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Securities Regulation: Improved Financing Alternatives for Small Issuers

SECURITIES REGULATION: IMPROVED FINANCING ALTERNATIVES FOR SMALL ISSUERS

The Securities Act of 1933 (1933 Act) imposes numerous obligations on small business enterprises that issue securities.[1] Small businesses provide a substantial amount of American productive capacity.[2] In recent years, small businesses have experienced difficulty in operating profitably.[3] Although other obstacles may also hinder business success,[4] the necessity to periodically raise operating and investment capital is a major hurdle that faces small businesses.[5] Many of the obligations that the 1933 Act imposes on small businesses that issue securities prevent small businesses from collecting adequate capital.[6]

The 1933 Act attempts to ensure complete disclosure to the investing public of material information[7] regarding a company issuing securities and to prevent fraudulent sales of securities.[8] The Act's essential disclosure requirements appear in Section 5.[9] Section 5 prohibits an

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[1] *See* 15 U.S.C. § 77b(1) (1976) ("security" defined). *See generally* Note, *What is a Security, 1978-1979 Securities Law Developments*, 36 WASH & LEE L. REV. 847 (1979); Note, *What is a Security, 1977-1978 Securities Law Developments*, 35 WASH. & LEE L. REV. 757 (1978); Note, *Definition of a Security, 1976-1977 Securities Law Developments*, 34 WASH. & LEE L. REV. 863 (1977).

[2] 126 CONG. REC. S. 13,470 (daily ed. Sept. 25, 1980) (remarks of Sen. Nelson). Independent businesses with fewer than twenty employees created fifty-two percent of American jobs between 1960 and 1976. *Id.* More than half of all American business receipts originate in small businesses. U.S. SMALL BUSINESS ADMINISTRATION, REPORT OF THE SBA TASK FORCE ON VENTURE AND EQUITY CAPITAL FOR SMALL BUSINESS, *reprinted in Small Business Energy Research Incentives Act: Hearings on Title I of S. 807 Before the Senate Select Committee on Small Business*, 95th Cong. 1st Sess. 64, 69 (1977) [hereinafter cited as Casey Report].

[3] *See* H.R. REP. No. 96-1341, 96th Cong., 2d Sess., *reprinted in* [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 88 at 20.

[4] *Id.*; [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 88 at 20 (small business injured by taxes and inflation).

[5] *Id.*; [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 88 at 20.

[6] *See* H.R. REP. No. 96-1341, 96th Cong., 2d Sess., *reprinted in* [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 88 at 20; Casey Report, *supra* note 2 at 70; *Small Business Access to Equity and Venture Capital: Hearings Before the Subcom. on Capital, Investment, and Business Opportunities of the House Comm. on Small Business*, 95th Cong., 1st Sess. 20 (1977) (statement of William Casey).

[7] Material information consists of facts that assume significance in the deliberations of a reasonable shareholder. *See* TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976).

[8] *See* Preamble, The Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74; SEC, THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION 2-3 (1974), *reprinted in* R. JENNINGS & H. MARSH, SECURITIES REGULATION 30 (4th ed. 1977); Dean, *Twenty-five Years of Federal Securities Regulation by the Securities and Exchange Commission*, 59 COLUM. L. REV. 697, 699 (1959).

[9] 15 U.S.C. § 77e (1976).

offer to buy or sell,[10] a sale,[11] or delivery after sale of any security through interstate commerce,[12] unless the transaction accords with the Act's registration requirements.[13] The Act's registration requirements include the filing of a registration statement[14] and a prospectus[15] with the Securities and Exchange Commission (SEC).

Section 11[16] of the Act provides the Act's primary enforcement mechanism against fraudulent sale of registered securities. The provision contains a civil remedy for investors when the issuer makes untrue material statements and misleading material omissions in a registration

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[10] *See id.* § 77b(3). An "offer to sell" includes any attempt to dispose of a security or interest in a security for value. *Id.*

[11] *See id.* A "sale" includes any contract of sale or disposition of a security or interest in a security for value. *Id.*

[12] *See id.* § 77b(7) ("interstate commerce" defined). Some courts have construed broadly the interstate commerce provision of the Act. In SEC v. Freeman, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,361 (N.D. Ill. 1978), the defendants claimed that § 5 and § 17 of the Act did not apply to their face-to-face securities transaction. The court held that injection of any means of interstate commerce into the sale, such as air travel, activated the disclosure provisions of the Act. *Id.* at 93,242. *See also* Hill-York Corp. v. Amer. Int'l Franchises, Inc. 448 F.2d 680, 693 (5th Cir. 1971) (interstate travel by private automobile to discuss sale of security invoked § 5 of the Act).

