Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses

Perry E. Wallace, Jr.

INTEGRATION OF SECURITIES OFFERINGS: OBSTACLES TO CAPITAL FORMATION REMAIN FOR SMALL BUSINESSES

PERRY E. WALLACE, JR.*

I. INTRODUCTION

Federal securities laws and regulations have always contained special provisions to promote capital formation by small businesses.[1] Many of these special provisions emphasize the elimination of unnecessary regulatory burdens on the sale of securities.[2] These regulatory relief initiatives derive from two well-founded beliefs: (1) when regulation is burdensome and inefficient, small issuers of securities suffer inordinately, and thus unfairly, compared with larger companies;[3] and (2) these small issuers confer significant eco-

---

* Assistant Professor of Law, University of Baltimore School of Law. B. Engr., 1970, Vanderbilt University; J.D., 1975, Columbia University. The author wishes to thank Jeffrey D. Saper and Russell B. Stevenson, Jr. for their comments on a draft of this Article. Thanks are also due to Mark A. Sargent for his sharing of ideas and insights and for his support.

1. The terms "small business," "small business issuer," and "small issuer," as used in this Article, are intended to be synonymous. They refer generally to businesses having relatively small assets and earnings, and sustaining no active market for their securities on a national exchange or over the counter. *See* Campbell, *The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention,* 74 KY. L.J. 127, 127 (1985-86). Quantitative measures for identifying a small business are set forth in both the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1982) (the 1933 Act) (total assets on the last day of its most recent fiscal year of $3,000,000 and engaged or proposing to engage in small business financing), and in the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1982) (the 1934 Act) (which does not use the term "small business," but provides an exemption from its registration requirements for public companies with less than $5,000,000—pursuant to regulatory provision—in total assets as of the last day of its most recent fiscal year). *See* Riccio, Cheney, Sibears & Garry, *The Securities and Exchange Commission and Small Business: An Overview of an Administrative Response to the Capital Needs of Small Business,* 18 NEW ENG. L. REV. 841, 842-43 (1983) [hereinafter Riccio]; *see also* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 337-38 (1st ed. 1983) ("'Small Business' is the darling of Congress and the essence of the American dream. . . . [O]ver the years both Congress and the SEC have addressed the problem of financing small business in various (not always consistent) ways.")

2. The statutory foundation of these provisions consists of certain exemptions from the expensive and time-consuming registration requirements of the 1933 Act and the 1934 Act. Sections 3 and 4 of the 1933 Act, 15 U.S.C. §§ 77c and 77d, contain the actual statutory exemptions most directly related to the capital formation process. They were not designed solely for small businesses, but the needs and problems of small businesses were prominent considerations in the adoption of these sections. *See* L. Loss, *supra* note 1, at 337-40; *infra* note 5.

3. *See* 1986 SEC GOV'T-BUS. F. SMALL BUS. CAPITAL FORMATION, FINAL REP. 22 (Jan. 1987) [hereinafter 1986 GOV'T-BUS. REP.] ("[T]he prohibitive effect of . . . [securities law compliance] costs is especially evident with the smaller businesses that can't bear the high

nomic benefits upon American society, making them particularly deserving of relief from unnecessary legal strictures.[4]

In creating and administering these initiatives, however, Congress, the Securities and Exchange Commission ("SEC" or "Commission"), and the courts have sought to preserve the statutory policy of promoting investor protection through full and fair disclosure; those bodies have attempted to balance this policy meaningfully with the goal of encouraging capital formation through the pragmatic application of the securities laws.[5] The result of this balancing act is the array of regulatory benefits, burdens, and conflicts visited upon small issuers of securities.

Governmental action aimed at producing an efficient and balanced securities regulatory system for small business capital formation generally has been well received.[6] Moreover, federal lawmakers and administrators continually have improved this system.[7] But in spite of the extensive im-

---

costs."); Riccio, *supra* note 1, at 843 ("[T]he problems of small businesses competing with larger companies for available capital are compounded by governmental regulation, which results in costs that fall proportionally more heavily on small companies."); Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251 (Mar. 8, 1982) (in which Securities and Exchange Commission adopted regulation D, 17 C.F.R. §§ 230.501-.506 (1987): "[T]he registration requirements and the exemptive scheme of the Securities Act impose disproportionate restraints on small issuers.").

4. 1986 WHITE HOUSE CONF. ON SMALL BUS., FINAL REP., at iii (Nov. 1986) (letter of transmittal to the President of the United States, submitting 60 recommendations for an improved governmental regulatory environment for small businesses and noting that: "[d]ynamic and innovative small businesses are the Nation's major job creators. Together they generate almost 40 percent of the GNP.").

5. The theme of balancing capital formation measures against investor protection is a constant one in securities law. One example is regulation D (17 C.F.R. §§ 230.501-.506), which "is the product of the Commission's evaluation of the impact of its rules and regulations on the ability of small businesses to raise capital." Securities Act Release No. 33-6389, *supra* note 3, at 11,251 (footnote omitted). After discovering that owners of small businesses and others believed that "the registration requirements and the exemptive scheme of the Securities Act impose disproportionate restraints on small issuers," the SEC promulgated regulation D "in order *to facilitate capital formation consistent with the protection of investors.*" *Id.* (emphasis added).

See also Gadsby, *The Securities and Exchange Commission and the Financing of Small Business*, 14 BUS. LAW. 144, 145 (1958), in which the author, then the Chairman of the SEC, describes the importance, as well as the interplay, of investor protection and capital formation:

> In the administration of the powers and responsibilities vested in it by the securities acts, the Commission is guided by two more or less overlapping standards, that of the public interest and that of the protection of investors. I say two standards, since the term "public interest" includes more than concern for a protection of investors as such. It requires the Commission to look beyond these immediate interests and to take into consideration the welfare of the economy as a whole. *Thus, while it [the "public interest"] is looking to the protection of prospective investors in dealing with small business, or big business for that matter, it must be careful not to erect such burdensome requirements as to discourage the raising of the capital necessary to the growth of business and industry.* (Emphasis added.)

6. *See* Gadsby, *supra* note 5.

7. For a discussion of the initiatives of the SEC and Congress over the years, from adoption of the 1933 Act up to the present, see Riccio, *supra* note 1. *See also* L. Loss, *supra* note 1, at 337-340.

provements, nagging problems remain. Many existing legal requirements and limitations inject undue restrictiveness and uncertainty into the capital formation regulatory structure, which means that small issuers attempting to distribute securities still must proceed in fear of substantial adverse legal and economic consequences.[8] And of the various sources of angst facing the small issuer, none has proved more frustrating and elusive than the doctrine of integration of securities offerings.

A. *The Integration Doctrine: Objectives and Rationale*

The integration doctrine requires that under some circumstances, the SEC may deem purportedly separate groupings of securities distributions by an issuer to be one single group. This single group—rather than the purportedly separate ones—must meet the requirements of any registration exemptions claimed, or in the alternative, must be registered under the Securities Act of 1933.[9] The integration doctrine contemplates that an issuer may try to divide what is, in reality, a single issue or offering[10] of securities into two or more smaller transactions, seeking to have each transaction classified as a discrete issue or offering. These smaller transactions ostensibly are structured so that they satisfy the requisites of sections 3[11] or 4[12] of the 1933 Act, and, therefore, are exempt from the registration requirement. The issuer's goal in attempting to divide a single issue into several smaller transactions (and thus hopefully qualify for an exemption from the registration requirement) is to avoid the substantially higher costs and other burdens associated with the registration process.[13] Under the integration

---

8. In addition to the integration doctrine, which is the topic of this Article, the commentators also have identified other troublesome areas, such as the disclosure requirements and the prohibition against general advertising of regulation D; the resale restrictions of rule 144; and the scope of the definition of "accredited investor" in regulation D. *See* Campbell, *supra* note 1; Kripke, *Has the SEC Taken All the Dead Wood Out of its Disclosure System?*, 38 BUS. LAW. 833 (1983). Violation of these often vague or unnecessary strictures gives rise to substantial legal liability and ensuing economic hardship. *See infra* note 17.

9. *See generally*, Note, *Securities Regulation: Integration of Securities Offerings*, 34 OKLA. L. REV. 864 (1981); Shapiro & Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always. . . .*, 31 MD. L. REV. 3 (1971). *See also* Deaktor, *Integration of Securities Offerings*, 31 U. FLA. L. REV. 465, 492 (1979):

> Integration is the logical extension of the notion that an issuer should not be allowed to circumvent an exemption's requirements by resorting to a combination of transactional exemptions to insulate what would otherwise be a nonexempt public offering from the 1933 Act's registration provisions.

10. The 1933 Act does not define the terms "issue" or "offering," but their meaning and interpretation clearly are central to any attempt to thwart circumvention of the registration requirement through the artificial division of what is actually a single financing transaction (i.e., an "issue" or "offering"). *See* Stevenson, *Integration and Private Placements*, 19 REV. SEC. & COM. REG. 49 (1986); Deaktor, *supra* note 9, at 492. Since these terms are used interchangeably throughout the literature, they will be so used throughout this Article.

11. 15 U.S.C. § 77c (1982).

12. 15 U.S.C. § 77d (1982).

13. See *infra* notes 36-48 and accompanying text for a discussion of the high costs and other extreme burdens of registration.

doctrine, however, if two or more otherwise exempt offering transactions by an issuer are found to violate the doctrine's principles of investor protection, the separate offerings will be combined, or "integrated," resulting in a single offering.[14] Depending on the extent of such integration and the absolute number and degree of sophistication of the integrated purchase group, the resultant offering may not qualify for any single exemption under sections 3 or 4, and therefore the issuer will be in violation of the section 5 registration requirement.[15]

The integration doctrine developed as a response to abuses in the registration process that were thought to threaten investor protection. Indeed, the exemptions from the burdens of registration promised by the 1933 Act, combined with the Act's broad and often imprecise language (for example, the failure of the Act to define "issue" and "offering"[16]) create a major incentive for the use of artificially separated securities transactions.[17] Yet the 1933 Act did not expressly define, or even strongly suggest, the integration doctrine.[18] Given the obvious potential for serious abuse emanating from the words of the Act itself, the development of some administrative construct was required to preserve the vitality of the Act's goal of protecting investors by requiring full and fair disclosure. Through regulatory initiatives and interpretations by the Securities Exchange Commission,[19] and through interpretive and no-action letters by the SEC staff,[20] the SEC, with some assistance from the courts,[21] formulated the integration doctrine.

---

14. *See* Kripke, *supra* note 8, at 839.

15. *See* Stevenson, *supra* note 10, at 57-58; T. HAZEN, THE LAW OF SECURITIES REGULATION 182 (1985); START-UP COMPANIES § 4.01, at 4-4 (R. Harroch ed. 1985) ("Failure to comply with the registration requirements of the federal securities laws could lead to a variety of severe consequences, including but not limited to rescission of the purchase . . . [15 U.S.C. § 77l], damages [15 U.S.C. § 77l], criminal prosecution [15 U.S.C. § 77x], and injunctive actions [15 U.S.C. § 77t]").

16. *See supra* note 10.

17. *See* Stevenson, *supra* note 10, at 49.

18. *See* Stevenson, *supra* note 10, at 49, 51.

19. The SEC has both general and specific rulemaking authority to promulgate rules in the nature of (1) substantive or legislative rules; (2) interpretative or definitional rules; and (3) internal or housekeeping rules. *See* Riccio, *supra* note 1, at 844-848; L. Loss, *supra* note 1, at 148-49, 375.

20. Both types of letters are generally referred to as "no action" letters. They are not formal pronouncements of the SEC, and, therefore, do not carry with them the force of law. These letters, and the written requests that initiate them, have been made available to the public since February, 1971, and merely provide guidance and advice from the SEC staff on whether any enforcement action will be taken based on a specific factual pattern. The policy of making no-action letter requests and responses available to the public, however, has probably increased their importance and impact. *See* Deaktor, *supra* note 9, at 525-26; Morrissey, *Integration of Securities Offerings — The ABA's "Indiscreet" Proposal,* 17 SEC. L. REV. 147, 165 (1986); Adoption of Section 200.81 and Amendment of Section 200.80, Securities Act Release No. 5098 [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,921 (Oct. 29, 1970).

21. There have been relatively few cases on integration, overall. The early cases often declined to integrate offerings, but later ones showed a trend toward integration, often relying on SEC regulations. See Morrissey, *supra* note 20, at 167-175.

Notwithstanding the salutary goal of the integration doctrine to protect investors, fairness requires that liability under the doctrine should ensue only if: (1) a clear and rational standard is used to judge when an issuer's offerings will be integrated into a single offering; and (2) the use of two or more artificially separated—but otherwise exempt—offerings, rather than a single, registered offering truly fails to provide the nature and degree of investor protection contemplated in the 1933 Act. As to the first point, workable standards are necessary to enable good faith issuers and their counsel to develop financing plans and implement them with a reasonable degree of certainty and utility. Workable standards also allow regulators to state the law accurately and intelligibly in their pronouncements on the doctrine.[22] As to the second point, the question whether artificially separated offerings actually threaten investor protection goes to the heart of the doctrine's *raison d'etre.*[23] Because any formulation designed to improve the integration doctrine must address these two points, both have been the focus of considerable comment.

B. *Current Formulations for Applying the Integration Doctrine*

The SEC currently determines whether an offering will be integrated into one or more offerings based upon factors enumerated in SEC Securities Act Release No. 4434, which reaffirms the applicability of integration to intrastate offerings that are exempt under section 3(a)(11) of the 1933 Act, and Release No. 4552, which reaffirms the applicability of integration to private placements under section 4(2) of the 1933 Act.[24] The releases provide that purportedly separate offerings may be integrated depending on the presence of the following factors:

(1) the offerings are part of a single plan of financing;

---

22. *Integration of Securities Offerings: Report of the Task Force on Integration,* 41 Bus. Law. 595 (1986) [hereinafter ABA Report]. In this report by a task force of the American Bar Association's Committee on Federal Regulation of Securities, considerable concern is expressed about the great "lack of certainty" facing any issuer attempting to determine whether two planned offerings will be integrated. The reason for this uncertainty is the failure of the securities laws to provide a clear and manageable analytical scheme for resolving integration questions. Given the potential for substantial liability attending a violation of the registration requirement, such uncertainty could undermine the capital formation process. *Id.* at 600; *see also* Deaktor, *supra* note 9, at 473-74.

23. *See* ABA Report, *supra* note 22, at 596. Perhaps the most strident critic of the integration doctrine is Professor Rutheford B. Campbell, Jr., who advocates the elimination of the doctrine itself:

> [T]he integration concept should be eradicated. The concept makes no sense. It has no defensible policy basis, limits the availability of legitimate exemptions from registration and, as a result, unnecessarily restricts the availability of capital for small (and large) issuers.

Campbell, *supra* note 1, at 163.

24. Exemption for Local Offerings From Registration, Securities Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2270 (Dec. 6, 1961); Non-Public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2770 (Nov. 6, 1962).

(2) the offerings involve the issuance of the same class of security;
(3) the offerings are made at or about the same time;
(4) the same type of consideration is to be received;
(5) the offerings are made for the same general purpose.[25]

In addition to the five factors derived from the releases, the SEC has incorporated a "safe harbor" concept into the calculus of solutions to integration problems. Rule 502(a) of regulation D [26] and rule 147 [27] both create a conclusive presumption that two or more exempt offerings will not constitute a single offering when they are separated by six-month intervals. Additionally, rule 152 provides that a private offering made under section 4(2) of the 1933 Act will not be integrated with a subsequent public offering.[28]

Although these SEC formulations were introduced to create greater objectivity and utility with respect to the integration doctrine, they often have had precisely the opposite effect. The five-factor test of Release Nos. 4434 and 4552 has been criticized severely as being confusing and unhelpful. Some of the factors are subjective and some overlap, for example. Perhaps the most unfortunate shortcomings of the test are that the SEC has not provided guidance as to the meaning of important terms used in these factors, has not provided information about the interrelationship of the factors (such as the relative weight and importance of each to the other), and has not suggested the number of factors that must be present to trigger operation of the integration doctrine. Additionally, the SEC staff and the courts have rendered interpretations of the integration doctrine that appear to invoke factors other than those of Release Nos. 4434 and 4552.[29]

In addition to the confusion surrounding the five-factor test, the six-month safe harbor rules potentially are disadvantageous to issuers because

---

25. Exemption for Local Offerings from Registration, Securities Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2272 (Dec. 6, 1961); Non-Public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2781 (Nov. 6, 1962). Although the factors stated in the two releases are the same, the language introducing the factors is different in the two releases. Release No. 33-4434 states that "[a]ny one or more of the following factors may be determinative of the question of integration . . ." while Release No. 33-4552 states that "[t]he following factors are relevant to such question of integration. . . ." Exemption for Local Offerings from Registration, Securities Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2272 (Dec. 6, 1961); Non-Public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2781 (Nov. 6, 1962). It is not clear whether the SEC intended that different treatment be given to integration questions arising under the different exemptions. *See* Morrissey, *supra* note 20, at 162-63; R. JENNINGS & H. MARSH, SECURITIES REGULATION 343 (5th Ed. 1982); Deaktor, *supra* note 9, at 503.

26. 17 C.F.R. § 230.502(a) (1988). *See also* Revisions of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982).

27. 17 C.F.R. § 230.147(b)(2) (1988).

28. 17 C.F.R. §230.152 (1988). *See also* Securities Act Release No. 33-305 (Mar. 2, 1935) (available from SEC).

29. ABA Report, *supra* note 22, at 595, 596, 600, 623; Deaktor, *supra* note 9, at 502, 505.

they restrict the issuers' flexibility in timing capital-raising efforts. Particularly with start-up companies, such flexibility is critical to successful capital formation.[30] The safe harbor rules also allow the SEC to avoid clarification of the regulatory language and refinement of the principles underlying integration. Additionally, these safe harbor protections are limited to offerings that fit into the exemptions from registration available under either rule 147 or regulation D.[31]

The protections offered by rule 152 also are limited. Rule 152, by its express terms, applies only to issuances in which private offerings under section 4(2) of the 1933 Act are attempted or effected prior to a public offering. Furthermore, rule 152, if interpreted literally, would not apply to public offerings made after a section 4(2) private offering unless the actual decision to carry out the public offering was made "subsequent" to the private offering; such an interpretation could serve as a direct disincentive to engage in sound, long-term financial planning.[32]

Finally, quite apart from the foregoing criticisms, a threshold question remains: Whether the requirements of each exemption provide such a high degree of investor protection so as to accomplish the goals of the Act and to nullify the need for the integration doctrine. This question is especially compelling in light of improvements in some exemptions.[33]

Because of the inadequacies in the present approaches to the integration doctrine, capital formation has suffered.[34] For small businesses in particular, the spectre of regulatory reproach and private litigation can easily dash capital formation plans.[35] Given these problems, various recommendations for change in the regulatory approach to the doctrine have been made in

30. See *infra* notes 204-15 and accompanying text for a discussion of the shortcomings inherent in a six-month integration safe harbor.

