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PRIVATE AND LIMITED OFFERINGS AFTER A DECADE
OF EXPERIMENTATION: THE EVOLUTION OF
REGULATION D

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INTRODUCTION

The securing of capital through unregistered private offerings has been a source of some anxiety to issuers and their attorneys since the adoption of the Securities Act of 19331 (the 1933 Act). In order to be sure that an offering was sufficiently “private” and did not require registration with the Securities and Exchange Commission (SEC), a prospective issuer had to consider several factors.2 The number of allowable offerees and purchasers,3 the nature of their financial sophistication,4 their investment intent on purchasing the securities offered,5 as well as the amount and quality of the information to be furnished by the issuer,6 were all among the vaguely defined and vaguely interrelated elements which issuers had to satisfy before they could be sure that the offering was truly private. The “limited offering” exemption, which dealt with those cases in which the offering was limited in amount rather than number of ofﬁcees, was no easier to use. The SEC’s regulations7 for use of the limited offering exemption required the preparation and filing of extensive (and expensive) documentation.

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Views and opinions expressed herein are those of the authors and are not to be attributed to any organization with which the authors have been or are associated.

3. See, e.g., In re Dempsey, 38 S.E.C. 371 (1958); Gilligan, Will & Co. v. SEC, 267 F.2d 461
(2d Cir. 1959); see infra note 54.
5. See, e.g., In re Ambrosia Minerals, Inc., 39 S.E.C. 734 (1960); see infra note 54.
7. 1933 Act, § 3(b); Regulation A consists of Rules 252–263, 17 C.F.R. § 230.252–263 (1981), and Forms 1-A through 6-A promulgated by the SEC under the legislative authority of § 3(b). Prior to the adoption of Rule 240 in 1975, an offering that was limited in amount but not “private” in terms of number of ofﬁcees or purchasers, was required to prepare substantial documentation and perfect its “Regulation A” exemption with a regional ofﬁce of the SEC. See D. Ratner, Securities Regulation 312–28 (2d ed. 1980).
Beginning with its adoption of Rule 144 in 1972, the SEC has made several attempts to reduce this issuer/attorney anxiety by adopting a series of rules intended to clarify the availability of private and limited offering exemptions. In March 1982, after a decade of experimentation, the SEC adopted Regulation D. The Regulation is intended to be the next logical step in the movement toward providing objective "safe harbor" standards for, and clarifying the interrelationship of, the elements of the private and limited offering exemptions. In addition, the Regulation, together with the statutory changes made by Congress in 1980, may amount to a significant federal deregulation of several types of private and limited offerings. Despite the Regulation's express non-exclusivity, few attorneys will voluntarily choose to rely on the ambiguous statutory exemption and its judicial interpretations in preference to Regulation D's generous safe harbor.

This article explores the private offering both as it was and as it may be changed by federal securities laws and regulations. The article begins with a summary of the statutory framework affecting private offerings and an extensive review of the evolution of the four basic elements of the Section 4(2), or pre-Rule 146 era through Rule 146 and its progeny (e.g., Rules 240 and 242). The "New Order" created by Section 4(6) and Regulation D is then analyzed in terms of the changes from both pre-Rule 146 and Rule 146 elements. It is the premise of this article

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8. 1933 Act Release No. 33-5223, 37 Fed. Reg. 596 (effective Apr. 15, 1972), and the related Rules 237 and 144 addressed the concerns of a report entitled "Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts" (The Wheat Report), at 174–82 (CCH). The Rules did not treat directly the subject matter of this article, i.e., the availability of the private offering exemption to the issuer, and addressed only the question of "investment intent": when and how a purchaser of restricted stock could legitimately transfer it. For a general discussion of Rules 144 and 237 and how they affect the purchaser of restricted stock in a private offering, see Lipton, Fogelson & Wamken, Rule 144—A Summary Review After Two Years, 29 Bus. Law. 1183 (1974).

9. Before the adoption of Regulation D, there were three rules for exemption from registration available to the issuer of a private or limited offering, Rules 146, 240, and 242. Each of these rules are cited infra at notes 72, 118 and 140 and discussed in the accompanying text.


11. See infra note 42 and accompanying text.

12. The changes in the area of private placements and limited offerings are only part of a larger scheme by the SEC to reexamine and update the federal securities laws as they relate to today's economy. Along with the adoption of Regulation D, the SEC has proposed and adopted major changes in Regulation A, Form S-18, and Regulation S-K. See Regulation D, supra note 10; Securities Act Release No. 33-6383 (Mar. 3, 1982), 6 Fed. Sec. L. Rep. (CCH) ¶ 72,328; Securities Act Release No. 33-6385 (Mar. 3, 1982), 1 Fed. Sec. L. Rep. (CCH) ¶ 3,760; Accounting Release No. 306, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,328. For purposes of this article, however, discussion will be limited to those changes in the area of private placements and limited offerings which are a result of Regulation D and related Rule 215.

A subsequent article, to be published in a later issue of this Law Review, will deal with the impact of the Regulation on requirements of state law and regulation. That article will include a commentary
that a full understanding of pre-existing private offering law and regulation is a prerequisite for understanding and appreciating Regulation D.

1. THE 1933 ACT FRAMEWORK

The purpose of the 1933 Act is to require an issuer of securities to provide full and fair disclosure concerning securities offered. This disclosure is intended to prevent fraud and misrepresentation in the sale of securities. To accomplish its objective, the 1933 Act contains registration provisions requiring the issuer to provide material information to both the SEC and to the investor, as well as full disclosure and antifraud provisions, ensuring that the information provided to the investor is both true and candid. In order to understand the private offering exemption, it is necessary to examine these provisions and their purposes.

A. Registration

Section 5 of the 1933 Act requires the filing of a registration statement for all securities offered and sold to the public by or through interstate means. This section makes it unlawful for any person to offer a security unless a registration statement has been filed with the SEC, or to sell a security unless a registration statement covering that security has become effective and a prospectus delivered to the purchaser. The registration statement and prospectus must contain certain itemized kinds of investment information about the issuer and its securities. This information on the recently proposed uniform limited offering exemption adopted by the North American Securities Administrators Association and the prospective federal-state coordination and cooperation envisioned by Section 19(c) of the 1933 Act and Regulation D. The article will also set forth recommended procedures for both perfecting the exemptions under existing federal and state law and regulations, and for making revision of state law without abandoning purchasers in limited offerings to the mercies of an unregulated marketplace.

13. Unlike many of the earlier adopted state "blue sky" statutes, the 1933 Act was not intended to regulate the quality of the investment or the merits of the securities being offered. The preamble of the 1933 Act states its purpose as follows: "To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, ch. 38, preamble, 48 Stat. 74. This purpose is further codified in Section 23 of the 1933 Act, which states, inter alia:

[T]he fact that the registration statement for a security has been filed or is in effect . . . shall [not] be deemed a finding by the Commission that the registration statement is true and accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, or to mean the Commission has in any way passed upon the merits of, or given approval to, such security. . . .


15. Id.

16. Section 7 sets forth the broad requirements for the type of information required in a registration statement and authorizes the SEC to require additional information and documents by rules or regulations. 1933 Act, § 7, 15 U.S.C. § 77(g) (1976). Section 10 sets forth the requirements for the type of information required in a prospectus, and also authorizes the SEC to require additional information and documents by rules or regulations. 1933 Act, § 10; 15 U.S.C. § 77(j) (1976).
includes the financial and managerial history of the issuer's business, factors affecting the price and value of the securities offered, certain financial data, and other facts which might make the securities offered a high risk investment. To ensure that the issuer making a public offering of securities does in fact file a registration statement and deliver the required information, purchasers of securities and the SEC are provided with a number of civil, injunctive and criminal remedies for the violation of Section 5 and its requirements.

B. Full Disclosure and Antifraud

The 1933 Act accomplishes its full disclosure and antifraud objectives by granting to the investor and the SEC a number of enforcement and remedial actions against an issuer of securities who is less than candid. Section 11 contains the first such remedy. That section provides the purchaser with a civil action for damages against persons involved in the preparation and distribution of a registration statement or prospectus which misrepresents or fails to state a material fact. Section 12(2) contains the second remedy. Section 12(2) allows the purchaser of a security, even where a registration statement or prospectus was not required, to rescind his purchase if the offer or sale of such security was accompanied by a misstatement or omission of a material fact. Finally, Section 17 makes it unlawful for any person to (1) offer for sale a security through the use of any fraudulent device or scheme, (2) obtain money or property by means of any untrue statement of a material fact, or (3) engage in any practice which operates as a fraud on the purchaser of a security. This

17. See 15 U.S.C. § 77(aa) (1976) (governing the information required in a registration statement); Regulation C, 2 Fed. Sec. L. Rep. (CCH) ¶ 5798 (which sets forth specific rules which apply to the registration statement and prospectus), and various forms which the SEC has adopted for the registration of particular types of offerings, set forth in 2 Fed. Sec. L. Rep. (CCH) ¶ ¶ 6011–7307, 7401–7411, 7415, 7421, 7427, 7433, 7451.
18. Section 12 of the 1933 Act provides the purchasers of stock the civil remedy of rescission. That section provides that:

Any person who—
(1) offers or sells a security in violation of section [5] . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction to recover the consideration paid for such security with interest thereon, upon the tender of such security, or for damages if he no longer owns the security.

20. Section 24 imposes criminal sanctions on willful violations of the act or the rules and regulations promulgated by the SEC, and upon any person who willfully makes an untrue statement of a material fact or omits to state any material fact required to be stated in a registration statement.
section may be enforced by criminal proceedings pursuant to Section 24 of the Act,\textsuperscript{24} injunctive proceedings pursuant to Section 20 of the Act,\textsuperscript{25} and, in a minority of jurisdictions, by a private right of action by the defrauded purchaser.\textsuperscript{26}

C. Private and Limited Offering Exemptions

The above registration and full disclosure/antifraud provisions create a general statutory mechanism which provides the investing public with material information relating to the securities offered and sold to it. Congress recognized, however, that there are situations in which there may be no need for the registration provisions of the Act,\textsuperscript{27} or the public benefits of registration may be too remote to require expensive and time-consuming compliance. Two such situations are (1) when the issuer makes an offering that is limited in terms of the total value of the securities offered (a “limited offering”), and (2) when the issuer makes a private placement of securities to a limited group of investors (a “private offering”). The cost to the issuer of preparing a registration statement for the securities offered is substantial, while the benefits, because of either the limited size of the offering or limited number of participants involved, are minimal.\textsuperscript{28} Accordingly, the 1933 Act provides three exemptions from registration requirements: Sections 3(b),\textsuperscript{29} 4(2),\textsuperscript{30} and 4(6).\textsuperscript{31}

Section 3(b) authorizes the SEC to exempt securities from the registration requirements of the Act for offerings equal to or less than $5,000,000. Before allowing the exemption, however, the SEC must find that registration for those securities is not necessary to the public interest by reason of the limited value of the securities offered.\textsuperscript{32} The SEC has adopted several exemptive rules and regulations which interpret this section and can be of significant value to the small business issuer. Among the most

\textsuperscript{24} See supra note 20.
\textsuperscript{25} See supra note 19.
\textsuperscript{26} Jurisdictions are divided on the question of whether there is a private right of action for civil damages under section 17. The majority view today follows that of Judge Friendly in his concurring opinion in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), that section 17 does not allow a private right of action. Contra, Crowell v. Pittsburgh & Lake Erie R.R., 373 F. Supp. 1303 (E.D. Pa. 1974).
\textsuperscript{27} H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).
\textsuperscript{28} The expense of preparing the disclosure materials for registration can be substantial. A study by the National Association of Securities Dealers, which examined the expenses of a firm commitment underwriting for a registered offering of a company going public for the first time, revealed that the cost now exceeded $200,000. See 126 Cong. Rec. S5373 (daily ed. May 14, 1980). Because these requirements apply whether the issuer is large or small, the smaller business feels the cost of compliance, by necessity, more heavily.
\textsuperscript{29} 15 U.S.C. §77c(b) (Supp. IV 1980).
\textsuperscript{32} 15 U.S.C. §77c(b) (1976).
important of these are the “mini-registration” requirements of Regulation A,\(^33\) the now rescinded Rules 240\(^ {34} \) and 242,\(^ {35} \) and the recently adopted Regulation D.\(^ {36} \) It is important to note that, prior to the adoption of former Rule 240 in 1975, the limited offering, while “exempt” under Section 3(b) by virtue of the small amount of capital involved, was nevertheless subject to SEC review and formal information requirements. Thus the SEC provisions entitled a large number of purchasers of securities of a limited aggregate value to receive extensive information in the Regulation A “Offering Circular.” This distinguished the limited offering from a private offering which was exempt from registration because there were very few offerees.

Section 4(2), commonly referred to as the “private offering” exemption, exempts from the registration requirements of the 1933 Act those “transactions by an issuer not involving any public offering.”\(^ {37} \) The 1933 Act does not define a “public offering.” As a result, the availability of this exemption has often been uncertain. In recent years, however, the SEC, through its adoption of now rescinded Rule 146\(^ {38} \) and that Rule’s counterpart in Regulation D,\(^ {39} \) has attempted to provide to the issuer some objective standards for determining when an offer or sale of a security will not be considered a public offering. The success of these attempts, as will be discussed, has enjoyed mixed results.

