by the SEC<sup>178</sup> under its Section 3(b) powers.<sup>179</sup> The rule is intended to provide a relatively inexpensive means for corporations<sup>180</sup> to raise limited amounts of corporate funds through

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<sup>175</sup> Cf., *Going Public*, *supra* note 27, at 24-25. In this sense, Regulation A lacks the market prestige of Form S-1.

<sup>176</sup> For example, transaction costs of \$100,000 constitute a lower percentage of a \$1.5 million offering (6%) than of a \$500,000 offering (20%). In order to obtain a low capital cost percentage, the issuer will, of course, have to sell more capital stock. This may in turn cause a dilution problem. See notes 323-326 and accompanying text *infra*.

<sup>177</sup> 45 Fed. Reg. 6362 (1980) (to be codified in 17 C.F.R. § 230.242).

<sup>178</sup> Prior to the adoption of Rule 242, the Carter Administration sent a proposal to Congress that would permit small businesses to sell without registration an unlimited amount of securities to institutional investors—such as, banks, insurance companies and pension funds—or individual investors who purchase not less than \$100,000 of the company's securities in a single offering. The resale of such securities would also be exempted from the registration process if the purchaser is itself an institutional or a large investor. Wall St. J., December 24, 1979, at 6, col. 3. Unlike Rule 242 and most existing exemptive or simplified financing devices, the White House proposal lacks a dollar limitation on the size of an offering. *Id.* This feature of the proposal may be unacceptable to Congress. *Id.* However, it would seem that investor protection would not be significantly jeopardized by the absence of a dollar ceiling. As in the case of Private Placement offering the sophistication and wealth of the investors would appear to provide adequate preventative measures against abuses by the issuer. See note 250-53 and accompanying text *infra*. In addition, remedial avenues are available to injured investors. See note 38 and accompanying text *supra*.

<sup>179</sup> 45 Fed. Reg. 6362, 6368 (1980) (Prel. Note 6). See notes 35-36 and accompanying text *supra*.

<sup>180</sup> Rule 242 is available only to domestic or Canadian Corporations not engaged in significant oil, gas or mining operations and not deemed to be an



public offerings of securities, without registration.<sup>181</sup>

Under Rule 242, an issuer is permitted to sell up to \$2 million<sup>182</sup> of its securities during any six-month period.<sup>183</sup> For the purpose of calculating the maximum aggregate offering price during any six-month period, the SEC will apply Section 3(b) aggregation rules<sup>184</sup> and probably resale aggregation rules.<sup>185</sup> Integration rules are also applicable.<sup>186</sup>

The number of purchasers in a single offering may be limited depending on whether they are classified as accredited or nonaccredited persons.<sup>187</sup> "Accredited persons"<sup>188</sup> are defined essentially as institutional investors,<sup>189</sup> large individual investors<sup>190</sup> and executive officers and directors of the issuer. There are no restrictions<sup>191</sup> on the number of accredited persons who may

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investment company. 45 Fed. Reg. 6362, 6368 (1980) (Rule 242(a)(5)).

<sup>181</sup> See 45 Fed. Reg. 6369 (1980) (Rule 242(b)). The balance between investor protection and capital formation is perhaps best addressed through the rule's provisions concerning the number and character of purchasers. See notes 38, 122 and 178 *supra*.

<sup>182</sup> The maximum aggregate offering price of a single transaction is pegged to the maximum amount allowed under Section 3(b) of the 1933 Act. 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(c)). The maximum amount is currently set at \$2 million. See note 36 *supra*.

<sup>183</sup> 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(c)).

<sup>184</sup> *Id.*

<sup>185</sup> See note 84 *supra*.

<sup>186</sup> 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(b)). Rule 242(b) contains a safe harbor from normal integration rules. In substance, any offerings which take place either six months before or six months after a Rule 242 offering will not be integrated with the latter. Rule 146 provides a similar safe harbor for Private Placement offerings. See note 287 *infra*. Neither the aggregation rules nor the integration rules should create a serious problem in the selection or use of financing devices. See note 114 and accompanying text *supra*. This is particularly the case where an issuer takes advantage of the safe harbors provided by the Intrastate Offering, Rule 242 and Private Placement. See notes 84-86 and accompanying text *supra*.

<sup>187</sup> See 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(e)).

<sup>188</sup> *Id.* at 6368 (Rule 242(a)(1)).

<sup>189</sup> *E.g.*, banks, insurance companies and pension funds. *Id.* at 6368 (Rule 242(a)(1)(i)).

<sup>190</sup> Such an investor is defined as any person who purchases \$100,000 or more of the issuer's securities during a single offering. *Id.* at 6368 (Rule 242(a)(1)(ii)).

<sup>191</sup> The number is limited only by the \$2 million dollar ceiling. See note 182 and accompanying text *supra*.

purchase the issuer's securities during a single offering.<sup>192</sup> The number of nonaccredited persons purchasing the issuer's securities during any single offering is limited to 35.<sup>193</sup> The issuer must make a determination, based on some affirmative act of inquiry, as to whether a purchaser is an accredited or nonaccredited person.<sup>194</sup>

The concept of accredited persons is also reflected in the disclosure requirements of Rule 242. If all purchasers of the issuer's securities are accredited persons, Rule 242 does not require affirmative disclosure of any specific information to such purchasers.<sup>195</sup> If even one nonaccredited person purchases a security, the issuer is required to furnish all purchasers the same kind of information specified in Part I of Form S-18.<sup>196</sup> Upon written request from the SEC, the issuer must file this information with the SEC.<sup>197</sup>

The financial statements required by Rule 242 are identical to those required under Form S-18.<sup>198</sup> However, unlike Form S-18, with the exception of the financial statements for the issuer's most recent fiscal year, there is no requirement under Rule 242 that financial statements furnished to the purchasers be certified by an independent or certified public accountant.<sup>199</sup>

Offerings pursuant to Rule 242 may not be accompanied by

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<sup>192</sup> 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(e)(2)(iv)).

<sup>193</sup> *Id.* at 6369 (Rule 242(e)(1)). Compare with notes 282-284 and accompanying text *infra*.

<sup>194</sup> 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(e)(1)).

