The One-Two Combination: Will Federal and State Securities Regulation Knock Out Small Business

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NOTES AND COMMENTS

THE ONE-TWO COMBINATION: WILL FEDERAL AND STATE SECURITIES REGULATION KNOCK OUT SMALL BUSINESS?

I. INTRODUCTION

In December, 1977, the Securities and Exchange Commission (SEC) announced hearings for the purpose of examining the effects of federal regulations on the ability of small businesses to raise capital and the impact of disclosure requirements under the Securities Acts.\(^1\) These hearings are appropriate in view of the fact that recent studies and investigations have concluded that small businesses are having great difficulty in raising capital.\(^2\) There appears to be little doubt that the SEC, in its zeal to protect the investing public, has been a significant contributor to this situation.

Ordinarily, any corporation desiring to sell its securities to the public must first file a registration statement with the SEC. The registration process is very costly, however, and small businesses typically seek capital under one of the several exemptions from registration. In addition, each state's blue sky laws regulate securities transactions within its boundaries independently of the SEC.

The purpose of this article is to examine the effects on small business of federal and state regulation with respect to the registration exemptions provided by federal and state securities laws. In balancing

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the need to protect the investor and the legitimate needs of small businesses to acquire growth capital, it appears that the scale has tipped too far against small businesses. If such regulation continues to restrict the growth of the small business sector, the repercussions may greatly hamper the vitality of the general economy. The ability of the SEC to respond to the present plight of the small business community is limited by past judicial interpretations of the relevant exemptions. Thus it is appropriate to examine the Commission’s past actions and subsequent judicial reaction. The following summary of the current state of small business will help to focus on the problem.

II. SMALL BUSINESS IN THE MONEY AND CAPITAL MARKETS

A. Small Business in the American Economy

Small businesses in the United States employ more than fifty percent of the private economic sector and account for forty-three percent of the gross national product. More than thirteen million enterprises comprise this sector of the economy. They constitute more than ninety-five percent of American businesses and foster a substantial percentage of the nation’s inventions and innovations. To say that a strong small business sector is vital to the American economy is an understatement, but the comparative economic disadvantages under which this sector operates severely limit its vitality.

Small businesses are finding it increasingly difficult to acquire venture capital needed for growth, operation and stability. Individually,
each lacks the resources to fight inequitable tax structures, to comply with government over-regulation, and to deal with nationally organized labor unions. While these constraints must be faced by businesses of all sizes, their effect on small business has had a proportionately greater impact. In addition, small firms are more sensitive to changes in the business cycle. They often have less diverse product lines and are not able to take advantage of economies of large scale production, marketing and financing. Thus they are more vulnerable to downturns in economic activity. Even successful small businesses often have difficulty demonstrating profits large enough to attract venture capital in sufficient amounts.

B. Problems Encountered in Raising Capital

Small corporations prefer to acquire venture capital, with variations, in two basic ways: through long-term loans and through the sale of equity securities. They cannot obtain long-term financing to the same extent as large corporations and thus have a greater proportion of their debt in short-term loans. This poses significant problems for small firms because it makes planning for future operations and earnings very uncertain during periods of inflation and rising interest rates. It must be emphasized that small businesses are competing for relatively scarce loan funds with local government, consumers, borrowers with real estate as collateral, and larger businesses.

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9. Id. at 19.

10. Long-term loan is a relative term which refers to the time required for the particular capital improvement or business as a whole financed by the loan to become profitable enough to pay off the principal and interest due. Usually these are secured loans. See Money and Capital Markets, supra note 7, at 51, 58.

11. Equity securities refers to all shares purchased in the firm, usually common or preferred stock.

12. Small businesses are highly leveraged, having debt equity ratios higher than the usually acceptable standards for sound financial practice. The fact that a substantial part of the debt factor is short-term indicates that much of the current earnings of the firm must go to satisfy debt obligations, usually at higher interest rates. [1976] SBA ANN. REP. 1, at 12-13.


14. Investors in the open equity markets and venture lending markets often operate with substantially different time horizons than those that fit the natural rhythm of small business development. Institutional investors and other large individual investors operate with objectives that are typically measured in terms of months, usually corresponding with long-term capital gains treatment time periods, and two years at the most. Investment performance has become a professional obsession. A small business, however, needs more than a few years in which to demon-
The acquisition of capital from the sale of stock is highly desirable because the proceeds do not have to be returned to the investor, as loan funds eventually must be. Also, dividends are discretionary, unlike interest payments, and usually depend on sufficient profits. If the small business concerned is profitable and displays good management and growth potential, the securities offering appears to be the best method of acquiring capital.

While some evidence suggests that small business investment produces average returns in accord with the risk faced, the strong possibility of a total loss still exists. While the sale of common and preferred stock presents the least risk or obligation to the small corporation, these securities present the greatest risk for investors if the business goes into bankruptcy. Inflation increases the risk to investors because it increases the nominal cost of capital, which makes budgeting and forecasting much more difficult for the business.

While small expanding firms must expect to encounter higher costs for capital in financial markets, additional legal risks are potentially greater obstacles to venture financing. The risk of liability for failure to comply with securities regulation can be substantial.

C. Problems of Registration

The small corporation may offer stock securities to investors either publicly by registering the offering with the SEC, or privately under
exemptions from registration specified in the Securities Act of 1933. Registration requires, among other things, disclosure of a summary of the issuer's operations for the preceding five years, a description of the internal organization, detailed descriptions of the business and its property, personal data concerning the directors and executive officers, relevant information about securities outstanding, and audited financial statements. The expense of preparation and filing of a registration statement is large for even the most solid of small companies and prohibitive for most. When the underwriting expenses are added to the cost of registration, a significant percentage of capital derived from a small offering may be lost to the issuer. In addition, printing costs and reporting expenses incurred in preparing the quarterly and annual reports require the small business to assume future financial burdens for "going public."

In addition to formidable expenses assumed during the registration process, the small corporation assumes potential liabilities under broad federal securities laws. Civil liability for the full amount of the

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) Necessity of prospectus meeting requirements of section 77j of this title

It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

c) Necessity of filing registration statement

It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.


22. The minimum expense for an S-1 registration is approximately $100,000, which includes finder's fees, legal fees, accountant's fees for a certified statement, printing expenses, annual reports, and blue sky registration. Underwriting discount for most small offerings further depletes the issuer's proceeds. The total cost of an issue of $1,000,000 is at least $200,000. This cost ignores the time factors involved in preparing a public offering which can run from two to six months. Alberg & Lybecker, New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities, 74 Colum. L. Rev. 622, 622 n.2. (1974) [hereinafter cited as Alberg & Lybecker].

offering can arise from disclosure violations in the registration statement, prospectus or proxy materials. 24 Although punitive damages are not provided for, an antifraud provision allows damages to be awarded in addition to the amount of the offering. 25

D. Exemptions from Registration

The Securities Act of 1933 contains two major exemptions 26 under which small issuers may offer their securities to investors without registration with the SEC: the intrastate offering 27 and the nonpublic offering. 28 While no registration statement must be filed under these exemptions, strict regulations dictate the manner in which a small business may make such offerings without running afoul of the securities laws. 29 Although federal antifraud provisions do not apply to intrastate offerings, the criminal and civil liabilities under the Securities Act still remain effective against issuers who erroneously claim exemptions. 30 This potential liability, coupled with the difficulty and expense of compliance with the complex regulations, substantially limits the number of small companies that can make use of the exemptions. The small business issuer must also comply with relevant state securities laws which apply regardless of registration. 31

24. Section 11(e) of the Securities Act describes the civil liabilities arising from a false registration statement. The successful plaintiff may recover such damages that represent the difference between amount paid for the security and (1) value at time of suit, (2) highest market price before suit, (3) the price of the security sold after the suit but before judgment. 15 U.S.C. § 77k(e) (1976).


26. Several minor (restricted capital amount) exemptions are available. See, e.g., 17 C.F.R. § 230.240 (1977) (offering amount limited to $100,000); 17 C.F.R. § 230.251-.263 (1977) (limited capital amount of $500,000).

27. "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." 15 U.S.C. § 77c(a)(11) (1976). (This exempts the securities from the application of the entire Securities Act.)


30. See generally Carney, The Perils of Rule 146, 8 U. TOLEDO L. REV. 343 (1977). While compliance with the regulations under the intrastate exemption is somewhat easier than compliance under the nonpublic offering regulations, substantial precautionary measures must be taken in either case.