Recently enacted Section 4(6)\(^ {40} \) contains the final statutory exemption available to an issuer. This section provides an exemption from the registration requirements of the Act for transactions involving offers and sales of securities to accredited investors\(^ {41} \) where the aggregate offering price does not exceed the limit allowed under Section 3(b), which presently is $5,000,000.\(^ {42} \) The legislative history of this section reveals an

\(^{33} \) See supra note 7.


\(^{42} \) When it passed Section 4(6) in 1980, Congress also amended section 3(b) to increase its dollar limitation from $2 million to $5 million. Small Business Investment Incentive Act of 1980,
intent by Congress that this exemption would provide substantial relief and aid to the closely held small business attempting to raise funds in the capital marketplace.\footnote{43}

II. PRE-RULE 146 REGULATION

A. Uncertainties as to the Exemption's Availability

Private offerings under the 1933 Act had been made for forty-one years before the critics' mid-life search for objective clarity\footnote{44} produced Rules 146, 240, 242 and, ultimately, Regulation D. With little to guide them but a dictionary, isolated judicial opinions,\footnote{45} and releases from the SEC,\footnote{46} issuers and their attorneys were nonetheless able to fashion offering procedures and techniques that were deemed (at least by them) to be "transactions by an issuer not involving any public offering."

Less cautious offerors and their attorneys originally may have understood the exemption to cover almost any offering that was made without the mechanism of the regular trading markets.\footnote{47} The United States Supreme Court upheld the more restrictive SEC view in SEC v. Ralston Purina Co.\footnote{48} The slight decrease in the estimated number of private


\footnote{47. See, e.g., SEC v. Sunbeam Gold Mines Co., 95 F.2d 699 (9th Cir. 1938).}

\footnote{48. 346 U.S. 119 (1953); see infra notes 56, 57 and accompanying text.}
offerings following Ralston, from 4,002 in 1952 to 3,497 in 1960 suggests that Ralston may have affected issuer attitudes toward private offerings.\footnote{SEC, 28th Ann. Rep., Table 5, A Summary of Corporate Securities Publicly Offered and Privately Placed in Each Year from 1934 through June 1962, at 185 (1962).} Ralston, followed five years later by the Second Circuit's opinion in Gilligan, Will & Co. v. SEC,\footnote{267 F.2d 461 (2d Cir.), cert. denied, 361 U.S. 896 (1959).} was instrumental both in limiting the availability of the exemption and in shaping the procedures that careful issuers adopted when using it. During the 1960's and early 1970's the trend toward restricting the exemption continued. Each new case that either supported the SEC position\footnote{See SEC v. Continental Tobacco Co. of S.C., 463 F.2d 137 (5th Cir. 1972); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir.), cert. denied, 389 U.S. 850 (1967).} or granted recovery to a purchaser of restricted securities cast increasing doubt on the availability of the exemption.\footnote{See Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977); Henderson v. Hayden Stone, Inc., 461 F.2d 1069 (5th Cir. 1972); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971); Bryant v. Uland, 327 F. Supp. 439 (S.D. Tex. 1971).} Yet the exemption was extremely valuable, even vital, to small businesses. These businesses could not afford to register their small offerings and so continued to run the enormous risks of civil and criminal liability which could attach if they failed to fall within the exemption. The need for some guidance was clear.

\section*{B. The Pre-Rule 146 Procedure for a Private Offering}

Offerors willing to risk using the exemption in the midst of this uncertain treatment developed a procedure, consisting of four basic steps that reflected the interrelated elements of the exemption. The careful practitioner considered that this procedure for making a private offering was likely to protect against either SEC or private litigant attacks. While the SEC took into consideration other factors,\footnote{An examination of the cases cited supra at note 45 and SEC releases dealing with private placement, supra note 46, reveals that four basic elements were consistently deemed relevant in determining whether an offering was private or public. Those four elements were (1) the numerical element (the number of offerees), (2) the information/access element, (3) the sophistication element, and (4) the resale element. Other factors were, e.g., the size or amount of the offering, the number of units offered, in determining the nonpublic nature of the offering, the procedure set forth below incorporates those elements that applied to issuers and their offerings regardless of their respective sizes.} such as the total amount of the offering, the relationship of the offerees to the issuer, and the number of units offered, in determining the nonpublic nature of the offering, the procedure set forth below incorporates those elements that applied to issuers and their offerings regardless of their respective sizes.\footnote{While more careful practitioners and their issuer clients were using the described procedure, those persons less careful or less familiar with the administrative and judicial interpretations of private v. public offerings continued to have their use of the exemption successfully challenged. The cases indicate that lack of only one of the four elements is rare in a defective private offering; however, a single element may receive more attention than the others in various cases. For example, in In re Ambrosia Minerals, Inc., 39 S.E.C. 734 (1960), and in In re Dempsey & Co., 38 S.E.C.
1. Restrict the Number of Offerees (the Numerical Element)

There was a potential double-edged uncertainty as to the number of persons who could be involved in a private placement: (1) uncertainty as to the appropriate number of offerees allowed and (2) uncertainty as to whether it was the number of purchasers or the number of offerees which was required to be limited. Early in the history of the private offering exemption the courts and the SEC took the position that it was the number of persons to whom offers were made, and not the number of persons who ultimately purchased the securities, which was the key numerical factor. If offers were made to one hundred persons, but sales only to two, the figure of one hundred was the number referred to by both the courts and the SEC in considering the private nature of the offering. One of the more frustrating aspects of the pre-Rule 146 private offering, however, was the lack of any objective test as to what number of offerees would be within the safety zone. The Supreme Court, in *Ralston Purina*, increased this frustration by quoting with approval the language of *Nash v. Lynde*: "'The public' . . . is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve. . . ." The Supreme Court thus highlighted the lack of any secure numerical limitation. An offering might be "public" if it was made "to few or many." In other words, an offering to 100 financial institutions might be a private offering, while an offer to three unrelated, unsophisticated investors might be a public offering. Deciding upon a safe number must have caused many sleepless night for attorneys representing issuers having private offerings: "If twenty-two offerees is a reasonable number, may we try for twenty-seven? Are forty-one too many if the officers and directors have extended families who are among the offerees?" And so on, ad nauseum. The questions had no definite answers.

371 (1958), the SEC determined that the exemption was not available because the issuer sold primarily to persons who ultimately resold to other persons (noncompliance with the Resale Element); in *SEC v. Continental Tobacco Co. of S.C.*, 463 F.2d 137 (5th Cir. 1972), the issuer failed to carry its burden of proof as to the number of persons to whom offers were made, which was at least a partial cause for the loss of the exemption (noncompliance with the numerical element); in *Lively v. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971), and *Bryant v. Uland*, 327 F. Supp. 439, 443 (S.D. Tex. 1971), despite the investor's sophistication, where the purchasers did not have the information that a registration statement would have disclosed, or at least have access to such information, the exemption was not available (noncompliance with the information/access element); and in *SEC v. International Scanning Devices, Inc.*, [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,147, at 92,165 (W.D.N.Y. Apr. 6, 1977), the court discussed the investor's general lack of investment sophistication in holding that the issuer could not rely on the 4(2) exemption (noncompliance with the sophistication element).

55. See *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699, 701 (9th Cir. 1938).
Despite this, careful issuers attempted to meet the numerical test by ensuring that there was some objective evidence of the limited number of total offers being made. For example, offering circulars and subscription agreements might be numbered "1 out of 30 total," "2 out of 30 total," etc. With the increased popularity of duplicating machines, the offering circular might be signed (occasionally with colored ink) to ensure that any offeree without an original would be advised that no offer was being made to him. Issuers also retained lists of offerees and instructions to their agents, hoping to provide themselves with a means of establishing that the offering was made only to a limited number of persons upon SEC or private litigant inquiry. Without such objective evidence, issuers could not prove that the total number of offerees were few enough to justify using the exemption.58

2. Inform the Offerees (the "Information/Access" Element)

Another means by which issuers sought to ensure the availability of the exemption was to provide information to the offerees. This stratagem addressed the SEC and judicial rationales that where offerees did not need the regulated delivery of information assured by the registration process, the exemption might be available. If the offerees had access to, or were provided with the information usually set forth in a prospectus, then the SEC and the courts deemed the protection of the registration process unnecessary and the offering fit within the exemption.59 The private offering circular arose as a result of this view. Issuers could be assured that the offerees did have such access or information if issuers took the precaution of furnishing offerees with a disclosure document which set forth most of the information required to be provided in a registration statement or prospectus. While the information actually set forth in offering circulars varied, those which most closely resembled the statutory prospectus were better assurance of the exemption's availability than less descriptive documents. The literary style of the offering circular came more and more to resemble the prospectus, both to protect the exemption and to meet the test for full and fair disclosure.

3. Ascertain the Sophistication of the Offerees (the Sophistication Element)

Both the SEC and the courts found the exemption applicable where the issuer approached only a limited number of offerees, who had no need for the kind of protection afforded the public with full-scale registration.60 If the issuer made offers only to those who were sophisticated

58. See, e.g., SEC v. Continental Tobacco Co. of S.C., 463 F.2d 137 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).
59. Id. This was true only if the other elements were present.
enough to fend for themselves, there would be an increased chance that the offering would be exempt. Accordingly, it became a common practice for issuers to secure descriptions of the offerees which highlighted their financial acumen and general good sense.

The purchase agreements began to set forth phrases such as “The undersigned acknowledges that he is capable of evaluating the merits and risks of this investment,” or “I have experience and skill and an understanding of finance.” The investor who had described himself as knowledgeable, sophisticated and financially aware (or had at least signed off on the issuer’s description of his qualities) would later have a more difficult time arguing, after the security had declined in value, that he really was not as sophisticated as he had held himself out to be.

4. Restrict the Purchasers’ Ability to Transfer the Securities Purchased (the Resale Element)

Pre-Rule 146 private offerings also required the issuer to be sure that its initial group of purchasers did not purchase the securities “with a view to the distribution thereof.” If a purchaser in a private placement distributed the securities purchased, the issuer was said to have made a two-step distribution. All those who purchased from the primary purchasers were considered for purposes of determining whether the offering was private. Thus, the SEC or courts sometimes held that the issuer had made an offering to the public through the subsequent sales by its primary purchasers. This would thereby cause the issuer to lose the exemption.

The standard means of ensuring against this were fourfold: (1) obtain a written commitment from the investor that he would not distribute (the “investment letter”); (2) issue stop-transfer instructions to the issuer’s transfer agent; (3) limit the number of physical certificates representing the shares purchased by the investor; and (4) legend the certificate with the language reflecting the nonpublic nature of the transaction in which they were sold.

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63. See In re Ambrosia Minerals, Inc., 39 S.E.C. 734 (1960). If a purchaser is deemed to be a statutory underwriter under section 2(11), then any restricted shares which he transfers will not be considered merely a resale of the shares, but rather “distribution” for public offering to the ultimate purchaser by the issuer, via the statutory underwriter. As such, if the total number of ultimate purchasers becomes too great, or the two-step distribution resembles a public offering, it is very possible that the offering which had been considered by the issuer to be private and exempted at its inception, may in this way become a public offering and thereby nonexempt. See also In re Unity Gold Corp., 3 S.E.C. 618 (1938); The Wheat Report, supra note 8, at 160–77; In re Gilligan, Will & Co., 38 S.E.C. 387 (1958).

64. An example of this is the following language, usually stamped in red ink on the face of the stock certificate:
II. RULE 146 AND ITS SHORT-LIVED PROGENY

As a result of the uncertain application of the private offering exemption, it became very difficult for the small business issuer to compete safely in the capital marketplace. The SEC and Congress, from the early 1970's to the present, adopted a number of measures for the purpose of clarifying the statutory 4(2) exemption and facilitating the ability of small businesses to raise capital. The most significant of these measures up to Congress's recent amendment of the 1933 Act adopting Sections 4(6) and 2(15) and the SEC's adoption of Regulation D were (1) the SEC's adoption of Rules 146, 240, and 242, and (2) the increase by Congress of the amount allowable under Section 3(b) from its original $100,000 in 1933 to $5,000,000 in 1980.

A. Rule 146

In April 1974 the SEC adopted Rule 146. The SEC intended Rule 146 to provide to the issuer a means of assuring its freedom from liability, or a "safe harbor," for those transactions which it made pursuant to Rule 146. Compliance with the Rule, moreover, assured issuers that they would be secure against potential civil suits by purchasers. The Rule was expressly nonexclusive and allowed the issuer, if he wished, the option of claiming the 4(2) exemption by complying with any administrative or judicial interpretation of the statutory exemption.

Rule 146 provided that the SEC would deem transactions by an issuer involving the offer and sale of its securities not to involve any public offering within the meaning of Section 4(2) of the 1933 Act if the offering complied with all the conditions of the Rule. Those conditions are similar

The shares of stock represented by this certificate have not been registered under the Securities Act of 1933 and may not be sold, assigned or otherwise transferred in the absence of an effective registration statement under said Act covering the transfer, or an opinion of counsel satisfactory to the issuer that registration under said Act is not required.