<sup>195</sup> See *id.* at 6369 (Rule 242(f)(1)). However, the issuer must provide accredited persons with the opportunity to perform "due diligence"; that is, to ask questions and receive answers about the issuer, its business and the terms of the transaction. *Id.* at 6369 (Rule 242(f)(2)).

<sup>196</sup> *Id.* at 6369 (Rule 242(f)(1)(i)). Part I of Form S-18 is discussed at notes 222-232 and accompanying text *infra*. To the extent that the issuer is subject to the periodic reporting requirements of Sections 13 or 15(d) of the 1934 Act, the disclosure requirements of Rule 242 may be satisfied by definitive proxy statements, annual reports and other documents required to be filed under Section 13(a) or 15(d) of the 1934 Act. 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(f)(1)(iii)). See note 15 *supra*.

<sup>197</sup> See 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(h)(2)).

<sup>198</sup> See 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(f)(1)(i)). The major financial statements called for in Item 15 include a consolidated balance sheet and consolidated statements of income and funds. See 44 Fed. Reg. 21,562, 21,574 (Item 15)(1979).

<sup>199</sup> 45 Fed. Reg. 6362, 6369 (1980) (Rule 242(f)(1)(i)).

solicitation to the general public.<sup>200</sup> In addition, general advertisement in connection with an offering is prohibited.<sup>201</sup>

Within a short period after an initial sale is made, the issuer must notify the SEC that it is offering securities in reliance on the rule.<sup>202</sup> The SEC has prescribed Form 242 for the purpose of providing such notification.<sup>203</sup>

Securities issued pursuant to Rule 242 are restricted securities.<sup>204</sup> Consequently, Rule 144 resale restrictions are applicable.<sup>205</sup> To avoid the possibility of a secondary distribution, the issuer must also exercise reasonable care to assure that a purchaser is not buying strictly for the purpose of reselling.<sup>206</sup>

The most significant benefit of Rule 242 is the exemption from the registration process when dealing with purchasers who are accredited persons. The concept of accredited persons suggests a close relation between the new financing device and Private Financings.<sup>207</sup> In effect, Rule 242 permits an issuer to effectuate a Private Placement without the detailed disclosure requirements of the latter device.<sup>208</sup> Thus, the accredited persons concept can substantially reduce the time and expense involved in standard financings.<sup>209</sup>

A possible disadvantage of Rule 242 is its relatively low dollar ceiling. The maximum annual offering price under the Rule is currently set at \$4 million.<sup>210</sup> This amount may not be high

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<sup>200</sup> *Id.* at 6369 (Rule 242(d)).

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* at 6370 (Rule 242(h)) (To be codified in 17 C.F.R. § 239.242).

<sup>203</sup> *Id.*

<sup>204</sup> *Id.* at 6370 (Rule 242(g)). See note 44 *supra*.

<sup>205</sup> See notes 44-47 and accompanying text *supra*.

<sup>206</sup> 45 Fed. Reg. 6362, 6370 (1980) (Rule 242(g)). The issuer must make reasonable inquiry to assure that the purchaser has an investment intent (Rule 242(g)(1)); must inform the purchaser of the restrictions on reselling the securities (Rule 242(g)(2)); and must place a legend on the share certificates referring to the restrictions on transferability (Rule 242(g)(3)).

<sup>207</sup> Compare notes 188-190 and accompanying text *supra* with notes 249-253 and 265-275 and accompanying text *infra*. Although the concept of accredited persons suggests that Rule 242 could be viewed as a Private Financing device, other features of Rule 242, such as, the unlimited number of accredited persons and the concept of unaccredited persons, would seem to suggest a stronger relation to the Public Financing devices.

<sup>208</sup> See notes 276-281 and accompanying text *infra*.

<sup>209</sup> See notes 20 and 21 *supra*.

<sup>210</sup> The maximum aggregate offering price is currently set at \$2 million on a six-month basis. See notes 182-183 and accompanying text *supra*.

enough for an issuer to meet its capital needs in a given year.<sup>211</sup> The dollar ceiling seems unnecessary, at least with respect to accredited persons.<sup>212</sup>

Another drawback to Rule 242 is its restrictions on resale.<sup>213</sup> Many investors are reluctant to become locked into an investment for a two-year period and may therefore turn to a more liquid form of investment.<sup>214</sup>

A final limitation of the rule concerns its availability. Rule 242 may only be used by corporations.<sup>215</sup> Unincorporated associations face the same limitation with respect to Form S-18 financings.

### E. Form S-18

Form S-18<sup>216</sup> is intended to provide a simplified registration process for non-reporting corporate issuers<sup>217</sup> who desire to raise cash through securities offerings in interstate markets.<sup>218</sup> The aggregate annual offering price of securities sold under Form S-18 may not exceed \$5 million.<sup>219</sup> Although this amount is not affected by the aggregation or integration rules,<sup>220</sup> it is subject to

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<sup>211</sup> This is particularly true in an inflationary economic environment since a continuous increase in the cost of doing business will undoubtedly increase the financial needs of the business. See note 12 and accompanying text *supra*. But see note 116 and accompanying text *supra*.

<sup>212</sup> See note 181 *supra*. Notwithstanding government efforts in the opposite direction, "*Caveat emptor*—let the buyer beware—still prevails as a doctrine!" P. SAMUELSON, *ECONOMICS* 107 (1976).

<sup>213</sup> See notes 203-204 and accompanying text *supra*.

<sup>214</sup> See notes 292-296 and accompanying text *infra*.

<sup>215</sup> See note 180 and accompanying text *supra*.

<sup>216</sup> 44 Fed. Reg. 21,562 (1979).

<sup>217</sup> Form S-18 is not available to all corporations. The most important restriction as to its availability is that it may not be used by corporations subject to the continuous reporting requirements under Sections 12 or 15(d) of the 1934 Act, discussed at note 15 *supra*. See 44 Fed. Reg. 21,562, 21,568 (1979) (Gen. Instr. A(a)).

<sup>218</sup> 44 Fed. Reg. 21,562, 21,568 (1979) (Gen. Instr. A(a)). Issuers have the option of filing Form S-18 registration statements at the SEC main office in Washington, D.C. or in regional offices. *Id.* at 21,568 (Gen. Instr. B).