31. Section 18 provides: "Nothing in this subchapter [title] shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person." 15 U.S.C. § 77r (1976).
ities Act\textsuperscript{32} adopted in whole or in part in thirty-five jurisdictions,\textsuperscript{33} contains a limited offering exemption,\textsuperscript{34} the provisions of which must be met along with federal requirements. Under the Uniform Securities Act, civil liabilities extend beyond federal penalties and provide for damages with interest.\textsuperscript{35}

III. ISSUER OF SECURITIES IS SUBJECT TO MULTIPLE JURISDICTIONS

A. Concurrent and Independent Regulation

Section 18 of the Securities Act of 1933 states expressly that the Act does not preempt the jurisdiction of the securities authority of any state.\textsuperscript{36} This is normally of little consequence to those issuers who file registration statements with the SEC, as most jurisdictions have "coordination" statutes which require only that a streamlined version of the statement be filed with the state authority.\textsuperscript{37} However, where an issuer intends to make an offering under one of the federal exemptions, the coordination of state regulation is distinctly lacking. In some states an issue offered under a federal exemption is required to be registered with the state securities authorities. Thus it may not be worth the ef-

\textsuperscript{32} See generally L. Loss & E. Cowett, Blue Sky Law (1958) [hereinafter cited as L. Loss & E. Cowett].


\textsuperscript{34} Uniform Securities Act 402(b)(9). See also L. Loss & E. Cowett, supra note 32, at 368.

\textsuperscript{35} Uniform Securities Act 409 (criminal penalties: $5,000 or 3 years or both); id. at 410 (civil liabilities: consideration paid for the security with interest at six percent per year from the date of payment plus attorney's fees, or damages if purchaser no longer owns the securities).

\textsuperscript{36} 15 U.S.C. § 77r (1976). See note 31 supra. See also Uniform Securities Act 303(c) (registration by coordination).

fort to satisfy the requirement for the federal exemptions where the state may also require substantial registration.

B. **Differing Philosophies Behind Regulation**

1. **Disclosure**

The federal disclosure philosophy emphasizes registration over other forms of securities control. The registration policy presumes that the investing public cannot be defrauded if it is given enough relevant information concerning the issuer.\(^{38}\) Congress has never intended that the registration system serve as an approval or guaranty of the quality of the securities offered,\(^{39}\) which is for the individual investor to decide.\(^{40}\)

While the theoretical operation of disclosure is to allow individual investors to protect themselves, the actual operation is much more indirect.\(^{41}\) The large underwriters, usually privy to additional key information concerning the issuer, only agree to market the offering if they are certain of the issuer's relative soundness. The individual investor relies on the reputation and integrity of the underwriter or his broker to decide whether the securities offered are a good investment.\(^{42}\) Thus, disclosure forces issuing businesses to put their operations in the view of the public, but the substance of the display can be interpreted by only a few sophisticated analysts.

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38. This philosophy assumes *a priori* that all disclosed information is accurate and truthful and that the investing public has the business sophistication to analyze and interpret the data.


40. It was assumed that the market place would best allocate available investment funds as long as sufficient comparable information could be available to investors so they could choose the investment best suited to their needs. However, most investors want to know the expectations of the business in the future and data upon which the projections are based. See generally *Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

41. If an issuer is "going public," the determination of the soundness of a business is reflected in the price of the securities issued in relation to the amount of the underwriter's discount, the cost of the underwriting to the issuer. Normally, the greater the risk the underwriter must assume, the larger the discount. See generally N. WOLFSON, CONFLICTS OF INTEREST: INVESTMENT BANKING (1976).

42. In this connection, the most relevant information might be who is buying the securities and in what amounts. When institutional investors or wealthy individuals are buying large amounts of a particular stock, one can usually depend on their judgment, particularly when large sums of money are involved.
2. The Merit Philosophy

The state merit systems reflect a fundamental difference in regulatory philosophy. While both federal and state blue sky laws generally require a significant degree of disclosure for any registered or exempted offering, it is clear that state regulation goes beyond this to look at the merit of the securities offered. Although most states require registration in some form, the emphasis of most blue sky laws is on the prevention of fraud through substantial administrative controls. Under the Uniform Securities Act, administrators evaluate the offering of an issuer. These administrators have the power to deny, revoke or suspend the registration of an offering under the exemption if it is in the public interest to do so and if certain requirements are not met. Perhaps the most vexing problem an issuer faces is differences in the rules and procedures in each state relating to an offering combined with differing degrees of enforcement by regulatory authorities.

3. The Result of Overlap

Whether an issuer chooses to make a prospective offering under either of the federal exemptions, he must ultimately disclose similar information to that required in a registration statement. In fact the term exemption is, to an extent, a misnomer. While a formal registration statement for exempted offerings is never required under state or federal laws, the regulations promulgated under the exemptions result in substantial disclosure. Fortunately, the expense of assembling such information is relatively small at the state level, but it must be remembered that the information must be filed in each state where the security is to be offered or sold. In any case, the state securities laws,

43. The Uniform Securities Act embodies all three regulatory methods of disclosure, fraud prevention, and administrative control. This was done in an effort to appease states which prefer one type of regulation over another. L. Loss & E. COWERT, supra note 32, at 236.
44. UNIFORM SECURITIES ACT 306. See also id. at 402(e) (administrator can deny or revoke exemptions).
45. Ideally the issuer wants his offering to become effective in every jurisdiction in which he plans to offer it on the same date. While this is not absolutely essential, it is a necessary convenience to an orderly offering. To the degree any one state authority hinders an exempt offering, it is more difficult to have an effective date of issue.
46. Both a rule 146 private offering and an exempt offering under section 402(b)(9) of the Uniform Securities Act require substantial disclosure, although it is discretionary with most state authorities with respect to 402(b)(9). UNIFORM SECURITIES ACT 402(b)(9).
47. Rule 146 requires access to information similar to that required in a registration statement, but a certified financial statement is not required in that information. But many states still require a certified financial statement for exempt offerings. The certified financial statement is a very expensive part of registration. See Proposed SEC Rules, supra note 23, at 124 n.24.
48. UNIFORM SECURITIES ACT 301, 305, 306.
in addition to complex federal regulation, make the task of the small business in need of new capital doubly difficult.

IV. THE PRIVATE OFFERING EXEMPTION AND RULE 146

A. Background and Purpose

The legislative history of the Securities Act indicates that it was intended to cover "public offerings" as distinguished from "private offerings." Hence, it was contemplated that registration would not be required for securities sold by an issuer to a particular person in a face-to-face, arm's length transaction. It was left to the Commission to interpret the broad language of section 4(2) of the Act.

Originally, the SEC did not formulate specific rules for the public to follow, but it issued an opinion release which indicated general criteria under which the nonpublic offering exemption would be evaluated. The key factors were the number of offerees, their relationship to each other and to the issuer, the number of units offered, and the size and manner of the offering. What constituted a nonpublic offering was necessarily determined on a case by case basis. It seems clear that any issuer who made an offering under the private offering exemption would have done so with great uncertainty and risk because no definite limits were set.

B. Judicial Interpretation

1. Access

It was twenty years after the enactment of the Securities Act before the courts began to interpret the private offering exemption. In 1953 the Supreme Court held in SEC v. Ralston Purina Co. that the nonpublic offering exemption must be interpreted in light of the statutory

49. Landis, supra note 39, at 37.
50. The exemption was directed to transactions where there is no practical need for the Act's application or where the public benefits are too remote. H.R. Rep. No. 85, supra note 39, at 5, 7, 15-16.
53. 346 U.S. 119 (1953). Ralston Purina, a close corporation at this time, offered Ralston Purina stock to offerees which the company specified as "key" employees who had earned the privilege through merit and loyalty according to the company. The Court rejected a numerical test, stating: "[T]here is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation." Id. at 125.
purpose of protection of the offerees and purchasers.\textsuperscript{54} The Court established a test for the exemption which equated lack of need for investor protection with investor access to information similar to that which would be disclosed in a registration statement. The Court held that an offering to persons who, because of their high positions with the company, had the ability to "fend for themselves" was a nonpublic offering.\textsuperscript{55} This ability turned on the knowledge of the offerees, and the Court found the investors involved did not have access to similar information to that found in a proper disclosure.\textsuperscript{56} The Court focused on access to information with little regard to business sophistication except to the extent that high employees are impliedly knowledgeable. This reasoning begged the question of whether a person with access to relevant information had the business acumen to analyze it.\textsuperscript{57}

The Fourth Circuit in \textit{United States v. Custer Channel Wing Corp.}\textsuperscript{58} recognized the difference between business sophistication and access to relevant information. Accordingly, the court held that such expertise was not a substitute for the type of information disclosed in a registration statement.\textsuperscript{59} Here the court required proof of access to the information at the time of the purchase,\textsuperscript{60} seemingly eliminating any claim by the defendant that investors were sophisticated enough to fend for themselves.