31. *See* Deaktor, *supra* note 9, at 516-519.

32. *See* Sachs & Cowan, *Integration of Securities Offerings—A Trilogy of Recent SEC Pronouncements,* The Daily Rec., Baltimore, June 10, 1986, at 5 (discussing the no-action letter in *Verticom Inc.* in which the SEC staff stated it would take no enforcement action with respect to a section 4(2) private placement and a planned registered offering notwithstanding the fact that the decision to make the registered offering was made prior to issuing securities using the private placement exemption); *Real Estate Syndicators Ask Staff to Consider Reg. D Changes,* 18 Sec. Reg. & L. Rep. (BNA) No. 17, at 590-91 (April 25, 1986).

33. ABA Report, *supra* note 22, at 596 ("Moreover, the integration concept currently is being invoked in many diverse circumstances involving the five transaction exemptions under the Act (and several rules thereunder) that would otherwise be available—many of which have their own means for ensuring investor protection—to which the necessity for an integration concept may vary greatly."); Campbell, *supra* note 1, at 167-69.

34. ABA Report, *supra* note 22, at 596 ("If consistently and strictly applied, the concept could cause numerous sales to be integrated (and thereby registered) when their registration would not significantly enhance investor protection and could seriously impair the issuer's capital formation and operating plans."); Deaktor, *supra* note 9, at 541 ("uncertainties and delays in implementing financial planning can be ruinous").

35. Campbell, *supra* note 1, at 163 ("[T]he tangles and snares of the doctrine generally are less troublesome to larger issuers . . . Small issuers . . . may not have [the same] . . . financing flexibility, so the loss of a single financing alternative through the impact of integration might be significantly more harmful.").

recent years. The most notable and comprehensive proposals come from two task forces of the American Bar Association (ABA).[36]

This Article will examine the more prominent approaches to improvement of the integration doctrine, focusing primarily on the latest and most comprehensive ABA proposals ("ABA Report").[37] After briefly discussing the basic regulatory scheme within which the integration problem occurs, the Article will explain the history and development of the doctrine, and proceed with an overall analysis of the proposals set forth in the ABA Report, simultaneously making recommendations. The major premise of this Article is that the comprehensive ABA task force proposals would be a substantial improvement over the present uncertain and inhibitory atmosphere created by the integration doctrine. The proposals should be modified and supplemented in several areas, however, because their present structure promises only limited utility to small and growing businesses. It is submitted that the ABA proposals, with the modifications and additions recommended herein, would greatly improve the capital formation environment for small businesses, while preserving investor protection as contemplated in the Securities Act of 1933.

II. Registration

The Securities Act of 1933 governs the distribution of securities under federal law.[38] Section 5 of that Act,[39] the key provision regarding disclosure in the distribution process, provides that no offer to sell or offer to buy a security may be made, in interstate commerce or through the mails, until a registration statement relating to that security is filed with the SEC;[40] that no sale or delivery after sale, in interstate commerce or through the mails, of such a security may take place until this registration statement has become effective;[41] and that no sale or delivery of the security, in interstate commerce or through the mails, may occur unless a legally sufficient prospectus relating to that security, which meets the requirements of section

---

36. One of the two reports focuses on integration of partnership offerings. ABA Subcommittee on Partnerships, Trusts, and Unincorporated Associations, *Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering,* 37 Bus. Law. 1591 (1982) (hereinafter ABA Partnership Report). The latest report addresses the integration doctrine generally. Rather than review or revise the ABA Partnership Report, the ABA decided, in its more comprehensive report, to "incorporate and integrate its very useful proposals into a more comprehensive integration analysis." ABA Report, *supra* note 22, at 597.

37. The Article will also draw upon observations and recommendations from studies of the doctrine other than those of the ABA.

38. *See generally* L. Loss, *supra* note 1, at 92; R. Jennings & H. Marsh, *supra* note 25, at 40-41.

39. 15 U.S.C. § 77e (1982).

40. 15 U.S.C. § 77e(c) (1982). Nor may any such offers be made while the registration statement is the subject of a refusal order or stop order or any pre-effective-date public inquiry under section 8 of the Act.

41. 15 U.S.C. § 77e(a) (1982).

10 of the Act,[42] has been provided to the purchaser.[43] The Act imposes these requirements in order "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails"[44] in the interest of investor protection.

Compliance with the registration requirements of the 1933 Act allows a company to sell its securities to the public, and "going public" carries with it certain advantages.[45] Capital infusion is generally the leading benefit of going public. The creation of a public trading market is another substantial advantage, carrying with it a significant increase in liquidity, immediate and future financial flexibility, credibility, and potential for providing employee incentives.[46] On the other hand, going public brings with it certain disadvantages that, particularly in the start-up phase, tend to discourage most small businesses from going public.

For a small business the most prohibitive aspects of becoming a public company are the time, expense, and increased potential liability that accompany the registration process.[47] Civil and criminal liability for improper registration under sections 11, 12 and 17 of the 1933 Act is of particular concern because not only the company, but also the officers, directors, and others participating in the registration process are potentially liable.[48] The founders' or the managers' control and management flexibility frequently are affected adversely by going public.[49] Additionally, compliance with the periodic reporting requirements of the Securities Exchange Act of 1934 entails potential liability, expense, loss of privacy as to material transactions, threats to competitive position, and generally greater accountability to investors and the capital markets.[50] Finally, if a securities issuance encounters an unreceptive market in an initial public offering or in the aftermarket, the result will be diminished investor confidence.[51] These disadvantages, inherent in the registration process, frequently discourage small businesses

---

42. 15 U.S.C. § 77j (1982).

43. 15 U.S.C. § 77e(b) (1982).

44. Securities Act of 1933, ch. 38, tit. 1, 48 Stat. 74 (1933) (current version at 15 U.S.C. §§ 77a (1982)); *see also* Securities & Exch. Comm'n v. Murphy, 626 F.2d 633, 641 (9th Cir. 1980).

45. *See generally* Schneider, Manko & Kant, *Going Public: Practice, Procedure, and Consequences,* 27 VILL. L. REV. 1 (1981)[hereinafter Schneider]; Sonsini, *Going Public for the First Time,* 9 A.L.I.-A.B.A. COURSE MATERIALS J., No. 6, at 45 (1985); T. HAZEN, *supra* note 15, at 24-26.

46. *See* Schneider, *supra* note 45, at 3-4; Sonsini, *supra* note 45, at 45-46; T. HAZEN, *supra* note 15, at 24-25.

47. *See* Schnieder, *supra* note 45, at 4-6; Sonsini, *supra* note 45, at 46; T. HAZEN, *supra* note 15, at 25-26; Jacobs, *Taking It to the Street,* Wall St. J., May 19, 1986, at 31D, col. 1.

48. 15 U.S.C. §§ 77k, e, q. (1982); *see* T. HAZEN, *supra* note 15, at 180-205.

49. *See* Schneider, *supra* note 45, at 4-6; Sonsini, *supra* note 45, at 46; T. HAZEN, *supra* note 15, at 25-26; Jacobs, *supra* note 47.

50. *See* Schneider, *supra* note 45, at 4-6; Sonsini, *supra* note 45, at 46; T. HAZEN, *supra* note 15, at 25-26; Jacobs, *supra* note 47. *See generally* Schneider & Shargel, *"Now That You Are Publicly Owned . . .",* 36 BUS. LAW. 1631 (1981).

51. *See generally* Schneider & Shargel, *supra* note 50.

from becoming public companies. If a company's management decides that the disadvantages of registration are too great, the company may still choose to raise capital through the distribution of securities; instead of registration, however, the company may elect to proceed under the registration exemptions of sections 3 and 4.

III. Exemptions From Registration

Because the section 5 registration process can be exceedingly costly and time consuming, and because certain securities and securities transactions are of such a character that they do not require extensive formal disclosure in order to protect investors, Congress enacted the exemptions in sections 3 and 4 of the 1933 Act.[52] Additionally, pursuant to these sections, the SEC has promulgated a series of rules and regulations to facilitate interpretation of the sections' various provisions. Included among these rules and regulations are several "safe harbor" provisions, designed to provide greater certainty for issuers in their attempts to comply with the statutory exemptions.[53]

The rationale behind certain of the exemptions from registration seems to apply particularly well to small businesses. These businesses require relatively modest capital infusions through the sale of securities, yet the businesses generally cannot afford to conduct a public registration.[54] Often, the prospective investors are a few insiders or others who have sufficient knowledge about the particular business to make an informed investment decision.[55] As a matter of public policy, those who invest with such knowledge are not viewed as requiring extensive formal disclosures. In other words, registration of some issues is unnecessary for investor protection because the size of the offering is relatively small, or because of the nature of the relationship between the issuer and the purchasers.[56]

A. *Section 3(a)(9)*

Section 3(a)(9) of the Act exempts exchanges of securities from the registration requirement when they are "exclusively" between an issuer and

---

52. *See* Start-Up Companies, *supra* note 15, at 4-2 - 4-5; 1986 Gov't-Bus. Report, *supra* note 3, at 22.

53. Pertinent to small businesses are rule 147, regulation A and the three exemptive rules under regulation D. *See* 17 C.F.R. § 230.147, § 230.251 - .262, § 250.504 - .506 (1988).

54. Section 3(b) of the 1933 Act, as well as rules 504 and 505 promulgated thereunder, for example, set dollar-value limits on the amount of capital that can be raised under the exemption as part of the compensating scheme for obviating the registration requirement. *See* 15 U.S.C. § 77c(b) (1982); 17 C.F.R. § 230.504 - .505 (1988).

55. Various exemptions, such as rule 506 of regulation D, limit the number of investors, require certain indicia of financial acumen or ability, or both. *See* 17 C.F.R. § 230.506 (1988).

56. This is the essential reasoning behind the exemptions of sections 3 and 4, particularly those generally used by small businesses. *See* M. Steinberg, Securities Regulation 97-98 (1986) (Professor Steinberg presents three problems involving typical factual contexts for small businesses that must raise capital through the use of exemptions).

existing security holders, provided no commission or other remuneration is paid, directly or indirectly, for soliciting the exchange.[57] The exemption is narrowly limited to the securities of a single issuer, and the exemption is subject to a good faith requirement that precludes availability where the issuance is designed to circumvent the registration requirements.[58]

Section 3(a)(9) has its greatest applicability in the context of recapitalizations. Securities issued in such circumstances are exempted from the section 5 requirements since only existing security holders may be offerees; no new capital is being raised; and no payment of commissions or solicitation fees is allowed.[59]

B. *Section 3(a)(10)*

Section 3(a)(10) provides an exemption from registration for issuances of securities in exchange for securities, claims, or property interests where the "fairness" of that issuance has been approved by a competent court or administrative body after a formal hearing.[60] This exemption is often used in acquisitions requiring a formal merit review hearing on the fairness of the exchange.[61] This type of review, based on the merits of the transaction, is considered by some to provide not only adequate investor protection, but even superior protection to that provided by the registration process.[62]

---

57. 15 U.S.C. § 77c(a)(9) (1982). The securities covered in Section 3, including those of section 3(a)(9), are technically called "exempted securities," which means that the securities themselves are exempt from registration. *See* 15 U.S.C. § 77c(a)(9) (1982). In contrast, the exemptions covered by section 4 are "transactional exemptions," since they apply to specific types of securities transactions and not to the securities themselves. *See* 15 U.S.C. § 77d (1982); T. HAZEN, *supra* note 15, at 85-86; Morrissey, *supra* note 20, at 154. But, as Professor Loss has observed, "the dichotomy between the 'exempted securities' and the 'exempted transactions' was not carefully considered." L. Loss, *supra* note 1, at 297. Indeed, the section 3 exemptions discussed in this Article are all, in essence, transactional ones, since they begin and expire with the creation and termination of the qualifying transaction. *See* L. Loss, *supra* note 1, at 297-98; T. HAZEN, *supra* note 15, at 85-86.

58. L. Loss, *supra* note 1, at 301-308; T. HAZEN, *supra* note 15, at 96-98; Hicks, *Recapitalizations Under Section 3(a)(9) of the Securities Act of 1933,* 61 VA. L. REV. 1057 (1975).

59. *See supra* note 58.

60. 15 U.S.C. § 77c(a)(10) (1982).

61. *See generally* T. HAZEN, *supra* note 15, at 98-99; Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933,* 75 NW. U. L. REV. 1 (1980); Glanzer, Schiffman & Packman, *Settlement of Securities Litigation Through the Issuance of Securities Without Registration: The Use of Section 3(a)(10) in SEC Enforcement Proceedings,* 50 FORDHAM L. REV. 533 (1982); R. JENNINGS & H. MARSH, *supra* note 25, at 327-330.

62. *See* R. JENNINGS & H. MARSH, *supra* note 25, at 328 n.1, *citing* Securities Act Release No. 33-312 (March 15, 1933); and H.R. REP. No. 85, 73d Cong., 1st Sess. 16 (1933) ("Reorganizations carried out without such judicial supervision possess all the dangers implicit in the issuance of new securities and are, therefore, not exempt from the act. For the same reason, the provision [Section 3(a)(10)] is not broad enough to include mergers or consolidations of corporations entered into without judicial supervision.").

C. *Section 3(a)(11): Intrastate Offerings*

Section 3(a)(11) of the Act exempts from registration "any security which is part of an issue offered and sold only to persons residing within a single State or Territory."[63] The issuer in such an issue must be "a person residing and doing business within, or, if a corporation, incorporated by and doing business within" that state or territory.[64] Although this exemption is fairly broad, imposing no limitations on the size of the offering or the number of offerees and purchasers, and no specific disclosure requirements, the exemption is a decidedly "local" offering exemption.[65] The rationale for this basic restriction is that where purely intrastate transactions are involved, the proximity of issuer and investor to each other, as well as state regulation, provide sufficient investor protection.[66] Because the rationale of the exemption is rigidly keyed to the local nature of the transaction, any minor violation of the exemption's locality requirements will cause the exemption to be lost.[67]

Because of the broad language in section 3(a)(11) and the narrow interpretations of its scope by the courts and the SEC, the exemption is often not a feasible alternative to registration.[68] Rule 147, however, has somewhat increased the viability of the section as a capital formation device.[69] Indeed, it was in light of the potential difficulties in complying with section 3(a)(11) that the SEC promulgated rule 147,[70] which provides

---

63. 15 U.S.C. § 77c(a)(11) (1982).

64. *Id.*

65. Section 3(a)(11) Exemption for Local Offerings, Securities Act Release No. 33-4434, 23 Fed. Reg. 498 (Dec. 6, 1961) ("[T]he fact should be stressed that section 3(a)(11) is designed to apply only to distributions genuinely local in character. From a practical point of view, the provisions of that section can exempt only issues which in reality represent local financing by local industries, carried out through local investment.").

66. ABA Report, *supra* note 22, at 602; S. REP. No. 47, 73d Cong., 1st Sess. 4 (1933); H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).

67. The pitfalls and restrictions of the exemption are numerous. For example, a mere offer to a non resident person can invalidate the exemption as to the entire offering. The state in which the offer is made must not only be the issuer's principal place of business, but also its state of incorporation, thus eliminating the use of the Delaware corporation. "Resident" means "domiciled" in the conflict-of-law sense. The securities sold must "come to rest" in the hands of local residents, meaning that resales by holders who are bona fide local residents to non residents could well invalidate the exemption. Finally, the issuer must be performing substantial operational activities in the state of incorporation and the proceeds of the offering must be used in the state. *See generally* Securities Act Release No. 33-4434, *supra* note 65; T. HAZEN, *supra* note 15, at 100-105; SEC v. McDonald Inv. Co., 343 F. Supp. 343 (D. Minn. 1972).

68. T. HAZEN, *supra* note 15, at 100; Barber, *Alternatives for Small Business Raising Capital Under the Securities Act of 1933,* 8 PEPPERDINE L. REV. 899, 927 (1981); Gadsby, *supra* note 5, at 148. (SEC Chairman stating that "as a practical matter the intrastate exemption is loaded with dynamite and must be handled with great care.")

69. Barber, *supra* note 68, at 927.

70. Notice of Adoption of Rule 147 Under the Securities Act of 1933, Securities Act Release No. 5450, [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) 2270 ¶ 79,617 (Jan. 7, 1974).

greater certainty in the compliance process by setting forth objective standards.[71] Notably, the "doing business" requirement of section 3(a)(11) is satisfied when at least eighty percent of an issuer's gross revenues, assets, and proceeds of the proposed issue remain situated within the state, and where the issuer's place of incorporation and principal place of business are in the state. Additionally, the question whether a security sold pursuant to this exemption has "come to rest" in the state as required by the section is satisfied by a nine-month restriction on resale to a non-resident person.[72] Further, rule 147, paragraph (b)(2), incorporates a six-month safe harbor with respect to integration questions.[73] Although rule 147 has been criticized for leaving certain questions open and interpreting section 3(a)(11) incorrectly, it is generally well-regarded.[74]

D. *Section 3(b)*

Section 3(b) of the Act empowers the SEC to exempt small offerings from registration when the aggregate public offering price does not exceed $5,000,000.[75] Although the SEC has promulgated several regulatory exemptions under this section, regulation A and rules 504 and 505 of regulation D are most pertinent to small businesses.[76]

Regulation A, which contains rules 251 through 264 and related forms, was issued pursuant to section 3(b) and allows an issuer to offer securities

---

71. *Id.* ("the Commission believes that adoption of the rule . . . is in the public interest, since it will be consistent with the protection of investors and provide, to the extent feasible, more certainty in determining when the exemption provided by . . . [Section 3(a)(11)] is available.").

72. *Id.; see* L. Loss, *supra* note 1, at 325-37.

73. 17 C.F.R. § 230.147(b)(2) (1988) provides as follows:

> For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by section 3 or section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sale pursuant to this rule, *Provided,* That there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

74. *See* L. Loss, *supra* note 1, at 334-37 (observing that rule 147 has transferred the "doing business" test of section 3(a)(11) into a harsher, "triple 80 percent test"; that substantial liability could flow to the issuer and those assisting it in the offering, and even to good faith issuers who inadvertently fail to comply with the rule; and that several other exemptions might better serve an issuer). "Rule 147 makes for considerable certainty. But the exemption is still no bargain." *Id.*

75. 15 U.S.C. § 77c(b) (1988).