[13] 15 U.S.C. § 77e (1976). Section 5's restrictions on the offer and sale of securities place different requirements on an issuer during three distinct time periods: the "pre-filing period," the "waiting period," and the "post-effective period." During the "pre-filing period," the period before the filing of a registration form, an issuer may make no oral or written offers and may make no sales. *Id.* An issuer or security holder, however, may conduct preliminary negotiations with an underwriter because such consultation is not an "offer to buy" under § 2(3) of the Act. *Id.* § 77(b)3. During the "waiting period," the period between the filing of the registration statement and the statement's effective date, an issuer may not sell any securities but may make oral sales offers. *Id.* § 77e. An issuer may also send a preliminary prospectus to potential purchasers if the prospectus complies with § 10(b) of the Act. *Id.* § 77j(b). Sales during the "waiting period" invoke liability under § 12(1) of the Act. *Id.* § 77l.

During the "post-effective" period, after the effective date of the registration statement, an issuer may sell the registered security. *Id.* § 77e. A final prospectus that accords with § 10(a) of the Act, *id.* § 77j(a), must precede or accompany any written offer or any delivery of the security after sale. *Id.* § 77e. *See generally* Ruder, *Federal Restrictions on the Sale of Securities*, 65 NW. U. L. REV. (Supp.) 1, 16-26 (1972).

[14] *See* 15 U.S.C. § 77b(8) (1976) (registration statement defined). *See also id.* § 77f (procedure for filing registration statement); *id.* § 77g (prescribed information for registration statement).

[15] *See id.* § 77b(10) (1976) (prospectus defined). Congress intended that a prospectus provide accurate and complete information for a prospective buyer of securities to allow the investor to make informed investment decisions. *See* H.R. REP. No. 85, 73d Cong., 1st Sess., 2, 8 (1933); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752-53 (1975). A prospectus contains a wide gamut of information of potential significance to a securities buyer. *See* Form S-1, Part 1, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7123. Among other provisions, a prospectus contains the issuer's plans for use of the proceeds of the prospectus's offering, *id.* at 6203 (Item 3); a statement of the financial condition of the corporation, *id.* at 6206 (Item 6), and a description of the issuer's business. *Id.* at 6207 (Item 9).

[16] 15 U.S.C. § 77k (1976).

statement.[17] Since any person who acquires a security sold pursuant to a misleading registration statement is a potential plaintiff,[18] Section 11 threatens a culpable party with substantial liability.[19] Sections 12(1),[20] 12(2),[21] and 15[22] supplement the provisions of Section 11. Section 12(1) imposes liability on any person who offers to sells a security in violation of Section 5.[23] Section 12(2) bars the offer or sale of a security with the aid of a misleading prospectus or a misleading oral communication.[24] Both Section 11 and Section 12 measure a purchaser's remedy as the difference between the sale price of the security and the actual value of the security to the purchaser.[25] Section 12, however, is narrower in scope than Section 11. A person who violates Section 12 is liable only to the immediate purchaser of the affected security.[26] A violator of Section 11 is liable to any subsequent purchaser.[27] Section 15 extends liability under Section 11 and 12 to any person who controls a violator of Sections 11 or 12.[28]

Form S-1[29] is the standard registration statement under the 1933 Act.[30] The form requires a comprehensive description of the securities covered by the registration statement,[31] the plan of distribution for the

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[17] *Id.* Any person who acquires a security issued pursuant to a registration statement that includes an untrue statement of material fact or omits a material fact may sue under § 11. *Id.* § 77k(a); *see* note 7 *supra*. Parties subject to suit include the issuer of the security, the underwriter, all directors of the issuing company, and any signer of the registration statement. *Id.* Section 11 limits a plaintiff's recovery to the price at which the issuer offers the security to the public. *Id.* § 77k(g).

[18] *See* note 17 *supra*.

[19] Section 11 does not require privity between an aggrieved purchaser and a defendant as a prerequisite to the purchaser's recovery. Stewart v. Bennett, 359 F. Supp. 878, 880 (D. Mass.), *supp. opinion*, 362 F. Supp. 605 (D. Mass. 1973).

[20] 15 U.S.C. § 77l(1) (1976).

[21] *Id.* § 77l(2).

[22] *Id.* § 77o.

[23] *Id.* § 77l(1).