<sup>219</sup> 44 Fed. Reg. 21,562, 21,568 (1979). Notwithstanding the dollar ceiling, the balance between investor protection and capital formation is basically approached from a preventative perspective since the central feature of Form S-18 is its registration process. See notes 38 and 122 *supra*.

<sup>220</sup> See *id.* at 21,562-21,578. These rules are discussed at notes 84-86 and accompanying text *supra*.

other rules concerning secondary sales.<sup>221</sup>

The most distinctive feature about Form S-18 is its disclosure requirements. Form S-18 requires disclosure of essentially the same categories of information called for in Form S-1.<sup>222</sup> However, the detail and the manner of disclosure in the former is not as onerous as the disclosure called for in the latter. For example, unlike Form S-1, Form S-18 does not require financial statements<sup>223</sup> to be prepared in accordance with Regulation S-X,<sup>224</sup> the regulation governing financial statements under the 1933 Act.<sup>225</sup> Instead, Form S-18 financial statements may be prepared in accordance with the less restrictive requirements of GAAP.<sup>226</sup>

In addition, the requirements as to the content of the nonfinancial portion of the Form S-18 prospectus do not track *en toto* Regulation S-K,<sup>227</sup> the regulation which sets forth requirements applicable to the content of the narrative portion of 1933 Act disclosure documents.<sup>228</sup> Form S-18 does not require, *inter alia*, disclosures concerning industry segments,<sup>229</sup> lines of business,<sup>230</sup> capitalization if the offering would not result in a material change in the issuer's capital structure,<sup>231</sup> nor a detailed breakdown of sources and types of management remuneration.<sup>232</sup>

Securities purchased in a Form S-18 transaction are not "restricted securities."<sup>233</sup> Secondary non-exempted resales of S-18 securities may be made either in conjunction with an issuer's

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<sup>221</sup> See notes 234-236 and accompanying text *infra*.

<sup>222</sup> See note 20 *supra*.

<sup>223</sup> The major financial statements required to be filed under Form S-18 include a consolidated balance sheet and consolidated statements of income and funds statement. These financial statements must be audited, except for stub periods. See 44 Fed. Reg. 21,562, 21,574 (1979) (Item 15).

<sup>224</sup> *Id.*

<sup>225</sup> See note 20 *supra*.

<sup>226</sup> 44 Fed. Reg., 21,562, 21,574 (1979) (Item 15). In this regard, Form S-18 and Regulation A are identical. See note 159 and accompanying text *supra*.

<sup>227</sup> Compare 44 Fed. Reg., 21,562, 21,569 (1979) (Item 1)—21,574 (Item 14) with 17 C.F.R. § 229.20 (1979) (Items 1-6).

<sup>228</sup> See note 20 *supra*.

<sup>229</sup> Compare 44 Fed. Reg., 21,562, 21,570 (1979) (Item 6) with 17 C.F.R. § 229.20 (1979) (Item 1(b)(1)).

<sup>230</sup> Compare 44 Fed. Reg. 21,562, 21,570 (1979) (Item 6) with 17 C.F.R. § 229.20 (1979) (Item 1(b)(2)).

<sup>231</sup> 44 Fed. Reg. 21,562, 21,569 (1979) (Item 5).

<sup>232</sup> Compare 44 Fed. Reg. 21,562, 21,571 (1979) (Item 10) with 17 C.F.R. § 229.20 (1979) (Item 4).

<sup>233</sup> See note 44 *supra*.

Form S-18 offering or as a separate shareholder offering under Form S-18.<sup>234</sup> However, the annual aggregate amount of secondary offerings may not exceed \$1.5 million.<sup>235</sup> In addition, the amount of all issuer or secondary offerings actually sold in reliance on Form S-18 in the course of a single year are aggregated for the purpose of calculating the \$5 million ceiling.<sup>236</sup>

The chief benefit of Form S-18 is the less restrictive requirements for financial and narrative disclosure.<sup>237</sup> A simplified registration statement can eliminate or reduce some of the services provided by lawyers and accountants in the standard registration process<sup>238</sup> and, consequently, lessen the regulatory burden for small businesses.

The resale features of Form S-18 are also favorable to small businesses. Shareholders are provided with a means for registering their offerings<sup>239</sup> and do not have to comply with Rule 144 prior to resale.<sup>240</sup> Relative ease of transferability of an investment interest can be an important factor in attracting investors.<sup>241</sup>

On the other hand, to the extent that shareholders take advantage of the resale features of Form S-18, the issuer is limited in the amount of cash it can bring in through Form S-18 in a given year.<sup>242</sup> Hence, Form S-18 may not be useful as a primary financing device for some small issuers.<sup>243</sup>

Small businesses with large financial needs may find it more

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<sup>234</sup> See 44 Fed. Reg. 21,562, 21,568 (1979) (Gen. Instr. A(b)).

<sup>235</sup> *Id.*

<sup>236</sup> *Id.* at 21,568 (Gen. Instr. A(c)). For example, if on November 1 the aggregate price of issuer and shareholder offerings to date made in reliance on Form S-18 is \$4 million, the aggregate offering price available until December 31 for the issuer and all secondary offerings is \$1 million.

<sup>237</sup> See notes 222-232 and accompanying text *supra*.

<sup>238</sup> See note 27 and accompanying text *supra*.

<sup>239</sup> See note 234 and accompanying text *supra*. Form S-16 may also be available for secondary nonexempted offerings. See 17 C.F.R. § 239.27(5)(1979). Before resorting to registration, a shareholder should look for the availability of an exemptive device. See notes 39-43 and accompanying text *supra*.

<sup>240</sup> See note 233 and accompanying text *supra*.

<sup>241</sup> See notes 292-296 and accompanying text *infra*.

<sup>242</sup> See notes 235-236 and accompanying text *supra*.

<sup>243</sup> If shareholders take full advantage of the resale features of Form S-18, issuer capital formation could not exceed \$3.5 million in a given year. See note 236 and accompanying text *supra*. This amount is less than the annual dollar ceiling for Rule 242. See notes 181-182 and accompanying text *supra*.

advantageous to pursue a Private Financing rather than a Public Financing. The Private Placement is the principal Private Financing device for small business equity capital formation.