65. See infra note 72.
66. See infra note 118.
71. Section 19(a) of the 1933 Act (as amended by Pub. L. No. 73-291, § 209(b), 48 Stat. 881, 908 (1934)), supra note 1, states, inter alia, that "[n]o provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any Rule or regulation of the Commission. . . . ." 15 U.S.C. § 77s (1976). Thus, if an issuer complied strictly with the objective criterion of the rule, the SEC would consider the offering a nonpublic offering within the language of section 4(2), and the issuer would thereby be secure against potential civil suits from purchasers who subsequently claimed that the offering was a public offering.
to the four elements required before Rule 146 and described in section II of this article: the sophistication of the offerees, access to or furnishing of information about the issuer, limitations on the number of purchasers, and limitations on the subsequent disposition of the securities. The Rule also added new elements. First, the issuer must notify the SEC (the “Notification Element”) of an offering made pursuant to the Rule. Second, the Rule contained different informational requirements depending upon (1) the issuer’s status as a 1934 Exchange Act reporting company (the “Nature of the Issuer Element”), and (2) the total amount of securities offered (the “Size of the Offering” Element). The new elements continued to evidence the SEC’s concern with the questions of sophistication and information. Unlike the changes made by Regulation D, the conditions of Rule 146 were basically an objective standardization of the elements which had already been applied by the courts and the SEC in defining a private offering. The process of standardization of the elements, however, made policy and practice more clear, and instituted procedures and considerations which are important to examine.

1. The “Numerical Element”

Rule 146 separated the numerical element of a private placement into three categories. The first was the non-public manner of making the offering. The second was the actual number of purchasers. The third was the case of several successive “private offerings” which, if integrated, could be considered one public offering.

a. Manner of Offering

To ensure the nonpublic manner of the offering, Rule 146 prohibited the issuer or any person acting on its behalf from offering or selling the issuer’s securities by any form of general solicitation or general advertisement. The prohibition included offers or sales through advertisement or other communications in newspapers, magazines, or other media; broadcast on radio or television; seminars or promotional meetings; or

73. See supra notes 55–64 and accompanying text.
74. This element was not adopted as part of the original rule. It was suggested in the proposal for the Rule, but the SEC later rejected the notification requirement on the ground that requiring a filing as a condition of the rule would unnecessarily increase the difficulty of complying with the rule for many small issuers. The SEC subsequently, in March of 1978, changed its mind and required that for offerings of over $50,000 a filing would be a condition of the rule. Securities Act Release No. 5912 [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,524, at 80,117 (Mar. 3, 1978).
75. See infra notes 97–98 and accompanying text.
76. See infra notes 99–103 and accompanying text.
77. See infra notes 206–209 and accompanying text.
78. Rule 146(c), supra note 72.
any letter, circular or other written communication. The last two forms of publication were permissible under certain circumstances. An issuer could make an offer through a letter, circular, or other written communication if the issuer reasonably believed that each offeree to whom the communication was directed was either capable of evaluating the risks of the investment ("sophisticated") or able to bear the economic risks of the investment ("wealthy"—the forerunner of the new "accredited purchaser" concept of Rule 242, Section 4(6), Regulation D, and Rule 215). Likewise, the issuer could make an offer or sale of securities through a seminar or promotional meeting if the issuer reasonably believed that each offeree in attendance was either (1) sophisticated or (2) wealthy and represented by someone who was sophisticated (a Rule 146 "offeree representative").

These prohibitions limited the manner of offering. In doing so, however, they did not limit the number of offerees to whom an offering could be made. Before Rule 146, the number of offerees had been critical to determination of the availability of the private offering exemption.

b. Number of Purchasers

To ensure that an offering pursuant to the Rule would not involve any public distribution, Rule 146 provided a limitation on the number of ultimate purchasers. Under the Rule the issuer must have had reasonable grounds to believe, and after having made a reasonable inquiry, in fact believe, that there would be no more than 35 purchasers of the securities of the issuer in any offering pursuant to the Rule. This setting of a fixed number was a significant departure from pre-Rule 146 principles.

In computing the number of purchasers, the Rule merged the infor-

79. Id.
80. Rule 146(c)(3) (referring to Rule 146(d)(1)), supra note 72.
81. Rule 146(c)(2) (referring to Rule 146(d)(1)), supra note 72. Prior to Rule 146, many practitioners believed that the holding of seminars or reasonably large meetings might be considered an offering to the public at large. Because of this, the careful practitioner sought to avoid such methods of solicitation. The adoption of Rule 146, however, provided a set of standards which brought a quantum of safety to this practice and was seen by most as a welcome change. See Coles, Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review, 58 Marq. L. Rev. 395, 438–39 (1975).
82. See supra notes 55–58 and accompanying text. The omission of such a requirement evidenced a movement by the SEC away from an emphasis on the offeree to the ultimate purchaser in the determination of the availability of the private offering exemption.

Additionally, the allowance of offers or sales of the issuer's securities through a seminar or promotional meeting or by a letter, circular or other written communication to certain qualified offerees provided an amount of certainty to a set of practices which had, prior to the Rule, been considered risky.
83. Rule 146(g), supra note 72.
84. See supra notes 55–58 and accompanying text.
PRIVATE AND LIMITED OFFERINGS

The creation/access element of the pre-Rule 146 era with the numerical element by providing that certain classes of purchasers would be excluded from the 35-purchaser limitation, apparently because they possessed some inherent superior ability in obtaining information from the issuer. The Rule required that the issuer be able to exempt these special purchasers from being included in the numerical computations, and that he satisfy all the other provisions of the rule with respect to such persons. Those purchasers excluded from the computations were:

(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 paragraph (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; and
(d) Any person who purchases or agrees in writing to purchase for cash in a single payment or installments, securities of the issuer in the aggregate amount of $150,000 or more.

c. Integration

The Rule, in providing for the computation of the 35 purchasers, continued the requirement that the offering in which the number of purchasers was computed be separate and not integrated with a larger offering. The Rule allowed two methods of making the determination as to whether the offering under the Rule would be integrated with another prior or subsequent offering. These methods are the traditional integration test provided by the SEC and a specific “safe harbor” test within the Rule itself. The traditional test is a subjective weighing of the following factors:

(1) whether the offerings are part of a single plan of financing;
(2) whether the offerings involve issuance of the same class of security;
(3) whether the offerings are made on or about the same time;

85. This creation of a class of superior purchasers appears to have been a forerunner of the "accredited person" and "accredited investor" of Rule 242, § (a)(1), supra note 67, and Regulation D, supra note 10. See infra notes 150, 193, 246 and accompanying text.
86. Rule 146(g)(2)(i), supra note 72.
(4) whether the same type of consideration is to be received; and 
(5) whether the offerings are made for the same general purpose. 88

The safe harbor test in the Rule for integration was based upon ex-
aminations of the offerings of the issuer six months preceding and six 
months following the offering. If, upon such examinations, the issuer or 
his representative made no offers or sales of securities of the same or 
similar class as those offered or sold pursuant to the Rule, then the SEC 
would deem the offering not to be part of a larger offering. 89

2. The “Sophistication” Element

To determine whether offerees could fend for themselves without the 
additional protection procedures of SEC registration, the Rule considered 
both ability of the purchaser to bear the risk and his financial sophisti-
cation. Specifically, the Rule required that the issuer and any person 
acting on his behalf have reasonable grounds to believe and in fact believe:

(1) Immediately prior to making any offer, either: 
   (i) [t]hat the offeree ha[d] such knowledge and experience in 
       financial and business matters that he [was] capable of evaluating 
       the merits and risks of the prospective investment [“sophisti-
       cated”], or 
   (ii) [t]hat the offeree [was] a person who [was] able to bear the 
       economic risk of the investment [“wealthy”]; and 

(2) Immediately prior to making any sale, after making reasonable 
inquiry, either:  
   (i) [t]hat the offeree ha[d] such knowledge and experience in 
       financial and business matters that he is capable of evaluating 
       the merits and risks of the prospective investment [“sophisti-
       cated”], or 
   (ii) [t]hat the offeree and his offeree representative(s) together 
       ha[d] such knowledge and experience in financial and business 
       matters that they [were] capable of evaluating the merits and 
       risks of the prospective investment [“sophisticated”] and that 
       the offeree [was] able to bear the economic risk of the investment 
       [“wealthy”]. 90

These requirements reflected a dual standard in determining the ability 
of an offeree to fend for himself depending upon the offeree’s position 
within the transaction which was not well articulated in the pre-Rule 146 
era. If the offeree were merely receiving an offer, the SEC deemed him

88. Id.
89. Rule 146(b)(1), supra note 72.
90. Rule 146(d), supra note 72.
to be able to fend for himself as long as the issuer reasonably believed that the offeree was either sophisticated or wealthy. If the offeree were actually preparing to purchase, the SEC would not deem him to be able to fend for himself unless the issuer reasonably believed that the offeree was either (1) sophisticated or (2) wealthy and represented by someone who was sophisticated (the "offeree representative").

The consideration of an offeree representative in determining the sophistication of the offeree deviated from previous law. Prior to Rule 146, the sophistication of the offeree was generally determined solely with reference to the offeree himself. Paragraph (d) of Rule 146, however, permitted a representative to step into the offeree's shoes for the determination of the offeree's sophistication provided that the offeree could bear the economic risk of the investment. As a result of this, the standard practice by prudent issuers and their attorneys who were arranging a private offering under the Rule was to see that all questionable purchasers had an offeree representative.

The cumulative effect of the Rule 146 requirements relating to the nature of the offeree was to provide a greater amount of objectivity to the determination of this sophistication. Before the Rule, the determination of offeree sophistication was purely subjective and created uncertainty in almost all transactions in which the issuer sought the protection of the private offering exemption. Afterward, because the Rule still required a subjective determination by the issuer concerning the sophistication of the offeree, there were still problems with certainty. The problems were mitigated in a number of ways. First, under the Rule, the issuer was not required to be correct in its determination of the offeree's qualifications, but rather need only have a reasonable belief of such qualifications. As long as the issuer retained this reasonable belief, he could not lose his exemption even if, subsequent to the offer or sale by an issuer to an offeree, it was determined that the offeree was not sophisticated and/or wealthy. Second, the sophistication of the offeree could be relatively assured by requiring each offeree to have a qualified offeree representative. Further, the SEC provided some guidance for determining the offeree's ability to bear the economic risk of the investment. In the synopsis of the Rule the SEC stated that in making the determination of the offeree's "ability to bear the economic risk" of the investment, important consideration was to be given to whether the offeree could afford to hold unregistered securities for an indefinite period and whether, at the time of the investment, the offeree could afford a complete loss.

91. Rule 146(a)(1), supra note 72.
92. See supra note 90 and accompanying text.
93. See supra note 70.
3. The "Information Element" and the Emergence of Two New Elements

In order to ensure that each offeree was afforded the protection which would have been provided by registration, the Rule required that the issuer provide certain information. During the course of the transaction and before the sale of the securities, each offeree or his representative must either have access to, or be furnished by the issuer with, the same kind of information specified in Schedule A of the 1933 Act, to the extent that the issuer possessed it or could have acquired it without unreasonable effort or expense.94

The Rule defined "access" in a manner similar to that used earlier by the courts and the SEC—as a function of the offeree's relationship with the issuer.95 Access existed only by means of an employment or family relationship or economic bargaining power which enabled the offeree to obtain information from the issuer in order to evaluate the merits and risks of the investment.96 Defining and ensuring compliance with this element, as evidenced by the case law prior to Rule 146, was generally uncertain. As a result, the careful practitioner did not rely upon merely giving access to the offerees, but rather continued to furnish to the offerees the required information under Rule 146 as he did in the pre-Rule 146 era.

a. The "Nature of the Issuer" Element

In one respect, the Rule served to streamline procedure and prevent duplication of effort. The informational requirements of Rule 146 were tied to whether that same information had been already reported under the Securities Act of 1934 (the 1934 Act) and were coordinated with such reported information. In the case of an issuer subject to the reporting requirements of Section 13 or Section 15(d) of the 1934 Act,97 the SEC would deem the informational requirements of Rule 146 to be satisfied if the offeree or his representative was furnished with:

1. the information contained in the annual report required to be filed under the 1934 Exchange Act, an S-1 registration statement under the 1933 Act, or a Form 10 under the 1934 Exchange Act (whichever was most recently required to be filed);

2. information subsequent to the above which was contained in any definitive proxy statement required to be filed pursuant to Section

94. Rule 146(e)(1)(i), supra note 72.
95. Rule 146(e), Note, supra note 72.
96. Id.
97. 15 U.S.C. § 79(l)(g)(1976). An issuer generally becomes subject to 1934 Act reporting requirements by having (1) at least 500 shareholders and (2) $1 million of assets.
14 of the 1934 Exchange Act, and any reports or documents required to be filed by the issuer pursuant to Section 13(a) or 15(d) of the 1934 Exchange Act; and

(3) a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs which were not disclosed in any of the above documents.98

b. The "Size of the Offering" Element

In the case of issuers who had not filed reports under the 1934 Act, the information required to be provided to the offeree depended upon the total aggregate amount of the securities offered in reliance upon the Rule. If the aggregate sales price did not exceed $1,500,000, the SEC would consider the informational requirement to be satisfied by furnishing to the offeree that information which was required to be disclosed under Schedule I of Regulation A under Section 3(b) of the 1933 Act.99 If the aggregate sales price exceeded $1,500,000, the Rule required the issuer to furnish the information that would be required to be included in a registration statement under the 1933 Act on the form which the issuer would be entitled to use.100