[24] *Id.* § 77l(2). Section 12(2) does not apply to any misstatement or omission made in connection with a security not sold by use of the mails or the means of interstate commerce. *Id. See generally* 3 L. LOSS, SECURITIES REGULATION 1699-1712 (2d ed. 1961, Supp. 1969).

[25] *See* 15 U.S.C. § 77k(e) (§ 11); § 77l (§ 12).

[26] *Id.* § 77l.

[27] *See* text accompanying notes 18 & 19, *supra*.

[28] 15 U.S.C. § 77o. A person may control a violator of § 11 or § 12 through stock ownership, agency, or "otherwise." *Id.* Section 15 renders a controlling person jointly and severally liable for a controlled person's violation of § 11 or § 12 of the Act. *Id.*

[29] *See* 17 C.F.R. § 239.11 (1980) (SEC prescription for Form S-1); Form S-1, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7122.

[30] Schedule A, *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶¶ 5501-5675, contains all the information that an issuer other than a foreign government must disclose in connection with a sale of securities. *See* 15 U.S.C. § 77aa (1976). The SEC may permit variations from the disclosure requirements of Schedule A, *id.* § 77g, and has done so by promulgating a variety of registration forms for different situations. *See* 17 C.F.R. § 239 (1980). The SEC prescribes Form S-1 for all distributions that other registration forms do not cover. *Id.* § 239.11.

[31] *See* Form S-1, Item 1, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7121.

securities,[32] the issuer's intended use of the proceeds of the issue,[33] and disclosure of the issuer's business operations and financial condition.[34] The prospectus, Part 1 of Form S-1, contains most of the information that appears in the registration statement.[35] The prospectus is normally the only part of the registration statement that an issuer distributes to potential investors,[36] and serves as an investor's primary source of information concerning a proposed issue.[37] Compliance with Form S-1's registration requirements is difficult and expensive.[38] Many small companies cannot bear the cost of registration and therefore decline to raise funds in the securities market.[39]

Section 3(b) of the 1933 Act permits the SEC to exempt certain offerings from the Act's registration provisions and thus relieve small

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[32] *See id.*, Item 2, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7121.

[33] *See id.*, Item 3, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7121.

[34] *See id.*, Item 6, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7121.

[35] *See* note 15 *supra*. *See generally* C. ISRAELS & G. DUFF, WHEN CORPORATIONS GO PUBLIC 177-253 (3d ed. 1962) (detailed discussion of drafting requirements of Form S-1) [hereinafter cited as ISRAELS & DUFF].

[36] Schneider & Manko, *Going Public—Practice, Procedure, and Consequences*, 15 VILL. L. REV. 283, 290 (1970) [hereinafter cited as Schneider & Manko].

[37] *See In re* Doman Helicopters, Inc., 41 S.E.C. 431, 439 (1963) (prospectus must make risk character of securities obvious to ordinary investor).

[38] *See* ISRAELS & DUFF, note 35 *supra*, at 121-147. The registration process brings together a variety of professionals with competing interests that often prove difficult to reconcile. For instance, an attorney who is primarily interested in protecting a client from legal liability may disagree with an investment banker who desires to ensure a security's saleability. *See* Brooks, *Small Business Financing Alternatives Under the Securities Act of 1933*, 13 U.C. DAVIS L. REV. 554, 549 n.27 (1980) [hereinafter cited as Brooks]. Certified public accountants must carefully prepare comprehensive financial statements in accordance with complex SEC requirements. *See* 17 C.F.R. § 210 (1980) (Regulation S-X) (enumeration of SEC's accounting standards). In addition, preparation of registration statements takes considerable time. Two to three months usually passes between the first draft of a registration statement and the ultimate issuance of securities because issuers must produce many drafts to formulate an effective registration statement. *See* Brooks, *supra*, at 550 n.28. SEC delay in processing registration statements contributes to the duration of the registration process. *See* ISRAELS & DUFF, note 35 *supra*, at 121. Furthermore, the time and effort that accompanies a formal registration under the 1933 Act results in substantial cost to an issuer. In 1976, the average total expense of a first public offering was $202,000. Brooks, *supra* at 550 n.29. The most expensive initial public offering cost $700,000. *Id.*