76. Two exemptions under Section 3(b) that will not be discussed in the Article are regulation B, which provides an exemption for certain fractional interests in undivided oil and gas rights; and regulation F, which provides an exemption for stock assessments and delinquency sales of assessable stock. *See* 17 C.F.R. §§ 230.300-.346, .651-.656 (1988). There are also several other rules. *See generally* T. Hazen, *supra* note 15, at 112; ABA Report, *supra* note 22, at 609-10; L. Loss, *supra* note 1, at 344-48.

in an aggregate amount not exceeding $1,500,000 million dollars in any given year.[77] Regulation A is the oldest regulatory exemption under section 3(b). The regulation is available to issuers in the United States and Canada, requires simpler documentation than that of the registration process, allows the use of unaudited financial statements, and permits the filing of disclosure documents in SEC regional offices rather than at the national office in Washington, D.C.[78] Therefore, compliance with regulation A is generally less expensive and less time consuming than compliance with the general registration requirements.[79]

Because of the more liberal notification, filing, and disclosure requirements, the regulation A offering process has been referred to as a "short form" or "mini" registration.[80] There are significant differences, however, between this exemption and actual registration, including differences in the potential liabilities.[81] Today, the presence of more convenient exemptions such as those under regulation D, as well as the streamlined registration process available through the use of form S-18, has brought about a decrease in the use of regulation A.[82]

E. Section 4(2)

Section 4(2) of the 1933 Act exempts "transactions not involving any public offering" from registration.[83] Offerings under this exemption are commonly known as "private placements." Section 4(2) was drafted by Congress to apply in situations "where there is no practical need for [the bill's] application or where the public benefits are too remote."[84] Because neither the language of this self-executing statutory exemption nor its

---

77. 17 C.F.R. §§ 230.251-264 (1988).

78. *Id.*

79. *See generally* Burge, *Regulation A: A Review and a Look at Recent Developments,* 46 L.A. B. Bull. 290 (1971); Frank, *The Processing of Small Issues of Securities Under Regulation A,* 1962 Duke L.J. 507; Green & Brecher, *When Making a Small Public Offering Under Regulation A (With Forms),* 26 Prac. Law. No. 2, 25-40, pts. 1-2; Weiss, *Highways and Byways Revisited,* 15 N.Y. L. F. 218 (1969); Weiss, *Regulation A Under the Securities Act of 1933—Highways and Byways,* 8 N.Y. L. F. 3 (1962).

80. L. Loss, *supra* note 1, at 340; T. Hazen, *supra* note 15, at 112.

81. T. Hazen, *supra* note 15, at 112-13. Although the procedures and content of the documents are similar to "full-blown" registrations, the bases of liability for material misstatements and omissions are not the same. Title 15 U.S.C. § 77l(2) (1982), 15 U.S.C. §77q(a) (1982), as well as section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (1982) and rule 10b-5, 17 C.F.R. § 240.105-5 (1988), are the means available to redress such grievances. Section 11 of the 1933 Act, 15 U.S.C. § 77k (1982), is available only for bona fide registrations.

82. T. Hazen, *supra* note 15, at 118-19 ("Many issuers who might otherwise rely on a Regulation A exemption may avail themselves of the streamlined registration for issuers qualifying to use Form S-18.").

83. 15 U.S.C. § 77d(2) (1982).

84. H.R. Rep. No. 85, 73d Cong., 1st Sess. 5, 6, 15-16 (1933).

legislative history cast much light on its scope, the SEC and the courts have further developed the scope of the exemption.[85]

In *SEC v. Ralston Purina Co.*,[86] the United States Supreme Court rendered what is still the most enduring judicial interpretation of section 4(2). In *Ralston* the Supreme Court required that all offerees in an offering under the 4(2) exemption (1) have access to the kind of information that would be made available in an actual registration statement;[87] and (2) be "sophisticated," that is, be able to obtain and comprehend the information made available to them and, in general, "fend for themselves."[88] The Court also stated that, as a matter of statutory interpretation, no quantitative limit is set on the number of offerees permitted in an offering under the exemption, and that the burden of proof that an exemption applies is on the issuer.[89] These guidelines remain the basis for all section 4(2) private placements. But even this Supreme Court guidance is very broad, and issuers are relegated to considerable uncertainty when they attempt to issue securities under the section 4(2) exemption. In response to this problem, as well as a similar problem under section 3(b), the SEC issued regulation D.

F. Regulation D

Regulation D, which became effective April 15, 1982, is a comprehensive exemptive scheme for small issues and small issuers.[90] It is the result of a study conducted by the SEC that "revealed a particular concern that the

---

85. *See* R. JENNINGS & H. MARSH, *supra* note 25, at 233-235; L. LOSS, *supra* note 1, at 349 ("These nine words ["transactions by an issuer not involving any public offering"] support a substantial gloss. The legislative history is of little help.").

86. 346 U.S. 119 (1953).

87. SEC v. Ralston Purina Co., 346 U.S. 110, 127 (1953) ("The focus of the inquiry should be on the need of the offerees for the protections afforded by registration."); *see* Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959).

88. *Ralston Purina Co.*, 346 U.S. at 125 ("Since exempt transactions are those as to which 'there is no practical need for [the bill's] application,' the applicability of § 4(1) [now § 4(2)] should turn on whether the particular class of persons affected needs the protection of the Act."). *See* Notice of Adoption of Rule 146 Under the Securities Act of 1933—Transactions By an Issuer Deemed Not to Involve Any Public Offering, Securities Act Release No. 5487, 1 Fed. Sec. L. Rep. (CCH) ¶ 2710 (Apr. 23, 1974).

89. *Ralston Purina Co.*, 346 U.S. at 125-27. The number of securities offered, the size of the offering and the presence of public advertising will be considered in determining the validity of any claim to an exemption. *See* T. HAZEN, *supra* note 15, at 130; Statement of the Commission Regarding Limitations of the Availability of So-Called "Private Offering Exemption," Securities Act Release No. 33-4552, FED. SEC. L. REP. (CCH) 2770-2783 (Nov. 6, 1962).

90. 17 C.F.R. §§ 230.501-506 (1988). *See generally* Berkeley & Churm, *An Analysis of Different Financings Under Regulation D*, 10 ALI-ABA COURSE MATERIALS J. 101 (1985); Elkins & Meeks, *Regulation D*, 51 C.P.S. (BNA) (1986); Parnall, Kohl & Huff, *Private and Limited Offerings After a Decade of Experimentation: The Evolution of Regulation D*, 12 N.M. L. REV. 633 (1982); Warren, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355 (1984); Note, *Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933*, 24 WM. & MARY L. REV. 121 (1982).

registration requirements and the exemptive scheme of the Securities Act impose disproportionate restraints on small issuers."[91] "[D]esigned to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions," regulation D consists of seven preliminary notes and rules 501 through 506.[92] Rules 504, 505, and 506 of regulation D are three separate exemptions from the section 5 registration requirement, while rules 501 through 503 contain certain definitions, terms, and conditions applicable to the three exemptions.[93]

Rule 501 sets forth seven definitions that apply generally throughout regulation D. The terms defined are: "accredited investor," "affiliate," "aggregate offering price," "business combination," "executive officer," "issuer," and "purchaser representative." This rule also sets forth certain tests for determining who is a "purchaser" under rules 505(b) and 506(b), which have a 35-purchaser limitation.

From the issuer's perspective, the definition of "accredited investor" in rule 501 is crucial, because (1) accredited investors do not have to be counted in the 35-purchaser limit of rules 505 and 506; (2) when all purchasers are accredited investors, no specific disclosure is required under rule 502(b); and (3) when the offering is made under rule 506, only non-accredited investors must meet the "sophistication" test.[94]

Rule 502 establishes four limiting conditions that apply to all registration-exempt offerings made under rules 504, 505 and 506. The first condition, rule 502(a), sets forth the integration doctrine, establishes the six-month safe harbor, and establishes the five-factor test of SEC Release No. 33-4552 as the formula for determining whether offerings not meeting the six-month safe harbor should be integrated. The remaining conditions set forth disclosure requirements, limitations on the manner of offering, including a prohibition on general solicitation or advertising, and limitations on resale.[95]

Rule 503 sets forth the requirement that notice of sales effected under regulation D must be filed with the SEC. Pursuant to SEC Release No. 33-

---

91. Regulation D—Revision of Certain Exemptions from Registration Under the Securities Act of 1933 for Transactions involving Limited Offers and Sales, Securities Act Release No. 6389, Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982).

92. *Id.*

93. *Id.*

94. 17 C.F.R. § 230.501 (1988). *See* Elkins & Meeks, *supra* note 90, at A-14.

95. 17 C.F.R. § 230.502 (1988). The six-month integration safe harbor of Rule 502(a) provides as follows:

> Integration. All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act [17 C.F.R. 230.405].

6663, issued in late 1986, only an initial notice filing within fifteen days after the first sale of securities is necessary. In that release the SEC also adopted a new form D, which will facilitate coordinated filings with the states.[96]

Rule 504 provides an exemption under section 3(b) of the Act for certain offers and sales not exceeding an aggregate offering price of $500,000. Rule 504 replaces rule 240, which exempted sales up to $100,000 to 100 investors, and requires that all proceeds from sales of securities within the previous twelve months under section 3(b) or in violation of section 5(a) of the Act be included in the aggregate offering price limitation. Although there are no specific disclosure requirements under rule 504, the issuer still is subject to federal antifraud and civil liabilities, as well as state securities provisions. With certain exceptions, the general requirements of rules 501 through 503 also apply.[97]

Rule 505, promulgated under the authority of section 3(b), exempts offers and sales to no more than thirty-five purchasers who are not accredited, when the aggregate offering price over twelve months does not exceed $5,000,000. Rule 505 replaces rule 242, which allowed sales aggregating $2,000,000 to an unlimited number of accredited persons, as well as to no more than thirty-five nonaccredited purchasers. As in rule 504, the aggregate offering price under a rule 505 offering must include proceeds from offers and sales of securities made twelve months prior to and during the rule 505 offering in reliance on any exemption under section 3(b) or in violation of section 5(a). Issuers making an offering under rule 505 are subject to the general terms and conditions of rules 501 through 503.[98]

Rule 506 exempts offers and sales of securities by issuers to no more than thirty-five purchasers other than accredited investors. There is no dollar limitation on the amount of capital that can be raised under this exemption. Rule 506 replaces the somewhat limited rule 146, and unlike rules 504 and 505, which were promulgated under section 3(b), rule 506's statutory basis is section 4(2) of the 1933 Act. Issuers relying on rule 506 must comply with the general terms and conditions of rules 501-503—just as they must under rules 504 and 505—but in addition, they must reasonably believe that each nonaccredited investor, either alone or along with a purchaser representative, is sophisticated enough to evaluate the investment properly.[99]

While regulation D has been the target of various criticisms and proposed revisions, its adoption generally has been regarded as a significant step in improving capital formation opportunities for small issuers.[100]

---

96. 17 C.F.R. § 230.503 (1988).

97. 17 C.F.R. § 230.504 (1988); *see* Elkins & Meeks, *supra* note 90, at A-15, 16.

98. 17 C.F.R. § 230.505 (1988); *see* Elkins & Meeks, *supra* note 90, at A-16.

99. 17 C.F.R. § 230.506 (1988); *see* Elkins & Meeks, *supra* note 90, at A-16.

100. *See generally* Campbell, *supra* note 1 (calling Regulation D "commendable attempt at balance," but recommending that SEC address specific areas in which various provisions of regulation created "problems [that] are especially difficult for small issuers."). The specific

G. *Section 4(6)*

Section 4(6) of the 1933 Act was enacted in 1980 to provide an exemption from registration for offers or sales of securities by an issuer solely to so-called "accredited investors." The aggregate offering price of an issue under this exemption may not exceed the maximum amount allowable under section 3(b) of the Act, which is at present $5,000,000. Nor may an issuer conduct "advertising or public solicitation in connection with" any issuance made pursuant to section 4(6). Finally, form D, the required notice form for all regulation D offerings, must be filed for any sales made in reliance on section 4(6).[101]

In view of the subsequent promulgation of regulation D, particularly rule 505, section 4(6) has had only limited use. Rule 505 operates under terms substantially similar to section 4(6), except that compliance with rule 505 is less burdensome.[102]

---

recommendations are as follows:

(1) eliminate regulation D's prohibition against general advertising;

(2) adjust the disclosure requirements of regulation D;

(3) modify the resale restrictions of rule 144;

(4) eliminate the integration concept.

Id. at 134-136; *see also* Warren, *supra* note 90, at 378-84. Warren similarly refers to the SEC's promulgation of regulation D as "commendable," but criticizes that effort for having "preserved and created defects in its restructured exemption scheme for limited offerings." *Id.* at 379. Specifically, Professor Warren attacks (1) the disparity between the suitability criteria for non-accredited investors in rules 505 and 506 ("sophistication" test required for rule 506 investors but not for rule 505 investors); (2) the definition of "accredited investor" in rule 501(a) (allows accreditation based solely on net worth, income, or amount of purchase; these tests provide no real guarantee that an investor "can evaluate the merits and risks of a prospective investment . . . [or] that the investor can bear the risks of losing the invested fund"); and (3) the failure of regulation D to include a "substantial compliance" test for satisfying each exemption's requirements ("Regulation D is an extremely technical and complex set of rules. Unfortunately, technical failure to satisfy the requirements would . . . [cause the issuer to be] forced out of its 'safe harbor' and into the rough seas of the section 4(2) exemption."). *Id.* at 379-383.

Finally, on January 16, 1987, the SEC issued Securities Act Release No. 33-6683, which proposes several amendments to regulation D, including expansion of the definition of "accredited investor," elevation of the ceiling on rule 504 offerings (under certain circumstances) to $1,000,000, and inclusion of a "good faith" test for compliance with regulation D. Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Securities Act Release No. 6683, [1986-1987 Transfer Binder] Fed. Sec. Rep. (CCH) ¶ 84,054 (Jan. 16, 1987).

101. 15 U.S.C. § 77d(6) (1982). The key term here, of course, is "accredited investor." SEC Rule 215 (17 C.F.R. § 230.215 (1988)) interprets section 2(15)(ii) of the 1933 Act, (15 U.S.C. § 77b(15)(88) (1982)) to define the term as including eight categories of the offerees and purchasers. Essentially, they fall into three categories: certain institutional investors; "insiders" of the issuer, and certain wealthy individuals. *See* T. HAZEN, *supra* note 15, at 126-27.

102. *See* Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sale, Securities Act Release No. 6339, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,014 (Aug. 7, 1981) (regulation D "may provide a more attractive alternative to registration for smaller issuers" than section 4(6)); Elkins & Meeks, *supra* note 90, at A-6 (citing Securities Act Release No.

IV. Origin and Development of the Integration Doctrine

A. Administrative Action

1. SEC Rules, Regulations, and Rulings

The integration doctrine was created and applied soon after the 1933 Act became effective. On December 28, 1933, the Federal Trade Commission (FTC)[103] ruled that an attempt to sell securities pursuant to the intrastate offering exemption would be integrated into a registered offering of the same class of securities that was under FTC review.[104] A registration statement covering all the securities in controversy already had been filed in that matter before the issuer decided to sell some of the securities separately.[105] It was not clear why the issuer wanted to carve out a portion of the entire offering and sell it to local purchasers prior to the public sale.

In what was to become the usual pattern in agency rulings and statements on integration matters, the government's response was brief, with very little helpful analysis or guidance. The issuer simply was admonished that it must either use a valid exemption for the entire offering or register that offering; a combination of the two would constitute a violation of the 1933 Act.[106]

Perhaps the issuer believed that the separate intrastate offering was necessary to provide crucial "bridge" financing in aid of the public offering. Whether or not this was the case, the FTC denied the issuer an important capital formation opportunity without the benefit of a clear explanation or

---

33-6339 and noting that (1) nonaccredited investors can participate in regulation D offerings but not in section 4(6) offerings, and (2) under section 4(6), a subjective "reasonable belief" that one is an accredited investor is not sufficient, while such is sufficient under regulation D).

103. Prior to creation of the SEC in 1934, the FTC administered the 1933 Act. The SEC was created by section 4 of the Securities Exchange Act of 1934, 15 U.S.C. § 78d (1982). *See* Morrissey, *supra* note 20, at 160 n. 131. (Section 2(5) of the 1933 Act was amended by the Securities Exchange Act of 1934, Pub. L. No. 73-291, Section 210, 48 Stat. 881, 908(1934) to accomplish the transfer of authority and establishment of the SEC).

104. Extracts from Letters of Federal Trade Commission Relating to Applications of Various Sections of the Act, Securities Act Release No. 97, Fed. Sec. L. Rep. (CCH) ¶¶ 1021-1029 (Dec. 28, 1933).

105. 11 Fed. Reg. 10,950 (1946).

106. *Id.;* Deaktor, *supra* note 9, at 493 (citing following excerpt and noting that in Release No. 97 "[t]he FTC's response launched the application of integration in conclusory, ambiguous terms"):

> The Securities Act will not permit you to use the mails inside the state of X for the sale of securities until a registration statement is effective unless, in accordance with the provisions of section [3(a)(11)] the entire issue is to be sold to residents of that state. It is understood that you plan to sell *part of the issue* to non-residents of X as soon as the registration statement becomes effective. If this is done, the conditions of section [3(a)(11)] will not be met, and any use of the mails for sales within the state pending an effective registration will be a violation of the Act.

11 Fed. Reg. at 10,950.

analysis of the alleged threat to investor protection. Indeed, it is possible that the FTC's denial of the issuer's financing proposal accomplished no protection for investors. One can only conclude that the ruling reflects a rather mechanical and superficial application of the issue concept, with an accompanying bias toward registration. Nonetheless, the integration doctrine was launched, and the principle of the sanctity of the single issue or offering was fundamental to the doctrine and its rationale.[107] Two years after the FTC's conception of the integration doctrine, the newly instituted SEC adopted the doctrine in *In re Brooklyn Manhattan Transit Corp.*,[108] affirming the use of the single issue concept in a matter in which the issuer had claimed an exemption under Section 3(a)(11).

During these early years of the doctrine's evolution, the SEC promulgated rule 152, which provides as follows:

> The phrase "transactions by an issuer not involving any public offering" in section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement.[109]

Rule 152 allows issuers to avoid integration with some degree of certainty when a section 4(2) private placement is followed by a registered offering.[110] The shortcomings of the rule are (1) its limited application, given the universe of possible offering combinations and needs; and (2) the literal requirement that the issuer actually decide to effect a registered offering

---

107. Deaktor, *supra* note 9, at 492:

> Underlying the scheme of transactional exemptions in sections 3 and 4 of the 1933 Act is a theoretical assumption that firm's past financial transactions can be separated into distinct and identifiable issues. The premise is explicit in several provisions. For instance, section 3(a)(11) exempts only those securities which are "part of an issue" offered and sold intrastate. Section 3(b) similarly is restricted in its application to an "issue" of securities with an offering price not in excess of $2,000,000 [now $5,000,000]. Despite the obvious significance of the issue concept, the vast array of variables that attend financial transactions has generated difficulty in its practical application.
>
> Implementation of the issue concept entails a determination whether a series of securities offerings constitutes one or more transactions. The concept itself had been interpreted at an early date to require that the transaction be registered or that all activities conducted in furtherance of a transaction or issue of securities strictly conform to the requirements of a single exemption. Integration is the logical extension of the notion that an issuer should not be allowed to circumvent an exemption's requirements by resorting to a combination of transactional exemptions to insulate what would otherwise be a nonexempt public offering from the 1933 Act's registration provisions. Likewise, an issuer should not be permitted to effect an otherwise nonexempt public offering by making a partially registered and partially exempt issue.