Along with the written informational requirements, the Rule mandated access to further information, if it was available. The Rule required that both 1934 Act reporting issuers and nonreporting issuers provide to each offeree or his representative the opportunity to ask questions of, and receive answers from, the issuer concerning the terms and conditions of the offering.101 Additionally, each offeree or his representative had the right to obtain any additional information, to the extent the issuer possessed such information or could have acquired it without unreasonable effort or expense, necessary to verify the accuracy of all information furnished by the issuer. This information or any other information required under the Rule was not required to be provided to any offeree who, during the course of the transaction, indicated that he was not interested in purchasing the securities offered.102

The access and informational requirements created a strict and often costly method of disclosure. For the issuer subject to Section 13 or 15(d) of the Exchange Act (whose documents had to be prepared anyway), the burdens of compliance with the Rule were usually minimal. For the small business issuer, whose documents were not already prepared, the costs

98. Rule 146(e)(I)(ii)(a), supra note 72.
100. Rule 146(e)(I)(ii)(b), supra note 72.
101. Rule 146(e)(2), supra note 72.
102. Rule 146(e)(3), supra note 72.
of complying with the above requirements often proved too great and effectively forestalled it from using the rule. It is largely because of this cost and time that the SEC adopted the subsequent exemption rules intended specifically for the small business issuer.\textsuperscript{103}

4. The Resale Element

To prevent the private offering from being converted into a two-step public offering,\textsuperscript{104} former Rule 146 required the issuer to take reasonable care to ensure that the purchasers of its securities did not intend to distribute them. Such reasonable care under the rule included, but was not limited to:

(1) Making reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons;
(2) Placing a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities;
(3) Issuing stop transfer instructions to the issuer’s transfer agent, if any, with respect to the securities, or, if the issuer transfer its own securities, making a notation in the appropriate records of the issuer; and
(4) Obtaining from the purchaser a signed written agreement that the securities will not be sold without registration under the Act or exemption therefrom.\textsuperscript{105}

These requirements ensured that the purchasers were buying for investment purposes only (the question was whether a purchaser had “investment intent”)\textsuperscript{106} and prevented one or more of the purchasers from dividing their unregistered securities into smaller parcels and then selling them to the general public without any of the protection afforded by the Rule. The requirements reflected substantially the same concerns as in the pre-Rule 146 era, and indicated no departure from pre-existing procedures.\textsuperscript{107}

5. Something New: The “Notification” Element

Rule 146, as adopted in 1974, contained no notification requirements.\textsuperscript{108} In May of 1978, however, the SEC amended the Rule to require the

\textsuperscript{103} See infra notes 116–119 and accompanying text.
\textsuperscript{104} See supra note 63 and accompanying text.
\textsuperscript{105} Rule 146(h), supra note 72.
\textsuperscript{106} See supra notes 62, 63 and accompanying text.
\textsuperscript{107} Id.
\textsuperscript{108} See supra note 74.
issuer at the time of the first sale of an offering over $50,000, made in
dependence upon the Rule, to file a Form 146 Report with the SEC.109 The
filing was a new requirement in the federal law of private offerings. The
purpose of requiring the issuer to file was (1) to provide the SEC with
empirical data on the usage of the Rule and (2) to allow the SEC to
discover abuses of the Rule and thus prevent fraud in its incipient stages.110
To accomplish these goals, the Form 146 Report required the issuer to
report to the SEC:

(1) basic information regarding the issuer and its chief executive
officer or natural persons who are the issuer’s general partner(s),
promoter(s), or controlling person(s);
(2) names and addresses of organizers, promoters and sponsors of,
and offeree representatives involved in, the offering;
(3) the title and dollar amount of existing and planned sales of the
security in the offering; and
(4) the existence of prior filings by the issuer with the SEC.111

The SEC used the information received in these Form 146 Reports in its
promulgation of subsequent exemptive rules and regulations relating to
private and limited offerings.112

6. Rule 146: An Evaluation

Rule 146 provided to the issuer of securities a greater amount of cer-
tainty than was available in the usage of the statutory private offering
exemption. It allowed more certainty in the issuer’s determination of the
offeree’s sophistication by allowing the use of an offeree representative
and by basing the determination of the offeree’s sophistication on the
reasonable belief of the issuer rather than the actual characteristics of the
offeree. It answered the difficult questions, concerning the definition of
“offeree access” and what type of information was required to be provided
to the offeree, by specifically defining and describing access and the type
of information to be provided. Finally, the Rule provided the issuer with
objective standards on the issues of numerical standards, investment in-
tent, and manner of offering. The Rule provided the standards by setting
specific limitations on the number of purchasers, requiring limitations on
the disposition of the securities, and strictly limiting the permissible
manners of offering.

109. Id. The Rule expressly omitted offerings of less than $50,000 from the filing requirement
because of the de minimis nature of those offerings and the unnecessary increased difficulty in
complying with the rule such a requirement would have upon small businesses.
at 80,117 (Mar. 3, 1978).
111. Id.
112. See infra note 206 and accompanying text.
While superior to the previous law, the Rule did require at least some subjective determinations on major questions, such as access to information, sophistication of the offeree or his representative, and the ability of the offeree to bear the economic risk of the investment. In addition, the Rule required that the issuer provide to each offeree the type of information which would be disclosed in registration. For a 1934 Exchange Act reporting company,113 which by law was required to prepare this information annually, this requirement was of little consequence; but for the small business, which had to go through the expense of preparing this information, compliance entailed a substantial cost. For many of those small businesses, the potential cost outweighed any possible advantages and thereby rendered the Rule useless to them. Finally, the Rule's provisions as to omissions of material information made technical violation likely. Recognizing the above inadequacies of Rule 146, especially as they related to small businesses, the SEC adopted Rule 240, to provide exemption for limited offerings by small business issuers. The SEC hoped that this new rule would alleviate some of the problems of Rule 146.114

B. Rule 240: Exemptions for Limited Offerings by Closely Held Corporations

On March 15, 1975, the SEC adopted Rule 240, pursuant to its authority under Section 3(b) of the 1933 Act.115 The purpose of this Rule was to assist closely held issuers in raising small amounts of capital on a periodic basis.116 To achieve this objective, the Rule provided an exemption from the registration provisions of the 1933 Act for offers and sales by a small business issuer where, because of the small size and limited character of the offering, the public benefits of registration would be too remote.117 Specifically, Rule 240 provided to the issuer having 100 or fewer beneficial owners118 an exemption from registration for periodic sales of securities totalling less than $100,000 for any twelve-month period.119

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113. See supra note 97.
115. Id.
116. Id.
117. Id.
119. While Rule 240 did provide an exemption from registration, it did not provide any exemption from the antifraud provisions of the federal securities laws, from the civil liability of Section 12(2) of the 1933 Act or from any other provisions of the federal securities laws. Purported reliance on the Rule did not constitute any election foreclosing the issuer from claiming the availability of any other applicable exemption. The Rule was available only to the issuer of the securities other than investment companies registered or required to be registered under the Investment Company Act of 1940, and was not available to affiliates or other persons for resales of the issuer's securities. See Rule 240, Preliminary Notes 1–4, Rule 240(b), supra note 118.
To the small business, Rule 240 represented a substantial improvement over Rule 146 that enhanced this ability of the small business to raise limited amounts of capital. It abolished Rule 146’s uncertain subjective determinations relating to the offeree’s sophistication as well as the Rule’s potentially expensive disclosure requirements. Rule 240 was not, however, a complete renunciation of the conditions and policies of Rule 146. In fact, Rule 240 retained many of the pre-existing elements of a private offering. In addition, it provided a number of new or substantially altered elements of its own.

1. The “Numerical/Nature of the Issuer” Elements

   a. Manner of Offering

   Rule 240 retained the general prohibition of Rule 146 that the securities could not be offered or sold by any means of general advertising or general solicitations. Unlike Rule 146, however, Rule 240 did not specifically define what actions would be included within this prohibition. Safe practice indicated that they should be understood as including Rule 146’s general prohibition against any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over television or radio.

   In addition, the manner of the offer under the rule was more restricted than under Rule 146. Rule 240 prohibited any payment of commissions or similar remunerations for soliciting any prospective buyer or in connection with any sales made in reliance on Rule 240. The purpose of this restriction as described by the SEC was to ensure that the securities would not be offered or sold by the use of “high pressure tactics or otherwise through organized securities distribution media.” By restricting the offers and sales in this manner, the Rule ensured that potential investors would be able to bargain directly with the issuer and thus be afforded a greater opportunity to make an informed investment decision. However, while allowing greater issuer/offeree contact, the Rule also carried with it the negative effect of hampering the ability of the issuer to find potential investors. The Rule prevented the issuer from providing incentive to employees or customers to find other buyers.

120. Rule 240(c), supra note 118.
121. The status under Rule 240 of an offer or sale through a seminar, promotional meeting, letter or circular was less clear. As a result, an issuer making such an offer either attempted to comply with the subjective qualified offeree provisions of Rule 146 for such offerings or tread upon uncertain grounds.
b. Limitation on the Number of Beneficial Owners

Rule 240 contained a numerical element which reflected its special concern with small business. To ensure that the Rule was available only to small or medium-sized businesses and that the offering would not involve or result in a two-step public distribution, Rule 240 provided for a limitation on the number of beneficial owners the issuer could have. Under its provisions the issuer must have had reasonable grounds to believe, and in fact believe, that both immediately before and immediately after any transaction in reliance on the Rule, that the "securities of the issuer" were beneficially owned by one hundred or fewer persons.123 The Rule defined "securities of the issuer" as all securities issued by the issuer and by any affiliate of the issuer.124

The numerical requirements of Rule 240 provided to the small business in its incipient stages a greater ability to secure up to 100 potential purchasers without worrying about the 35-purchaser limitation under Rule 146. Given that a small business is often forced to seek more investors than the larger business to raise the same amount of capital, this change

123. Rule 240(f), supra note 118.
124. The Rule also considered that securities issued "by partnerships with the same or affiliated general partners and fractional undivided interests in oil or gas rights created by the same or affiliated persons," Rule 240(a), supra note 118, were to be included as "securities of the issuer." In computing the number of beneficial owners owning securities of the issuer, the Rule provided:

(1) That the following holders of the issuer's securities would be deemed a single beneficial owner.
   (a) Any relative or spouse of a beneficial owner and any relative of such spouse who has the same residence as the beneficial owner;
   (b) Any trust or estate in which a beneficial owner or any of the persons related to him, as specified in subparagraphs (i) or (iii) herein, collectively own one hundred percent of the beneficial interest (excluding contiguous interests); and
   (c) Any corporation or other organization of which a beneficial owner or any person related to him as specified above collectively are the beneficial owners of all the equity securities (excluding directors' qualifying shares) or equity interests.

(2) That a corporation or other organization be counted as one beneficial owner, unless such entity was organized for the specific purposes of acquiring the securities offered. In such case each beneficial owner of the equity in the entity be counted as a separate beneficial owner.

(3) That any owner of only a purchase money mortgage and any bank, savings institution, trust company, insurance company, investment company registered under the Investment Company Act of 1946, Small Business Investment Company or Minority Enterprise Small Business Investment Company licensed by the U.S. Small Business Administration, or pension or profit-sharing trust which purchases or holds only nonconvertible or similar evidence of indebtedness of the issuer. Any covenants of other rights enabling the purchaser to acquire an equity interest in the issuer attached to the above nonconvertible notes would result in the holder of such a note to be considered a business owner.

See Rule 240(f), supra note 118.
seemed appropriate. It should be noted that when contrasting the numerical limitations of the two rules, the limitations of Rule 240 applied for total number of purchasers throughout the history of the business, i.e., beneficial owners, while the limitations of Rule 146 applied on an offering-by-offering basis. Thus, while Rule 240 may have in some respects seemed more permissive in this requirement than Rule 146, the benefit accrued only so long as the beneficial ownership of the business remained small. Once the ownership of the business expanded to near one hundred, the usefulness and numerical aspects of Rule 240 became less attractive.125

2. The “Resale” Element

The SEC deemed the securities acquired pursuant to Rule 240 to have the same status as if they had been acquired in a transaction pursuant to the private offering exemption and could not be resold without registration under the 1933 Act or an applicable exemption from the Act. Given this, the Rule required that the issuer take reasonable care, in a somewhat less comprehensive manner than the procedures set forth in Rule 146, to ensure that the purchasers of the securities of the offering not be underwriters within the meaning of Section 2(11) of the 1933 Act. Reasonable care under the Rule included, but was not limited to:

(1) Making reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons;
(2) Informing the purchaser of the restrictions on resale; and
(3) Placing a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities.126

3. The Abandoned “Information and Sophistication” Elements

Rule 240 departed radically from both pre-Rule 146 and Rule 146 principles in two ways. First, the new Rule omitted any requirements as to the type of information to be furnished to purchasers. Second, the Rule failed to ensure that purchasers be the sort of sophisticated investors for whom the registration provisions of the 1933 Act were unimportant. While the Rule made express reference to the nonexemption from the full dis-

125. Moreover, since the Rule’s numerical limitation was set at one hundred beneficial owners it had the practical effect of precluding its use by 1934 Exchange Act reporting companies who by definition would have over 500 beneficial owners. See 1934 Exchange Act §12(g), 15 U.S.C. §78(l)(g) (1976).
126. Rule 240(g), supra note 118.
closure/antifraud aspects of the 1933 Act, it did not specify what information was to be conveyed nor did it set forth any guidelines as to the significance of a purchaser's sophistication. An issuer might sell $10,000 worth of stock to an illiterate chimney sweep by means of an accurate five-minute discussion as to the nature of the issuer's computer software business, and Rule 240 protected the transaction from SEC or judicial scrutiny.