Nevertheless, in \textit{Lively v. Hirschfeld}\textsuperscript{61} the Tenth Circuit held that, in addition to possessing exceptional business experience, the purchaser must also be in a position in relation to the issuer that he would have regular access to all information which would indicate the potential of

\textsuperscript{54} \textit{Id.} at 124-25 (in light of disclosure principles).
\textsuperscript{55} \textit{Id.} at 125.
\textsuperscript{56} \textit{Id.} at 127. The Court felt that the opportunities for pressure to purchase the stock made it advisable to require registration.
\textsuperscript{57} The Court suggested that employees on the executive level may have had proper access, but otherwise the Court seemed to imply that some special relationship between the issuer and the offeree had to exist before an offeree had proper access to information. \textit{Id.} at 125-26. \textit{See also}, Gilligan, Will & Co. v. SEC., 267 F.2d 461 (2d Cir. 1959). The court found the partnership to be an underwriter because they had acquired and distributed debentures and common stock which were not registered, thus making a "public offering."
\textsuperscript{58} 376 F.2d 675 (4th Cir. 1967). In this case, the issuer sold over one million shares of stock to three "associates" set up by the issuer, who later distributed the stock to 136 purchasers. This was done in violation of an injunctive order permanently prohibiting the issuer from selling unregistered securities.
\textsuperscript{59} \textit{Id.} at 678.
\textsuperscript{60} \textit{Id.} at 678-79.
\textsuperscript{61} 440 F.2d 631 (10th Cir. 1971). An airline pilot with considerable business experience rescinded a purchase of 8,000 shares held to be publicly offered by the defendant, the controlling shareholder. Certain minimal information was provided and no further information was requested by the purchaser. Business sophistication of all the offerees in addition to the plaintiff was required, as well as regular access to information.
the corporation. It was clear at this point that investor sophistication was a required element of the private offering exemption. However, the element of the access relationship between the issuer and purchaser gave rise to great uncertainty for the potential issuer.

The decision of the Fifth Circuit in *Hill York Corp. v. American International Franchises, Inc.* recognized that even sophisticated investors could not apply their knowledge without the proper information. The court determined that, in order to satisfy the “access relationship,” the purchasers must be in a privileged relationship to the issuer, permitting them to acquire relevant information easily. While this test was more restrictive than the *Lively* requirement, there were still no clear guidelines which would allow an issuer to operate safely.

The same court that decided *Hill York* also made the final restrictive interpretation of the nonpublic offering exemption prior to the establishment of rule 146. The Fifth Circuit, in *SEC v. Continental Tobacco Co.*, held that the disclosure of the information required in a registration statement alone would not insure the exemption. Relying on its *Hill York* decision, the court concluded that only a “privileged relationship” with the issuer could guarantee that the offeree needed no protection from the Act. “Privileged relationship” as construed by the court required that the issuer prove that all offerees had received certain written and oral information, had access to any additional information requested, and had personal contacts with the officers of the issuer. In addition the court embraced the *Lively* standard that, as to every offeree, it must be shown that there was not any practical need for registration and that the offerees were well able to fend for themselves.

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62. *Id.* at 632.
63. 448 F.2d 680 (5th Cir. 1971). In this case, the defendant sold stock in a franchise in a pyramid scheme to thirteen sophisticated investors without providing adequate information. In addition, what information was supplied was misleading. See Weinburg & McManus, *The Private Placement Exemption Under the Securities and Exchange Act of 1933 [sic] Revisited, and Rule 146*, 27 Baylor L. Rev. 201, 221 (1975).
64. 448 F.2d at 688 n.6. “[W]here the number of offerees is so limited that they may constitute a class of persons having such a privileged relationship with the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection, then the exemption is available.” *Id.*
65. 463 F.2d 137 (5th Cir. 1972). Debentures were sold with warrants to purchase common stock in Continental without registration. The only information presented was a series of filmstrips involving the unique character of Continental cigarettes. After the shares were purchased, a prospectus was available but unread by the purchasers.
66. *Id.* at 160.
67. *Id.*
68. *Id.*
The result of this decision was virtually to destroy any reasonable grounds for reliance on the private offering exemption. Only those issuers who were willing to assume significant risks of liability could place their faith in such an uncertain exemption. Not only did the issuer have to supply to the offeree the same information which was required in a registration statement, but the issuer had the burden of establishing the business sophistication or special position of each offeree. This meant that a purchaser who was not satisfied with his investment could sue for rescission if he could establish that the issuer failed to satisfy each of the requirements with respect to each offeree. This burden was far greater than that required of corporations which filed registration statements since normal registrants had no obligation to discern the business expertise of investors.

The dual obligation of the private offering issuer appeared to be in conflict with the purpose of the exemption. If the purpose of the private offering exemption was to allow transactions of securities on a small scale without registration because of the business expertise of the investors, the requirement of disclosure to such an investor contravened that purpose. The exemption's underlying policy assumed that the experienced private investor would require specific information of the issuer before he invested. If the required information was not disclosed, the investor would not invest. The sophisticated investor would not need the protection of registration because he could fend for himself.

Nevertheless, the courts required the issuer to establish that each offeree was a sophisticated investor and had access to additional information based on a privileged relationship with the issuer. This was required in addition to full disclosure.

2. Distribution Restrictions

In addition to the information disclosure, access, and business sophistication requirements, the basic rule that the securities must have been purchased without a view towards distribution further hampered

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70. See, e.g., Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972).
71. Landis, supra note 39, at 37.
72. "Fend for themselves" has been construed by the SEC to mean sufficient economic bargaining power to enable the offeree to obtain information from the issuer in order to evaluate the merits and risks of the investment as distinguished from situations where such position does not exist and the issuer voluntarily offers to provide such information. See 17 C.F.R. § 230.146 (1977).
73. H.R. REP. NO. 85, supra note 39, at 5.
an issuer's use of the exemption. If an offeree purchased the exempted securities intending to sell them, he became an underwriter under the Act. The issue then became a public offering in violation of registration requirements. The offerees must have acquired the securities as ultimate purchasers with the intention of keeping them as investments.

The sale of the securities to a third party by one purchaser destroyed the exemption for the issuer and for all other purchasers. This was because the securities had failed to come to rest in the hands of the initially informed group. The Commission viewed investment letters as self-serving and thus not conclusive of a purchaser's actual intent. In fact the issuer was required to ascertain whether the offeree intended to offer and sell the securities to others. Once again, the burden placed on the issuer to determine the intent of his purchasers was onerous. Reasonable efforts to prevent distribution by the purchasers such as investment letters, appropriate stock legends and "stop-transfer orders" may not have been sufficient to meet the standards required by the Commission.

These restrictive and uncertain criteria obviously posed a substantial problem to any small business which required the use of the exemption to raise capital. In response to this, the SEC established rule 146 to provide objective standards which could be relied upon by responsible businessmen when raising capital under the private offering exemption. The SEC also wished to deter the use of the exemption for offerings of securities to those in need of the protection of full disclosure.

74. 15 U.S.C. § 77b(3) (1976). (Section 2(3) defines sell or sale.)
77. These are letters from the purchasers stating that they were buying the securities as an investment and that they would not transfer them.
79. Such legends usually stated that the stock was not registered under the Securities Act and could not be sold except pursuant to effective registration or unless the issuer was provided with a written opinion of counsel satisfactory to the issuer that registration was not required.
80. "Stop transfer orders" means that the corporation will stop the transfer of stock on its books, hence the stock cannot be voted by the purchaser nor can he receive dividends.
C. Analysis of Rule 146

Rule 146 is essentially a codification of judicial interpretation of the private offering exemption with specific standards established to determine business sophistication, access, and limitations on disposition. To obtain the protection of the rule, the issuer sustains the burden of proving that it has satisfied all the rule's conditions with respect to each offeree. Moreover, rule 146 exempts an issuer from registration but not from the antifraud provisions or the civil liability provisions of the Act.