Id. at 492 (footnotes omitted).

108. 1 S.E.C. 147 (1935).

109. 17 C.F.R. § 230.152 (1988).

110. ABA Partnership Report, *supra* note 36, at 1594-95.

"subsequent" to the private offering, which clearly discourages sound financial planning.[111] Two recent SEC Staff no-action letters, however, appear to have eliminated the necessity that an issuer actually defer a decision to effect a public offering.[112]

Not until the SEC's decision in *In re Unity Gold Corp.*[113] did government pronouncements on integration begin to articulate anything approaching an analytical scheme. In *Unity Gold* the SEC integrated an offering made under rule 202, which was a predecessor of regulation A, with a registered offering of securities of the same class for which a registration statement had been filed two months after the exempt offering.[114] Invoking the issue concept, as well as the SEC's resolve that exemptions should not be abused, the SEC supported its ruling that the two offerings were in effect one issue, and thus the section 3(b) exemption was unavailable, with the following language:

> The manifest purpose of the $100,000 proviso contained in Section 3(b) of the Act is to limit the exercises of the Commission's exempting power to cases of small financing. It follows that the proviso cannot be construed to permit the exemption of small portions of large financing operations. This would defeat its very purpose. Thus, securities of the same class, offered on the same general terms to the public in an uninterrupted program of distribution, cannot be segregated into separate "issues" merely by claiming an exemption for a limited portion of such shares under Rule 202, or under any other rules of the Commission adopted in accordance with Section 3(b) of the Act, and registering the remainder. Nor can this be accomplished, it may be noted, by the mere formality of filing successive prospectuses under one or more of these rules if in fact the shares thereby offered otherwise constitute a single "issue" within the meaning of Section 3(b).[115]

Most importantly, the SEC in *Unity Gold* specified six factors that it would use in determining whether certain ostensibly separate offerings should be integrated:

---

111. *See* ABA Report, *supra* note 22, at 611; Stevenson, *supra* note 10, at 55.

112. *See* Vulture Petroleum Corp., SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,407 (Dec. 31, 1986)(extending rule 152 application to rule 506 of regulation D); Verticom, Inc., SEC No-Action Letter, Feb. 12, 1986.

113. 3 S.E.C. 618 (1938).

114. In re Unity Gold Corp., 3 S.E.C. 618, 625 (1938). This ruling resulted in a stop order, under section 8(d) of the 1933 Act, 15 U.S.C. § 77h(d), directed at the issuer's plan to offer registered securities. The registration statement contained an assertion that the earlier offering was in compliance with section 3(b) exemption requirements; because the offerings were integrated, their total dollar value exceeded the $100,000 exemption ceiling, and thus, that exemption was not available. This in turn made the assertion in the registration statement false and misleading, subjecting the issuer to liability and the resultant stop order.

115. *Id.*

(1) whether the plan to distribute the securities includes, in addition, the distribution of other securities;
(2) the methods of sale and distribution;
(3) the classes of securities offered;
(4) the general terms on which the securities were offered;
(5) the timing of the offerings; and
(6) the use of proceeds of the offerings.[116]

Although the *Unity Gold* decision provided more objective standards in assessing integration than had previously existed, the SEC failed to define certain key terminology, explain the relative weights the factors should be given, or state whether all factors must be present for integration to take place.[117] Nonetheless, the *United Gold* decision has had a substantial impact on the subsequent development of the integration doctrine.[118]

After the initial agency rulings on integration in the 1930s, there was very little activity until the early 1960s when the SEC promulgated Release Nos. 4434 and 4552.[119] These releases retained essentially the same factors for integration as *Unity Gold,* except for the factor concerning similarities in sale and distribution methods. These factors evaluate whether the offerings at issue (1) are part of a single plan of financing; (2) involve the issuance of the same class of security; (3) are made at or about the same time; (4) require the same kind of consideration to be received; and (5) are being made for the same general purpose.[120] Like the factors of *Unity Gold,* however, these factors have been criticized for their failure to provide real guidance as to the precise definitions of the factors or the interrelationship and relative weighting of the factors. Moreover, the introductory language

---

116. *Id.* The SEC noted that

> [t]he determination whether securities are being offered as part of a single "issue" will depend upon a consideration of various factors concerning the methods of sale and distribution employed to effect the offerings and the disposition of the proceeds. If the offerings may be segregated into separate blocks, as evidenced by material differences in the use of the proceeds, in the manner and terms of distribution, and in similar related details, each offering will be a separate "issue." In the main, of course, each case must be determined upon the basis of its own facts.

Id.

117. *See* ABA Partnership Report, *supra* note 36, at 1594; Deaktor, *supra* note 9, at 495; Opinion of General Counsel on Exemption of Refunding Issues Where Unsubscribed Portion Will Be Sold to the Public For Cash, Securities Act Release No. 2029, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2140-2141 (Aug. 8, 1939) (expanding doctrine's application to private placements under section 4(2) and stating that not all factors set forth in Unity Gold are necessary to integration analysis).

118. Probably the best examples of Unity Gold's impact are Securities Act Release Nos. 4434 and 4552. *See supra* notes 24-25 and accompanying text; *infra* note 119.

119. Exemption for Local Offerings, Securities Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2165.103, 2270-2277 (Dec. 6, 1961); Announcement of Statement Regarding Availability of Non-public Offering Exemption from Registration Requirements, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2770 (Nov. 6, 1962); *see supra* notes 24-25 and accompanying text.

120. *Id.*

of the two releases was not consistent, with Release No. 4434 stating that "[a]ny one or more of the . . . factors may be determinative," and Release No. 4552 stating that "[t]he following factors are relevant." This discrepancy only added to the confusion and uncertainty in answering integration questions.[121]

Because of the continuing problem of vagueness in the formulas for resolving integration problems, the SEC included six-month integration safe harbors when it promulgated rules 146 and 147 under sections 4(2) and 3(a)(11) respectively.[122] Rule 146(b)(1) now has been rescinded and replaced by a similar six-month safe harbor, rule 502(a) of regulation D.[123]

Notwithstanding the beneficial nature of the safe harbor provisions of rules 147 (b)(2) and 502(a), certain deficiencies in the safe harbor concept have been recognized: safe harbors do not apply to all exemptions, they discourage efforts to improve the overall analytical scheme, and the interval chosen is arbitrary and therefore may unnecessarily hinder capital formation needs of businesses with high or unpredictable capital requirements.[124]

2. SEC No-Action Letters

In February, 1971, the SEC staff began responding to specific, fact-based inquiries concerning statutes, rules, and regulations administered by the SEC.[125] These responses and the inquiries generating them are termed "no-action letters." And while they do not represent formal action by the SEC, no-action letters are available to the public[126] and generally have been relied upon by securities practitioners in the continuing effort to ascertain the law regarding matters such as integration of securities offerings.[127]

---

121. *See supra* note 25, and accompanying text. In particular, see Deaktor, *supra* note 9, at 541: "The formula, however, appears insufficiently focused to provide guidance for the structuring of complex financial arrangements. The generality of its language and the existence of substantial overlaps in the factors engender confusion."

122. *See* Securities Act Release No. 5487, *supra* note 88, ¶ 2710 (adopting rule 146, 17 C.F.R. § 230.146 (1979)); Securities Act Release No. 5450, *supra* note 70, ¶ 79,617 (adopting rule 147, 17 C.F.R. § 230.147 (1987)). The integration safe harbors were set forth in rules 146(b)(1) and 147(b)(2). Except for the fact that rule 147(b)(2) uses the term "issue" (consistent with its statutory basis) and rule 146(b)(1) uses the term "offering," the language of the two rules is identical. The language of rule 147(b)(2) is quoted *supra* in note 73.

123. 17 C.F.R. § 230.520(a)(1988). For a general discussion of the evolution of regulation D from rules such as rule 146, see Parnall, *supra* note 90. The language of rule 502(a) appears *supra* in note 95.

124. *See infra* notes 204-15 and accompanying text.

125. Securities Act Release No. 5098 *supra* note 20, ¶ 77,921 (adopting 17 C.F.R. § 200.81, 202.2 (1988)); *see supra* note 20, authorities cited therein, and accompanying text.

126. Note also that the staff will respond to requests for interpretations of SEC statutes, rules and regulations; these responses, termed "interpretative letters," are often also called "no action letters." *See* Morrissey, *supra* note 20, at 165 n. 176; Lowenfels, *SEC No-Action Letters: Conflicts with Existing Statutes, Cases and Commission Releases,* 59 VA. L. REV. 303, 304 (1973).

127. Procedures Utilized by Division of Corporate Finance for Rendering Informal Advice, Securities Act Release No. 6253, 1 Fed. Sec. L. Rep. (CCH) ¶ 373 (Oct. 28, 1980); Deaktor, *supra* note 9, at 526.

But in the integration doctrine area, staff no-action letter responses generally have left practitioners unsatisfied about how to analyze a particular problem. The following quote from the ABA Report aptly summarizes the confusion wrought by no-action letters:

> Thus, the Staff's no-action letters and interpretative responses show that the explicit principles the Staff developed to guide its decisions on questions of integration are all too often inadequate to handle the hard cases presented. As a result, the Staff has often decided on the basis of considerations other than those explicitly given as the principles to be applied in such cases. In the "offering integration" letters, for example, the Staff claimed to apply a five-factor test, when often only one factor was even nominally decisive and even its application was sometimes ambiguous and uncertain. In the "venture" and "issuer" integration letters, the five criteria of Release No. 4552 seem secondary to whether the securities seem to have a common issuer, and even in these letters, the apparent risk of the offering seems to have a determining effect upon the Staff's position on this question. Thus, the Staff's letters have contributed little toward the understanding of this complex issue, which may explain why the Staff discontinued such letters from 1979 through 1984.[128]

Although the no-action letters, as noted above, generally have been regarded as confusing and inconsistent, commentators have discerned certain

---

128. ABA Report, *supra* note 22, at 622-23.

The staff's decision to discontinue issuance of no-action letters may have been a result of the failures in clarity and consistency of the no-action letters. *See* Clover Financial Corp., SEC No-Action Letter (Mar. 5, 1979) ("Because of the complexity of the proposed arrangements and the possibility that staff positions on the integration concept may be misconstrued and misapplied in other situations, we will not be issuing interpretations in this area any longer.") The staff resumed the no-action letter practice in 1985. *See* 17 Sec. Reg. & L. Rep. (BNA) 403 (1985).

Other commentators have reached the same conclusion about the staff's responses to no-action letter inquiries. For example, Stevenson, *supra* note 10, at 50 states:

> Unfortunately, many of the no-action positions are difficult to reconcile. The staff typically purports to follow the "analysis" of Release No. 4552. In general, however, the letters shed little light on the weight to be given the factors set forth in the release or how they are to be used in arriving at a conclusion on any particular issue. Indeed, the staff occasionally appears to have abandoned the factors in favor of one or more other considerations not mentioned in the release.

See also Morrissey, *supra* note 20, at 165 ("If considered as a coherent body of law, the letters pose . . . problems . . . [T]he letters are often difficult to harmonize even when they deal with analogous situations. They typically contain little reasoning or elaboration on the basis for the staff's opinion."); Deaktor, *supra* note 9, at 541 ("[T]hese nebulous factors and admonitions against fragmenting a single transaction are the extent of the perspective provided by the SEC's formal and informal actions.").

Two extensive discussions of the staff's no-action letters on integration appear in the ABA Report, *supra* note 22, at 617-623, and in the Deaktor article, *supra* note 9, at 525-46. For this reason, this Article will not attempt yet another discussion of the same subject.

notable patterns. For example, in the most basic category of integration, "offering integration," which involves only one issuer with the focus being on multiple issues of that issuer,[129] staff no-action letters have emphasized the "general purpose" factor of Release No. 4552 in private placements and intrastate offerings.[130] These letters hopefully indicate that not all five factors of the release must be satisfied for offerings to be integrated, but they also raise important questions concerning the relative weight to be accorded the various factors.[131]

Additionally, the cases arising under section 3(a)(3) of the Act, which provides an exemption for sales of commercial paper, similarly seem to place emphasis on the purpose of the offerings, but tend toward a nonintegration position regardless of the purposes articulated. The real basis for staff decisions under this exemption seems not to be the five-factor test at all, but the "absence of a need for further investor protection [than that already provided in the exemptions themselves] in . . . circumstances that typically involve unspeculative securities and sophisticated institutional investors."[132]

Another category of integration problems which has developed centers on "venture integration." Venture integration occurs when the offerings of ostensibly different issuers are deemed a single offering because the issuers, although separate legal entities, conduct projects that are closely related.[133] Often these entities are limited partnerships, frequently with a common general partner, engaged in the exploitation of mineral rights.[134] The absence of any clearly articulated standard in integration problems is also a source of anxiety in this arena, because the SEC staff seems to have developed a special, more stringent test for oil and gas financings.[135] Apparently, the

---

129. *See* ABA Report, *supra* note 22, at 617-23; Stevenson, *supra* note 10, at 51-57 (discussing the terms "offering," "venture," and "issuer" integration).

130. ABA Report, *supra* note 22, at 618-17 (citing Wellington Fund, Inc., SEC No-Action Letter (Aug. 23, 1976); Rosenberg Capital Management, SEC No-Action Letter (Jan. 19, 1979); DeLorean Motor Co., SEC No-Action Letter (June 14, 1976); UST Corp., SEC No-Action Letter (Feb. 23, 1977); Cactus Beef, Inc., SEC No-Action Letter (Aug. 5, 1971)).

131. *See* ABA Report, *supra* note 22, at 619.

132. *See* ABA Report, *supra* note 22, at 620; Stevenson, *supra* note 10, at 52. In Stevenson's article he states, regarding the "general purpose" and "single plan of financing" factors: "neither seems related in any discernible way to the need of investors for the protection of registration." *Id. But see* Deaktor, *supra* note 9, at 539 n.413 (stating that "[t]he difference in the general purposes of the offerings is the primary basis for this [no-action] position.").

Examples cited in the ABA Report include First Merchants Corp., SEC No-Action Letter (July 27, 1978); Pittsburgh Nat'l Corp., SEC No-Action Letter (July 13, 1977); Alabama Bancorporation, SEC No-Action Letter (June 8, 1977); Security Pac. Corp., SEC No-Action Letter (Oct. 14, 1976); Liberty Nat'l Corp., SEC No-Action Letter (May 21, 1976).

133. Stevenson, *supra* note 10, at 56; ABA Report, *supra* note 22, at 620.

134. *Id.*

135. ABA Partnership Report, *supra* note 36, at 1605-06 ("It appears to have been easier for the staff to find separate projects, and therefore discrete transactions, if real estate, horses, or shopping center booths, rather than oil and gas properties, were involved."); ABA Report, *supra* note 22, at 620-21.

SEC bases its stringent test on a *sub silentio* attempt to shield investors from "perceived risks of mineral exploration ventures, even when registration issues [are] not truly present."[136] Moreover, there are inconsistencies even in the outcomes generated under this unarticulated scheme. Two no-action letters aptly demonstrate this point. In *JIC Drilling Cos.*[137] the staff denied a no-action letter request to offerings by two oil and gas limited partnerships that had common general partners and drilling partners and were conducting operations in two separate states. In *Martin Exploration Co.*[138] the staff took a no-action position with respect to financing plans by two limited partnerships that had a structure similar to—but no more independent than—the ones in *JIC Drilling Cos.* In *Martin,* all drilling operations were to take place in the same state—some as close as twelve miles apart.[139] Clearly, such inconsistencies in SEC responses do not further the refinement of the integration doctrine.

"Issuer integration" presents yet another type of integration problem to which the SEC has responded inconsistently. Issuer integration may result where separate, but closely related, issuers attempt contemporaneous financings.[140] The staff's responses in this area reflect those in the offering and venture integration areas in terms of inconsistencies. Two common threads of note, however, are the special treatment of mineral exploration ventures (mirroring the venture integration staff responses) and the emphasis on the extent to which the issuers' financial risks are independent of one another.[141]

Certain recent no-action letter responses have been a source of both relief and concern to issuers seeking to avoid integration problems.[142] In *LaserFax, Inc.,*[143] the staff denied a no-action letter request when the issuer previously had sold common stock pursuant to a private offering exemption, and was proposing to sell (within six months) convertible subordinated debentures under regulation D, followed by a second sale of common stock (within six months of the regulation D offering) to the public through a registered offering.[144] The staff, relying on Release No. 4552, rejected the issuer's interpretation of its right to proceed, stating that the offerings would

---

136. ABA Report, *supra* note 22, at 621; ABA Partnership Report, *supra* note 36, at 1606.

137. JIC Drilling Cos., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 80,765 (Aug. 23, 1976)

138. Martin Exploration Co, SEC No-Action Letter (Oct. 7, 1976).

139. *See* Stevenson, *supra* note 10, at 56. These grossly inconsistent responses were issued only two weeks apart.

140. ABA Report, *supra* note 22, at 621-23; Stevenson, *supra* note 10, at 57.

141. ABA Report, *supra* note 22, at 621-22.

142. The responses are: LaserFax, Inc., SEC No-Action Letter (Aug. 15, 1985); Sonnenblick, Parker & Selvers, SEC No-Action Letter (May 3, 1985); Verticom, Inc., SEC No-Action Letter (Dec. 31, 1986); Vulture Petroleum Corp., SEC No-Action Letter (Dec. 31, 1986). *See generally* Sachs & Cowan, *supra* note 32.