## II. PRIVATE PLACEMENT

Section 4(2) of the 1933 Act<sup>244</sup> exempts from the registration requirements of Section 5 of the Act<sup>245</sup> "non-public offerings," or "transactions by an issuer not involving any public offering."<sup>246</sup> This exemption is commonly referred to as the Private Placement exemption.<sup>247</sup>

It is often difficult for an issuer<sup>248</sup> and counsel to determine whether a proposed issue can qualify under the Private Placement exemption. The uncertainty arises from the inability of the courts and the SEC to set forth a satisfactory definition of a "non-public offering."<sup>249</sup>

In 1953, the Supreme Court attempted to resolve the question of what constitutes a "non-public offering." The Court held, in *Securities and Exchange Commission v. Ralston Purina Co.*,<sup>250</sup> that a numerical test is not determinative of the question. The standard for determining what constitutes a "non-public offering" is whether the offerees need the protection of the securities laws.<sup>251</sup> The Court stated two factors which should be considered in judging whether this standard was met in a given case: whether the offerees had access to the kind of information con-

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<sup>244</sup> See note 34 and accompanying text *supra*.

<sup>245</sup> See note 19 and accompanying text *supra*.

<sup>246</sup> 15 U.S.C. § 77d(2)(1976).

<sup>247</sup> This exemptive device is justified on grounds of the character of the investors. In other words, the balance between investor protection and capital formation is based upon the sophistication and wealth of the investor. See notes 250-253 and accompanying text *infra*.

<sup>248</sup> The exemption is available to unincorporated and incorporated forms of businesses. See 15 U.S.C. § 77b(4) (1976); 17 C.F.R. § 230.146(a)(2)(1979).

<sup>249</sup> Neither the 1933 Act nor its legislative history defines a "nonpublic offering". *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953).

<sup>250</sup> 346 U.S. 119 (1953). *Ralston Purina* made unregistered offerings of its treasury stock to what it deemed to be its "key employees": foremen, stock clerks, veterinarians, clerical assistants, stenographers and others. The SEC sought to enjoin the offerings as violative of Section 5 of the Act. The Supreme Court reversed the lower court's ruling that the offerings qualified as a non-public offering under what is now Section 4(2) of the Act.

<sup>251</sup> 346 U.S. at 125, 127.

tained in registration statements<sup>252</sup> and whether they were able to fend for themselves.<sup>253</sup>

However, lower court cases and SEC rulings subsequent to *Ralston Purina* have developed other factors that can be taken into account in judging whether *Ralston Purina's* need-for-protection test could be met in a given case.<sup>254</sup> The net effect of both judicial and SEC construction of the Private Placement exemption has been the general tightening of the definition of a "non-public offering" and uncertainty as to the availability of the exemption.<sup>255</sup>

In order to clear up the confusion surrounding the Private Placement exemption, the SEC in 1974 promulgated Rule 146.<sup>256</sup> The Rule is nonexclusive; it does not preempt the prior law concerning the requirements for qualification as a Private Placement.<sup>257</sup> However, given the relative uncertainties of the deci-

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<sup>252</sup> 346 U.S. at 125-6, 127.

<sup>253</sup> 346 U.S. at 125. For example, persons enjoying a special relationship with the issuer, such as, executive personnel, "because of their position have access to the same kind of information that . . . [Section 5 of the Act] would make available in the form of a registration statement." 346 U.S. at 125-6. These individuals would be able to fend for themselves. *See id.* *See also* Opinion of General Counsel, Sec. Rel. No. 33-285 (Jan. 24, 1935).

<sup>254</sup> For example, in *S.E.C. v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972), the court stated that the test was met only if the investors were able to acquire information available to an insider. For a while, it was believed that the test could be met by limiting the number of investors or offerees to a certain number, such as 25 individuals or, in the case of an investment club, no more than 100 club members. *See, e.g.*, *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 604 (5th Cir. 1975); *U.S. v. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir. 1967) *cert. denied* 389 U.S. 850 (1967), *reh. denied* 389 U.S. 998 (1967). SEC Rel. No. 33-4552 (Nov. 6, 1962). However the SEC has since stated that the number of investors or offerees is not controlling. *See, e.g.*, *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 604 (5th Cir. 1975) (*Citing Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959), *cert. denied* 361 U.S. 896 (1959)). *See generally* *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 687-91 (5th Cir. 1971) (material cited therein); *Victor & Bedrick, Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869 (1959).

<sup>255</sup> For example, under the standard announced in *S.E.C. v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972), it appeared that a limited distribution of securities to investors other than insiders, regardless of their ability to fend for themselves, could not qualify as a "nonpublic offering."

<sup>256</sup> 17 C.F.R. § 230.146 (1979).

<sup>257</sup> *Id.* at § 230.146 (Prel. Note 1). If an issuer cannot meet the numerical standard under Rule 146, qualification under judicial and SEC interpretations would be advisable since such interpretations do not contain a numerical stan-



sional and administrative law, lawyers who seek qualification are well advised to structure their private placements in accordance with the provisions of Rule 146.<sup>258</sup>

The Rule purports to provide objective criteria for determining whether a transaction qualifies as a Private Placement. All of Rule 146's criteria must be met if an offering of securities is to qualify as a Private Placement under that Rule.<sup>259</sup> These criteria may be summarized as follows:

#### A. Manner of the Offering<sup>260</sup>

General solicitation or advertisement in connection with an offering is prohibited.<sup>261</sup> This includes advertisements or communications with or through a newspaper, magazine, radio or television station.<sup>262</sup> However, as an exception to the foregoing criterion, the Rule does permit letters and other forms of written communication to individuals who qualify as offerees.<sup>263</sup> It also allows oral communications in the form of seminars or meetings as long as they only involve individuals who qualify as offerees.<sup>264</sup>

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standard. Compare note 254 *supra* with notes 282-284 and accompanying text *infra*. On the other hand, Rule 146 relaxes the insider standard contained in the case law. Compare note 254 *supra* with notes 265-273 and accompanying text *infra*. For further comparisons, see material cited in note 258 *infra*.