1. Limitations on Manner of Offering

Neither the issuer nor its agent may offer or sell securities by any form of general solicitation published or broadcast over any of the news media. Generally, the rule prohibits the use of any distributable written material or the holding of a meeting of potential investors unless it is to satisfy another requirement of the rule. Naturally this provision is intended to force the issuer to operate on a personal basis with each of its offerees. Written communications with the offerees prior to an offering cannot be utilized by the issuer unless it is to establish the sophistication of the offeree.

2. Nature of Offerees

The issuer is obligated under the rule to make a reasonable attempt to ascertain the business sophistication of the offeree or of the offeree representative. Basically stated, the offeree or his representative must have sufficient financial and business experience and knowledge to evaluate the risk of the prospective investment. While it does not appear to be mandatory to inquire whether the offeree can bear the economic loss of the investment, it would be an effective safeguard for all issuers, particularly when an offeree representative is involved.

83. Id.
85. Agent does not mean underwriter, attorney, promoter or broker-dealer; it means a person working for him, for his company, or with him on the offering.
86. 17 C.F.R. § 230.146(c) (1977).
87. Id.
88. Id. at § 230.146(a)(1) (offeree representative defined).
89. Id. at § 230.146(d)(1), (2).
90. Id. at § 230.146(d)(2)(ii). If an offeree representative is involved, both sophistication requirements and ability to bear the economic loss must be met. See also id. at § 230.146(g)(2)(d) (any person investing $150,000 or more need not be counted as an offeree in the thirty-five purchaser limit).
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An offeree representative, either alone or together with the offeree, must possess the same sophistication required of the offeree above. However, many other limitations are put on the representative's qualifications. He can neither be connected with the issuer in any employment relationship nor be a beneficial owner of ten percent or more of the issuer's securities. This provision should benefit the small issuer in obtaining the exemption as he may sell securities through a qualified third party whose presence permits access to the capital of investors who are not themselves sufficiently sophisticated.

However, when an offeree representative is present, there must be detailed disclosure of all material relationships between the issuer and the representative and of any compensation resulting from the relationship. Following this, the offeree must acknowledge his representative in writing with specific reference to the prospective investment. These requirements must be met for each offeree and could add considerable expense and paperwork to that already demanded by the rule.

3. Access to or Furnishing of Information

The rule requires that the offeree have significant information available in one of two ways. One alternative is for each offeree to have access during the transaction process to the same kind of information that registration would disclose. This option is highly restrictive due to the requisite special relationship of the offeree to the issuer. Unless the offeree is an employee in a high position with the issuer or is related to the directors of the issuer in some other close fashion, the issuer may not wish to risk a later finding that the offeree was not adequately informed. Also, it is unclear whether the access requirement can be met in relation to offeree representatives.

91. 17 C.F.R. § 230.146(a)(1)(i)(a) (1977) (unless the offeree is closely related to the offeree representative by blood, marriage, or adoption).
92. Id. at § 230.146(a)(4): "The term 'material' when used to modify 'relationship' means any relationship that a reasonable investor might consider important in the making of the decision whether to acknowledge a person as his offeree representative."
93. Id. at § 230.146(a)(1)(iv), 146(e)(3). Both offeree representatives and issuers must make written disclosure of any material relationship prior to this present transaction.
94. Id. at § 230.146(a)(1)(iii), n.2.
95. Id. at § 230.146(e) Note: "Access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate the merits and risks of the prospective investment."
96. Id. at § 230.146(e)(1)(i).
The second alternative allows the issuer to furnish the offerees or their representatives full disclosure materials in a private offering memorandum. This method provides for greater certainty for the issuer that the disclosure will be adequate. The information which is required is less costly to assemble than that for a registration statement as audited financial statements are not required. Unaudited financial statements are normally prepared for tax purposes, thus there is a considerable cost savings to the issuer. Still, the issuer must bear considerable other expense, primarily attorney's fees, in preparing the private offering memorandum.

The private offering memorandum offers an advantage over registration statements in that the issuer can make projections of performance supported by information on planning and budgeting. This information is vital to the venture capitalist, allowing him to evaluate company management and the merits of the investment. Thus the use of the memorandum can enhance sales possibilities. However, the issuer must use extreme caution in preparation of the memorandum due to penalties which attach to inaccuracies.

Rule 146 also requires the issuer to provide the opportunity for the offerees and their representatives to ask questions regarding the conditions of the offering and to verify the information disclosed. It is at this point that the sophisticated buyer will likely request a detailed explanation of the firm's expectations. While this method of supplying information may create an opportunity to enhance sales, such a

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97. Id. at § 230.146(e)(1)(ii). This information need only be supplied to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense. It is likely, however, that the courts will construe reasonable effort or expense very expansively in view of their past decisions. See, e.g., Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975).


99. See Casey, SEC Rules 144 and 146 Revisited, 43 BROOKLYN L. REV. 571, 576 (1977) [hereinafter cited as Casey] (Casey is former Chairman of the SEC).

100. Id.

101. It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


102. 17 C.F.R. § 230.146(e)(2) (1977). The provision requires that the information requested by the offeree at this meeting need be provided only to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense. Id.

meeting will more probably interest the experienced investor solely as an information gathering device.104

4. Limitations on Disposition

Perhaps the most subtly distasteful requirement of the rule of disclosure is that the purchaser must bear the risk of loss of the investment for an indefinite period of time.105 The securities exempted as a private offering must be held indefinitely or until they are subsequently registered.106 In addition, rule 144 promulgated since the adoption of rule 146, requires that the beneficial owner must have held the securities for two years before resale.107 Also, rule 144 limits the amount of securities a small business investor may sell in a six-month period to one percent of the shares outstanding.108 These severe restrictions on the subsequent resale of unregistered securities increase the cost of capital because of the inability to turn the investment into cash.109

Along with disclosing that the offeree must hold the securities indefinitely, the issuer must also disclose that a legend will be placed on the stock certificate stating that the securities have not been registered and indicating any other restrictions on their transferability.110 The issuer must obtain a signed agreement from the purchaser that he will not sell the securities until they have been registered or they are exempted therefrom.111

104. The venture capitalist is far more concerned with management evaluation and projected future earnings and performance than the "historical" material supplied in disclosure information.


106. Id.


108. Id. at § 230.144(e)(2). See also id. at § 230.144(h) (Seller of restricted unregistered securities must place the securities with a broker to sell them. He must concurrently file a notice of proposed sale with the SEC unless the seller sells less than 500 shares and a dollar amount of $10,000 or less in a given six-month period.)

109. Through a series of steps intended to protect investors, the channels of venture capital and small business equity financing have inadvertently been shaped so that more and more responsible and experienced venture capitalists have come to confine their investments—capital that used to be available as seed money—to companies with established earnings. Thus, in a favorable market, the expensive registration and sale of high-risk securities to a large number of smaller investors at higher prices seems likely to become the easiest, if not the only way to acquire venture capital. At the same time, small local businesses with only a few investors—firms that were never intended and should not be required to register—find themselves in a position where failure to register exposes them to welching whenever a deal doesn't [sic] pan out.

Casey, supra note 99, at 575 (footnotes omitted).

110. 17 C.F.R. § 230.146(h) (1977). (The issuer must make a reasonable effort to make certain that the purchasers are not underwriters under § 2(11) of the Act by inquiring whether the purchaser is acquiring the securities for his own benefit.)

111. Id. This agreement gives the issuer a right to sue for breach of contract if the purchaser
5. Necessary Conditions

If the issuer does not make any other offerings within six months before or after the exempted offering,\(^{112}\) he can avoid harsh integration standards.\(^{113}\) The traditional integration standards might cause the present offering to become part of a larger offering. This would cause the issuer to lose the exemption if as a result a public distribution has taken place.\(^{114}\) Assuming the issuer is able to complete an offering successfully under rule 146 in one month, he could make an exempted offering every thirteen months without the offerings becoming integrated.

The new rule has eliminated a traditional factor of uncertainty by fixing the number of purchasers at thirty-five persons.\(^{115}\) Several classifications of purchasers may be excluded in determining the thirty-five purchaser limit if all the requirements of the rule are satisfied with respect to all purchasers.\(^{116}\) Interestingly, those purchasers who agree in writing to purchase securities of the issuer in the amount of $150,000 or more need not be counted.\(^{117}\) No doubt the Commission felt that any

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\(^{112}\) id. at § 230.146(3).