[39] *See Capital Formation: Hearings Before the Senate Select Comm. on Small Business*, 95th Cong., 2d Sess. 120 (1978) (statement of John C. Whitehead) (preparation of full scale registration statement even for small offering terribly difficult). In 1968 and 1969, 1,056 small companies raised two billion dollars in equity capital from the public. In 1978 and 1979, only seventy-nine small businesses entered the public securities market and raised only four hundred million dollars. 126 CONG. REC. S. 13,480 (daily ed. Sept. 25, 1980) (remarks of Sen. Nelson). *See also* H.R. Rep. No. 1341, 96th Cong., 2d Sess., *reprinted in* [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 88 at 20; Sargent *The Federal Securities Laws and Small Business*, 33 BUS. LAW. 901, 903 (1978) (economically impossible for small business to comply with federal securities regulation).

businesses from the Act's rigorous registration requirements.[40] The section provides that the SEC can exempt an offering from compliance with Section 5 if enforcement of the registration provisions is unnecessary to protect the public interest, or unjustified due to the small amount of money involved in the issue or the limited public nature of the offering.[41] The section bars the SEC from exempting an offering if the aggregate amount of the issue offered to the public exceeds five million dollars.[42]

Regulation A is the traditional exemption that the SEC promulgated pursuant to Section 3(b).[43] If an issuer complies with Regulation A's provisions, the issuer is exempt from the registration requirements of Section 5.[44] Subject to "unworthy issuer" limitations,[45] Regulation A is available to any incorporated or unincorporated Canadian or American enterprise.[46] An issuer may use Regulation A to raise no more than 1.5 million dollars during a twelve month period.[47] A business is subject to the SEC's aggregation and integration rules in calculating whether the business has reached the regulation's monetary limit.[48] An issuer that

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[40] 15 U.S.C. § 77c(b) (1976).

[41] *Id.*

[42] *Id.* The monetary limit for § 3(b) was originally $100,000. The Securities Act of 1933, P.L. No. 73-22. Subsequently, Congress raised the limit to $300,000 (The Act of May 15, 1945, P.L. No. 79-55); $500,000 (The Act of Dec. 19, 1970, P.L. No. 91-565); $1,500,000 (The Act of May 21, 1978, P.L. No. 95-283); and $200,000 (The Act of Oct. 6, 1978, P.L. No. 95-425). Congress most recently raised the limit in the Small Business Investment Incentive Act of 1980, P.L. No. 96-477, to $5,000,000.

[43] 17 C.F.R. §§ 230.251-263 (1980) (rules 251 through 263).

[44] *Id.* § 230.252(a).

[45] *See* 17 C.F.R. § 230.252(c), (d), (e). Exemption from the Act's registration requirements is not available if persons affiliated with the issuer or underwriter of the issuer have suffered administrative or judicial sanctions for securities violations or postal frauds. *Id.* In addition to the unworthy issuer restrictions, an issuer with a fractional undivided interest in oil or gas rights as defined in § 230.300 may not use Regulation A. *Id.* at § 230.252(b).

[46] *Id.* § 230.252(a)(1).

[47] *Id.* § 230.254(a)(1)(i). A person other than an issuer or its affiliate may use Regulation A to offer or sell up to $100,000 worth of the issuer's securities over a twelve-month period. *Id.* § 230.254(a)(1)(ii). The aggregate amount of all Regulation A offerings by nonaffiliates may not exceed $300,000 during the annual period. *Id.* Thus, a non-affiliate may claim all or part of the $100,000 exemption only to the extent that other non-affiliates have not used Regulation A or other § 3(b) exemptions, or made offerings in violation of § 5(a) of the Act. *Id.*

[48] *See id.* § 230.254(a)(1). The SEC applies the aggregation rules of § 3(b) of the Act to determine when an issuer has reached Regulation A's monetary limit. *Id.* The SEC adds the dollar value of all securities that the issuer offers or sells pursuant to a § 3(b) exemption or in violation of § 5(a) of the Act within a year of the proposed offering. The Commission then subtracts the total from the regulation's $1.5 million dollar limit to determine the dollar ceiling of a Regulation A offering for the same period. *Id.*

If an issuer makes one or more other offerings in the year before a Regulation A offering, or makes another offering during a Regulation A offering, the issuer risks losing the Regulation A exemption. If the SEC finds that offerings are substantially similar, the Commission may decide to "integrate" them and consider them part of the same issue. An issue

desires to use Regulation A must file a notification form[49] with the SEC and prepare an offering circular[50] for distribution to prospective purchasers.[51] Regulation A places greater restrictions than does formal registration on the time an issuer may begin sales efforts. As issuer that uses a registration statement may make oral offers to sell securities during the "pre-effective period" between the time the issuer files a registration statement and the effective date of the statement.[52] In contrast, a Regulation A issuer must await SEC approval before offering to sell securities through any mechanism.[53] The SEC may suspend an offering's exemption from registration under Regulation A if an issuer fails to comply fully with the regulation's requirements.[54]