<sup>258</sup> See, e.g., Sargent, *supra* note 14, at 911. For further discussion of the Private Placement exemption outside of Rule 146, see, e.g., material cited in notes 253 and 254 *supra*; Sargent, *id.* at 911-13; *A Position Paper of the Federal Regulation of Securities Committee*, 31 BUS. LAW. 485 (ABA 1975); Orrick, *Non-Public Offerings of Corporate Securities—Limitations on the Exemption under the Federal Securities Act*, 21 U. PITT. L. REV. 1 (1959).

<sup>259</sup> See 17 C.F.R. § 230.146 (1979) (Prel. Note 3).

<sup>260</sup> *Id.* § 230.146(c)(Rule 146(c)).

<sup>261</sup> *Id.* at § 230.146(c).

<sup>262</sup> *Id.* at § 230.146(c)(1).

<sup>263</sup> *Id.* at § 230.146(c)(3). See discussion at notes 265-270 and accompanying text *infra* for definition of offeree.

<sup>264</sup> 17 C.F.R. at § 230.146(c)(2)(1979). However, where the invitee qualifies as an offeree only by virtue of being able to bear the economic risk of the transaction, he or she must be accompanied by a representative who is knowledgeable and has experience in financial and business matters, but is not materially affiliated with the issuer.

*B. Nature of Offerees*<sup>265</sup>

Prior to making any permissible offer to individuals, the offeror must reasonably believe that the offeree is either "sophisticated" or "rich," given the terms of the offering. The rule requires that there must be reasonable grounds on which to believe that (i) "The offeree has such financial and business knowledge and experience that he is capable of evaluating the merits and risks of the prospective investment,"<sup>266</sup> or (ii) the offeree is able to bear the economic risk of such investment.<sup>267</sup> This belief must be manifested just prior to the offer.<sup>268</sup>

At the time of sale of any securities issued in connection with the offering, the seller must make another determination in addition to but slightly different from the determination made at the time of the offer. The seller must have reasonable grounds to believe that the prospective buyer is sophisticated *and* rich<sup>269</sup> or, if not sophisticated but rich, represented by an offeree representative<sup>270</sup> who is sophisticated.<sup>271</sup>

Prior to sale, the seller must make "reasonable inquiry"<sup>272</sup> and on the basis of such inquiry form a reasonable belief as to the sophistication of the buyer, or offeree representative if necessary, and the wealth of the buyer.<sup>273</sup> Sophistication and wealth determinations are highly subjective; they depend on one's reading of the relevant data<sup>274</sup> within the context of the total circum-

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<sup>265</sup> *Id.* § 230.146(d) (Rule 146(d)).

<sup>266</sup> *Id.* at § 230.146(d)(1)(i).

<sup>267</sup> *Id.* at § 230.146(d)(1)(ii).

<sup>268</sup> *Id.* at § 230.146(d)(1).

<sup>269</sup> *Id.* at § 230.146(d)(2)(ii).

<sup>270</sup> See note 264 and accompanying text *supra* for discussion of offeree representative.

<sup>271</sup> 17 C.F.R. § 230.146(d)(ii)(1979).

<sup>272</sup> One technique employed by lawyers to establish "reasonable inquiry" is to draft a comprehensive questionnaire for distribution to offerees and offeree representatives. The questions may probe such matters as type of employment, salary, present net worth, types and amounts of investments made over the past five or so years (including any investments in private offerings) and objective of the prospective investment. This sort of probing need not be made at the time of offer. Compare 17 C.F.R. § 230.146(d)(1)(1979) with 17 C.F.R. § 230.146(d)(2)(1979). Presumably, the issuer at the time of offer can merely rely on the offeree's appearance, demeanor or general reputation in making the requisite determinations.

<sup>273</sup> *Id.* at § 230.146(d)(2).

<sup>274</sup> See note 272 *supra*.

stances surrounding the transactions. Although the asserted purpose of Rule 146 was to provide objective criteria for compliance with the Private Placement exemption, it is difficult to certify in advance whether a company can qualify under the exemption.<sup>275</sup>

### C. Availability of Information<sup>276</sup>

The offeree must have access to or be furnished with information of the type called for in Schedule A.<sup>277</sup> The access feature of the requirement is satisfied where the offeree maintains a special relationship with respect to the issuer.<sup>278</sup>

The other feature of the requirement, that the offeree be furnished with the requisite information, can be satisfied by delivering to the offeree any basic disclosure document of the Securities Acts plus a brief description of the securities being offered, the intended application of the proceeds and any undisclosed material changes in the business or financial condition of the company.<sup>279</sup> In addition, each offeree, *inter alia*, must be given an opportunity to perform due diligence<sup>280</sup> as well as be informed of any restrictions on the transferability of the securities issued.<sup>281</sup>

### D. Number of Purchasers<sup>282</sup>

Rule 146 limits the number of purchasers that can be involved in a Private Placement transaction. The issuer must reasonably believe, after reasonable inquiry, that there are no more than 35

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<sup>275</sup> For this reason, a business person should not expect his or her attorney to give an opinion letter (that is, written certification) as to the qualification of investors as offerees. The questionnaire discussed in note 273 *supra* may provide "cold" comfort to the issuer and its lawyers.

<sup>276</sup> 17 C.F.R. § 230.146(e)(1979) (Rule 146(e)).

<sup>277</sup> *Id.* at § 230.146(e)(1). Schedule A is basically Form S-1 with slightly less detailed disclosure. See note 20 *supra*.

<sup>278</sup> *E.g.*, a family or employment relationship, or the possession of equal bargaining power. 17 C.F.R. § 230.146(e)(Note)(1979). See note 253 *supra*.

<sup>279</sup> 17 C.F.R. § 230.146(e)(1)(ii)(1979). See note 253 *supra*.

<sup>280</sup> 17 C.F.R. § 230.146(e)(2)(1979). See note 195 *supra*.

<sup>281</sup> *Id.* at § 230.146(e)(3)(iii). The issuer may not sell any shares in the offering to an underwriter, as defined in Section 2(11) of the 1933 Act. Other restrictions on transferability are similar to Rule 242 transfer restrictions. See 17 C.F.R. § 230.146(h)(1979); note 205 *supra*.

<sup>282</sup> 17 C.F.R. § 230.146(g) (Rule 146(g)).

purchasers of the securities being offered.<sup>283</sup> Since, however, certain purchasers are not included in the computation,<sup>284</sup> the number of actual purchasers often exceeds 35.