\(^{113}\) Whether offers and sales should be regarded as part of a larger offering and thus should be integrated, the following factors should be considered: (a) Whether the offerings are part of a single plan of financing; (b) Whether the offerings involve issuance of the same class of security; (c) Whether the offerings are made at or about the same time; (d) Whether the same type of consideration is to be received; and (e) Whether the offerings are made for the same general purpose.

\(^{114}\) What may appear to be a separate offering to a properly limited group will not be so considered if it is one of a related series of offerings. A person may not separate parts of a series of related transactions, the sum total of which is really one offering, and claim that a particular part is a non-public transaction.

\(^{115}\) id. at § 230.146(2):

For purposes of computing number of purchasers for paragraph (g)(1) of this section only:

(i) The following purchasers shall be excluded:

(\(a\)) Any relative or spouse of a purchaser and any relative of such spouse, who has the same home as such purchaser; and

(\(b\)) Any trust or estate in which a purchaser or any of the persons related to him as specified in paragraph \(g\)(2)(i)(a) or (c) of this section collectively have 100 percent of the beneficial interest (excluding contingent interests);

(\(c\)) Any corporation or other organization of which a purchaser or any of the persons related to him as specified in subdivision \(g\)(2)(i)(a) or (b) of this section collectively are the beneficial owners of all the equity securities (excluding directors' qualifying shares) or equity interest.

\(^{116}\) id. at § 230.146(g)(2)(i)(d) (1977).

\(^{117}\) id. at § 230.146(g)(2)(d) (1977).
purchaser who could afford to invest such a sum would have the requisite economic bargaining power to obtain adequate access to information. Corporations, partnerships and trusts are treated as one purchaser unless the entity was formed specifically to buy the securities. In such a case, each owner of any equity interest in the entity is counted as a separate purchaser. 118 This provision, of course, prevents circumvention of the purchaser limitation.

6. Comment

Rule 146 provides some objective standards and reduces many of the uncertainties in the nonpublic offering as construed in Ralston and its progeny. However, strict adherence to the disclosure policy renders costs under the rule unjustifiable for most small businesses. The cost for a small firm includes primarily retention of counsel to assemble required information, to present it to the offerees or their representatives, to ascertain the offerees’ business sophistication, to supervise transactions and to monitor subsequent transfers. This cost is potentially greater than the expense of filing an appropriate registration statement. 119 Congress and the SEC must consider whether investor protection is worth leaving small issuers without an economically advantageous way to raise capital.

The requirement of providing access to or the furnishing of full disclosure information to experienced investors seems inappropriate to the thrust of the exemption. Sophisticated investors are able to glean the information they desire from the issuer without access or a private offering memorandum. The focus of regulation by the SEC should be on investor sophistication, not on forcing de facto registration. 120 Further, noncompliance with rule 146 would allow sophisticated purchasers to rescind the sale of otherwise valid subscriptions without the presence of fraud. 121

118. Id. at § 230.146(g)(2)(i)(c) (1977).
120. “The novel concept of permitting an offeree representative with experience in financial and business matters to compensate for the lack of sophistication of an offeree should provide an issuer with substantially improved certainty as to the ability of its offerees to fend for themselves.” Alberg & Lybeck, supra note 22, at 642.
121. See, e.g., Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972) (a wealthy and experienced investor possessed all the required information and rescinded his purchase of unregistered securities simply because the defendant could not prove that all the other offerees had been fully informed).
For these reasons, the small issuer may wish to seek venture capital via another route, the intrastate exemption. While the exemption is supposed to take an issue outside the Securities Act, it is in fact highly regulated by federal law. The small business issuer must conform to an entirely different set of criteria which appear to be more concerned with keeping an offering intrastate than with the disclosure policy of the Act.

V. THE INTRASTATE EXEMPTION AND RULE 147

A. Background and Purpose

The legislative history of the Securities Act indicates that the intrastate exemption, section 3(a)(11),\(^\text{122}\) was intended to apply to local financing carried out in the state where the issuer was both incorporated and doing business.\(^\text{123}\) The federal legislation was enacted primarily to augment state regulation by preventing interstate transactions which were frustrating state control.\(^\text{124}\) If an intrastate issue became an interstate transaction, the offering would be subject to federal civil liability and antifraud provisions.\(^\text{125}\)

Prior to rule 147, the SEC had not established objective standards for the elements of the exemption.\(^\text{126}\) In 1961 the Commission issued a release providing guidelines which generally adopted the narrow interpretation of the courts.\(^\text{127}\) In any event, the problems encountered in the intrastate offering became more complex as the law developed, particularly in areas unrelated to the offering itself.

B. Judicial Interpretation

1. Part of an Issue

The intrastate exemption extends to any security which is "part of an issue" distributed within a single state. This phrase has been interpreted by the Commission\(^\text{128}\) and the courts to mean that the entire

\(^{123}\) Securities Act Release No. 33-1459, [1973] 1 FED. SEC. L. REP. (CCH) ¶¶ 2260-62. The application of the exemption is limited to situations where the entire issue is offered and sold to residents of the particular state. \textit{Id.}
\(^{125}\) \textit{Id.} See notes 24-25 \textit{supra}.
\(^{126}\) 17 C.F.R. § 230.147 (Preliminary Note 3) (1977).
\(^{128}\) \textit{Id.}
issue must be offered and sold exclusively to residents of the state in question. The court in Shaw v. United States\textsuperscript{129} held that state law would not be used to determine what constituted an issue under the Act.\textsuperscript{130} The court defined issue as all shares of the same type even if they were from successive issues.\textsuperscript{131} This expansive definition viewed issue as being synonymous with "class" of stock and necessarily prevented an issuer from making an offering of the same class in another state in the future.\textsuperscript{132}

Whether an offering was "part of an issue" depended on whether the offering was a related part of a plan.\textsuperscript{133} If so, the offerings could have become integrated\textsuperscript{134} with a previous offering or a proposed offering. The factors established by the Commission which determined the question of integration were the same as those used in the private offering.\textsuperscript{135} Generally, if the offerings were part of a single plan of financing and were the same class of security, they would have been integrated automatically.\textsuperscript{136} In SEC v. Hillsborough Investment Corp.,\textsuperscript{137} the First Circuit stated that two substantially distinct classes of securities would not be integrated, even if they were offered simultaneously. Two classes of stock were functionally distinct if they differed in voting rights, dividends, or liquidation preferences.\textsuperscript{138}

It was clear that any part of an issue offered or sold to a nonresident, whether directly or by integration with another offering, destroyed the exemption for all securities forming a part of the issue,

\textsuperscript{129} 131 F.2d 476 (9th Cir. 1942).
\textsuperscript{130} Id. at 480.
\textsuperscript{131} Id.
\textsuperscript{133} SEC Release No. 33-4434, supra note 127.
\textsuperscript{134} See note 41 supra. The concept of integration has been succinctly defined as "that relationship between separate offers and sales of securities by an issuer which is such as to constitute a single related or continuous distribution of such securities." McCauley, supra note 124, at 944.
\textsuperscript{135} SEC Release No. 33-4434, supra note 127.
\textsuperscript{136} If one or more of the relevant factors had been absent, the surrounding circumstances would have been considered in order to have evaluated the importance of the factors which were present. McCauley, supra note 124, at 944. Nevertheless, any one of the factors may have been sufficient to establish integration. SEC Release No. 33-4434, supra note 127.
\textsuperscript{137} 173 F. Supp. 86 (D.N.H. 1958), perm. injunction granted, 176 F. Supp. 789 (1959), aff'd, 276 F.2d 665 (1st Cir. 1960). The issuer had made an intrastate offering, some of which had ended up in the hands of nonresidents, which was enjoined from further distribution. The company then authorized a new intrastate offering which was to be exchanged for the securities subject to the injunction and subordinated to the securities held by nonresidents which could not be exchanged without losing the exemption claim of the new issue. The SEC sought and was granted a permanent injunction.
\textsuperscript{138} Cummings, supra note 132, at 172.
including those sold to residents.\textsuperscript{139} Thus the integration problem could have severely hampered the small issuer in need of new capital. He could not have properly considered using the intrastate exemption if any of the original stock had been sold to a nonresident.\textsuperscript{140}