4. The "Size of the Offering" Element

To ensure that the exemption would apply only to limited offerings, the Rule provided a limitation of $100,000 on the total dollar amount of securities which could be sold pursuant to the Rule within any twelve-month period. The Rule required the issuer, in calculating the aggregate sales price of the securities for the limitation, to include all consideration received for the securities, including cash, services, property, notes, or other consideration.

The purpose in having the above dollar limitations in the Rule was clearly to ensure that the exemption would be available only for those offerings which because of their limited nature or small amount involved did not require registration for the protection of the investor. The problem with the Rule's limitation was that it proved to be too low to provide relief to any but the smallest of issuers. The small business which needed to raise $200,000 to expand its business and could not afford the cost or

127. Rule 240, Preliminary Note 1, supra note 118.
128. The antifraud/full disclosure aspects of the 1933 and 1934 Exchange Acts would, however, at least arguably protect this purchaser. See supra notes 21-26 and accompanying text.
129. Rule 240e, supra note 118.
130. In making this computation, the Rule allowed the issuer to exclude the following:
   (1) All securities of the issuer registered or exempt from registration under the 1933 Act if the securities were sold prior to the effective date of the rule;
   (2) The following securities if sold in reliance on an exemption from registration other than Rule 240:
      (a) Nonconvertible notes or similar evidence of indebtedness (i) representing a purchase money mortgage or (ii) issued to banks, savings institutions, insurance companies, trust companies, registered investment companies, small business investment companies, minority small business investment companies, or pension or profit-sharing trusts. Nonconvertible notes for purposes of this exclusion did not include notes which, although on their face were nonconvertible, carried with them warranted or other rights which would have allowed the issuer to later acquire an equity interest in the issuer.
      (b) Securities sold to promoters, directors, executive officers or full-time employees of the issuer. While the securities sold to these persons were excluded from the computation of the aggregate sales amount, each of these persons did count in the rule's computation of the number of beneficial owners of the issue.

Rule 240(e) Note 3, supra note 118.
131. See supra note 114.
risk involved under Rule 146 was excluded under Rule 240. Thus, the dollar limitation of Rule 240 may have served its purpose of investor protection too well. The level at which it was set appeared to be lower than that needed to provide that protection.

5. The "Notification" Element

To allow the SEC effectively to monitor the use of Rule 240, the Rule included a notification requirement. The rule provided that within ten days after the close of the first month in which a sale in reliance on the rule was made, the issuer must file a Form 240 Report with the SEC. The form needed only to be filed once in each calendar year. The Form 240 Report required the issuer to disclose to the SEC (1) its name, address, and telephone number; (2) the names of its executive officers, promoters, and beneficial owners of ten percent or more of the equity of the issuer; (3) the title and class of securities held; (4) the aggregate sales price of unregistered securities sold within the preceding twelve months, along with the number of beneficial owners of securities of the issuer computed as of the date of the filing and computed as required by the Rule.

6. Rule 240: An Evaluation

Rule 240 represented a significant change in securities law. It provided for the small business issuer a relatively safe harbor with reasonably objective criteria. Compliance with the Rule was neither unnecessarily burdensome nor complicated. For an issuer to qualify under the Rule, it needed only to limit the manner of its offer, have less than 100 beneficial owners, sell no more than $100,000 in a twelve-month period, and put limitations on the resale of the securities. The Rule did not require an issuer to make subjective determinations concerning the qualifications of the offerees, nor did it require him to provide to the offerees extensive informational documents. The offeree, however, was not left completely unprotected under the Rule. All sales pursuant to the Rule remained subject to all the antifraud provisions of the 1933 Act, the 1934 Exchange Act, and all applicable state blue-sky laws. In addition, by disallowing brokerage transactions, the SEC intended the Rule to ensure that the

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132. Rule 240(h)(1), supra note 118.

133. Notwithstanding the Rule's notification requirement, the exemption provided by the Rule was available for the first $100,000 of the securities sold by the issuer if the sale of such securities complied with all the conditions of the rule other than the notice requirement. The exemption was not, however, available for any subsequent sale of the securities, unless the issuer filed:

(1) prior to such subsequent sale in reliance on Rule 240 a Form 240 covering the prior sale of all securities for which reliance on Rule 240 is claimed; and

(2) a notice on a Form 240 covering the subsequent sale.

Rule 240(h)(2), supra note 118.
offeree had as much contact as possible with the issuer. Through restrictions on disposition, the SEC attempted to make the offeree aware that he was buying into a long-term investment which involved risks. The Rule balanced the needs of the small business to raise capital with the protection of the investor.

Criticism of the Rule suggested that the balance was not well struck; that it did not go far enough in liberalizing the law for small business issuers.\textsuperscript{134} There were suggestions that the $100,000 limitation on the aggregate sales price be increased, that the beneficial owner limitations be eliminated, that brokerage transactions be allowed, and that the filing requirement be abolished. The complaints which gave rise to these suggestions, however, were not based upon any inherent problems in the Rule, but upon a general disillusionment with how the securities laws were affecting the ability of the small business to raise capital.\textsuperscript{135}

Reacting to this, the Advisory Committee on Corporate Disclosures recommended in 1977 that the SEC evaluate the impact of its rules and regulations on small businesses. The Committee suggested that the SEC consider the ability of a small business to raise capital, as well as the financial and other effects on small businesses of SEC disclosure policies.\textsuperscript{136} In April and May of 1978, the SEC conducted an examination into these matters in public hearings held in six cities across the country.\textsuperscript{137} From these hearings the SEC recognized that Rules 146 and 240 were not especially helpful to small businesses.\textsuperscript{138} Subsequently, in 1980, in an attempt to address the problems existing in the area of small business financing, the SEC adopted Rule 242.

\section*{C. Rule 242: The Exemption for Qualified Issuers and Accredited Persons}

The now rescinded Rule 242 was adopted by the SEC in January 1980\textsuperscript{139} for the purpose of providing an additional method for certain corporate


\textsuperscript{135} \textit{See supra} note 44. It should also be noted that Rule 240 created a potential conflict between federal and state regulation of the securities offered: state law frequently required registration for securities offered under the Rule, but regardless of such registration, the Rule required the securities to be subject to restrictions and resale. Regulation D deals with the "federal exempt-state registered" offering in a more appropriate manner. \textit{See infra} note 253.

\textsuperscript{136} Committee Print 95-29, House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess. 511 (1977).


issuers to raise limited amounts of capital without having to comply with either Rule 146 or the registration provisions of the 1933 Act. The SEC designed the Rule to provide to those issuers objective requirements which were less burdensome than those found in Rules 146 and 240. The Rule took the traditional four elements of pre-Rule 146 law, modified the sophistication, information, and numerical elements, modified the elements of notification, nature or qualification of the issuer, and size of the offering from Rules 146 and 240, and added a new element, that of the "accredited person." The Rule was a much more lenient and objective rule than either Rule 146 or Rule 240 and was a welcome change for most practitioners.

Rule 242 allowed certain issuers, who complied with all the conditions of the Rule, to offer and sell up to $2,000,000 of their securities to an unlimited number of accredited persons. "Accredited persons" were, for example, purchasers of at least $100,000 of securities, or the issuer's executive officers or directors. In addition, the issuer could sell to 35 nonaccredited purchasers. The unique aspects of the Rule were related to the nature and qualification of both the issuer and the "accredited" purchaser. In other respects, such as the manner of offering, sophistication of offerees, number of purchasers, availability of information, limitations on resale, and notification, Rule 242 was similar, though not identical, to the prior law.

1. Issuer Qualifications: The "Nature of the Issuer" Element

Unlike the earlier rules, Rule 242 was not available to all issuers, but rather only to "qualified issuers." The Rule defined a qualified issuer as any United States or Canadian corporation which was:

1. not an investment company;
2. not engaged in significant oil or gas related operations;
3. not a subsidiary of an issuer which would not be qualified to use the exemption; and
4. not a company barred from using Regulation A because of prior misconduct by it or associated persons.

These issuers were excluded from the Rule as a matter of caution. At the time Rule 242 was adopted it was in the nature of an experiment, and

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142. Rule 242(a)(5).
143. This prohibition was subsequently amended in 1981 to exclude from the rule those companies which intended to engage in oil and gas related operations which would exceed the criteria for the exemption specified in §210.10(k) of Regulation S-K. Securities Act Release No. 6299, 1981 Transfer Binder Fed. Sec. L. Rep. (CCH) ¶ 82,851, at 84,186 (Mar. 18, 1981).
144. See 17 C.F.R. § 230.252(c) (1981).
the SEC felt that, because the Rule's disclosure provisions were not geared toward these types of issuers and the potential of abusing the Rule was greater among them, they should be excluded in the interest of investor protection. The problem with the exclusion, however, was that it discriminated against a great many issuers for which no other effective method of raising capital was available. Moreover, the information delivery requirements in cases involving sales to both accredited and non-accredited purchasers were a practical deterrent for use of the Rule by issuers not already compiling such information for purposes of reporting under the 1934 Exchange Act. The informational requirements effectively limited the use of the Rule to 1934 Exchange Act reporting companies. There still was not an available means for small businesses to raise significant amounts of capital.

2. The "Numerical" Element

To ensure that the offering would be made only to a limited number of persons, the Rule prohibited the offering to be made through any form of general solicitation or general advertising. This prohibition was similar to Rule 146 and Rule 240 requirements as well as pre-Rule 146 law. Rule 242 also contained limitations on the number of ultimate purchasers, but in a form which varied from prior law and regulation. As in Rule 146, this limitation required that the issuer have reasonable grounds to believe, and after making reasonable inquiry, in fact believe, that there would be no more than 35 purchasers of the securities of the issuer in any offering pursuant to the rule. Rule 242, however, differed from Rule 146 in its method of computing the number of purchasers by more clearly linking the pre-Rule 146 sophistication element with the numerical element.

Rule 242 expanded the number of persons who were excluded from the Rule 146 computation of the number of purchasers. It retained Rule

146. See supra notes 97–102 and accompanying text.
147. Rule 242(d), supra note 140.
148. Rule 242(e)(1), supra note 140; compare Rule 146(g), supra note 72.
149. Rule 146 allowed the issuer to exclude from his computations:

(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); and
(c) Any corporation or other organization of which a purchaser or any of the persons related to him as specified in paragraph (g)(2)(ii)(a) or (b) of this section collectively are the beneficial owners of all the equity securities (excluding directors' qualifying shares) or equity interest; and
146's basic exclusions for related purchasers, but replaced the $150,000 purchaser exclusion with an exclusion for any sale to an "accredited person." The Rule defined an accredited person as any person which the issuer reasonably believed was:

1. A bank (as defined in Section 3(a)(2) of the Securities Act), whether acting in its individual or fiduciary capacity;
2. An insurance company (as defined in Section 2(13) of the Securities Act);
3. An employee benefit plan, provided the investment decision was made by a plan fiduciary which was a bank, insurance company or registered investment adviser;
4. An investment company registered under the Investment Company Act of 1940;
5. A small business investment company licensed by the United States Small Business Administration;
6. A purchaser of $100,000 or more of the issuer's securities sold in reliance on Rule 242 who made payment through one or more of the following: cash, a full recourse obligation against the purchaser which is to be discharged within 60 days of the first issue of the securities, or a cancellation of the issuer's debt to the purchaser, or
7. A director or executive officer of the issuer. Included within these are the president, secretary, treasurer, and any vice-president in charge of a principal business function.\textsuperscript{150}

The replacement of the $150,000 purchaser exclusion for the "accredited purchaser" exclusion resulted in an expansion of the potential size of an exempted private or limited offering. Prior to this change, for offerings of over $100,000, the number of purchasers was limited to 35, plus any related purchasers or purchasers of over $150,000.\textsuperscript{151} After the change, the number of ultimate purchasers became, in fact, unlimited, as long as the purchasers were institutional investors, investment companies, principals in the business or purchasers of over $100,000 of the issuer's securities. These changes expanded formally the private and limited offering exemptions to include what might have hitherto been considered semi-public offerings, thus making offerings that might be otherwise subject to attack expressly lawful.

\textsuperscript{150} Any person who purchases or agrees in writing to purchase for cash in a single payment or installments, securities of the issuer in the aggregate amount of $150,000 or more.

\textsuperscript{151} See \textit{supra} note 86 and accompanying text.
3. The "Size of the Offering" Element: Limitations on the Aggregate Dollar Amount

Commentators before the small business hearings\textsuperscript{152} complained that there was an absence of an effective exemption for offerings having a dollar amount larger than that allowable under Rule 240 but smaller than that envisioned under Rule 146. In response to these criticisms, the SEC in Rule 242 set an aggregate maximum of $2 million for offerings made pursuant to the rule during any six-month period. This amount, at the time,\textsuperscript{153} was the full extent to which Congress allowed the SEC to exempt pursuant to its authority under Section 3(b) of the 1933 Act.\textsuperscript{154}

4. The "Information" Element

Prior to Rule 242, the SEC generally required an issuer making an offering of securities for more than $100,000 to furnish to the purchaser information similar in nature to that which would be contained in a registration statement.\textsuperscript{155} Commentators generally criticized this requirement as being unduly expensive and often, because of the sophistication of the purchaser, unnecessary.\textsuperscript{156} Rule 242 addressed that criticism by providing for a dual standard of disclosure which depended upon the nature or sophistication of the purchaser, in effect clearly linking the sophistication with the information element. Under the Rule, the SEC determined sophistication by whether the investor was an "accredited person" as defined above.\textsuperscript{157}

For offerings by an issuer in which sales were solely limited to "accredited persons," the Rule did not specify what information had to be furnished to the purchaser.\textsuperscript{158} The rationale behind this omission was that

\textsuperscript{152} See supra note 137.