*E. Private Placement Advantages and Disadvantages.*

One of the major benefits of Private Placement financings is the absence of a dollar ceiling. Neither the law outside of Rule 146<sup>285</sup> nor the rule itself<sup>286</sup> imposes a limit on the amount of capital formation available to an issuer in a single year.<sup>287</sup> Hence, small businesses may rely on a Private Placement financing as a primary vehicle for capital formation.

The Private Placement disclosure document<sup>288</sup> is not a filing document.<sup>289</sup> The absence of registration can eliminate or reduce many of the registration services provided by lawyers and other professionals<sup>290</sup> and, consequently, decrease the regulatory burden for small businesses.<sup>291</sup>

One potential problem inherent in Private Placement financings is the restrictions placed on resale of securities acquired in the transaction. Secondary offerings must be transacted in

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<sup>283</sup> *Id.* at § 230.146(g)(1).

<sup>284</sup> *E.g.*, certain controlled entities and persons who purchase securities in excess of an aggregate amount of \$150,000 and certain relatives of a purchaser. *See* 17 C.F.R. § 230.146(g)(2)(i)(1979). *See also* 17 C.F.R. § 230.146(g)(2)(ii)(1979).

<sup>285</sup> *See* material cited in notes 253, 254 and 258 *supra*.

<sup>286</sup> *See* 17 C.F.R. § 230.146 (1979). Depending on the wealth of the purchasers, the 35-purchaser limitation may constitute a structural limitation on the amount of cash that can be raised in a single transaction. *See* notes 282-284 and accompanying text *supra*.

<sup>287</sup> The aggregation rules are inapplicable to Private Placement offerings because of the absence of a dollar ceiling. *See* note 84 *supra*. The integration rules are applicable to Private Placement financings. *See* notes 85-86 and accompanying text *supra*. However, Rule 146 provides a safe harbor from integration. In substance, any offerings which take place either six months before or six months after a Private Placement offering will not be integrated with the latter. *See* 17 C.F.R. § 230.146(b)(1)(1979).

<sup>288</sup> *See* note 277 and accompanying text *supra*.

<sup>289</sup> *See* 17 C.F.R. § 230.146(e)(1979). Issuers must report each Private Placement financing to the SEC on Form 146. *Id.* at § 230.146(i).

<sup>290</sup> *See* notes 28 and 30 *supra*.

<sup>291</sup> In addition, the availability of Private Placement financings is not limited. Unincorporated and incorporated forms of business associations have access to the device. *See* note 248 *supra*.

compliance with Rule 144,<sup>292</sup> which purports to set objective requirements for determining qualification under Section 4(1).<sup>293</sup> The principal requirement is that the investor hold the restricted securities beneficially for a period of two years prior to resale.<sup>294</sup> Many investors do not wish to be locked into a deal for such a period of time because they cannot take advantage of better investment opportunities which might arise during the two-year holding period.<sup>295</sup> Hence, unless the investment appears solid and competitive with other investments over a two-year period, a company may have problems in attracting investors.<sup>296</sup>

An issuer may attempt to avoid any potential problems with Rule 144 by pursuing another financing device. However, prior to the selection of any financing device, it is important that the issuer clarify the underlying business and financial objectives of the offering.

### III. THE SELECTION OF ALTERNATIVE FINANCING DEVICES

A small business must consider a variety of business and financial factors in selecting a financing device. There is no set number of such factors to be checked off in connection with every financing decision. Each financing decision presents a unique set of business and financial factors. In addition, while certain factors may be important for a particular person or or-

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<sup>292</sup> 17 C.F.R. § 230.144 (1979). See also notes 44-47 and accompanying text *supra*.

<sup>293</sup> Section 4(1) is discussed at note 43 and accompanying text *supra*.

<sup>294</sup> 17 C.F.R. § 230.144(d)(1)(1979). Other requirements include the following: 1) public information about the issuer must be made available to the purchaser (*id.* at § 230.144(c)); 2) the amount of securities which may be sold by the shareholder from time to time after the expiration or the holding period is limited, and this number includes all restricted securities during a specified period of time (*id.* at § 230.144(e)); and 3) the shareholder must file a notice of proposed sale on Form 144 with the SEC and the stock exchange on which the shares are sold (*id.* at § 230.144(h)). See also Sec. Rel. No. 33-6032 (Mar. 5, 1979); Sec. Rel. No. 33-5995 (Nov. 8, 1978); Sec. Rel. No. 33-5979 (Sept. 18, 1978).

<sup>295</sup> There is nothing eleemosynary about the intention of the typical investor. The intention, quite simply, is to make a profit on the investment. One of the primary rules of successful investment is to cut one's total losses as quickly as possible. Any restrictions on holding onto one's investment can obviously have a chilling effect on this rule.

<sup>296</sup> See, e.g., Sargent, *supra* note 14, at 908.

ganization, these same factors may be relatively insignificant for another person or organization engaged in the same type of business.<sup>297</sup>

Among the initial factors which should be considered are the capital requirements of the business over a given period of time and the regulatory burden of each financing device. Other relevant factors include the application of the offering's net proceeds, business prestige, financial contacts, government regulation, owner control of the business and resale restrictions on the securities issued.

### A. Capital Requirements

Where an issuer is solely or primarily interested in raising as much equity capital as the market will bear, the choice will normally be between an Intrastate Offering<sup>298</sup> and Private Placement.<sup>299</sup> These financing devices are the only ones capable of facilitating unlimited equity capital formation in a single year.<sup>300</sup>

Financing devices with dollar ceilings<sup>301</sup> may still be useful individually or in combination with others.<sup>302</sup> In particular, these devices may be adequate to meet a minor financial need of a business in a given year.<sup>303</sup>

The suitability of a financing device may not be solely contingent upon the size of the offering. The regulatory burden engendered by the registration process will usually be an important consideration for small businesses.<sup>304</sup>

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<sup>297</sup> For example, developing a national image for the business may be an important factor for XYZ Company, but not for ABC Company, even though both companies are engaged in the same line of business. The weight given to any business or financial factor depends to a large extent, if not entirely, on the basic business and financial preferences of the owners.

<sup>298</sup> See notes 55-89 and accompanying text *supra*.