143. LaserFax, Inc., SEC No-Action Letter (Aug. 15, 1985).

144. *Id.*

consist of essentially the same class of stock; there was a single plan of financing; the funds raised would be used primarily for the single purpose of "business operations"; and the offerings all would have occurred less than six months from one another.[145]

The *LaserFax* letter caused considerable concern among practitioners, probably because the issuer's plan to sell convertible debentures, which are seemingly a different class of securities from common stock, as well as the absence of any unusually risky elements in the financing dynamics, would seem to have made integration undesirable.[146] At an ABA Small Business Committee meeting, an SEC official later explained informally that the SEC always has focused on the purpose of the offering and type of securities in its analyses. Moreover, explained the official, the issuer in this instance had been unspecific about which part of regulation D would be relied upon to justify the registration exemption.[147]

In *Sonnenblick,*[148] the SEC staff denied a no-action letter request regarding a plan by a proposed start-up issuer to raise capital through a rule 504 common stock offering and a subsequent registered public offering of common stock conducted within six months of the initial 504 offering.[149] The staff's response identified the most important factors of Release No. 4552:

> The Division considers the factors enumerated in Securities Act Release No. 4552 to be relevant to a determination of whether a series of transactions must be integrated for purposes of registration under the 1933 Act. In the instant case, we have noted particularly that the proposed offerings are part of a single plan of financing in that the issuer anticipates the need for the capital from both offerings in order to go forward with its operations. Further we are unable to conclude from your letters that there are any factors distinguishing the purposes of the two offerings. While we consider those factors to be most important to a determination whether to integrate the offerings discussed in your letter, we also note that the sales will involve issuance of the same class of securities, common stock; the sales will be made at or about the same time, within a six month period; and, although the price per share may vary in the offerings, the same type of consideration, cash, will be received.
>
> We also note that the offerees in the Rule 504 offering are not limited to those possessing first-hand information with respect to

145. *Id.*

146. *See Real Estate Syndicates Ask Staff to Consider Reg. D. Charges,* 18 Sec. Reg. & L. Rep. (BNA) 590, 591 (Apr. 25, 1986) ("The LaserFax letter 'caused a lot of stir.' ")

147. *Id.* at 591. (description of comments on the letter by Mary E. T. Beach, Associate Director of the Corporate Finance Division, on April 3, 1986, at a meeting of the ABA Small Business Committee).

148. Sonnenblick, Parker & Selvers, SEC No-Action Letter (May 3, 1985).

149. *Id.* (staff response).

the proposed venture who are providing capital for organization and preliminary operations.[150]

Thus, the staff acknowledged the greater relative importance of the "plan of financing" and "general purpose" factors in its analysis. The staff also was forthcoming about its use of some policy analysis regarding the presence of a need to protect the potential investors. The staff relied on similar considerations in the *LaserFax* letter.[151]

In *Verticom, Inc.,*[152] the staff finally granted a no-action letter request. But rather than rely on Release No. 4552, as it had in *Sonnenblick* and *LaserFax,* the staff chose the more vague and less analytical test of rule 152, expressly disavowing any reliance on Release No. 4552.[153] The issuer, a high-tech start-up company located in northern California's Silicon Valley, had raised most of its funds through venture capital investors pursuant to private offering exemptions. Its inquiry letter focused on its plan to make one more private offering, pursuant to section 4(2), before effecting a registered public offering of common stock. The issuer characterized the planned private offering as part of the "venture financing phase," while the public offering was denominated as part of a "public financing phase." The first phase was intended to get the issuer started and operating, while the next phase was for expansion purposes.[154]

While the SEC staff's decision to rely on rule 152 as the basis for its response was not inappropriate, the staff clearly declined the opportunity to clarify the application of Release No. 4552. Indeed, had the staff applied the release in *Verticom,* in which the financing was well planned, well presented, and provided substantial guarantees of investor protection, issuers would have been able to use the staff's response as a model to compare with cases in which the financing plans were not as well planned, such as in *LaserFax* and *Sonnenblick.*[155] Perhaps in *Verticom* the staff was reluctant to attempt an analysis under the release because, although the level of investor protection and general quality of the issuer's operations were high, the general purpose factor and possibly the plan of financing factor might have pointed toward integrating the offerings. Such a potential conflict, under a Release No. 4552 analysis, is especially possible in light of the undefined, overlapping terms of the release and the prior conflicting responses of the staff.[156] These potential conflicts may have encouraged the

150. *Id.*

151. *See supra* note 143, LaserFax letter.

152. Verticom, Inc., SEC No-Action Letter (Dec. 31, 1986).

153. *Id.*

154. *Id.*

155. The reader should compare the structure and planning of the three issuers' proposals, as well as the thoroughness and quality of the counsels' letters of inquiry.

156. The purpose behind a financing plan and the actual plan of financing are often indistinguishable. Moreover, the lack of definition between a financing plan and the plan's purpose further frustrates matters. *See* Stevenson, *supra* note 10, at 52. Stevenson writes that, "The 'single plan of financing' test and the 'same general purpose' test are obviously closely related. In many no-action letters they appear to be interchangeable." *Id.*

staff to avoid any analysis under the release. In any event, aside from the greater investor protection guarantees inherent in the facts of *Verticom* and the failure of counsel for the issuer in *LaserFax* to state specifically that rule 506 would be relied upon in the private offering, the two cases are difficult to reconcile.[157]

Despite the fact that the *Verticom* response is not easily reconcilable with responses like *LaserFax,* the staff's position in *Verticom* is quite significant. In *Verticom* the rule 152 requirement that, to avoid integration an issuer must defer making the actual decision to effect a registered public offering until after completion of a section 4(2) private offering, was "interpreted" out of that rule. The staff stated it would not integrate the offerings "notwithstanding Verticom's contemplation of a registered public offering at the time of the placement."[158] In *Vulture Petroleum Corp.,*[159] the staff extended this principle to rule 506 of regulation D., stating that, on the facts presented, "the proposed offering of securities under Rule 506 of Regulation D . . . need not be integrated with the later public offering in reliance on Rule 152."[160]

B. Judicial Decisions

The courts that have addressed integration doctrine issues have not contributed substantially to the development of a reliable analytical scheme for the doctrine.[161] (The cases that present integration issues generally are either suits brought by private parties for rescission of sales of securities sold pursuant to an exemption,[162] or suits for injunctive relief brought by the SEC.)[163] Prior to 1976, the courts consistently refused to integrate

157. *See Real Estate Syndicates Ask Staff to Consider Reg. D Changes,* 18 Sec. Reg. & L. Rep. (BNA) 590, 591 (April 25, 1986) (stating informally that *Verticom* does not overrule *LaserFax* and remarking that individual decisions were consistent with facts of cases.)

158. *See* Verticom, SEC No-Action Letter (Dec. 31, 1986); *see also supra* note 157, 18 Sec. Reg. & L. Rep. (BNA) at 591 (quoting Mary Beach for idea that enforcing literal language of rule 152 rewards poor planning and encourages issuers to make misrepresentations about issuers' intentions).

159. Vulture Petroleum Corp., SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,407, at 77,319 (Dec. 31, 1986).

160. *Id.*

161. *See* Stevenson, *supra* note 10, at 50. Stevenson stated that, "[t]here is relatively little judicial authority helpful in elucidating the integration doctrine." *Id; see also* ABA Partnership Report, *supra* note 36, at 1597. According to the ABA Partnership Report, "very few cases have provided an analysis that is instructive to counsel involved in securities offerings that present such issues." *Id. But see* Deaktor, *supra* note 10, at 505-13. Professor Deaktor opines that although "the releases have proved of little aid to the courts in their analyses of the integration problem . . . an examination of the cases treating integration is potentially instructive for the issuer." *Id.* at 505-06.

162. *See* 15 U.S.C. § 77(1) (codifying basis for recissionary relief). A number of individuals have filed suit seeking recissionary relief. *See, e.g.,* Doran v. Petroleum Mgt. Corp., 545 F.2d 893 (5th Cir. 1977); Smith v. Jackson Tool & Die, Inc., 419 F.2d 152 (5th Cir. 1969); Bayoud v. Ballard, 404 F. Supp. 417 (N.D. Tex. 1975).

163. 15 U.S.C. §77t(b); *see, e.g.,* SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225 (E.D.N.Y. 1976); SEC v. Continental Tobacco Co., 326 F. Supp. 588 (S.D. Fla. 1971), *rev'd on other grounds,* 463 F.2d 137 (5th Cir. 1972).

securities offerings.[164] At times, the courts gave no weight to SEC releases, other court cases, or any other authority.[165] But some courts have, in fact, relied or purported to rely upon the five-factor test of Release No. 4552.[166] To the extent that courts have relied on Release No. 4552, the "single plan of financing" factor clearly has been the most important one in determining whether to integrate separate offerings.[167]

One of the most celebrated and controversial cases concerning integration is *SEC v. Murphy*,[168] decided in 1980. In *Murphy*, the Court of Appeals for the Ninth Circuit integrated offerings of limited partnership interests in approximately thirty limited partnerships and held that the real "issuer" of those interests was a separate legal entity (Intertie), a corporation for whose financial benefit the limited partnerships had been organized.[169] The limited partnerships were set up as part of an elaborate sale-leaseback financing scheme, in which Intertie, through Murphy, its principal officer and chairman, purchased cable television systems for cash and notes and sold those systems to the limited partnerships for cash and nonrecourse notes. Concurrently, Intertie leased back the systems for its own cable operations.[170] Although neither Murphy nor Intertie served as general partners in the limited partnerships, Murphy was the "architect of this financing scheme, by which Intertie took in approximately $7.5 million from 400 investors."[171] The offerings were not registered, as the offerings purportedly were exempt under section 4(2) of the Act and rule 146.[172] No effort was made, however, to determine whether the offerees or their purchaser representatives were "sophisticated" as is required by the registration exemption. Additionally, the offering memoranda made material misstatements and omissions regarding Intertie, particularly with respect to Intertie's serious financial problems.[173]

---

164. *See* Deaktor, *supra* note 9, at 508; Morrissey, *supra* note 20, at 168.

165. *See* Deaktor, *supra* note 9, at 509. Professor Deaktor states that, "a proportion of the integration cases make no mention of the work of the SEC in the area, nor of cases or authorities which have drawn on that work. Rather, the courts and parties appear to have dealt with the integration issue purely on instinct." *Id.*

166. *See, e.g.*, SEC v. Murphy, 626 F.2d 633, 645 (9th Cir. 1980); Livens v. William D. Witter, Inc., 374 F. Supp. 1104, 1107 (D. Mass. 1974); SEC v. Dunfee, [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,970 (W.D. Mo. 1966); Value Line Fund, Inc. v. Marcus, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. 1965).

The ABA Partnership Report discussed *Murphy, Witter, Dunfee, Marcus,* and several other cases. ABA Partnership Report, *supra* note 36, at 1597-1605; *see also* ABA Report, *supra* note 22, at 614-617; Morrissey, *supra* note 20, at 167-175.

167. *See, e.g., Murphy,* 626 F.2d at 645-46; SEC v. Holschuh, 694 F.2d 130, 144 (7th Cir. 1982); Deaktor, *supra* note 9, at 510; Stevenson, *supra* note 10, at 50.

168. 626 F.2d 633 (9th Cir. 1980).

169. SEC v. Murphy, 626 F.2d 633, 643-44 (9th Cir. 1980).

170. *Id.* at 637.

171. *Id.*

172. *Id.*

173. *Id.* at 637-38

The Ninth Circuit, emphasizing the need "to 'protect investors by promoting full disclosure of information thought to be necessary to informed investment decisions'," held that Intertie was the real issuer of all the offerings.[174] Although the *Murphy* holding has been characterized as "startling . . . because of the breadth of its language . . . [and] extraordinary,"[175] the court did attempt to limit its scope:

> [W]e note that our holding today does not mean that anyone who has information material to an investment decision is transformed into an issuer. We hold only that when a person organizes or sponsors the organization of limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer for purposes of determining the availability of the private offering exemption.[176]

The court then proceeded to integrate the limited partnership offerings, relying upon Release No. 4552:

> All but the third factor militate in favor of finding integration. The separation in time from one system offering to the next suggests that the offerings were not integrated, but that factor is heavily outweighed by the remaining considerations. Clearly, the offerings were all made for the same general purpose: they were part of one financing plan which Murphy aptly described, "to give dollars to the cable operating company that could be used at a cost they could live with." To the extent that we can define classes of securities that are not stocks or bonds, the securities at issue here—all limited partnership interests—are of the same class. Finally, the consideration for all partnership shares was the same, cash and notes secured by the particular cable systems purchased.[177]

As a result of the integration no exemption from registration was available, and therefore, Intertie was in violation of the section 5 registration requirement.[178] Murphy also was liable as a "substantial factor" in the securities law violations.[179]

The *Murphy* decision has broadened the range of offering scenarios in which integration may occur.[180] The decision also has been credited with

---

174. *Id.* at 642-43

175. *See* ABA Partnership Report, *supra* note 36, at 1603; *see also* Morrissey, *supra* note 20, at 175. Professor Morrissey supports the *Murphy* holding. *Id.* Additionally, Professor Morrissey commented on the ABA Partnership Report proposals, in response to cases like Murphy. *Id.* According to Professor Morrissey, "the ABA's proposal . . . would undermine this tie between appropriate disclosure and the identity of an issuer and would deprive investors of protection against such fraudulent schemes as those in Murphy and Holschuh." *Id.*

176. *Murphy,* 626 F.2d at 644.

177. *Id.* at 646.

178. *Id.* at 641.

179. *Id.* at 648-52.

180. ABA Report, *supra* note 22, at 596.

formally placing the focus of integration inquiries on (1) the existence of investor protection through full and fair disclosure; and (2) the economic realities behind the formal financial and legal structures of the offerings involved.[181] Several courts have adopted the *Murphy* approach.[182]

V. Proposals for Change; an Analysis

In view of the considerable uncertainty and inconsistency of interpretation in cases involving the integration doctrine, the American Bar Association Committee on Federal Regulation of Securities impaneled a task force "to examine the entire integration area and to make proposals that would help the Commission and the securities bar to answer [troublesome] questions."[183] The result of the task force's work is the extensive ABA Report, which describes the doctrine and its development, and culminates in specific proposals to improve the application of the doctrine.

The ABA task force report intentionally avoids an overall revision of the doctrine; nor does the report attempt to clarify the doctrine's theoretical underpinnings.[184] Instead, the report takes a much more narrow approach, merely proposing "additional and specific safe harbor tests that would provide guidance in a large number of circumstances under which integration questions might arise."[185] In particular, the task force report proposes the following:

> These quidelines are divided into six major categories: issuer distinctions, temporal separations, differences in securities offered, purpose differences, policy considerations, and domestic and foreign offering distinctions. By qualifying for any single safe harbor, the offerings in question would be deemed separate and distinct for the purpose of determining whether the exemptions from registration relied upon by the issuer are available. The task force further suggests that these safe harbors be embodied in the new rule 152 appended to this report.[186]

In general, the task force report represents a substantial contribution to the overall utility of the integration doctrine. If adopted, the ABA proposals will be of invaluable assistance to both regulators and issuers, and will promote capital formation within the context of 1933 Act investor protection. Nonetheless, the proposals are in several instances unresponsive to the needs of small businesses. Additionally, in its safe harbor proposals,

181. *See* Morrissey, *supra* note 20, at 174.

182. *See SEC v. Holschuh*, 694 F.2d at 137; Western Federal Corp. v. Erickson, 739 F.2d 1439 1442-43 (1984); Stoppelman v. Owens, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,511 at 98,580 (D.D.C. 1984); *see also* Morrissey, *supra* note 20 at 174-75.

183. ABA Report, *supra* note 22, at 596.

184. *Id.* at 596-98.

185. *Id.* at 597.

186. *Id.* at 624.

the report does not go far enough, failing to include several important areas that are quite susceptible of safe harbor treatment with no attendant infringement on investor protection. The result is that even under the ABA's proposed scheme, certain unnecessary obstacles to capital formation still exist that can and should be addressed in a more extensive safe harbor regime.

A. *The Issuer Safe Harbor*

The first proposal in the ABA Report is for an "issuer" safe harbor. The focus of this safe harbor would be those scenarios in which "offerings potentially subject to integration are made by two legally distinct entities."[187] This proposal addresses the "issuer integration" problem, which often involves syndications of real estate or mineral rights business entities by a common promoter or sponsor.[188] The question posed under the integration doctrine is whether the relationship of the entities to one another and to the promoter is such that their otherwise exempt securities offerings should be integrated.[189] Generally, this inquiry translates into the question who is the real, or *de facto,* "issuer" of the securities of the related legal entities.[190] The ABA's issuer safe harbor proposal purports to answer this question.

This ABA proposal consists of a three-condition test adopted directly from a 1982 ABA study, which was devoted to integration of partnership offerings and was conducted by the ABA Subcommittee on Partnerships, Trusts, and Unincorporated Associations of the Committee on Federal Regulation of Securities.[191] The proposal provides that if all three conditions are met, offerings will not be integrated, notwithstanding any other integration rules. According to the proposal, "[n]o presumption shall arise as to whether offerings that do not meet all of the . . . conditions are integrable with other offerings, and the administrative and judicial interpretations on integration in effect at the time thereof shall apply."[192] The proposal sets forth the following three conditions, which, if satisfied, would demonstrate that the offerings in question are separate and distinct: (1) separate entities: the issuers must keep separate books and records and capital and other funds of the issuers must not be commingled; (2) economic independence: each issuer should have "an independent opportunity to meet its primary investment objectives"; and (3) application of proceeds: no issuer may use

187. *Id.*

188. *Id.* at 621-22

189. *Id.* at 624.

190. *Id.; see also* SEC v. Murphy, 626 F.2d 633, 644 (9th cir. 1980). In *Murphy* the court stated that "[w]hen a person organizes or sponsors the organization of limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer for purposes of determining the availability of the private offering exemption." *Id.* at 644.

191. *See* ABA Report, *supra* note 22, at 631; ABA Partnership Report, *supra* note 36.

192. *See* ABA Report, *supra* note 22, at 631; ABA Partnership Report, *supra* note 36, at 1610-11.

material portions of capital raised to invest in properties or projects in which an affiliated issuer, or one with a common sponsor, has invested or will invest a material portion of the capital it has raised.[193]

The issuer safe harbor proposal appears to be, in part, a reaction to the holding in *SEC v. Murphy*.[194] Both the ABA Report and the ABA Partnership Report criticize the *Murphy* decision not only for being overbroad in its language but also for placing improper emphasis on the role of disclosure; the *Murphy* court integrated the offerings involved.[195] The ABA Report does acknowledge, however, that even if there had been full disclosure regarding the rather shady business arrangements in *Murphy* "it seems clear that the Ninth Circuit would have imposed liability for violation of Section 5 since it found that Intertie was the 'issuer' for both registration and disclosure purposes."[196] Moreover, the report guardedly admits that the *Murphy* court's focus on the economic interdependence of the common sponsor and the issuing entities was not totally misplaced:[197]

> To be sure, economic interdependence is a useful test because separate entities, financially independent of one another *a priori*, should not be regarded as part of a single business enterprise. It is not true, however, that financially interdependent entities (such as franchisees) should automatically be regarded as parts of a single issuer. Thus, *Murphy* can be properly viewed as a litmus test to ascertain which entities are not part of a single issuer. To use it as a test for finding integration, however, is to create a presumption in favor of integration.[198]

Following this reasoning, the ABA proposal established the test discussed herein for identifying discrete offerings. The test defines discrete offerings

193. *See* ABA Report, *supra* note 22, at 631-32; ABA Partnership Report, *supra* note 36, at 1610-11. If half or more of the assets to be purchased with the offering proceeds are not disclosed to offerees, the third condition of the proposed issuer safe harbor prohibits the offering of securities until other partnerships with a common sponsor have "invested, or committed for investment, the major portion of its gross offering proceeds" for the same general types of activities, unless the assets in which the other partnership "intends to invest at least fifty percent of its gross offering proceeds are specifically identified to its offerees."