Regulation A offers an issuer several advantages not available with a registration statement. Preparing and filing disclosure documents is less expensive than compliance with registration requirements.[55] In addi-

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enlarged through integration might exceed Regulation A's monetary ceiling. The SEC may suspend a Regulation A exemption if an issuer fails to fully comply with the regulation's provisions. *See* text accompanying note 54 *infra*. An issuer that loses the benefit of the Regulation A exemption because the SEC enlarges the issue through integration faces liability under § 12(1), 15 U.S.C. § 77l(1) (1976), for offering securities without a formal registration statement pursuant to § 5, *id.* § 77e. The SEC weighs five factors when considering whether to integrate separate sales. *See* Securities Act Release No. 33-4552, 27 Fed. Reg. 1136, 1137. The Commission considers (a) whether the sales are part of a single plan of financing; (b) whether the sales involve issuance of the same class of security; (c) whether the sales are made at about the same time; (d) whether the seller receives the same type of consideration; and (e) whether the sales are made for the same general purpose. *Id.*

[49] 17 C.F.R. § 239.90 (1980).

[50] The offering circular appears as Schedule I to Form I-A, 21 Fed. Reg. 5739-47 (1956), *reprinted in* 2 FED. SEC. L. REP. (CCH) § 7327. An offering circular is an abbreviated prospectus. Both an offering circular and a prospectus contain statements of any risks involved with the offering, the organization and operation of the issuer's business, the characteristics of the offered securities and the financial position of the issuer in years preceding the offering. *Compare* Schedule I to Form 1-A, 2 FED. SEC. L. REP. (CCH) ¶ 7327 *with* Form S-1, Part 1, *id.* § 7123.

[51] 17 C.F.R. § 230.256(a)(2) (1980). A seller making a Regulation A offering must send an offering circular to any person that the seller expects is about to buy any of the offering. *Id.* A seller must provide the offering circular at least forty-eight hours before receiving the buyer's confirmation of sale. *Id.* If the issuer files reports pursuant to § 13(a) or § 15(d) of the Securities Act of 1934, 15 U.S.C. § 78m(a), § 78(o)(d), the seller may furnish the offering circular at any time before or at the time of confirmation of sale. *Id.*

[52] *See* note 13 *supra*.

[53] 17 C.F.R. § 230.255(a) (1980). Ten working days must elapse between the time an issuer informs the SEC and the issuer plans to issue securities under Regulation A and the time the offer commences. *Id.* Although technically an issuer may begin sales after ten days, the issuer customarily delays any offering activity until the SEC comments on its filing. *See* Compusec Corp., No-action letter from SEC (Jan. 22, 1974) [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,713, at 83,907.

[54] 17 C.F.R. § 230.261 (1980).

[55] Brooks, note 38 *supra*, at 565 n.171. As of 1979, a Regulation A offering could cost up to $100,000. *Id.* In contrast, the average registered public offering cost $202,000 in 1976. *Id.* at 555 n.29.

tion, the notification form[56] and offering circular[57] demand less disclosure than the complex reporting that Regulation C[58] mandates for a formal registration statement. Unlike an issuer that files a formal registration statement, an issuer that uses Regulation A can satisfy the Act's financial reporting requirements by submitting a financial statement that is uncertified.[59] Instead of filing in Washington, D.C., an issuer files under Regulation A with an appropriate regional office of SEC.[60] Regional filing affords an issuer prompt SEC attention that the issuer could not expect in Washington, D.C. where a complete registration statement competes with all other SEC statements.[61] Finally, the liability provisions of Section 11 of the Act do not apply to Regulation A transactions, although a Regulation A issuer remains liable under Sections 12 and 17 of the Act and under the antifraud provisions of the 1934 Securities Exchange Act.[62]

Regulation A does not solve all of a small issuer's problems. Though Regulation A is less expensive than formal registration an issuer still incurs substantial costs in complying with the regulation.[63] In addition, the regulation's 1.5 million dollar monetary limit may prevent a small issuer from raising sufficient funds.[64] Also, state blue sky laws may obviate Regulation A's relaxed disclosure requirements by requiring full

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[56] *See* text accompanying note 49 *supra*.

[57] *See* text accompanying notes 50-51 *supra*.