<sup>299</sup> See notes 244-296 and accompanying text *supra*.

<sup>300</sup> See notes 58 and 287 and accompanying text *supra*.

<sup>301</sup> Form S-18 permits an issuer to raise as much as \$5 million annually. Rule 242 allows \$4 million annually. Regulation A offerings may not exceed \$1.5 million or \$100,000 annually, depending on the structure of the offering. Rule 240 offerings are limited to \$100,000 annually. See notes 93, 126, 128, 183 and 219 and accompanying text *supra*. See also the appendix to this article.

<sup>302</sup> Successive offerings in a single year must be structured around the aggregation and integration rules. See notes 84-86 and accompanying text *supra*.

<sup>303</sup> See note 116 and accompanying text *supra*.

<sup>304</sup> See notes 12-14 and accompanying text *supra*.

### B. Regulatory Burden

The regulatory burden is least severe in Intrastate Offerings, Rule 240 transactions, Regulation A offerings not exceeding \$100,000 annually and Rule 242 issues to accredited purchasers. Neither a disclosure document<sup>305</sup> nor a filing document is required in connection with any of these transactions.<sup>306</sup> Hence, the complexity, length of time and cost of complying with the applicable SEC disclosure and registration requirements should not be significant.<sup>307</sup>

On the other hand, the regulatory burden impacts significantly upon Private Placements, Form S-18 offerings, Rule 242 offerings involving at least one nonaccredited person, and Regulation A offerings in excess of \$100,000 annually.<sup>308</sup> For the price range in which these four devices compete,<sup>309</sup> complexity, time consumption and, most important, the cost of capital as a percentage of the aggregate offering price<sup>310</sup> is greatest for those financings utilizing the more voluminous or involved disclosure documents. Usually Form S-18 financings<sup>311</sup> or Private Placements<sup>312</sup> fit into this category. Therefore, Regulation A and Rule 242 are more advantageous from the regulatory burden perspective.

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<sup>305</sup> Notwithstanding the fact that a disclosure document is not expressly required with respect to any of these financings, it is unlikely that an investor would be willing to proceed without some form of disclosure, especially covering the financial condition of the issuer. Sophisticated investors in particular are inclined to want detailed information before committing themselves. Hence, accredited purchasers may engender a degree of complexity and cost to Rule 242 financings not otherwise intended by the SEC.

<sup>306</sup> See notes 78, 98, 126 and 195 and accompanying text *supra*.

<sup>307</sup> But see note 305 *supra*.

<sup>308</sup> See notes 277, 222, 196 and 144 and accompanying text *supra*.

<sup>309</sup> All four devices compete where the aggregate offering price does not exceed \$1.5 million annually. Private Placements, Form S-18 and Rule 242 compete where the aggregate offering price does not exceed \$4 million annually; and Private Placements and Form S-18 compete where the aggregate offering price does not exceed \$5 million annually. See note 301 *supra*.

<sup>310</sup> See notes 28 and 176 and accompanying text *supra*.

<sup>311</sup> See note 222 and accompanying text *supra*.

<sup>312</sup> See note 277 and accompanying text *supra*. Of course, Private Placements become less expensive on a percentage basis as the size of an offering expands relative to cost.

### C. Application of Proceeds

The selection of a financing device based upon the intended use of the proceeds from the financing may not necessarily favor those devices on which the regulatory burden impacts the least. Rather, the nature of the expenditure to which the proceeds shall be applied is the appropriate criterion here.<sup>313</sup>

For example, where the proceeds of the financing will be applied to current capital expenditures,<sup>314</sup> the selection of a financing device may be predicated primarily on speed. The funds will be used to supplement slow cash flow or to help support seasonal adjustments in business activities. Any device which does not require the preparation and filing of a disclosure document is most able to facilitate a relatively speedy financing.<sup>315</sup>

On the other hand, for long-term capital expenditures<sup>316</sup> speed is probably less important than dollar ceiling. Hence, a Private Placement, on which the registration process impacts heavily, or an Intrastate Offering, which is affected very little by the registration process, would be a suitable selection since either device can facilitate unlimited capital formation.<sup>317</sup>

### D. Prestige and Financial Contacts

The issuer may wish to develop a national reputation and contacts within the major financial centers of the country. A national reputation can add to the market value of the business<sup>318</sup> and improve its operation if the company deals in consumer

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<sup>313</sup> Proceeds from a financing are used for any number of business purposes, including debt liquidation, market expansion and capital expenditures. See, e.g., Brooks, *Currency Translations in the Registration Statements of Foreign Issuers*, 35 BUS. LAW. 435, 436, n.7 (1980). If the nature of the expenditure is well anticipated, pre-planning may help to resolve time-lag problems. Unanticipated market changes, of course, can make pre-planning nugatory.

<sup>314</sup> A current capital expenditure involves the acquisition of a current asset; such as, inventory or securities as a form of business investment. A long-term capital expenditure is the purchase of a fixed or noncurrent asset, such as land-buildings or machinery. See, e.g., 17 C.F.R. § 210.3-11 (1979).

<sup>315</sup> See notes 304-306 and accompanying text *supra*.

<sup>316</sup> See note 314 *supra*.

<sup>317</sup> See notes 298-300 and accompanying text *supra*.

<sup>318</sup> A major category of intangible assets is goodwill. See 17 C.F.R. § 210.5-02(16)(1979). For a more detailed discussion of goodwill, see, e.g., H. FIFLIS & H. KRIPKE, ACCOUNTING FOR LAWYERS 186-195 (1971).



goods or with the public at large.<sup>319</sup> Prestige can also give the owners a psychological sense of financial success and attract, as well as retain, highly competitive personnel.<sup>320</sup>

Financial contacts with investment bankers, securities associations and blue chip law firms will make the business and its management known to important elements within the financial community. Such contacts can reduce the cost of future financings.<sup>321</sup>

Form S-18 presents the best opportunity for achieving the objectives of prestige and financial contacts. Its registration process can facilitate a national distribution of the issuer's securities and bring the business within contact of many important financial persons and institutions.