194. *See* ABA Report, *supra* note 22, at 630; SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980).

195. *Id.* The ABA Report stated that "[t]he question of whether information should be disclosed regarding an entity is conceptually different from whether a single issuer has divided itself into two or more nominally separate entities to avoid the registration requirement." *See also* ABA Partnership Report, *supra* note 36, at 1603. The Partnership Report was even more critical of the *Murphy* opinion, calling the opinion "startling . . . to many practitioners," "extraordinary," and "result oriented." *Id.*

196. ABA Report, *supra* note 22, at 630.

197. *Id.* The ABA Report stated that "[a]lthough Murphy and its progeny have been properly criticized for their disclosure-oriented analysis, in light of the staff's earlier no-action letters, the focus on the economic interdependence of the promoter and the issuing entities should not have been unexpected." *Id.*

198. *Id.*

as those "designed to fund a separate and independent entity that is not financially dependent upon any entity created through any other offering involving a common sponsor."[199] Under the ABA proposal, offerings not satisfying the test would not necessarily be integrated; as stated earlier, they would be analyzed according to the other existing administrative and judicial interpretations.[200]

Professor Morrissey has vigorously attacked the ABA issuer safe harbor proposal. Professor Morrissey proposes instead that *Murphy* be given the broadest possible interpretation, and that full disclosure regarding common sponsors be required. According to Professor Morrissey, the full disclosure requirement would result in larger numbers of registered offerings and greater investor protection:

> The American Bar Association's "discrete offering" proposal is merely an elegant attempt to circumvent the registration process by artificially expanding its carefully restricted exemptions. The various financial dealings of issuers are separable, but not on the basis of contrived divisions. Even though closely timed offerings may be "financially independent" in that they have claims to different assets, they are, in reality, part of a continual attempt to fund one business operation. In such situations, the crucial insight of *Murphy* is extremely pertinent; i.e. investors need information about the central enterprise. If a combination of offerings would place the total issuance outside the well considered exemptions to registration, an SEC filing is in order.[201]

Professor Morrissey makes forceful arguments concerning the need to consider economic realities in determining the true issuer in an offering, as well as the importance of disclosing to investors material information about the true issuer. Further, although the ABA Report insists "[i]t is clear . . . that the question of whether information should be disclosed regarding an entity is conceptually different from whether a single issuer has [artificially] divided itself . . . to avoid . . . registration,"[202] the investor-protection mandate of the 1933 Act suggests otherwise. Indeed, the integration doctrine is grounded in the need for full and fair disclosure to achieve investor protection.[203]

The ABA issuer safe harbor proposal, nevertheless, probably strikes the best practical balance between the availability of non burdensome capital

---

199. ABA Partnership Report, *supra* note 36, at 1610.

200. *See* ABA Report, *supra* note 22, at 631.

201. Morrissey, *supra* note 20, at 182-83.

202. ABA Report, *supra* note 22, at 630.

203. *See* Little & Robbins, *Structuring Limited Partnership Offerings—Recent Developments*, 43 WASH. & LEE L. REV. 829, 835 (1986). According to Little and Robbins "[t]he rationale for integration must at bottom be a concern that the disclosure obligations not be circumvented by separating a unitary offering into its component parts. Without disclosure concerns there would appear little need for invoking the doctrine." *Id.*

formation devices and the protection of investors. Fraudulent schemes such as the one in *Murphy* would not be protected by the proposed safe harbor, primarily because the essence of such schemes is the economic interdependence of the business entities involved and the use of the separate offerings to siphon funds from the limited partnerships into a common sponsor through the application of proceeds.[204] Thus if the ABA proposal were adopted, a *Murphy*-type fact pattern clearly would fall outside safe harbor protection, and the matter therefore would be relegated to a decision based on "the administrative and judicial interpretations. . .in effect at the time."[205] Prior decisions of the courts and the SEC staff indicate that the aforementioned scheme would be interpreted against the issuing and affiliated entities in a manner that clearly furthers the interest of investor protection. Indeed, because the three conditions at the core of the ABA proposal reflect the staff's no-action letter responses, as well as judicial decisions such as *Murphy,* it could be said that this safe harbor represents both a distillation of salient policy and practical features of the general issuer integration analysis and a formula for obviating the necessity of analyzing the easier cases.[206]

Appropriately, the ABA proposal also would allow certain entities to escape integration even though they are affiliated with other businesses. That is, in some circumstances, where the spirit and the letter of proposal are substantially met, the separate nature of the financial structures and offerings of businesses should be respected notwithstanding some degree of common sponsorship or promotion. The policy and practical questions presented in these cases are not altogether unlike those presented in actions to "pierce the corporate veil:"

> At the outset, it is recognized that a corporation is an entity, separate and distinct from its officers and stockholders, and that its debts are not the individual indebtedness of its stockholders. This is expressed in the presumption that the corporation and its stockholders are separate and distinct. . . . But this concept of separate entity is merely a legal theory, "introduced for purposes

204. The subjects of the second and third conditions of the proposal are the key features of most schemes: economic interdependence based on some contractual, corporate or limited partnership arrangement, and the application of proceeds generated by various businesses to further directly a larger business aim.

205. ABA Report, *supra* note 18, at 631-32; *see* SEC v. Murphy, 626 F.2d 633, 638 (9th Cir. 1980). The *Murphy* Court stated that funds were commingled from the various partnerships, significant economic interdependence existed between the common sponsor and the partnerships, and proceeds from the partnerships were applied to the needs of the common sponsor. *Id.*

206. *See* ABA Report, *supra* note 22, at 627-28. The ABA Report discussed the factors that appeared relevant to the SEC staff's no-action decisions, even though the Report also acknowledged that the SEC's letters were often inconsistent and complex. *Id.* Additionally the ABA Report noted that "Murphy and its progeny . . . focus on the economic interdependence of the promoter." *Id.* at 630.

of convenience and to subserve the ends of justice," and the courts "decline to recognize [it] whenever recognition of the corporate form would extend the principle of incorporation 'beyond its legitimate purposes and [would] produce injustices or inequitable consequences'."[207]

Thus, the issuer safe harbor proposed by the ABA would preserve the entity and issuer status for essentially separate and distinct businesses of common sponsors, and this would be in furtherance of both capital formation and the public interest. It is appropriate to note here that even the *Murphy* court stated its "holding . . . does not mean that anyone who has information material to an investment decision is transformed into an issuer."[208] Accordingly, while full and fair disclosure principles might even require that information regarding common sponsors of business be provided, to the extent such information bears upon the risks and fortunes of that business, where it is fully independent and self-sustaining, there should not be issuer integration simply based on the mere existence of a common sponsor. Investors would be sufficiently protected by such disclosure as is required by the particular exemption relied upon, and the extraordinary step of integration would not add any meaningful protection.[209]

B. The Temporal Safe Harbor

In addition to its issuer safe harbor proposal, the ABA Report recommends a so-called "temporal safe harbor," which essentially provides that otherwise exempt offerings, when separated by a six-month period, are not integrable.[210] The ABA temporal safe harbor proposal would extend the present six-month safe harbors of rule 147 and rule 502(a) of regulation D to all offerings.[211] In addition, the proposed extension would clarify the temporal boundaries of the six-month period. According to the ABA proposal, the six-month period "should be measured from the closing of the final sale in the initial offering to the first offer of the succeeding offering."[212] The ABA proposal is a definite improvement over the existing situation. Certainly, exempt offerings other than those under rule 147 and regulation D are equally susceptible to the reasoning that the passage of time creates a presumption of separateness and distinctness in offerings.[213]

207. DeWitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681, 683 (4th Cir. 1987); *see also* American Trading & Prod. Corp. v. Fischback & Moore, Inc., 311 F. Supp. 412, 414-45 (N.D. Ill. 1970) (holding that without some degree of control and supervision Court would not pierce veil of corporate subsidiary to reach parent).

208. *Murphy*, 626 F.2d at 644.

209. ABA Report, *supra* note 22, at 632, 642 app.

210. *Id.*

211. *Id.*

212. *Id.* at 633.

213. Deaktor, *supra* note 9, at 516. Professor Deaktor stated that "the likelihood that integration [is] appropriate decreases as the time between offerings increases." *Id.*

But the safe harbor proposed by the ABA is potentially and unjustifiably useless in a variety of critical situations, simply by virtue of the purely arbitrary six-month time interval.

The ABA task force report admits that the choice of six months as an appropriate time interval is "arbitrary;"[214] yet the report urges that there is "no compelling reason . . . to suggest changing it at this time."[215] Thus, no facts, data, or analyses other than the original reasoning behind the presumption regarding the general passage of time support the specific choice of a six-month period. While perhaps no studies exist to support the selection of a six-month period, some facts suggest that a six-month safe harbor is much less useful to small business issuers and others than, for example, a three-month safe harbor would be.[216] Therefore, given the arbitrary nature of the six-month interval, the correspondingly arbitrary limitation on the utility of the safe harbor to small businesses should be a cause for concern. Indeed, to the extent investor protection can be maintained, there may well be "compelling reason[s]" to change this safe harbor's time interval.

Without cavil, small businesses are less well capitalized than larger ones; have fewer resources for discerning and planning for their present and future financial needs; and suffer a much greater threat to their existence in the face of sudden or extensive economic shifts.[217] For these reasons, a small business is more likely than a larger business to discover suddenly that it must raise a significant amount of capital in order to continue its operations. In such circumstances, requiring a six month waiting period before allowing the business to make an offering of securities could be fatal.[218] Additionally, and ironically, the clarification of the scope of this safe harbor in the ABA proposal exacerbates the problem for small businesses since it would require a "cooling-off" period of six full months between the last sale of a security in one offering and even so much as an *offer* to sell securities in a succeeding offering.[219] Thus, the particularly time-sensitive nature of the financing process, particularly for small businesses, combined with the admittedly arbitrary choice of a six-month interval for the proposed safe harbor, suggests there should at the very least be an inquiry into the feasibility of

214. ABA Report, *supra* note 22, at 633.

215. *Id.*

216. *See* Deaktor, *supra* note 9, at 517-19. Professor Deaktor, commenting on the six-month integration safe harbors of rules 146 and 147, noted that the time period is "largely arbitrary." *Id.* Professor Deaktor also discussed the special timing problems for small business financing situations, and recommended a three-month time interval. *Id.*

217. *Id.* at 517. Professor Deaktor wrote that "[s]mall issuers tend to have difficulty accurately predicting capital needs and are often financially unable to delay for any appreciable period the additional financing necessary to meet unanticipated expenses." *Id.*

218. *Id; see* Note, *supra* note 9, at 869 (discussing six-month safe harbors of rules 146 and 147). The author commented that "[t]his [safe harbor] may provide sufficient time for all companies except for those needing the exemptions . . . the most, i.e., the capital intensive companies, particularly those in the areas of oil and gas and real estate development." *Id.*

219. ABA Report, *supra* note 22, at 633, 642.

a shorter interval. A three-month interval, for instance, as suggested by Professor Deaktor in relation to rule 146, would increase the utility of a temporal safe harbor to small businesses—to the extent reasoned factual analysis indicates such an interval would not pose any greater threat to investor protection than does the six-month choice.[220]

Whatever the final choice, it is clear that some shorter period may well exist that strikes a fairer and more rational balance between the policies of investor protection and encouragement of small business capital formation.[221] Certainly, a purely arbitrary choice such as the proposed six-month period should not be allowed to impede both the search for such a balance and the potential for an increase in capital formation opportunities.

C. *The Securities Safe Harbor*

In addition to the issuer and temporal safe harbor proposals, the ABA task force report also proposes a safe harbor based on the class of security issued. Offerings of securities of any one class would not be integrable with offerings of any other class.[222] At the heart of this proposal are four "fundamentally distinct" classes of securities: (1) common stock; (2) preferred stock; (3)nonsecured debt; and (4) secured debt.[223]

The justification for the securities safe harbor proposal, according to the report, lies in the "fundamental" relevance of the "nature of the securities offered . . . to the integration concept."[224] Presumably, this assertion is grounded in the belief that the greater the basic differences between the various classes of securities of an issuer, the more likely it is that an offering of securities from one class is separate and distinct, for integration purposes, from an offering of those from another class.[225] More particularly,

---

220. Deaktor, *supra* note 9, at 517-19. According to Professor Deaktor, "[r]eduction of the six-month 'windows' might entice smaller issuers, whose securities ordinarily pose greater risks than their well-established competitors, to use the rules. . . . Certainly, a ninety-day "window" on both sides of a rule 146 offering should be more than adequate." *Id.* Professor Deaktor supports his arguments with reference to the ninety-day prospectus delivery period requirement of section 4(3) of the Act. Deaktor, *supra* note 9, at 517-519. 15 U.S.C. § 77(d)(3) (1982). Instituting a three-month safe harbor for an exemption raises the question whether all exemptions (statutory and regulatory) provide sufficient protections for investors to support the time interval proposed.

221. At a minimum, public hearings on the topic could generate useful insights and information. Empirical studies should not be dismissed immediately as an informative source, particularly since the SEC now has an Office of the Chief Economist. *See generally* J. MONAGHAN & L. WALKER, SOCIAL SCIENCE IN LAW: CASES & MATERIALS (1985); J. Monahan & L. Walker, *Social Authority: Obtaining, Evaluating, and Establishing Social Science in Law,* 134 U. PA. L. REV. 477, 477 (1986). Monaghan & Walker write that, "[although] once heretical, the belief that empirical studies can influence the content of legal doctrine is now one of the few points of general agreement among jurists." *Id.*

222. ABA Report, *supra* note 22, at 633-35, 642-43.

223. *Id.*

224. *Id.* at 633.

225. *Id.* The ABA Report emphasized the importance of the classes of securities being different in the most basic ways. Accordingly, the task force chose only four "archetypical forms" of securities with "traditional and easily determinable characteristics." *Id.*

the report appears to premise its reasoning on a belief that the difference in "straight" debt and equity securities, for example, represents not only a difference in the basic features of the two types of investment instruments, but also a difference in both the respective investors' and issuer's fundamental needs and purposes.[226] Therefore, offerings of two different types of securities by the same issuer, because they have such different characteristics and address such basically different needs and purposes, necessarily are separate and distinct.[227] The ABA Report appears to use similar reasoning to assume that the same type of dichotomy exists between common and preferred stock in the equity category, and between secured and nonsecured debt in the debt category.[228] The report concludes that a safe harbor protecting such basically different securities from integration would provide "no threat to the integrity of the registration process."[229]

While the nature of the securities offered probably does indeed bear significantly on the question whether several ostensibly separate offerings should be deemed part of a single "offering," certain differences between small and large businesses suggest that there are significant shortcomings in both this premise and the proposed securities safe harbor based on it.

---

226. *See* R. McDermott, Legal Aspects of Corporate Finance 1 (1986). McDermott states that

> [t]he parties' expectation is, of course, that ownership of the security acquired by the investor will result in income (through yield in the form of interest on debt securities and dividends on equity securities), and capital gain (through realized appreciation upon disposition). In the case of a debt security, there is the expectation of a return of capital through repayment of principal at maturity.

Id. The basic expectations of debt and equity security holders, however, often differ, and thus the holders may conflict with respect to their desires regarding corporate operations. This conflict arises primarily because of the different positions that the security holders occupy with respect to the fundamental elements of the business bargain: "(a) risk of loss, (b) return, (c) control, and (d) duration." *Id. See* W. Klein and J. Coffee, Business Organization and Finance, Legal and Economic Principles, at x, xi (2d ed. 1986); B. Manning, A Concise Textbook on Legal Capital 1 (2d ed. 1981) (describing development of legal capital statutes and common law as attempt to mitigate conflicts among security holders). According to Manning:

> The interest of creditors of a corporation and the interests of shareholders of a corporation are likely to conflict whenever assets of shareholders are to be committed to the corporation's treasury and whenever assets are to be distributed to shareholders from the corporate treasury. The legal apparatus built by common law and statute around the concept of "legal capital" is fundamentally aimed at striking a partial accommodation of that conflict of interests. *Id.* at xxi.

Id.

227. ABA Report, *supra* note 22, at 633-35.

228. *Id. See generally* W. Klein & J. Coffey, *supra* note 226 (discussing basic differences between motives of issuers and purchasers of different securities and resulting way in which securities' terms are structured); *see also* R. McDermott, *supra* note 226; R. Hamilton, Corporation Finance, Cases and Materials (1984); J. Weston & E. Brigham, Managerial Finance (5th ed. 1975).

229. ABA Report, *supra* note 22, at 635.

1. Limited Utility to Small Issuers

Because of the large issuer's generally greater appeal and bargaining power in the capital markets, a large issuer would be in a better position to use this proposed securities safe harbor than would a small issuer. In fact, a large issuer may even be able to split up a single offering into several artificially separate transactions under this safe harbor, and thus circumvent the registration requirement merely by issuing a different class of securities in each transaction. A small issuer, on the other hand, would probably have neither the economic power nor the influence in the capital markets to allow it to decide independently which particular class of security to sell.[230]

The typical venture capital financing arrangement illustrates the limited flexibility of the small issuer with respect to choice of security. Venture capitalists frequently make capital contributions in promising start-up businesses in exchange for a senior security, typically convertible preferred stock or convertible debentures.[231] This choice of security provides a "hedge" against the high risks inherent in venture capital investments by allowing the investor to retain a preference with respect to distributions in liquidation and bankruptcy, and possibly in mergers and acquisitions.[232] Given the usual

---

230. Perhaps the strongest proof of the differences in the ability to choose the type of security sold in small and large companies is the very nature of the choice-of-security discussion when companies are large enough to make regular sales of securities to the public. In such a case, commentators have written that the question is more likely to be what choice of security is necessary to "maximize the value of the corporation to its present security holders . . . and to reduce the cost of capital." K. BIALKIN & W. GRANT, SECURITIES UNDERWRITING: A PRACTITIONER'S GUIDE, at 89 (1985). The question is much less likely to be whether the company can choose at all, as is true with smaller companies. Indeed, the focus of the discussion often centers on topics such as what debt-equity mixture is most beneficial. *See, e.g.*, V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE, at 317-415 (2d ed. 1979); Modigliani & Miller, *The Cost of Capital, Corporate Finance & the Theory of Investment*, 48 AM. ECON. REV. 261 (1958); GRAHAM, DODD & COTTLE, SECURITY ANALYSIS, at 539-50 (4th ed. 1962).