2. The Residence Requirement

Section 3(a)(11) mandates that the issuer, offerees, and purchasers of the securities all must be residents of the same state. The residence of offerees and purchasers has always been interpreted by the Commission as synonymous with domicile,\textsuperscript{141} with mere presence in the state not sufficient to constitute residence.\textsuperscript{142} Because they were viewed by the SEC as self-serving, formal representations of residence and agreements not to resell the securities to nonresidents without additional evidence to establish the availability of the exemption could not be relied upon by the issuer.\textsuperscript{143} Thus, the Commission's position presumably necessitated that the offeree maintain his principal place of residence in the state where the securities were issued and that he intend to remain there indefinitely.\textsuperscript{144}

Naturally it was unreasonable to assume that any issuer could insure against a legitimate change of residence by a given purchaser, or that a person who purchased securities in an intrastate offering would hold them indefinitely.\textsuperscript{145} Nevertheless, it was essential that the intrastate offering first come to rest within the state of issue in the hands of resident investors who had purchased without a view towards distribution or resale to nonresidents.\textsuperscript{146} The rule-of-thumb reasonable time for resident investors to refrain from selling intrastate securities was one year after the completion of the distribution by the issuer (having

\begin{footnotes}
\item[139] SEC Release No. 33-4434, \textit{supra} note 127. Integration problems often arose with promoters, who resided outside the state and who were given stock in lieu of cash. The corporation later issued an intrastate offering of similar stock which was integrated with the promoters' stock and the exemption was destroyed. Cummings, \textit{supra} note 132, at 173-74; McCauley, \textit{supra} note 124, at 945.
\item[140] This was particularly true of family enterprises with purchases of stock by nonresident members and out-of-state promoters. See note 137 \textit{supra}.
\item[141] McCauley, \textit{supra} note 124, at 945. A corporate purchaser was deemed to be a resident in the state of its incorporation.
\item[142] SEC Release No. 33-4434, \textit{supra} note 127 (military personnel at a military post).
\item[143] \textit{Id.} at 11897.
\item[144] Cummings, \textit{supra} note 132, at 172.
\item[145] McCauley, \textit{supra} note 124, at 946.
\item[146] SEC Release No. 33-4434, \textit{supra} note 127. Note that the nonresidence of the underwriter or dealer was not pertinent so long as the ultimate distribution was solely to residents of the state. \textit{Id.} at 11897.
\end{footnotes}
sold his last offering to his last purchaser). 147

While this period helped insure that the securities would come to rest in the hands of residents, it was nevertheless very difficult for the issuer to monitor. Several precautions were necessary to prevent interstate distribution, including investment letters which stated that the securities were purchased as investments and would not be sold to nonresidents. It was also customary for the small issuer to include restrictions on transfer in the legend on the certificates of intrastate securities similar to those discussed in regard to private offerings. 148

The small business which issued securities under the intrastate exemption had additional unrealistic obligations in monitoring secondary distributions by its purchasers. A purchaser could resell the exempt securities to a nonresident and vitiate the exemption for the entire offering, and the issuer would have at best a remedy for breach of contract.

3. Doing Business

The requirement that the issuer be a resident of and doing business within the state of the offering must have been satisfied whether the issuer was a corporation, a partnership or an individual. For purposes of the intrastate exemption, doing business meant that the issuer was performing substantial operational activities in the state of the issue. 149 In SEC v. Truckee Showboat, Inc., 150 the defendant California corporation, with assets of less than $13,000, sold over 4,000 shares of stock at $1,000 each. The proceeds were used to acquire and remodel a large hotel in Las Vegas, Nevada. The court held without giving its rationale that the intrastate exemption was not available. The Commission has construed the decision as requiring that the proceeds of an offering must be used primarily for the purpose of conducting new business in the state of the issue. 151

147. Cummings, supra note 132, at 175.
148. See note 79 supra.
149. SEC Release No. 33-4434, supra note 127, at 2. See also McCauley, supra note 124, at 950 (suggesting that the test was a "principal place of business" test).
151. SEC Release No. 33-4434, supra note 127. Token functions of business operation, such as bookkeeping and other record keeping, would not satisfy the "doing business" requirement, even when all of the directors and officers were residents of the state. "In the case of a newly organized corporation with no business activity except the selling of its stock, the appropriate determination of 'business' would probably be the one the issuer proposes to conduct." Cummings, supra note 132, at 178 n.54.
There is no doubt that this requirement, while in line with the SEC's intent that the intrastate exemption should apply to local financing only, became more onerous to developing small businesses whose operations were increasingly interstate in nature. It was not clear what percentage of business must have been done in the state of issue to qualify under the exemption.

The intrastate offering exemption could not be relied upon by subsidiaries organized in different states where there was, in fact and purpose, a single enterprise. This was true whether it was planned to merge or consolidate the various corporations at a later date. The Commission drew this conclusion from SEC v. Los Angeles Trust, Deed & Mortgage Exchange. The district court held that the exemption was unavailable to a number of associated corporations where each was making an intrastate offering in its respective state of incorporation.

4. Other Conditions

As with the nonpublic offering exemption, the issuer always had the burden of establishing the availability of the intrastate exemption. If the issuer failed to meet the criteria of the exemption and the issue became an interstate offering, it became subject to the civil liability and fraud provisions of the Act, sections 12 and 17, respectively. Once the exemption was lost, regardless of the issuer's culpability, the Commission normally required the issuer to inform purchasers that they could rescind the sale and have their money refunded. The Securities Act is a remedial statute, and the terms of an exemption will be strictly construed against one who relied upon it. However, securities issued in a transaction properly exempted could be offered, sold and delivered without registration through the mails or in any of the instruments of interstate commerce.

152. SEC Release No. 33-4434, supra note 127.
154. In order for the exemption to apply, an investor must obtain a financial interest in the issuer's business conducted in the state of its residence when an offering is made to raise capital for an out of state interest. Cummings, supra note 132, at 180; SEC Release No. 33-4434, supra note 127 (especially of interest to issuers with real estate holdings and developments out of state).
156. Of course, the issuer was also criminally liable under § 5 because there had been no registration.
157. Cummings, supra note 132, at 182.
158. SEC Release No. 33-4434, supra note 127. The securities offering may be the subject of a general newspaper advertisement, provided the advertisement is properly limited to indicate that...
C. Rule 147

1. Background and Purpose

The SEC adopted rule 147 in January, 1974, to provide more objective standards for small businessmen raising capital from local sources under the intrastate exemption. Although it is not as pervasive as rule 146, rule 147 provides some realistic criteria for issuers desiring to make use of the intrastate offering.

The preliminary notes to rule 147 indicate that transactions by an issuer which do not meet all the requirements of the rule do not create a presumption that the intrastate exemption is unavailable. Thus, like the private offering exemption under rule 146, the rule is not entirely synonymous with the exemption. It is also clear that compliance with the rule does not exempt an intrastate offering from the antifraud provisions of the federal securities laws or from the civil liability of section 12(2) of the Act.

2. Part of an Issue

Rule 147 transactions are offers and sales of securities which are "part of an issue" sold within a single state. The issuer must be a "person" residing and doing business in that state. Generally the same integration standards applied to the private offering exemption are used to determine whether other offerings are part of an issue. However, rule 147 designates specific types of offers and sales which will not be integrated with other offerings, thereby providing more certainty for reluctant small business issuers. The provisions of rule 147 provide a safety zone of six months before and after the intrastate offering during which certain previous offerings, specifically exempted securities listed in section 3, exempted transactions listed in section 4,
and registered securities, will not be integrated with the immediate offering.\textsuperscript{167} This relaxing of the integration standards allows a small issuer to have an intrastate offering every thirteen months. The ability to seek new financing, with the assurance that the current issue will not become part of another offering thus destroying the exemption, is a realistic assessment of small business' needs.

3. Residency Requirements

a. Issuers

The Commission has taken a predictable approach to the residency requirements of issuers, basically codifying established law. A general partnership resides where it has its principal office, and an individual resides where he has his principal residence.\textsuperscript{168} As it is the intention of the SEC to treat all business entities in a similar manner, it is not necessary for general partnership to be organized under the laws of the state of the issue.\textsuperscript{169} In all likelihood an individual's principal residence is a less strict requirement than that of domicile, although the rule seems to have avoided the use of that term in particular.\textsuperscript{170}

Section 3(a)(11) and rule 147 mandate that a corporate issuer be incorporated under the laws of the state of the offering.\textsuperscript{171} However, this requirement appears unduly harsh to many small corporations, specifically those that are able to meet the strict "doing business" provisions\textsuperscript{172} but are not incorporated in the state of their primary operations.\textsuperscript{173} The SEC recognizes that a company's principal office is a much more significant indicator of the local character of a business than its state of incorporation.\textsuperscript{174} Nevertheless, the residency requirements are interpreted narrowly and can only further restrict the number of businesses allowed to make use of the intrastate exemp-

\textsuperscript{167} This is true provided that there are during either of the said six month periods, no offers, offers for sale, or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale, or sold pursuant to the rule. 17 C.F.R. § 230.147(b)(2) (1977).