In contrast, the Intrastate Offering, with its emphasis on local financing, would do relatively little in terms of realizing the objectives of prestige and financial contacts on a national scale. This is especially true for a business located away from New York City, Chicago and other major financial centers of the country.<sup>322</sup>

#### *E. Government Regulation versus Owner Control*

One of the major disadvantages of equity financing for small incorporated businesses is the dilution of ownership and control occasioned by an increase in the number of equity shares.<sup>323</sup> A reduction in owner control of the business can also result from SEC regulation.<sup>324</sup>

The dilution problem is best handled other than by the selec-

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<sup>319</sup> Some consumers may prefer to do business with nationally-known companies, such as Sears or Macy's, rather than smaller, local businesses.

<sup>320</sup> The high failure rate among small businesses has been primarily attributed to unskilled management. See note 11 *supra*. Perhaps if the owners of a business established growth on a national basis as a top business objective, skilled managers would find the business challenging and rewarding.

<sup>321</sup> See note 175 and accompanying text *supra*.

<sup>322</sup> Of course, to the extent the business objectives of the owners do not contemplate prestige on a national scale, the Intrastate offering may be sufficient in terms of generating goodwill within a local context.

<sup>323</sup> On the problem of dilution, see, e.g., *Katzowitz v. Sidler*, 24 N.Y.2d 512, 301 N.Y.S.2d 470, 249 N.E.2d 359 (1969); *Hyman v. Velsicol Corp.*, 342 Ill. App. 489, 97 N.E.2d 122 (1951); *Stokes v. Continental Trust Co.*, 186 N.Y. 285, 78 N.E. 1090 (1906).

<sup>324</sup> See note 14 *supra*. Cf. Haynsworth, *supra* note 12, at 847-917.

tion of a particular financing device. The current shareholders can be given preemptive rights<sup>325</sup> or the charter can be amended to designate classes of stock.<sup>326</sup>

Basically, any financing device which does not require the filing of a disclosure document<sup>327</sup> helps to resolve the SEC regulation problem. The only way in which a small issuer can become involuntarily committed to SEC continuous regulation is by filing a registration statement under the 1933 Act.<sup>328</sup>

### F. Resale Restrictions

Restrictions on the transferability of an interest in a business can militate against equity capital formation.<sup>329</sup> All sales as well as all resales of securities are subject to registration unless exempted.<sup>330</sup>

Restricted securities<sup>331</sup> potentially offer the most serious problems concerning resales because of the strict requirements of Rule 144.<sup>332</sup> Therefore, an issuer may wish to avoid transactions involving such securities if possible.

Form S-18 resale features, though beneficial to shareholders, may be troublesome to some issuers. To the extent that selling shareholders take advantage of Form S-18 registration, the size of the issuer offering is *pro tanto* reduced.<sup>333</sup> Thus, the small businessperson, who is frequently both an owner and manager of the operation, must consider this feature of Form S-18 from both perspectives.

### CONCLUSION

Capital formation is a major problem facing small businesses today. The inability to raise equity capital is to a large extent a function of the regulatory burden imposed by the 1933 Act. To

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<sup>325</sup> See, e.g., MODEL BUSINESS CORPORATIONS ACT §§ 26, 26A. See also cases cited in note 323 *supra*.

<sup>326</sup> See, e.g., MODEL BUSINESS CORPORATIONS ACT. § 16.

<sup>327</sup> Only Form S-18 has filing requirements.

<sup>328</sup> See note 15 *supra*.

<sup>329</sup> See note 296 and accompanying text *supra*.

<sup>330</sup> See notes 39-40 and accompanying text *supra*.

<sup>331</sup> Securities issued in a Rule 240, Rule 242 or Private Placement transaction are restricted securities. See note 44 and accompanying text *supra*.

<sup>332</sup> See notes 292-296 and accompanying text *supra*.

<sup>333</sup> See notes 239-243 and accompanying text *supra*.

alleviate part of this burden, the SEC has enacted several exemptive financing devices.

There are two basic types of exemptive devices available to small businesses: Public and Private Financing devices. The Public Financing devices offer small businesses a wide array of financing techniques. The Private Placement exemption also has wide usage for small business capital formation.

Whether Public or Private, the selection of an appropriate financing device depends upon various factors. An evaluation of these factors requires the combined intellectual effort of many professionals, securities and financial experts in particular. No small businessperson should attempt to make the decision in isolation.

However, each small businessperson must seek to articulate the basic business and financial objectives of the enterprise, as only he or she can. The devices are but a means of implementing the business and financial values of the owners; hence, the suitability of a device ultimately depends on a matrix of those very values.<sup>334</sup>

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<sup>334</sup> See note 297 and accompanying text *supra*.

## Appendix

SUMMARY OF CERTAIN FEATURES OF  
PUBLIC AND PRIVATE FINANCING DEVICES

Interstate Offering	Rule 240	Reg. A	Rule 242	Form S-18	Private Placement
Availability	Closely-held Corporations	AFB(1)	Corporations	Corporations	AFB(1)
Annual Dollar Ceiling	\$100,000	\$1.5 million/\$100,000	\$4 million	\$5 million	Unlimited
Aggregation Rules	Not Applicable	Applicable	Applicable	Not Applicable	Not Applicable
Integration Rules	Safe Harbor	Applicable	Safe Harbor	Not Applicable	Safe Harbor
Narrative Disclosures	None	Less than Full-Scale (2) (3)	Less than Full-Scale (3)	Less than Full-Scale (3)	Equivalent to Full-Scale (3)
Financial Disclosures	None	Less than Full-Scale (2) (4) (5)	Less than Full-Scale (4) (6)	Less than Full-Scale (4) (7)	Equivalent to Full-Scale (4) (7)
Purchaser Restrictions	Intrastate Residency	100 or less Beneficial Owners	Unlimited Accredited; 35 or less unaccredited	None	Sophisticated and Wealthy
Rule 144	Not Applicable	Applicable	Applicable	Not Applicable	Applicable

(1) AFB = All Forms of Business.

(2) There are no specific purchaser disclosure requirements for \$100,000 offerings.

(3) Full-Scale narrative requirements are set forth in Form S-1 and Regulation S-K.

(4) Full-Scale financial requirements are set forth in Form S-1 and Regulation S-X.

(5) Unconsolidated and unaudited financial statements permitted.

(6) Consolidated and primarily unaudited financial statements permitted.

(7) Consolidated and audited financial statements required.