\textsuperscript{153} The SEC's authority to exempt offerings under section 3(b) at the time of the enactment of Rule 242 was $2 million. Congress, however, later raised this limitation to its present level of $5 million in 1980, as part of the Small Business Issuers Simplification Act of 1980. See infra note 183.

\textsuperscript{154} To ensure that an issuer would not exceed this limitation by using other exemptions under Section 3(b) in combination with it, the Rule required that in computing the $2 million aggregate offering price, the issuer include the aggregate gross proceeds from all securities sold pursuant to any Section 3(b) exemption within the prior six months. In addition, the Rule required (through the use of traditional integration principles) the inclusion of all other sales of securities which were in fact part of the same issue. As with Rule 146, the Rule did provide a "safe harbor" for use in the question of integration. The safe harbor was that if, during the period beginning six months preceding the offering and ending six months after that offering, there were no offers or sales of securities by or for the issuer of the same or similar class of those offered or sold pursuant to the rule, then the offering would be deemed not to be part of a larger offering. See Rule 242(c), supra note 140, and preliminary note 6; see also Securities Act Release No. 6180 (Jan. 17, 1980), [1979–1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,426, at 82,813.

\textsuperscript{155} See Rule 146(e)(1)(ii)(b); see also supra notes 94–103 and accompanying text.


\textsuperscript{157} See supra note 150 and accompanying text.

\textsuperscript{158} Rule 242(f)(1), supra note 140.
the SEC presumed such purchasers, by reason of their position with the issuer or their economic power, to have had access to any information which they thought material to their investment decision.\(^{159}\) This omission of specific disclosure requirements under the Rule for "accredited persons" in offerings of over $100,000 reflected a substantial change from the prior law.

Before the adoption of Rule 242, it was generally believed that, in order for an offering of over $100,000 to be exempt, the offeree must have been furnished with detailed informational documents relating to the issuer and the securities. These documents, as noted earlier,\(^ {160}\) were expensive for the small business to prepare and, therefore, often made the private offering exemption more trouble than it was worth.\(^ {161}\) Rule 242, through its relaxed informational requirements for sales to accredited persons, broke through this barrier and provided the issuer with a method by which it could make an offering of over $100,000 without having to go through the expense of preparing disclosure documents.

After Rule 242, many issuers still, as a practical matter, continued to prepare disclosure documents because of the economic power of the "accredited persons." A fixed set of requirements, however, no longer dictated the content of these documents. Rather, the bargaining process in which the type and amount of information provided reflected the specific needs of the investors involved as well as the ability of the issuer to provide such information shaped the content of the disclosure documents.\(^ {162}\)

Rule 242's approach to disclosure when nonaccredited persons were involved remained very similar to that of the prior law. This reflects a recognition by the SEC of the realities of the marketplace and the basic inability of the average person to gain access to material information.\(^ {163}\) For offerings which involved only nonaccredited persons, or both accredited and nonaccredited persons, Rule 242 required the issuer to furnish in writing to all purchasers during the course of the offering and prior to the sale (1) the same kind of information as was specified in Part I of Form S-18 (with certified audited financial statements for the most current

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160. See supra notes 94–103 and accompanying text.
161. Id.
162. Because Rule 242 was only an exemption from the registration requirements and not the antifraud requirements of the federal securities laws, the careful practitioner preparing a Rule 242 offering to "accredited persons" still prepared the traditional disclosure documents because of investment bargaining powers and as insurance against any subsequent claims of failure to disclose material information. In many cases the documents were almost identical to those prior to Rule 242, but because of the absence of SEC mandatory requirements as to their content in many cases practitioners were able to simplify these documents and direct them to the individual investment interests of the investors rather than those of the SEC.
163. See supra note 160.
year) and (2) any other information necessary to make the required information not misleading.\footnote{164}

In addition to the above requirements, if an accredited person received any additional written information, then the Rule required the issuer to furnish in writing to the nonaccredited persons a brief description of such information, and upon request, to furnish complete copies of the information.\footnote{165} Moreover, for all persons, accredited and nonaccredited, Rule 242 required the issuer to make available, during the course of the transaction and prior to sale, the opportunity to ask questions of, and receive answers from, the issuer concerning the terms and conditions of the offering.\footnote{166} Finally, the Rule required that the issuer make available, to the extent reasonable, information necessary to verify the accuracy of the furnished information.\footnote{167}

The ease of compliance with these disclosure requirements varied with the type of issuer. For issuers subject to the reporting requirements of the 1934 Exchange Act, compliance was relatively easy and could be accomplished by furnishing purchasers with the company's most recent annual report, definitive proxy statement, and all other reports and documents required to be filed by it since the filing of its annual report.\footnote{168} For issuers not subject to the 1934 Exchange Act, compliance was more difficult and required the drafting of a document equivalent to an S-1 registration statement\footnote{169} and the preparation of audited and certified financial statements. For many small issuers these requirements proved to be more onerous than those under Rule 146, for several reasons. First, Rule 146 did not always require certified audited financial statements; and, second, for issues under $1.5 million, Rule 146 allowed disclosure equivalent to the more relaxed requirements of Regulation A.\footnote{170} Thus, the nonreporting issuer often chose the more subjective Rule 146 over the more objective and certain Rule 242.

5. The "Sophistication" Element

Rule 242's greatest departure from prior law and regulation was its modification of the element of offeree and purchaser sophistication. Prior to its adoption, in all offerings of over $100,000, the SEC required the issuer to make subjective determinations concerning the sophistication of each of its offerees and purchasers. The SEC required the issuer, in making

\footnotesize{\begin{itemize}
  \item \footnote{164}{Rule 242(f)(1)(i), (ii), \textit{supra} note 140.}
  \item \footnote{165}{Rule 242(f)(3), \textit{supra} note 140.}
  \item \footnote{166}{Rule 242(f)(2), \textit{supra} note 140.}
  \item \footnote{167}{Id.}
  \item \footnote{168}{Rule 242(f)(1)(iii), \textit{supra} note 140.}
  \item \footnote{169}{Form S-18, 2 Fed. Sec. L. Rep. (CCH) ¶ 7301.}
  \item \footnote{170}{See Rule 146(e), \textit{supra} note 72.}
\end{itemize}}
this determination, to deal with such vague standards as the offerees’
ability to fend for themselves, the offerees’ knowledge and experience
in financial and business matters, and the ability of the offeree to bear
the risk of the investment. Rule 146 brought some certainty to these
determinations by allowing for the use of an “offeree representative,”
but even then the Rule required the issuer to determine subjectively
whether the representative had “knowledge and experience in financial
and business matters.” Thus, prior to Rule 242, the element of so-
phistication was troublesome for issuers (and their attorneys) who were
making private or limited offerings.

Rule 242 reduced the anxiety in this area by modifying both when and
how the determination of the offeree’s sophistication should be made.
Under the Rule, the only time the issuer was required to determine the
offeree’s sophistication was if it wished to use either the Rule’s expanded
numerical allowances or its reduced informational provisions. For the
issuer not using these provisions, the Rule did not require that the issuer
make any determination relating to the offeree’s sophistication. For ex-
ample, a 1934 Exchange Act reporting issuer could sell $2,000,000 of
securities to 35 persons, regardless of their sophistication, provided that
it furnished such persons certain documents filed under the 1934 Exchange
Act. It was only for the issuer wishing to sell to over 35 persons or
wishing to ignore the Rule’s specific informational requirements that the
offeree’s sophistication was at all relevant. In all such cases, however,
an “accredited” person was conclusively presumed to be “sophisticated.”

Rule 242 eliminated the element of offeree sophistication. In its place
arose the concept of the “accredited person.” The Rule defined an ac-
credited person as someone who, because of his economic bargaining
power or position, would have access to information and therefore did
not need the protection of the securities laws. As noted earlier, the Rule
objectively defined “accredited persons” and included institutional inves-
tors, investment companies, directors and executive officers of the issuer,

171. Rule 146, Preliminary Note 3, supra note 72.
172. Rule 146(d)(1)(i), supra note 72.
174. Id.
175. Under Rule 242 the only time the SEC required the issuer to make any inquiry into the
qualifications of the offeree was when the issuer wished to use the rule’s allowance for sales to
unlimited “accredited persons” or wished to utilize its relaxed information requirements for “ac-
credited persons.” Thus, if an issuer was making an offering to under 35 nonaccredited purchasers,
the Rule in effect required no inquiry into the offeree’s sophistication. This was a major step from
the previous law, except for Rule 240, which always considered the sophistication of the offeree a
major criterion for an exemption from registration. See supra notes 60 and 90–91 and accompanying
text.
L. Rep. (CCH) ¶ 82,426, at 82,815.
and purchasers of at least $100,000 of the issuer’s securities within the
definition. Thus, under Rule 242 the issuer no longer had to make sub-
jective determinations as to the sophistication of the offeree, but only had
to see whether a specific purchaser fell within the numerous objective
criteria for an accredited person.

6. The “Resale” Element
To ensure against the possibility of a two-step public offering, the Rule
continued both the pre-Rule 146 and Rule 146 concerns that the issuer
take reasonable care to see that its purchasers would not distribute the
securities, and thus be considered underwriters under Section 2(11) of
the 1933 Act.177 The Rule included, as acts of such reasonable care, the
inquiry into whether the purchaser was acquiring the securities for his
own account, informing the purchaser of the restrictions on resale, and
the legend of the stock certificates.178

7. The “Notification” Element
To allow the SEC to monitor adequately the use of Rule 242, the SEC
conditioned the availability of the Rule upon the issuer’s notification to
the SEC by filing Form 242.179 The Rule required such notification to be
made within ten days after the first sale, periodically every six months
during the sale, and ten days after the last sale pursuant to the Rule. If
the issue was completed before the initial filing was made, then the Rule
allowed a single filing. The information required in Form 242 was similar
to that in Form 146, and related to information such as expenses of the
offering, use of proceeds, number of accredited and nonaccredited per-
sons, dollar amounts of sales to accredited and nonaccredited persons,
and names of brokers, promoters, officers and affiliates involved in the
issue.180

D. The Old Order in a Nutshell
Rules 146, 240 and 242 offered significant safe harbor relief to issuers
(and their attorneys) in search of capital without the expense and delays
of full registration or Regulation A compliance. Although Rule 242’s two-
year duration was probably too short to allow any meaningful evaluation,
the three Rules’ combined effect was to free small business issuers from

177. Rule 242(g), supra note 140.
178. Rule 242(g)(1), (2), (3), supra note 140.
L. Rep. (CCH) ¶ 82,426, at 82,819–20; Rule 242(b).
Fed. Sec. L. Rep. (CCH) ¶ 82,426, at 82,820.
many of the concerns caused by the pre-Rule 146 subjective nature of the 4(2) exemption.

While the statutory exemption and related rules each provided for a number of different uses and limitations as described above, the general pattern of their usage for private or limited offerings can be summarized as follows:

1. **Section 4(2)**

   The statutory 4(2) exemption was best left for free-wheeling issuers who enjoyed taking risks. It also provided some comfort to the attorneys of such issuers, whose clients, usually facing litigation, had consulted the attorneys only after the completion of the offering. Relying on the statutory exemption alone, without reference to the safe harbor standards of the Rule, was ill-advised in view of its restrictive judicial construction.181

2. **Rule 240**

   Rule 240 was a major benefit to the small issuer and exempted most small offerings of $100,000 or less. Issuers and attorneys with a minimal familiarity with federal securities laws could appreciate the simplicity of a Rule 240 offering and concern themselves primarily with state blue sky compliance.182

3. **Rule 146**

   Rule 146 assured freedom from liability for issuers who were using essentially the same pre-Rule 146 private offering procedures outlined in Part II of this article. Issuers could make Rule 146 offerings for unlimited amounts of private capital. While requiring the preparation of extensive documentation by non-1934 Exchange Act reporting companies, the Rule relieved most issuers from the spectre of lawsuits brought by disgruntled purchasers.

4. **Rule 242**

   Rule 242 gave issuers the flexibility of approaching an unlimited number of “accredited” purchasers for up to $2,000,000 of private capital without the requirement of any prescribed documentation.

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181. See supra notes 51–54 and accompanying text.
182. See supra note 12.
IV. THE NEW ORDER: SECTIONS 4(6), 2(15) AND REGULATION D

A. Section 4(6)

Shortly after the SEC’s adoption of Rule 242, Congress, in the Small Business Issuers Simplification Act of 1980, amended the Securities Act of 1933 to create a new statutory exemption under Section 4(6): the “accredited investor” exemption. The purpose of this exemption was to enhance the ability of the SEC to assist small businesses in their efforts to compete in the capital marketplace.