\textsuperscript{168} 17 C.F.R. § 230.147(c)(1)(ii),(iii) (1977).


\textsuperscript{170} See Cummings, supra note 132, at 196-98.


\textsuperscript{172} See 17 C.F.R. § 230.147(c)(2) (1977). See note 181 infra.

\textsuperscript{173} The fact that a corporation is incorporated in a state not its principal place of business is usually a matter of convenience and should not be an obstacle to the use of the intrastate exemption, particularly when the restrictive "doing business" standards of the rule are satisfied. Obviously the SEC must follow the statute, but Congress should recognize that form is currently controlling substance in this case and amend § 3(a)(11), dropping the requirement of incorporation in the state of issue.

\textsuperscript{174} SEC Release No. 33-5450, supra note 169.
b. Offerees and Purchasers

Rule 147 makes it somewhat easier for the purchasers to satisfy residency requirements than have past requirements. The individual purchaser is no longer required to possess domiciliary intent to be a resident; he need only have his principal residence in the state.\footnote{176} Corporations, partnerships, and trust purchasers are residents for purposes of the rule if they have their principal offices in the state at the time of the offer and sale of the intrastate securities.\footnote{177} The Commission has bowed to the reality that the state of incorporation is often a matter of convenience, even for small companies, and not the best indication of its principal place of business.\footnote{178} However, the rule prohibits the formation of a corporation for the purpose of acquiring the exempt securities unless all equity beneficiaries are residents of the state.\footnote{179}

4. Doing Business

The most onerous and unrealistic provision of rule 147 is the subsection which defines the requirements of "doing business" with respect to resident issuers of intrastate securities.\footnote{180} The SEC has devised a three-pronged, eighty percent test, each section of which must be satisfied by the issuer before he is deemed to be doing business in the state. Basically stated, the issuer must have derived eighty percent of its gross revenues from its intrastate activities during its most recent fiscal year.\footnote{181} It must also have eighty percent of its assets (and those of its

\footnote{175} The object of the § 3(a)(11) exemption, i.e., to restrict the offering to persons within the same locality as the issuer who are, by reason of their proximity, likely to be familiar with the issuer and protected by the state law governing the issuer, is best served by interpreting the residence requirement narrowly.

\footnote{Id. 17 C.F.R. § 230.147(d)(2) (1977). Prior to the rule it was required that an individual have no present intent of moving his residence to another state in order to qualify as a “resident” for exempt securities purchases. SEC Release No. 33-5450, supra note 169.}

\footnote{177. 17 C.F.R. § 230.147(d)(1) (1977).}

\footnote{178. See note 175 supra.}

\footnote{179. 17 C.F.R. § 230.147(d)(3) (1977).}

\footnote{180. 17 C.F.R. § 230.147(c)(2) (1977).}

\footnote{181. 17 C.F.R. § 230.147(c)(2)(i) (1977) provides: The issuer shall be deemed to be doing business within a state or territory if: (i) the issuer derived at least 80% of its gross revenues and those of its subsidiaries on a consolidated basis; (A) for its most recent fiscal year, if the first offer of any part of the issue is made during the first six months of the issuer’s current fiscal year; or (B) for the first six months of its current fiscal year or during the twelve month fiscal period ending with such six month period, if the first offer of any part of the issue is made during the last six years.}
subsidiaries) located within the state during the most recent semiannual fiscal period. In addition, the issuer must intend to use eighty percent of the proceeds of the issue in connection with the operation of its business in the state. Finally, the issuer must have its principal office located in the state of the offering.

The SEC ignores the fact that all commerce, including that engaged in by small businesses, has become increasingly interstate in nature since the promulgation of the Securities Act. Perhaps the Commission feels that securities will more likely be an interstate issue if business operations are multistate in character. Of course, there are no limitations on the number of purchasers of intrastate securities other than the limit imposed by the state blue sky laws. Nevertheless, the small business attempting to expand into a larger market, which in all likelihood would include out-of-state markets, is severely restricted in its use of the intrastate exemption.

5. Limitations on Resale

Resales of exempted intrastate securities are limited to the period during which the issuer is making offers and sales of the securities and for a period of nine months after the issuer's last sale. Resales must be made only to residents of the state of the issue. The same provisions apply to convertible securities. Apparently the Commission has de-

182. For the purpose of the rule, the assets of the issuer and its subsidiaries are considered as a whole. An issuer must have 50% control of a subsidiary for it to be included in the consolidation. 17 C.F.R. §§ 240.12(g)-2 (1977).
184. 17 C.F.R. § 230.147(c)(2)(iv) (1977). It hardly seems possible that any company meeting the three-tier 80% test would not have its principal office located in same state, but the investor needs the extra precaution.
185. See Cummings, supra note 132, at 199.
187. For purposes of the rule, a conversion in reliance on § 3(a)(9) of the Act does not begin a new period. Section 3(a)(9) pertains to "[a]ny security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such securities." 17 C.F.R. § 230.147(e) (1977).
decided that the nine-month period following the last sale by the issuer is sufficient to satisfy the "coming to rest" standards of the pre-rule interpretation.

The issuer is required to take several precautionary measures to insure that no interstate resales are made. As with a Rule 146 private offering, the issuer must place a proper legend on each certificate stating that the security is unregistered and subject to limitations on transfer. Stop transfer instructions must be issued to the transfer agent with regard to resales to nonresidents by original purchasers. All proper transfers by original purchasers must be noted in the issuer's books. In addition, the issuer must acquire from each purchaser a written statement indicating that he is a resident of the state. In turn, the issuer must disclose in writing all of the restrictions and limitations mentioned above.

It is necessary to note that the rule 144 holding period of two years probably does not apply to section 3(a)(11) securities for the purpose of interstate sales of those securities. It is likely that a purchaser must have held the intrastate securities for five years as required by rule 237. For venture capitalists this is much too long a period to hold a speculative security.

6. Summary

Rule 147 provides certainty to a previously unreliable exemption. However, the unfortunate coupling of corporate residence requirements with the doing business provisions automatically restricts the use of the intrastate exemption to very small corporations. The SEC has ignored both the overwhelming growth of interstate commerce since the promulgation of the Securities Act and the fact that small local businesses can trade in several states with some facility. There is no
reason to deprive an expanding small company of the use of the exemption because it is not incorporated in the state of its principal office or because it fails one of the doing-business tests.

These restrictions become even more apparent when the small business concerned must simultaneously comply with state blue sky laws. A new set of regulations completely separate from the federal provisions must be satisfied by the small business issuer. Subjecting small issuers to additional regulation places an unneeded and unwarranted burden on them.

VI. STATE BLUE SKY EXEMPTIONS

A. The Limited Offering Under the Uniform Securities Act

The Uniform Securities Act (U.S. Act) has been adopted in thirty-five 195 jurisdictions, usually with modifications, which makes it the most prevalent blue sky format. As a general rule under this Act, registration is required of every issuer who intends to make an offering of its securities in each state where the securities will be offered or sold. 196 However, the U.S. Act provides for exemptions from registration requirements197 including the offering to a limited number of persons198 as established by each state. 199 Since there is no federal pre-

195. See note 33 supra.
196. Section 301 of the Uniform Securities Act provides that “[i]t is unlawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempted under section 402.” 1 BLUE SKY L. Rptr. (CCH) ¶ 4921.
197. Section 402 exempts securities from registration (section 301) and section 403 allows the administrator to require the filing of any prospectus, pamphlet, circular, form letter, advertisement, or other sales literature or advertising communication addressed or intended for distribution to prospective investors, including clients or prospective clients of an investment advisor. 1 BLUE SKY L. Rptr. (CCH) ¶¶ 4932-33.
198. Uniform Securities Act 402(b)(9). The following transactions are exempt from sections 301 and 403:

(9) any transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in paragraph (8)) in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is present in the state, if (A) the seller reasonably believes that all the buyers in this state (other than those designated in paragraph (8)) are purchasing for investment, and (B) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state (other than those designated in paragraph (8)); but the (Administrator) may by rule or order, as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption or increase or decrease the number of offerees permitted, or waive the conditions in Clauses (A) and (B) with or without the substitution of a limitation on remuneration.