Even in the larger corporate context, however, an issuer's underwriters, "[i]n consultation with the owners, the company's lawyer and accountant . . . [must] determine what type of security will be both flexible enough to enable the company to carry out its policies and be attractive to investors." G. ROBINSON & K. EPPLER, GOING PUBLIC 105 (2d ed. 1976). The problem for small businesses is to become attractive in the eyes of the investors.

231. VENTURE CAPITAL AND PRIVATE OFFERING NEGOTIATION 253-57 (M. Halloran, L. Benton & J. Lovejoy ed. (1983)); START-UP COMPANIES, *supra* note 15, at 7-7; *see also* ABA SECTION OF CORPORATION, BANKING AND BUSINESS LAW COMMITTEE ON SMALL BUSINESS, 1983 ANNUAL MEETING FINANCING GROWTH-ORIENTED VENTURES: "WHERE THE MONEY IS", at 6-7 (1983). The ABA Committee on Small Business stated that

> [t]oday, the "standard" venture capital investment is almost always in the form of a senior preferred stock, with dividend and liquidation preference (and participation), convertible into common stock on an agreed upon ratio (and with dilution protection against sales below the per share investment price and against splits, dividends, and other changes in capital structure), bearing registration rights, and frequently granting investors other rights. *Id.*

232. *See supra* note 231.

strength of venture capital firms' bargaining positions, viewed against the typical backdrop of limited financing alternatives for small businesses, a small issuer generally will not reject the venture capital investor's preference regarding type of security.[233]

Acceptance of such a financing preference thereby limits severely the issuer's subsequent financing choices under the ABA proposal. Should the issuer decide to accept the venture capital financing offer and also make other separate offerings contemporaneously, two of the four classes of securities available under the safe harbor would be eliminated automatically from consideration. This is because under the ABA proposal, a convertible security is "deemed to constitute both the convertible security itself and the security into which it is convertible."[234]

For example, if a small issuer makes an offering of convertible preferred stock to a venture capital firm, under the ABA proposal the issuer could not then use the safe harbor shortly thereafter to make another offering if existing or prospective investors will accept only equity participation in that subsequent offering through the purchase of common, preferred, or convertible preferred stock.[235] The only remaining possibility under the proposed safe harbor is nonconvertible debt. To the extent a small business has a preference for debt financing, which is often not true with many start-ups, its prerogative to issue debt securities or borrow funds in any form usually is constricted by such factors as the absence of a long and successful "track record" of profits; a small base of assets to back up the debt in the event of default; and an inadequate "equity cushion" to support the debt.[236] Again, small business' weaker economic position, as well as any minimum

233. Hoffman & Blakey, *You Can Negotiate With Venture Capitalists,* HARV. BUS. REV., 16-24 (Mar.-Apr. 1987). Hoffman and Blakely acknowledge the traditional difficulties and vulnerabilities small and start-up companies have in raising capital. *Id.* However, Hoffman and Blakely argue that through the proper use of planning and negotiating, an enterpreneur can utilize the venture capital process without giving in to all the extreme demands that venture capitalists often make. *Id.* On the choice-of-security issue, however, the authors admit that, "Chances are, however, . . . you won't get them to agree to this [taking common stock instead of convertible preferred stock or convertible debentures] unless your bargaining position is extremely strong." *Id.* at 16-17; *see also Investors Tighten the Terms,* VENTURE, May, 1988, at 134 (stating that tight money is giving venture capitalists more leverage in setting conditions of deal).

234. ABA Report, *supra* note 22, at 634-643.

235. *Id.*

236. Hoffman & Blakey, *supra* note 233, at 16-17. In the LaserFax no-action request letter, counsel for the issuer explained that the plan to sell subordinated convertible securities was a reluctant alternative to obtaining bank loans. *Supra* note 143. The issuer was too new and too asset-poor to obtain a loan. The issuer's plan of financing was to obtain bank loans, but the banking institutions advised the issuer that the issuer's request for financing must be turned down due to the issuer's lack of a "track" record, and the issuer's inability to provide adequate collateral. Accordingly, the issuer reluctantly decided to conduct another private placement under regulation D, which resulted in an integration of the issuer's offerings. *Id.* *See also* START-UP COMPANIES, *supra* note 15, at 6-7 (stating that generation of internal financing through profits and bank financing is not viable alternative for great majority of venture-financed entrepreneurs).

limits their founders legitimately might seek to place on sales of control, or of preferences, to "outsiders,"[237] portends a limited practical utility of the proposed securities safe harbor to small businesses.[238]

2. Exclusion of Negative Net Worth and Development Stage Issuers; Additional Limits on Utility

The ABA proposal contains another limitation that would affect small businesses adversely. The proposed securities safe harbor would protect sales of different classes of securities only where "immediately prior to the second offering the issuer does not have a negative net worth and is not a development stage company."[239] The task force report observes, quite cor-

237. *See supra* notes 231-33 and accompanying text. (demonstrating that if business owners are not astute, owners can be "negotiated" out of many beneficial aspects of ownership, such as control, return, and like, during capital formation process).

238. The proposed securities safe harbor may be unavailable at times even to larger issuers because of the potential conflict between the proposal's strict requirement that each class of security be based on "broad, simple definitions," and the trend toward creative combinations of the features of securities. *See* ABA Report, *supra* note 22, at 633-35; R. HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS, CASES AND MATERIALS 257 (3rd ed. 1986). Hamilton writes that

> it should be clear that the precise line between "preferred" and "common" shares, at the margin at least, was always a shadowy one. There might be little or no difference, for example, between a "participating preferred" and a "class A common" except the title. Developments during the 1970s and early 1980s also tended to blur this distinction (as well as the distinction between "debt securities" and preferred shares). This was a period of extremely high interest rates and the development of novel financing devices . . . . Faced with these developments, the draftsmen of the Revised Model Business Corporation Act, in section 6.01, made a significant philosophical break with the past by studiously avoiding the words "preferred shares" and "common shares" and by establishing a scheme of consummate generality that is designed to accommodate the most innovative and ingenious creator of new classes or types of shares.

Id.

According to the ABA Report, the securities safe harbor necessarily must contemplate "those classes of securities so fundamentally distinct from one another [in order] that there will be no threat to the integrity of the registration process." ABA Report, *supra* note 22, at 635. The result, however, may be that issuers with substantial enough economic positions to consider using the securities safe harbor would be thwarted if the issuer's capital structures are as creative as they often have to be in an increasingly complex economic environment. In that event, if no other safe harbor is available, the issuer "will have to rely on Release No. 4552." ABA Report, *supra* note 22, at 635.

239. ABA Report, *supra* note 22, at 642. The exclusionary language in the proposed securities safe harbor appears to require that before a second offering, "the issuer does not have a negative net worth *and* is not a development stage company." *Id.* (emphasis added) The report's description of the proposal, however, seems to describe the two situations disjunctively, thereby making each a basis for exclusion from safe harbor protection. The report states that, "[i]t seems appropriate to limit the use of the securities safe harbor to companies other than development-stage companies, companies having a negative net worth, and companies with financial statements qualified on a going-concern basis." *Id.* at 633.

It is not clear whether the third category mentioned in the ABA Report, "financial statements qualified on a going-concern basis," is a separate test that simply was not included in the actual proposal, or whether the third category is considered to be part of the "negative net worth" category. This Article assumes the latter.

rectly, that in businesses that are developing or that are seriously troubled financially, the different classes of securities may be facially quite different in their characteristics, but are all functionally the same. The varying characteristics of the different classes of securities simply are not viable in the absence of a financially sound and operational business.[240] Nonetheless, it does not follow that a securities safe harbor should exclude developing issuers or issuers in financial trouble.

As a practical matter, the negative net worth and development stage limitation would exclude small business issuers from protection from integration in two very critical stages of their existence, i.e., during their development stage and during periods of extreme financial difficulty. As such, the net worth limitation is counterproductive and should be eliminated. Since the aim of the integration doctrine is investor protection in accordance with the 1933 Act, the proposed securities safe harbor should be available to developing and financially troubled businesses when the terms of the securities are expressed clearly and when the businesses use exemptions that contemplate extensive disclosure or comparable investor protection guarantees to offerees.[241] Offerings under rules 505 and 506 of regulation D, regulation A, sections 4(2) and 4(6) of the Act, as well as registered offerings all appear to ensure that prospective purchasers can make informed investment decisions when these issuers distribute securities.[242] The ABA's proposed exclusion for negative net worth and developing issuers seeks to inject "merit regulation"[243] reasoning into a full-disclosure regime for investor protection under the 1933 Act. Clearly, the 1933 Act neither requires nor contemplates such a standard.[244]

---

240. *Id.* at 633.

241. SEC v. Murphy, 626 F.2d 633, 642 (9th Cir. 1980) (stating that "the purpose of Securities Acts [sic] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions").

242. *See supra* notes 38-51, 77-81, 90-102. Offerings under these provisions promote high levels of investor protection by requiring extensive disclosure, financial "sophistication" of investors, "accredited" investors, or various combinations of these elements.

243. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities,* 46 MD. L. REV. 1027, 1039 (1987). Sargent states that

> [i]n essence, merit regulation is a paternalistic system of securities regulation permitting the administrator to deny effectiveness to a registration statement if the terms of the offering, the structure of the issuer, or any associated transactions do not (i) ensure a fair relationship between promoters and public investors, and (ii) provide public investors with a reasonable relation between risk and return.

Id.

This definition stems from the definition of the Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings,* 41 BUS. LAW. 785 (1986). Professor Sargent was the principal author of that report. *See* Sargent, *supra,* at 1039 n.61.

244. Sargent, *supra* note 243, at 1039. According to Sargent,

> The establishment of a disclosure-based federal securities regulatory system in 1933 was tantamount to a rejection of the merit-based system. Merit regulation in 1933, as well as merit regulation in 1987, contemplated a far greater degree of intervention

It should be noted that the economic status of the businesses excluded under the proposed ABA safe harbor does not always render them automatically unattractive or harmful to potential investors. Indeed, some investors are attracted particularly to high-risk, (potentially) high-return investments in new and "turnaround" businesses.[245] Whether these investors are motivated by the belief that substantial changes in management will bring about a business recovery, that market demand for the business' product is or will be strong, or by some other belief, such investors are potent and crucial forces in the capital formation process and in the capital markets generally.[246] Hence, when substantial investor protection guarantees under the 1933 Act are present, even an issuer in the development stage or with a negative net worth should not be foreclosed from taking advantage of the proposed safe harbor to raise capital from willing, informed investors.

Ironically, the proposed safe harbor may have its greatest utility among small issuers in the categories excluded by the proposal. Consider, for example, a financially troubled or development stage company whose common stock is purchased in an acquisition. Assume that the new owners have the financial facility and business acumen to recapitalize the company on favorable terms through a sale of preferred stock or debt.[247] This scenario is certainly feasible in the real world, and a securities safe harbor with the investor protection approach suggested herein could be a very useful capital formation device. To the extent the new owners are able to persuade other investors to provide capital in exchange for preferred stock or debt, the owners could accomplish the task of financing the company at a level necessary to support successful operation, while retaining basic control and ownership of the company. Investors in the company would have the same protections any investors have and deserve under the federal securities laws:

---

into private economic decisionmaking than did the form of disclosure regulation adopted in the 1933 Act." *Id.*

According to one commentator, "[i]t must not be thought, however, that Disclosure and Merit are two gods that sit on separate but equal thrones." L. Loss, *supra* note 1, at 36. According to another commentator, "[M]erit and disclosure, to some extent, occupy relative positions on a single regulatory continuum." Sargent, *supra* note 243, at 1046.

245. *See, e.g., The Turnaround King Investors Love,* FORTUNE, Jan. 5, 1987, at 66 (discussing dealmaker Michael Dingman). Dingman was an extraordinary dealmaker who raised "$1.2 billion . . . in the largest U. S. initial public offering ever"). *Id.* The money that Dingman raised went to the Henley Group, "a money-losing bunch of businesses that Allied-Signal didn't want and spun off to its shareholders." *Id.* Dingman's business philosophy was: "[b]uy companies at a discount in depressed markets, spruce them up, wait for the market to bounce back, then sell or spin them off at a handsome profit." *Id.; see also,* VENTURE, February, 1987, at 65, 69 (explaining that investment banking firm established "Vulture" fund to buy oil and gas properties from companies ravaged by the free-fall in oil prices).

246. *See supra* note 245.

247. *See supra* note 245. Of course, the influence of the new owners is the key factor that arouses the level of investor interest, making such an offering possible. According to Professor Morrissey, "The investors' ultimate decisions are to place their funds with a given individual running an on-going business [as opposed to a particular legal entity] . . . . The promoter's entrepreneurial skills are what attract investors." Morrissey, *supra* note 20, at 151.

an opportunity to invest in a venture with the expectation of a profit and subject to the risks of loss that they have learned of and deemed acceptable based on "full and fair disclosure" of all material information.[248]

Yet another scenario in which the ABA proposal's net worth limitations would be ill advised is when an issuer with a negative net worth has assets with fair market values significantly higher than their historical cost. Since generally accepted accounting principles require that net worth be calculated using the "actual" or "historical" cost of business assets less certain reductions in those assets, any appreciation in the assets' value will not be taken into account.[249] But this failure to consider the current value of assets could render any financial analysis of a business totally distorted and unrealistic.[250] The undervalued asset could be a parcel of real property, whose value has risen because of favorable events occurring or about to occur in close geographical proximity. Similarly, the asset could be a patent on an important product that has just been proved effective in scientific experiments and approved by government regulators as safe and effective for marketing and sale to the public.[251] A negative net worth issuer that is the beneficiary of such asset appreciation actually may be in a sound and advantageous position to engage in business enterprise and yet may be hampered by what are essentially accounting technicalities.[252] To deny a

---

248. SEC v. Murphy, 626 F.2d 633, 642-43 (9th Cir. 1980).

249. *See* FIFLIS, KRIPKE & FOSTER, ACCOUNTING FOR BUSINESS LAWYERS, TEACHING MATERIALS 79 (3rd ed. 1984):

> With few exceptions, financial statements are presented on the basis of "historical cost." This means that asset values are presented at their original cost less certain reductions, including assumed depreciation and depletion and certain diminutions in value, but without any recognition of increases in value, some of which have become normal in our economy. The two primary causes of increases in value are inflation and economic changes.

Id.

250. *See generally,* KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 160-68, 185-90 (1979). Although Professor Kripke discusses the disadvantages of historical cost accounting in the context of public companies, Professor Kripke's arguments still carry force in the private company context.

251. *See* FIFLIS, KRIPKE & FOSTER, *supra* note 249, at 80:

> Economic changes are changes in the value or utility of an asset not solely related to inflation. These changes may be due to any other factors, for example, discovery of natural resources, zoning changes, changes in local conditions (e.g., a new facility in the community), temporary shortages of supply (e.g., the oil shortage of the 1970's), profitability of investees, reduction in interest rates, changing demand for housing or office space.

252. *See id;* Manning, *supra* note 226, at 71-72. In Remote Computing Corporation, SEC No-Action Letter (Dec. 28, 1972), an issuer sought to issue common stock to certain debt holders after completion of a regulation A offering of common stock. The issuer's financial strategy was to reduce the issuer's extremely high level of debt and negative stockholders' equity because this had been a serious impediment in the issuer's relations with banks, suppliers, and larger customers. *Id.* Significantly, the issuer already was operating at a profit, and wanted to change its balance sheet because it gave the misleading appearance that the issuer was experiencing going-concern problems. Although the issuer's problems in Remote Computing

negative net worth issuer the use of financing devices such as the proposed securities safe harbor is unnecessary and inefficient, and limits the vitality of the issuer, the capital markets, and the economy. Permitting the negative net worth issuer to use the safe harbor in this instance, with the modification suggested herein, would pose no threat whatsoever to investor protection. A prospective investor, therefore, could make an informed choice as to whether and to what extent to invest, based on access to information about the real, as well as the technical, financial status of the issuer, and no injustice would occur as a result.[253]

D. *The Purpose Safe Harbor*

The fourth safe harbor proposed by the ABA focuses on certain basic purposes for issuing securities. Like many of the other proposals, this proposal extracts a single criterion from Release No. 4552, and because of the criterion's "fundamental" relevance, makes it alone the basis of a safe harbor.[254]

Admitting that the purpose criterion is highly subjective, the ABA task force proposes to make the purpose criterion more objective by recognizing only the following "four fairly well defined purposes for securities offerings:"[255]

(i) to raise capital;
(ii) to extinguish indebtedness through an exchange of securities;
(iii) to secure human resources; and
(iv) to acquire business operations or assets.[256]

Under the ABA proposal, any one of these four purposes could be the basis of a separate and distinct offering. Further, when several purposes exist for an offering, any purpose requiring more than twenty-five percent of the proceeds of the offering would be deemed the "purpose" of the offering.[257]

The purpose safe harbor would make offerings for certain typical and clearly different purposes nonintegrable with each other, and therefore, would be quite useful to issuers. Nevertheless, certain other purposes also could have been included in this proposal that would not compromise the

---

Corporation did not result from an historical cost valuation problem, the case illustrates the dilemma of a company limited by accounting technicalities even though its business prospects are strong. It is also noteworthy that the issuer used a securities offering to eliminate the issuer's financial "image" problem.

253. *See* Sargent, *supra* note 243, at 1039. Sargent wrote that "theoretically, therefore, the SEC will not, indeed cannot, deny registration to an offering that appears to be egregiously unfair to the public investor, or presents an extraordinary amount of risk, so long as all information material to the offering has been disclosed." *Id.*

254. ABA Report, *supra* note 22, at 635.

255. *Id.*

256. *Id.* at 635-36.

257. *Id.*

protections for investors under the Act, and would provide great practical benefits to issuers. Given their typically more precarious economic circumstances, small business issuers would benefit immeasurably from the adoption of the recommendations below.

1. Offerings Necessitated by "Unforeseen Operating Difficulties"

When the purpose of an offering is to provide funds necessitated by "unforeseen operating difficulties," such as the substantial loss, unavailability, or destruction of assets caused by criminal acts, acts of God, severe economic downturns, technological developments, or similar phenomena, the offering should receive the protection of a purpose safe harbor. This formulation is based on cases such as *Barrett v. Triangle Mining Corp.*,[258] in which a prior offering was not integrated with a subsequent offering when the purpose of the second offering was to raise funds to sustain a new tungsten ore mining company until unforeseen operating difficulties could be resolved.[259] The court in *Barrett* relied directly on *Livens v. William D. Witter, Inc.*[260] in deciding not to integrate the offering. In *Livens* "each successive financing was expected to be the last which would be required to make . . . [the issuer] self-supporting," but "[a] series of obstacles to profitability was encountered, many of them beyond the control of the company or the defendants."[261] It should be noted that the "unforeseen operating difficulties" contemplated by the proposed addition to the purpose safe harbor would begin with the types of problems present in *Barrett* and *Livens* and continue along a spectrum of increasingly compelling phenomena justifying the offering.