To achieve these goals, Congress drafted Section 4(6) in a manner similar to the “accredited person” provision of Rule 242, and provided that the exemption would exempt from registration those offerings under five million dollars which are made solely to “accredited investors.” While Section 4(6) at its inception resembled Rule 242, the operation of the two exemptions, because of their differences in dollar limitations and their definitions of “accredited,” was quite different. The SEC’s adoption of Regulation D and the Rule 215, which brought uniformity to the dollar limitations and definitions between the various private and limited offering exceptions, narrowed these differences.

1. The “Informational” Element

Section 4(6) contains no specific requirements relating to the dissemination of information to offerees or ultimate purchasers. Because the exemption is limited only to offerings made to “accredited investors” who presumably possess the economic power or position to obtain whatever information they individually deem important to their investment decision, it appears that Congress and the SEC do not consider them as needing the protection of the government to obtain such information. The approach of Section 4(6) is thus merely an extension of the “accredited person” philosophy first announced in Rule 242.

2. The “Numerical” Element

Section 4(6) prescribes no specific limitations on the total number of offerees or ultimate purchasers which an “accredited investor” offering

may have. The Section's only limitation on size is its requirement that there be "no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf. . . ."\(^{188}\) Congress apparently intended this restriction to ensure that the offering is not a public offering. The restriction is consistent with similar restrictions contained in exemptions prior to it.\(^{189}\) It should be noted, however, that unlike Rule 242, Section 4(6) contains no allowance for sales to any purchasers who are not accredited. Thus, if an offering necessarily includes such purchasers, the issuer may not utilize this exemption and must comply with some other applicable exemption or register the offering.

3. **The "Size of the Offering" Element**

Under Section 4(6), the "aggregate offering price of an issue of securities offered in reliance on . . . [the exemption may] not exceed the amount allowed under section 3(b)" of the Securities Act.\(^{190}\) Prior to the enactment of Section 4(6), the limitation of Section 3(b) was $2 million. The passage of Section 4(6), in recognition of the effects of inflation, raised Section 3(b)'s ceiling to $5 million.\(^{191}\) Regulation D sets forth no comparable ceiling limitation for offerings made exclusively to accredited investors. It is thus likely that Section 4(6) will be neglected by issuers who will prefer the greater flexibility of Regulation D.\(^{192}\)

4. **The "Sophistication" Element**

Section 4(6) adopted the premise of Rule 242, which presumed that if the investor possessed certain objective characteristics he was per se sophisticated, or, in the terms of Section 4(6), an accredited investor. Congress, along with its passage of Section 4(6), amended the Securities Act of 1933 to add Section 2(15),\(^ {193}\) which defines this investor as:

(i) a bank as defined in section 3(a)(2) of the Act whether acting in its individual or fiduciary capacity; an insurance company as defined in section 2(13) of the Act; an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of the Act; a Small


\(^{189}\) See supra notes 55, 78, 120, 147 and accompanying text.


\(^{192}\) See infra text accompanying note 233.

Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser; or

(ii) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.¹⁹⁴

This definition, because of the initial absence of SEC guidance pursuant to subsection (ii), caused the de facto limitation of the 4(6) concept to large institutional investors. The SEC’s adoption of Regulation D and Rule 215 in March of 1982, however, eliminated this limitation.¹⁹⁵

The SEC’s definition represented a broadening of the prior law. Previously, under Rule 242, for a purchaser to be “accredited,” he would either have to have been an institutional investor, an insider, or a purchaser of over $100,000 worth of securities.¹⁹⁶ With the adoption of Rule 215, a purchaser is “accredited” either if he meets any of the previously mentioned criteria, or if his individual income exceeds $200,000 for the two years preceding the offering or his personal or joint net worth exceeds $1,000,000.¹⁹⁷ The latter changes represent a departure from the prior law which held that to be sophisticated one must be knowledgeable.¹⁹⁸

Under Rule 215, to be accredited (or conclusively sophisticated) one does not need to be knowledgeable or to be taking a significant investment position as under Rule 142; he need only be a high earner or wealthy. While the wisdom of the SEC for this change is subject to some question, its “Let the Rich Buyer Beware” logic is not without its appeal.¹⁹⁹

5. The “Resale” Element

Like Section 4(2), Section 4(6) contains no prohibition against the resale of securities offered pursuant to it. Despite this omission in the

¹⁹⁴. Id.
¹⁹⁶. See Rule 242(a)(1), supra note 140.
¹⁹⁷. Rule 215, supra note 187. The only more stringent requirement of Rule 215 is that the purchaser must purchase over $150,000 worth of securities rather than $100,000 as was allowable under Rule 242. See infra note 251 and accompanying text.
¹⁹⁹. The authors generally agree that banks and assorted millionaires can reasonably be expected to take care of themselves in financial matters. In some cases, however, potentially unsophisticated wealthy persons, e.g., ranchers, farmers, doctors and (dare we say it?) lawyers, may rapidly lose their accredited status if they are overly eager to purchase in Regulation D offerings. Moreover, the authors hope that the SEC keeps inflation in mind: the $1 million net worth test may need upward adjustment in a few years despite the anti-inflationary efforts of the Federal Reserve Board.
statute itself, both its legislative history and the traditional understanding of the rights of a holder of restricted stock to use the 4(1) exemption, make it clear that securities purchased pursuant to use the 4(6) exemption are restricted, and cannot be resold unless registered or sold pursuant to an applicable exemption. Moreover, because Section 4(6) is only an exemption for transactions to "accredited investors" the 4(6) transaction should not be turned into a two-step transaction wherein the ultimate purchaser is not an "accredited investor" or the issuer would lose its exemption.

To protect against these problems, an issuer relying upon Section 4(6) must take certain precautions. The issuer must inquire whether the purchaser is acquiring for his own account or on behalf of other persons; and it must inform the purchaser of the restrictions on resale, and must legend the stock certificates.

6. The "Notification" Element

The Section 4(6) exemption is contingent upon a notification to the SEC of its utilization. Such notification must be made pursuant to SEC Form 4(6). Form 4(6) is very similar to former Form 242, although the SEC has deleted certain items inapplicable to a Section 4(6) offering. The filing requirements are identical to those of former Rule 242: an issuer must file within ten days after the first sale, ten days after the final sale, and every six months until it files the final notice.

B. Regulation D

On March 8, 1982, the SEC issued Securities Act Release No. 6389, adopting Regulation D. The Regulation resulted from the SEC's re-evaluation of private and limited offering exemptions following Congress's adoption of the Small Business Investment Incentive Act of 1980.

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201. See supra note 63 and accompanying text.
204. Compare SEC Form 4(6) with SEC Form 242.
206. Regulation D, supra note 186.
Much of Regulation D simply continues the SEC's efforts, begun with Rule 146, to set forth objective standards for determining how the pre-Rule 146 elements are interwoven. The Regulation is principally a clarified statement of the four pre-Rule 146 elements of a private offering as well as the new elements (notification, size of the offering and nature of the issuer) added to the law by former Rule 146 and its progeny. For example, offerings of securities totaling more than $500,000, made to nonaccredited investors, are generally subject to the same requirements set forth in Rule 146. Other provisions of the Regulation, however, especially in the area of offerings under $500,000, offerings of less than $5,000,000 to unsophisticated persons, and offerings exclusively to accredited investors, contain substantial deregulatory aspects and are a departure from pre-existing law and regulations. Cautious issuers, however, may find that Regulation D changes little in terms of sound offering procedures, even given the Regulation's increased flexibility.209

The following section of this article sets forth a summary of the rules which make up the Regulation. The summary is followed by an analysis of how the regulation makes changes from both pre-Rule 146 and Rule 146 elements of private and limited offerings.

**SUMMARY OF THE RULES**

Rules 501210 and 502211 set forth definitions and general conditions which apply to the exemptions made available by the regulation. Rule 503212 provides for the form of notice to be filed (Form D) in the event the exemptions are used. Rule 504,213 as an expansion of rescinded Rule 240, allows for sales of securities to any number of purchasers by non-1934 Exchange Act reporting companies of any size, up to a maximum of $500,000 in a twelve-month period. Rule 505,214 which replaced rescinded Rule 242, provides an exemption for sales of securities for up to 5 million dollars to an unlimited number of "accredited investors" and

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209. While Regulation D reduces the formalities of perfecting exemptions from the 1933 Act's registration requirements, it provides no exemption from the antifraud/full disclosure aspects of either the 1933 Act or the 1934 Exchange Act. Accordingly, the cautious issuer may be slow to depart from known procedures and the preparation of lengthy disclosure documents until case law clearly support an immunization from such liability for issuers using abbreviated offering circulars.


to 35 other persons not falling under that term. Rule 505, unlike Rule 504, is also generally available for offerings of 1934 Exchange Act reporting companies. While other companies are not excluded from this rule's coverage, its more stringent information requirements would be more easily met by reporting companies. Unlike Rules 504 and 505, Rule 506 has no ceiling limitation.215

Rule 215,216 defining the "accredited purchaser," is linked to the regulation by Rule 501(a)'s restatement of the definitions under Rule 215.217

A. The "Information" Element

The SEC has systematically linked the information element of the pre-Rule 146 era to the size of the offering and the nature of the issuer elements. This linkage was suggested by former Rule 146218 and was more clearly established in former Rules 240219 and 242.220 In lieu of the uncertain informational requirements of pre-Rule 146 private offerings,221 Regulation D sets forth a clear pattern of information requirements that must be met by an issuer. The requirements differ depending upon (1) the total value of the securities offered, (2) the nature of the issuer in terms of its 1934 Exchange Act reporting status, and (3) the nature of the purchaser.

1. Offerings and Sales of Securities Not Exceeding $500,000 (Rule 504)

a. Non-1934 Exchange Act Reporting Companies

Preliminary Note 1 to the Regulation restates the warning222 that the availability of an exemption from the 1933 Act's registration provisions does not preclude either SEC or private actions based upon the full disclosure/antifraud provisions. With the exception of this general warning, the Regulation requires no specific information to be furnished by issuers to offerees for compliance.223 This new position reflects a break both from pre-Rule 146 and Rule 146 private offerings. Its closest coun-

217. See infra note 251.
218. See supra note 99 and accompanying text.
219. See supra notes 127–28 and accompanying text.
220. See supra note 168 and accompanying text.
221. See supra note 59 and accompanying text.
222. Regulation D, supra note 186, Preliminary Note 1; see generally Rule 240, supra note 118, Preliminary Note 1 (stating that Rule 240 exemptions do not preclude applicability of the antifraud provisions).
223. Rule 502(b)(1)(i), supra note 211.
terpart is former Rule 240, which, however, was more restrictive both in terms of the size of the offering and the number of allowable purchasers.224

b. 1934 Exchange Act Reporting Companies

1934 Exchange Act reporting companies must furnish the same information as set forth in the next section. Such reporting companies are not entitled to use Rule 504.225

2. Offerings Between $500,000 and $5,000,000 (Rule 505)

a. Non-1934 Exchange Act Reporting Companies

Non-1934 Exchange Act reporting companies must furnish purchasers with the same kind of information as that specified in Part I of Form S-18 or, for issuers not entitled to use Form S-18, the same kind of information as required in Part I of a registration form available to such issuer.226 This reflects no substantial departure from former Rule 146 requirements.227

b. 1934 Exchange Act Reporting Companies

1934 Exchange Act reporting companies must furnish offerees certain existing 1934 Exchange Act reports as well as a brief description of the securities being offered, use of proceeds, and any material changes in its business not disclosed in the 1934 Exchange Act documents.228 This does not reflect any substantial departures from Rule 146 requirements.229

3. Offerings Exceeding $5,000,000 (Rule 506)

a. Non-1934 Exchange Act Reporting Companies

Non-1934 Exchange Act companies must furnish the same information as would be required to be included in a registration statement under the 1933 Act on the form which the issuer would be entitled to use.230 This represents no departure from pre- or post-Rule 146 regulation.231

224. See supra notes 115–35 and accompanying text.
225. Rule 504(a), supra note 213.
226. Rule 502(b)(2)(i)(A), supra note 211.
227. Regulation D is more restrictive than former Rule 146 with respect to prescribed information requirements for offerings between $500,000 and $1,500,000. See infra note 262.
228. Rule 502(b)(2)(ii), supra note 211.
229. See supra notes 94–103 and accompanying text.
230. Rule 502(b)(2)(i)(B), supra note 211.
231. See supra notes 59, 99 and accompanying text.
b. 1934 Exchange Act Reporting Companies

1934 Exchange Act companies must furnish the same information described in 2(b) above. This reflects no substantial departure from Rule 146.232

4. Offerings Solely to Accredited Investors

When dealing with accredited investors, Regulation D requires no specific information of any issuer for any amount offered.233 This reflects a significant departure from pre- and post-Rule 146 regulation. The SEC has in effect deregulated sales of securities to such investors regardless of the size of the offering or the number of ultimate purchasers, and regardless of the paucity of information furnished by the issuer. Offerings made solely to accredited investors under Regulation D’s provisions, unlike those of Section 4(6) and Rule 215, are free from a ceiling limitation. Section 4(6) is thus unlikely to retain any significance, assuming the continued existence of Regulation D.234

B. The Numerical Element

Rule 501(e) sets forth several general exclusions for purposes of computing the total number of purchasers for the remaining Rules. The most significant exclusion is an exclusion for all accredited investors.235 Issuers can clearly now make private offerings to persons defined as accredited investors regardless of their number.