199. The average number of purchasers allowed under the 402(b)(9) exemption in states which have adopted the U.S. Act is approximately 20; for all states the average is approximately 25 purchasers. See Note, State Exemptions from Securities Regulation Coextensive with S.E.C. Rule 146, 61 Cornell L. Rev. 157 (1975), Appendix—Summary of State Private Offering Exemptions.
emptions of state securities regulation, the small business issuer must comply with the restrictions of each state where it plans to sell securities.

The small issuer wishing to make a rule 146 private offering to purchasers residing in several different states must satisfy the section 402(b)(9) exemption provisions as modified in each state. Regardless of whether registration is ultimately demanded by the state securities authorities, a minimum of information will usually have to be filed in order to qualify for the exemption. If the issuer has prepared a private offering memorandum for the purpose of satisfying rule 146 disclosure requirements, much of the material that went into its preparation can be used for state qualification purposes. However, state securities authorities have the discretion to demand full state registration or certified financial statements to protect the public interest. Most states which have adopted the U.S. Act allow fewer than the thirty-five purchasers permitted by rule 146. Thus the small issuer will have to make its private offering in a minimum of two states, assuming it desires to make full use of the Rule 146 private offering exemption. The preparation of a private offering memorandum is expensive. With the added expense of state filing and the assumption of significant potential liability under the state blue sky laws, the ordeal of seeking

200. See note 31 supra.

201. Regulations of most states accompanying the § 402(b)(9) exemption require sufficient information to indicate that the issuer is in compliance with the given provisions including the articles of incorporation, current financial statements, directors' backgrounds, identity of purchasers, copies of all sales literature, and copies of the securities. Often the administrator has the discretion to require any additional information he thinks is appropriate.

202. The last clause of section 402(b)(9) implies such power and regulations usually reserve the power to the administrator. See note 198 supra.

203. Sections 409 and 410 of the UNIFORM SECURITIES ACT provide for criminal and civil liability respectively. Nothing in this act limits the power of the state to punish any person for any conduct which constitutes a crime by statute or at common law. UNIFORM SECURITIES ACT § 409(c).

Any person who (1) offers or sells a security in violation of section 201(a), 301, or 405(b), or of any rule or order under section 403 which requires the affirmative approval of sales literature before it is used, or of any condition imposed under section 304(d), 305(g), or 305(h), or (2) offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security.
new capital can become even more burdensome for small businesses.

In connection with the rule 147 intrastate exemption, the U.S. Act exemption and the accompanying state regulations control the disclosure aspect of the offering to a greater extent than the rule 146 offering. Since an intrastate offering can be initiated in only one state, the small company may be constructively prohibited from making use of the exemption in states which permit limited sales to ten or fewer purchasers. However, assuming that a small issuer meets the doing business requirements of rule 147, an intrastate offering under a section 402(b)(9) type statute which allows more than fifteen, and preferably twenty to thirty purchasers, becomes more practical.

That the drafters of the U.S. Act did not provide for greater coordination of federal and state private and limited offering exemptions was in all probability due to basic differences in the merit and disclosure philosophies of securities regulation. Several states have passed legislation which permits greater coordination between state and federal exemptions, including some which have adopted the U.S. Act. Two notable states, California and New York, which have not adopted the U.S. Act have treated the issue in significantly different ways. California has greatly limited private exemptions, and New York has allowed the attorney general considerable discretion in the granting of

Uniform Securities Act § 410(a).

204. As no disclosures are required of the issuer under rule 147 other than stock transfer restrictions, the state filing requirements will be the extent of any disclosure.

205. Unless the small issuer can interest several institutional investors, which are not counted in the 10 purchasers, or the 10 purchasers are very wealthy (e.g. $1,000,000 purchase each), the 10 purchaser limit may restrict the amount of capital obtainable to the point where it is a waste of time to make an intrastate offering.


private exemptions. 208

B. The California Limited Offering Exemption

California blue sky law exempts from registration requirements sales of voting common stock incorporated in any state, provided that immediately after the issue there is one class of stock outstanding owned by no more than ten persons. 209 This exemption is clearly more restrictive than section 402(b)(9) of the U.S. Act. The Securities Commissioner of California even issued a release indicating that the rule 146 exemption would not necessarily be exempt under state blue sky law. 210 The Commissioner based his conclusion on the substantial state interest in local securities transactions and the basic differences in the federal disclosure philosophy and merit standards of California. 211 This kind of zealous paternalism can significantly inhibit if not prevent justified small business growth.

C. New York Private Exemptions

New York exempts from registration requirements all offerings and sales of securities if an effective registration statement has been filed with the SEC. A further exemption is offered where an offering is exempt under the Securities Act of 1933 other than the section 3(a)(11) intrastate offering. 212 Clearly, a rule 146 private offering is exempt from registration under New York blue sky law, even if the offering is sold entirely to residents of that state. Thus, a constructive thirty-five person intrastate offering exemption is feasible, provided the requirements of rule 146 are met.

However, the tedious process of complying with rule 146 and the required registration 213 of an ordinary intrastate offering can be avoided. This is so if the attorney general grants an exemption for a limited offering in which securities will not be sold to more than forty persons. 214 This discretionary intrastate exemption in conjunction

[Notes]
209. Id.
211. Id.
214. See note 206 supra. The attorney general can grant an exemption for more than forty persons when he deems the exemption to be within the purposes of § 359(f)(2). Id. (Section 359-f(7)) makes this applicable to intrastate offerings.
with rule 147 compliance would allow significant disclosure avoidance in New York, but it must be remembered that antifraud provisions are still applicable. The advantage of state recognition of the rule 146 private offering exemption would be to eliminate the need for the intrastate exemption and rule 147. Maryland and Delaware have opted for such recognition.

D. The Delaware-Maryland Coextensive Exemption

Delaware and Maryland both have adopted the U.S. Act and have retained the section 402(b)(9) exemption in which each state has limited the offering to twenty-five persons. In addition, both states have adopted a private offering exemption equivalent to rule 146 which effects an exemption by coordination. Thus, the small issuer must make its choice between a rule 147 offering coupled with the section 402(b)(9) requirements for the intrastate exemption, and a rule 146 private offering as either an intrastate or interstate exemption.

The prudence of such a policy provides benefits for both state securities commissions and the small business interests. Firms which are not small enough to meet rule 147 requirements can utilize the rule 146 exemption and acquire the advantage of making offers to ten more persons than allowed under section 402(b)(9). However, the small firms that qualify under rule 147 can maintain their exemption under section 402(b)(9) and avoid all of the involved disclosure requirements of rule 146. Thus, there is coordination of federal and state regulation for both the intrastate and private offering exemptions.

This coordination with respect to rule 146 is not a constructive preemption because the state has adopted it as its own law. This means that the balance of its securities laws apply to the issuer, thus assuring

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216. While this would cause some very small issuers who would otherwise qualify for the rule 147 exemption to assemble private offering memoranda, in all likelihood such memoranda would be no more expensive than compliance with state registration requirements. Of course, the states can preserve their limited offering exemptions which require no registration, but usually limit the number of purchasers to well below thirty-five.


218. It is possible under the coordination system for a small issuer who meets Rule 147 requirements to make a rule 146 private offering all to residents within a single state, thus avoiding federal regulation entirely. Whether this situation will occur with any regularity is speculative, but it would probably be limited to states with large populations of wealthy investors.
The salvation of the coordination policy is that both state and federal jurisdiction is preserved, but the small issuer need satisfy only one set of regulations. In all probability, the states which adopt a coordination policy with respect to federal exemptions will prove to be better "watchdogs" than the SEC has been.

VII. CONCLUSION

The problem of permitting easier access to venture capital by small businesses and providing for investor protection is difficult at best. If sophisticated investors can truly fend for themselves, full disclosure is not necessary and could be limited to essential material. Greater coordination between federal and state exemptions, whether by federal pre-emption or by state adoption of federal standards, would greatly simplify the issuer's task and still provide substantial protection for investors. Under present circumstances, the continued growth of the small business sector is considerably restricted.

David Barnes

219. Cost savings are implicit in a coordination policy. Small businesses will have easier access to more capital sources.