The courts in *Barrett* and *Livens* relied primarily on the conclusion that offerings based on unforeseen operating difficulties are not part of a single plan of financing.[262] But those types of offerings also can be said to be for distinctly different purposes, thus making them appropriate for a "purpose" safe harbor. Indeed, it has been said that "plan of financing" and "purpose" are overlapping, if not synonymous, factors.[263] For example, and to

258. Barrett v. Triangle Mining Corp., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,438 (1976).

259. *Id.* at 99,212.

260. 374 F. Supp. 1104 (D. Mass. 1974).

261. *Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104, 1107 (D. Mass. 1974).

262. *Livens*, 374 F. Supp. at 1107; Barrett, *supra* note 258, at 99,212.

263. *Livens*, 374 F. Supp. at 1107. The court in *Livens* stated that the offerings were for the same general purpose. *Id.* However, the court's characterization merely reflects the confusing semantics involved in the usage of the two terms. If the term "purpose" implies the assets, liabilities, or operations on which the raised funds will be spent, the court's characterization of the term is correct. On the other hand, if the purpose of the offering constituted an attempt to raise funds to compensate for an unexpected lack of profitability, the *Livens* court should have distinguished between the two offerings.

See also ABA Partnership Report, *supra* note 36, at 1610. According to the ABA Partnership Report, "whether or not the different offerings 'are part of a single plan of illustrate the proposal, if a fire or a flood destroys a company's inventory, an offering to raise capital to replace the destroyed inventory definitely could not be considered part of any previous company plan of financing. Further, even if the company had made prior offerings to raise capital for general operating purposes, including the purchase of inventory, the emergency-based offering is clearly different in purpose because of the exigent facts providing the impetus for the offering. Therefore, the addition of an unforeseen operating difficulty purpose to the proposed purpose safe harbor would reflect the two most significant criteria of Release No. 4552, and the purpose safe harbor itself would provide critical and justified assistance in numerous real-life business situations.

As with other safe harbors, failure to comply with the unforeseen operating difficulty proposal's requirements could render the issuer in violation of section 5 of the Act.[264] Therefore, an issuer would be obliged to make a careful analysis of its financial situation before attempting to invoke this safe harbor purpose. Additionally, a disclosure requirement that the unforeseen problem be explained fully would be a deterrent to attempts by an issuer to "create" emergencies in order to effect nonintegrable exempt offerings. Finally, the phrase "operating difficulties" should be interpreted to mean a threat to continued business existence. This narrow interpretation, when combined with a disclosure requirement and the general categories of sources of totally unforeseen operating difficulties described herein, would restrict the applicability of this safe harbor to demonstrably exigent circumstances in which potential investors are fully aware of all material matters. The balance of utility to business issuers and protection for investors makes the unforeseen operating difficulty purpose ideal for incorporation into the ABA's proposed purpose safe harbor regime.[265]

---

financing,' can be viewed as a restatement of the question of whether or not the offerings are being made for the same general purpose." *Id.; see also* Stevenson, *supra* note 10, at 52 (stating that in many no-action letters the terms "plan of financing" and "purpose" appear to be interchangeable); Deaktor, *supra* note 9, at 529 (explaining that in some inquiries, courts appear to equate single plan of financing factor with purpose of offerings factor). In *SEC v. Murphy*, the Ninth Circuit essentially equates the two factors, holding that, "[T]he offerings were all made for the same general purpose: they were part of one financing plan . . . 'to give dollars to the cable operating company [to] be used at a cost they could live with.'" SEC v. Murphy, 626 F.2d 633, 646 (9th Cir. 1980). (quoting Murphy's own testimony).

264. *See* 15 U.S.C. § 77(e) (1982). If a safe harbor's terms are not met, the issuer must rely on Release No. 4552. There, of course, the uncertainties abound, but one very possible outcome is integration. *See* Rule 502(a) of Regulation D, 17 C.F.R. § 230.502(a) (1987).

265. Clearly, the language of an unforeseen operating difficulties purpose would leave room for interpretation, and therefore, some uncertainty. However, the compelling need for a purpose tied to financially debilitating exigencies, along with the narrowly drawn elements of the purpose, presents a considerably more reliable alternative than the purposes that presently exist. In this regard it should be noted, however, that the SEC rejected a "change in circumstances" concept when the SEC promulgated rule 144. *See* Securities Act Release No. 33-5223 (Jan. 11, 1972). *See also* 17 C.F.R. § 230 (1987) (governing time at which investors can engage in resale of securities). While this may bode ill for the adoption of the proposal, the practical and policy rationales expressed herein deserve, at the least, serious consideration.

2. Offerings to Comply with "Antidilution" Agreements

The purpose safe harbor also should exempt from integration certain offerings to negate or reduce the dilutive effects of another offering when a written preemptive right or other antidilution agreement exists, written notice of intent to exercise antidilution rights is provided to the issuer, and full disclosure of the nature and purposes of both offerings is made to all offerees.

In the early stages of a business, antidilution agreements are often central to financing arrangements. They are almost invariably present in venture capital financing deals.[266] To the extent that they arise in fair, arms-length transactions, these agreements, which allow an investor to preserve some percentage of his initially-acquired claim to earnings, net assets in the event of liquidation, and control of the business, deserve to be enforced. Potential for conflict exists, however, between antidilution agreements and subsequent plans to issue securities to others. When the subsequent offerings themselves cannot accommodate the antidilution rights, a separate offering is necessary, and thus, an integration issue can arise and possibly thwart the issuer's financing plans.[267]

Antidilution offerings can be protected by a safe harbor without jeopardizing investor protection. This is true for several "structural" reasons. First, in an antidilution offering the securities are sold at the insistence of the investors entitled to purchase them, and the offering is mainly in furtherance of the interests of the investors, not those of the issuer. Second, the investors already have purchased the issuer's securities and want to purchase more of precisely the same class of security; thus, the investors can be presumed to be familiar with the terms of the security and the issuer.[268] To the extent the issuer makes full disclosure to all offerees of both offerings, and the antidilution agreement is pre-existing and in writing, the separate offering poses no threat to investor protection. For these reasons, integrating the offerings would serve no practical purpose or policy.

In *Pacific Resources, Inc.*,[269] the SEC staff took a no-action position with respect to integration of a proposed registered public offering by existing shareholders and warrantholders of a corporation with a concurrent issue of common stock pursuant to an antidilution agreement. It was particularly significant in this matter that the public offering was to be made by existing stockholders and warrantholders, while the private offering

266. *See* VENTURE CAPITAL, *supra* note 231, at 260; CAPITAL FORMATION, PRIVATE AND PUBLIC FINANCINGS 237 (PLI 1982).

267. For example, the subsequent offering could be made under the authority of rule 506 to thirty-five unaccredited investors, under circumstances in which the securities with the antidilution provision were also sold to unaccredited investors. Alternatively, the subsequent offering could be sold pursuant to the intrastate exemption, and the previous offerings with antidilution provisions could have been to nonresidents.

268. *See* A. HOFFMAN, ISRAELS ON CORPORATE PRACTICE § 5.22, at 148-49 (4th ed. 1983).

269. Pacific Resources, Inc., SEC No-Action Letter, (Aug. 14, 1987).

was to be made by the issuer corporation.[270] Obviously, there was no single plan of financing, although the corporation was obligated to issue stock upon exercise of the warrants and, of course, would receive funds based on that issuance. Additionally the purposes of the two offerings clearly were different. As a result, integration of the offerings was unnecessary, because investors were protected; the corporation merely sought to comply with the express terms of an investment contract.[271]

Although there were two different offerors in *Pacific Resources,* there is also justification for not integrating an antidilution offering with a contemporaneous offering when the corporate issuer makes both offerings. Such was the situation in *Kaiser Resources, Ltd.*[272]

In *Kaiser Resources,* the SEC staff took a no-action position when the issuer, a Canadian subsidiary, proposed to issue restricted common shares through a private offering to its American parent and to ten Japanese companies. The issuer also proposed to make a concurrent registered public offering of warrants to purchase common stock. The stated purpose of the public offering was "[to] minimize the dilutive effect (from 25% to 10.4%) upon public shareholders resulting from issuance of shares to [the] Japanese Purchasers and Kaiser Steel." This clear difference in purposes was significant in the Staff's decision not to recommend enforcement action based on the integration doctrine.[273]

In summary, while there are numerous scenarios under which the antidilution/integration issue can arise, the inherent nature of the antidilution agreement, combined with a written agreement, written notice of intent to exercise antidilution rights, and full disclosure to all offerees,[274] presents a compelling case for adding this purpose to the proposed purpose safe harbor.

E. The Policy Safe Harbors

The ABA Report recommends certain policy safe harbors directed at sections 3(a)(9) and 3(a)(10) of the 1933 Act, and at issuance sequences wherein an exempt offering is made "in close proximity" to a public offering.[275] The ABA recommends policy safe harbors because the ABA task force believes that improvements in the securities laws since enactment of the 1933 Act have "augmented investor protection in a number of ways," thus rendering the registration process "less important in the overall pattern of investor protection." Thus, the ABA task force believes that any necessity

---

270. *Id.*

271. *Id.*

272. Kaiser Resources, Ltd., SEC No-Action Letter, (Aug. 1, 1973.)

273. *Id.*

274. Disclosure could be important, for example, to an offeree concerned about the post-offering control structure of the issuer.

275. ABA Report, *supra* note 22, at 636-643.

for a policy bias favoring registration is diminished.[276] These proposed policy safe harbors generally would bring sound and welcome relief.

Section 3(a)(9) exempts from registration "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."[277] Securities exchanged in Bankruptcy Act proceedings under 11 U.S.C. § 1145 are not included in the exemption's coverage. The policy safe harbor proposal would extend safe harbor protection to issues made under this section *only* in instances in which the issuer "has been subject to, and has satisfied, the reporting requirements of the Exchange Act during the twelve months preceding the otherwise exempt exchange offer."[278] Even though only existing security holders who are presumably familiar with the issuer are involved, no new funds are being raised, and no solicitation pressures are allowed under this section, the task force does not believe safe harbor treatment is justified without the protection of Exchange Act reporting requirements.[279]

The proposed policy safe harbor, which the report describes as "a great [practical] convenience for convertible securities and routine refinancing transactions,"[280] would be unavailable to most small businesses. The unavailability results directly from the requirement that the issuer be an Exchange Act reporting company, with all the attendant costs, potential liabilities, and other burdens.[281] Indeed, a strict requirement that issuers be Exchange Act reporting companies appears to conflict with the task force's prefatory language that sufficient enhancements to investor protection have occurred during the past fifty years such that no bias toward registration is warranted.[282] Under the policy safe harbor proposal, registration—under the 1934 Act instead of the 1933 Act—is not merely the bias, it is the prime requirement.

From the perspective of small businesses, an infinitely better requirement would be one-time disclosure according to rule 502(b)(2)(i) of regulation D, as applied to nonreporting companies issuing securities under rule 505 and 506.[283] First, a one-time disclosure requirement still would require that the issuer provide extensive and specific disclosure, under one of the SEC's more recent regulatory improvements in investor protection, using a disclosure process of the type with which a small business' principals may be

276. *Id.* at 636.
277. 15 U.S.C. § 77c(a)(9) (1982).
278. ABA Report, *supra* note 22, at 637.
279. *Id.*
280. *Id.* at 636.
281. *See* Scheider & Schargel, *supra* note 50.
282. ABA Report, *supra* note 22, at 596, 600, 636, 641.
283. *See* 17 C.F.R. § 230.502(b)(2)(i). Rule 502(b) requires the disclosure of most of the information that an offeror would have to disclose in part 1 of an applicable registration statement form. The somewhat abbreviated financial disclosure requirements are a major exception. *See* ELKINS & MEEKS, *supra* note 90, at A-33 through A-39.

familiar.[284] Second, the costs and other burdens incurred by a one-time disclosure would be much lower than they would be if Exchange Act reporting were required, particularly when a small company needs to effect only a few transactions, one of which is a section 3(a)(9) offering.[285] If the claims of improvements in the securities laws are true, this recommended change to the ABA proposal, coupled with the built-in protections of section 3(a)(9), would provide a much-improved balance of investor protection and promotion of capital formation for *all* businesses.

Section 3(a)(10) provides an exemption from registration for certain exchange issuances of securities when the issuance is approved by a judicial or administrative body.[286] The ABA task force observes that an opportunity to be heard and a specific determination of the "fairness" of the transaction constitutes "merit review," and thus, provides "even greater investor protection than the registration process."[287] Accordingly, the ABA task force proposes section 3(a)(10) as a policy safe harbor. Given the proposal's applicability to all businesses and guarantees of investor protection, it is acceptable and could be beneficial to small businesses.

The task force also proposes to extend rule 152, which precludes integration of a private offering under section 4(2) with a contemporaneous public offering, to any exempt offering/public offering combination.[288] Since "registration provides the ultimate protection to investors," an exempt offering in close proximity to a registered offering is said to be no threat to the public offering investors.[289] There is no specific requirement, however, that the issuer disclose the registered offering to exempt offering investors. Additionally, the ABA report assumes that exempt offering investors are "no worse off (and, in many cases, better off) than if the public offering had not taken place." The theory is that the exempt offering investor could only benefit when the issuer is free to raise capital "at the time it is needed."[290] Finally, any exempt investors who invested without knowledge of an issuer's planned or contemplated subsequent offering would be "sufficiently protected" under the 1933 Act's antifraud provisions.[291]

The ABA proposal should require affirmative disclosure by the issuer of its known offering plans to offerees of both offerings (to the extent, of course, that the issuer is aware of such plans). This is the fairest and most practical arrangement for potential investors in exempt offerings. Private and small offering investors may have concerns about dilution, registration

284. *See* ELKINS & MEEKS, *supra* note 90, at A33-A39.

285. *Id.;* Scheider & Schargel, *supra* note 50.

286. 15 U.S.C. § 77c(a)(10) (1982).

287. ABA Report, *supra* note 22, at 637. The proposal appears in the appendix to the ABA Report at page 643. *Id.* at 643.

288. *Id.* at 638, 643.

289. *Id.* at 638. The ABA report noted that, "In all probability, the public offering prospectus would disclose any prior exempt offering." *Id.*

290. *Id.*

291. *Id.*

rights, and the like, which could affect their investment decisions.[292] Such investor concerns should be raised and resolved early on in the investment transaction. In the event an issuer's overall financing plans are objectionable to an offeree, the offeree can inquire further, negotiate other terms of investment, or simply refuse to invest. In this way, issuers can avoid expensive, time-consuming litigation under the antifraud provisions of the Act. Small businesses would benefit particularly from a proposal structure that encourages resolution of objections and disputes without litigation, which depletes precious resources and jeopardizes newly-earned reputations.

Finally, the proposed extension of rule 152 wisely excludes the requirement in rule 152 that to preclude integration, an issuer effecting a public offering after an exempt offering must have made the decision to effect the public offering after completion of the exempt offering.[293] The theory of the ABA task force is in accord with the SEC staff's positions in *Verticom*[294] and *Vulture Petroleum*.[295]

F. Foreign Offering Safe Harbor

The final safe harbor proposal made by the ABA Report would protect offerings made outside the United States to persons not residents of the United States as long as the issuer has taken "reasonable measures" to prevent the securities sold from flowing back into the United States.[296] The foreign offering safe harbor proposal derives primarily from previous SEC pronouncements protecting such foreign offerings made under section 4(2) of the Act[297] and under regulation D.[298] In the rare instances in which the SEC has provided significant guidance, it has adhered to the position that the registration requirements are designed to protect only American investors.[299] A key requirement of this safe harbor, also true of the SEC pronouncements, is the efforts of the issuer to ensure that the purchased securities actually "come to rest" abroad.[300]

The foreign offerings safe harbor proposal poses no threat to the investors sought to be protected under the 1933 Act, and clearly is welcome in an era of the globalization of securities markets. While the scarcity of resources available to small businesses to make foreign offerings of securities may well limit the safe harbor's utility to small businesses, the proposal has merit generally and should be adopted.

---

292. *See generally* VENTURE CAPITAL, *supra* note 231, at 259-64; START-UP COMPANIES, *supra* note 15, § 7.06.

293. ABA Report, *supra* note 22, at 643.

294. *See supra* notes 152-60 and accompanying text.

295. *Id.*

296. ABA Report, *supra* note 22, at 643.

297. Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 4708, 1 Fed. Sec. L. Rep. (CCH) ¶ 1361 (July 9, 1964).

298. 17 C.F.R. §§ 230.501-230.506 (1988).

299. ABA Report, *supra* note 22, at 639-40.

300. *Id.* at 640-41.

VI. Conclusion

The integration doctrine continues to frustrate issuers engaged in the capital formation process, engulfing them in a sea of ambiguity, uncertainty, and potential liability. Although the doctrine was created out of a legitimate concern that the investor-protection mandate of the Securities Act of 1933 not be thwarted, the doctrine's development has left unresolved many serious problems. The integration doctrine has elusive formulas, with subjective, unweighted, and overlapping terms, and the doctrine's safe harbors have arbitrarily derived time intervals. Finally, the application of the doctrine by the courts, the SEC, and the SEC staff has often resulted in vague and inconsistent pronouncements.

Of the various proposals to improve the doctrine, those submitted by the task force of the ABA Committee on Federal Regulation of Securities are the most comprehensive and promising. While the task force avoided any attempt at developing a complete "analytical matrix . . . for resolving all integration problems," that body developed several very "safe" safe harbors, hoping that conservatively crafted proposals would be more readily adopted.[301] Unfortunately, the Commission has not seen fit to adopt, in whole or in part, the ABA proposals, thus leaving the integration enigma fully intact.[302]

The modifications to the ABA proposals that this Article recommends are offered in the interest of the many small businesses that are particularly and inherently disadvantaged in the capital formation arena. The recommendations are at times less conservative than the ABA proposals, but they still represent a balance of the interests of investor protection and capital formation that furthers the public interest. The SEC should give serious consideration to the ABA proposals as modified by the recommendations outlined in this Article. The result of such consideration could well be the beginning of a truly useful and workable doctrine of integration of securities offerings.

301. ABA Report, *supra* note 22, at 597-98.

302. In a letter dated March 13, 1987, commenting on SEC proposed revisions to regulation D, the ABA expressed the following opinion to the SEC regarding the SEC's failure to adopt various ABA integration proposals:

> Unfortunately, the Commission staff has not reacted to these repeated requests for assistance. The need for pragmatic analysis of the integration issue continues.
>
> . . . .
>
> [A]though letters such as Verticom . . . are helpful, we urge the Commission to address the integration issue as a whole and to assist practitioners towards a practicable application of the major relevant factors.

Id.