Other exclusions are for relatives and spouses of the purchaser and trusts, estates, or corporations of other organizations in which the purchaser has a beneficial interest. Moreover, the Rule counts corporations or other organizations (except those formed for the specific purposes of acquiring the securities offered) as one purchaser.236

Rule 502(c) also affects the numerical element insofar as it restricts the manner in which the securities are offered (with the exception of certain state-registered Rule 504 offerings).237 In this respect, Regulation D varies from pre-Rule 146 law, but is consistent with former Rules 146, 240 and 242, because it addresses itself to the total number of ultimate

232. See supra notes 94–103 and accompanying text.
233. Rule 502(b)(1)(i), supra note 211.
234. See supra note 192 and accompanying text.
237. Rule 504(b)(1) exempts from the manner of offering requirement of 502(c) those offerings of less than $500,000 by nonreporting companies that are made exclusively in one or more states whose law provides for (1) the registration of the securities and (2) the delivery of a disclosure document before the sale. This change for “state registered-federal exempt” offerings and other prospective coordination between federal and state regulation is also the subject of Section 19(c) of the 1933 Act. See also supra note 12.
purchasers rather than the total number of offerees. The Regulation’s limitation on the manner of the offering is intended to limit the number of offerees, however, as it prohibits general solicitations by radio, newspapers, magazines, etc.\textsuperscript{238}

1. Offerings of Less than $500,000

\textit{a. Non-1934 Exchange Act Reporting Companies}

Non-1934 Exchange Act reporting companies may offer and sell securities having an aggregate offering price of not more than $500,000 to an unlimited group of investors, whether they are accredited or non-accredited.\textsuperscript{239} In this respect, Regulation D reflects a significant departure from pre-Rule 146 principles. Former Rule 240, with a cutoff of 100 or fewer\textsuperscript{240} purchasers, is the closest counterpart.

\textit{b. 1934 Exchange Act Reporting Companies}

1934 Exchange Act reporting companies (except those disqualified from using Rule 505\textsuperscript{241}) may sell to no more than 35 purchasers, excluding accredited investors and certain other persons with close relationships to the issuer.\textsuperscript{242} This represents a continuation of the philosophy of Rule 240 that issuers already having a large number of shareholders must comply with more restrictive limitations on the number of purchasers than corporations having a limited number of shareholders.\textsuperscript{243}

\textsuperscript{238} Rule 502(c), supra note 211. There is no absolute prohibition on mail as a means of inviting persons to seminars, however. See Securities Act Release No. 6389 [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 83,106 n.23, at 84,907, 84-917. It would thus seem permissible to invite specific persons to a seminar, but impermissible to announce generally (e.g., by means of a radio notice) that such a seminar would be held.

\textsuperscript{239} Rule 502(b)(1)(i), supra note 211.

\textsuperscript{240} See supra notes 123–25 and accompanying text.

\textsuperscript{241} See Rule 505(b)(2)(ii), supra note 214, for those issuers disqualified from using the Rule. Generally, this disqualification covers issuers who have had federal securities law difficulties.

\textsuperscript{242} Rule 505(b)(2)(i), supra note 214. Rule 501(e)(1), supra note 210, includes the following as persons having such a relationship:

- (i) Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser;
- (ii) Any trust or estate in which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(iii) of this § 230.501 collectively have more than 50 percent of the beneficial interest (excluding contingent interests);
- (iii) Any corporation or other organization of which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(ii) of this § 230.501 collectively are beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; and
- (iv) Any accredited investor.

\textsuperscript{243} See supra note 125 and accompanying text.
2. Offerings Between $500,000 and $5,000,000

The Regulation limits all issuers, regardless of the nature of their 1934 Exchange Act reporting status, to 35 purchasers, excluding accredited investors and certain other persons with close relationships to the issuer. This continues the basic philosophy of Rule 146.

3. Offerings in Excess of $5,000,000

The Regulation limits all issuers to 35 purchasers, excluding accredited investors and certain other persons with close relationships to the issuer.

C. The Sophistication/Access Element

Regulation D retains a certain amount of the pre-Rule 146 and Rule 146 concern respecting the sophistication of the purchaser of securities in a private offering. The concern is limited, however, to only those offerings in excess of $5,000,000 made in part or in full to "nonaccredited" purchasers. Regulation D makes a sharp break from pre-Rule 146 and Rule 146 principles in eliminating the sophistication element for all other private or limited offerings. It follows Rule 242's lead in this respect. The "access" aspects of the element, which Rule 146 partially shifted from the information element to the numerical element, are now to be found both in the definition of accredited investor and in a general exclusion of close family members from the computation of the number of ultimate purchasers.

The Regulation's definition of "accredited investor," coupled with recently adopted Sections 2(15) and 4(6), results in highly increased flexibility for issuers who restrict the sale of their securities to such purchasers. Where sales are made exclusively to such investors, Regulation D does not restrict the number of purchasers. Nor is there a definite requirement as to the kind of information which must be disclosed. Moreover, the Regulation does not require any inquiry as to their true sophistication in terms of financial acumen. Accordingly (with the exception of the Resale Element), Regulation D has effectively deregulated sales of securities to accredited investors regardless of their number and regardless of the size of the offering.

The Regulation, in effect, conclusively presumes that an "accredited

245. See supra note 83 and accompanying text.
247. See supra note 175 and accompanying text.
248. See supra note 86 and accompanying text.
249. Rule 501(a), (e), supra note 210.
250. Rule 502(d), supra note 211.
investor” is sophisticated. Section 4(6) and Rules 215 and 501(a) define such an investor as:

any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act whether acting in its individual or fiduciary capacity; insurance company as defined in section 2(13) of the Act; investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in Section 501(c)(3) of the Internal Revenue Code with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any person who purchases at least $150,000 of the securities being offered, where the purchaser’s total purchase price does not exceed 20 percent of the purchaser’s net worth at the time of sale, or joint net worth at the time of sale, or joint net worth with that person’s spouse, for one or any combination of the following: (i) cash, (ii) securities for which market quotations are readily available, (iii) an unconditional obligation to pay cash or securities for which market quotations are readily available which obligation is to be discharged within five years of the sale of the securities to the purchaser, or (iv) the cancellation of any indebtedness owed by the issuer to the purchaser;

(6) Any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds $1,000,000;

(7) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 in the current year; and

(8) Any entity in which all of the equity owners are accredited investors under paragraph (a)(1), (2), (3), (4), (6), or (7) of this [Rule].

251. 1933 Act § 2(15), supra note 1; Rules 215, supra note 187, and 501(a), supra note 210. Section 2(15) and Rule 215 combined are substantially identical to Rule 501(a).
The definition is thus broader than that of the "accredited person" of former Rule 242: any person whose individual income exceeds $200,000 for at least two years, or whose joint net worth exceeds $1,000,000, is "accredited" under the new Regulation. Neither former Rule 242 nor Rule 146 went as far in terms of excluding such persons from the scope of federal protection. In this respect, Regulation D, like Section 4(6), appears to reflect an attitude that persons of this income level and net worth are capable of fending for themselves.

The new Regulation also makes a substantial change in the sophistication element as it applies to offerees of securities offered in a private offering. The SEC has abandoned the pre-Rule 146 and Rule 146 concept that offerees must be of a certain income/asset level or of a certain sophistication. Instead, the term "offeree representative" has become "purchaser representative" under Regulation D. It is now clear that, subject to limitations on the manner of the offering, an issuer can make an offer to any person, regardless of that person's income or assets and regardless of his financial sophistication, in any offering under $5,000,000. It is only in offerings over $5,000,000 that the issuer must be assured that by the time the offeree is ready to become an actual purchaser, either the purchaser or his purchaser representative have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[252]

D. The Resale Element

Preliminary Note 4 sets forth the general caveat that, with the exception of Rule 504's state-regulated, federally exempt private offering,[253] securities sold pursuant to the Regulation are unregistered or restricted securities and are subject to the same limitations on resale as were pre-Rule 146 and Rule 146 securities. Specifically, the Regulation requires, in Rule 502(d), that the issuer take reasonable care to ensure that its purchasers are not underwriters; i.e., that they are not purchasing the securities with an intent to distribute them and thus effect a two-step public offering.[254]

The steps to be taken by an issuer to ensure against this possibility are substantially the same as those taken in the pre-Rule 146 era as well as those taken under former Rule 146.[255] Accordingly, the Regulation does

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253. Regulation D, supra note 186, Preliminary Note 4; Rule 504(b)(1), supra note 213. If a Rule 504 offering has been registered under state law in states requiring registration and the delivery of an offering circular, then the federal limitations on the manner of offering and on resale do not apply.
254. Rule 502(d), supra note 211; see supra note 63 and accompanying text.
255. See supra note 105 and accompanying text.
not represent any break with past practices with regard to the resale element except for those offerings which are registered as a matter of state law.

E. The Notification Element

Unlike the pre-Rule 146 procedures, but similar to those of former Rules 146,256 240,257 and 242,258 the Regulation requires in Rule 503 that the issuer file a notice with the SEC. The Regulation's notice provisions are more liberal than those required under former Rules 146, 240 and 242. Rule 503 requires that the notice be filed no later than 30 days after first sale, as opposed to “at the time of the first sale” (Rule 146),259 or “ten days after close of the first month in which a sale is made” (Rule 240),260 or “10 days after completion of the offering” (Rule 242).261

F. Regulation D: A Preliminary Evaluation

The decade of 1972–1982 produced considerable SEC activity in the area of private and limited offerings. The recently accelerated evolution of standards for such offerings, prompted by increasingly frequent judicial denial of the statutory 4(2) exemption, has culminated in an integrated and logically presented series of objective rules. Gone are the metaphysical questions of the pre-Rule 146 era; greatly diminished are the burdensome sophistication, information, delivery, and numerical requirements which were only partially relieved by Rules 146, 240, and 242. Regulation D is a far step from Ralston Purina, as the SEC considers neither the rich nor persons purchasing securities in an offering of less than $500,000 to be members of the public at large entitled to the protection of the 1933 Act’s registration requirements.

The four basic elements of the pre-Rule 146 private offering find at least some continuing expression in Regulation D. They have been, however, significantly altered in the case of several types of offerings:

1. The Numerical Element

The numerical element has disappeared as a requirement for offerings of less than $500,000 and for those offerings made exclusively to accredited investors. The element is present only in terms of the manner

256. See supra notes 109–12 and accompanying text.
257. See supra notes 132–33 and accompanying text.
258. See supra notes 179–80 and accompanying text.
259. Rule 146(i), supra note 72.
260. Rule 240(h)(1), supra note 118.
261. Rule 242(h), (ii), supra note 140.
in which the offering is made and for those offerings in excess of $500,000 involving at least some non-accredited investors.

2. The Sophistication Element

Regulation D has also virtually eliminated the sophistication element. In its place has arisen the concept of the "accredited investor" whose financial position is conclusive evidence of his ability to fend for himself. The only occasion for the issuer to inquire as to the true financial sophistication of its purchasers is for offerings in excess of $5,000,000.

3. The Information Element

The information element, except as to continuing anti-fraud/full disclosure requirements of both the 1933 Act and the 1934 Exchange Act, has disappeared for offerings of less than $500,000 or for those involving only accredited investors. The element is very much present, however, for all other types of offerings and may in fact be more burdensome for some issuers. The specific information required to be disclosed in such offerings now varies depending upon the size of the offering and the 1934 Exchange Act reporting status of the issuer.

4. The Resale Element

This element has survived intact from the pre-Rule 146 era through Regulation D. The only exception made by the new rules is for those offerings of less than $500,000 which, though exempt from federal registration, have been registered under applicable state securities laws.

The question remains: what the impact of Regulation D will be on both (1) increasing the flow of venture capital to issuers in a world where such capital is becoming scarcer; and (2) decreasing the federal protection traditionally afforded purchasers of securities. The impact may be very little, perhaps, in the sense that responsible and careful issuers (and their lawyers) will be likely to continue, in view of the 1933 Act's full disclosure/antifraud aspect, writing comprehensive offering circulars, limiting the number of both offerees and ultimate purchasers, inquiring into

262. Rule 146 allowed issuers of securities having an aggregate value of less than $1.5 million to comply with the information requirements by furnishing to the offeree that information required to be disclosed under Schedule I of Regulation A. Regulation D, however, provides no similar allowance, but rather requires the issuer to provide the same kind of information as specified in Part I of Form S-18, which is generally more detailed. Thus, compliance with Regulation D's information provisions may prove more burdensome for the issuer who would otherwise have been entitled to use Rule 146's more relaxed requirements. See supra note 99 and accompanying text.

263. See Rules 502(d), supra note 211, and 504(b)(1), supra note 213; see also supra note 237.
their financial acumen, and restricting their ability to resell the securities. On the other hand, Regulation D may indicate that the SEC is no longer very interested in small offerings, or in offerings in which most of the purchasers can afford to lose their entire investment. If so, one might anticipate the imminent emergence of questionable offerings. The spectre of antifraud/full disclosure litigation, both by the SEC and by private litigants, should put issuers on notice as to their continued responsibilities. For several types of private offerings, however, Regulation D places the federal regulatory emphasis on post-offering enforcement, as opposed to pre-offering precautions.