[58] 17 C.F.R. §§ 400-494 (1980); *see* text accompanying notes 31-37 *supra*.

[59] *See* Regulation S-X, 17 C.F.R. § 210 (1980). An issuer that registers with Form S-1 must provide the SEC with an exhaustive financial statement certified by a public accountant. *Id.* § 210.1-01(1). In contrast, a statement prepared according to general accounting practices usually fulfills Regulation A's requirements. *See* Schedule I, *supra* note 50 at Item 11.

[60] 17 C.F.R. § 230.255 (1980). The SEC put the administration of Regulation A into the hands of its regional offices to simplify compliance with the 1933 Act by smaller issuers. Securities Act Release No. 2410 (Dec. 3, 1940), [1941-1944 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 75,111.

[61] *See* note 38 *supra*. As of June 1, 1979, the SEC estimated that its regional offices used an average of sixteen days to review Regulation A notifications and return comments in response to the notifications. Securities Act Release No. 6075 (June 1, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,101, 81,877 n.4.

[62] *See* text accompanying notes 16-22 *supra*. Section 11 applies only to misstatements or omissions in registration statements. *Id.* An issuer using Regulation A remains subject to § 17 of the Act, 15 U.S.C. § 77(g) (1976), and § 12(2) of the Act, *id.* § 77 1 (2), which apply to both registered and unregistered securities. Section 17 provides a criminal antifraud remedy. *Id.* § 77(g). Section 12(2) creates a right of action in favor of the immediate purchaser of any security to redress fraudulent sales practices in securities. *Id.* § 77 1 (2). A plaintiff may also sue a Regulation A issuer under § 10b of the 1934 Exchange Act, *id.* § 78j(b) (1976), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1980). *See* Jordan Building Corp. v. Doyer, O'Connor & Co., 401 F.2d 47, 51 (7th Cir. 1968) (availability of remedies under § 12(1) and § 12(2) of the 1933 Act presented no bar to suit under § 10(b) of the 1934 Exchange Act).

[63] *See* note 55 *supra*.

[64] *See* Brooks, note 38 *supra*, at 565.

registration at the state level prior to sales.[65] If an issuer registers an offering under the 1933 Act, most states allow an issuer to meet state registration requirements by "coordination." State statutes may permit an issuer to register with the state by providing the state with the same registration material that an issuer files with the SEC.[66] Only a few state laws, however, allow registration by coordination with a Regulation A filing.[67] Finally, many underwriters, due to their fear of civil liability, refuse to distribute securities by use of Regulation A with any less than the full disclosure that attends formal registration.[68]

The SEC has responded to some of the small issuer's difficulties with full registration and Regulation A by providing Form S-18.[69] Unlike Regulation A, Form S-18 constitutes a formal, though simplified, registration statement.[70] In contrast to the wider availability of Form S-1

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[65] *See, e.g.*, MD. CORPS. & ASS'NS CODE ANN. § 11-501 (1975); MICH. COMP. LAWS ANN. § 451.701 (Supp. 1981); 70 PA. CONS. STAT. § 1-301 (1981); VA. CODE § 13.1-504 (1978).

[66] The following state provisions allow registration by coordination (parenthetical notations to BLUE SKY L. REP. (CCH)): ALA. CODE § 8-6-6 (1975) (¶ 7106); ALASKA STAT. § 45.55.090 (Supp. 1977) (¶ 8123); ARK. STAT. ANN. § 67-1243 (1980) (¶ 10,109); CAL. CORP. CODE § 2511 (West) (1977, Supp. 1981) (¶ 11142); COLO. REV. STAT. § 11-51-109 (1974) (¶ 13,110); DEL. CODE ANN. tit. 6, § 7305 (1975) (¶ 15,105); HAWAII REV. STAT. § 485-11 (1976) (¶ 20,111); IDAHO CODE §§ 30-1420-1421 (1980) (¶¶ 21,121-22); IND. CODE ANN. § 23-2-1-4 (Burns) (1974) (¶ 24,105); IOWA CODE ANN. § 502.206 (West) (Supp. 1981) (¶ 25,116); KAN. STAT. ANN. § 17-1275 (1974) (¶ 26,109); KY. REV. STAT. § 292.360 (1981) (¶ 27,107); MD. CORP. & ASSN'S CODE ANN. § 11-503 (¶ 30,153); MASS. GEN. LAWS ANN. ch. 110A § 303 (West) (Supp. 1980) (¶ 31,122); MICH. COMP. LAWS ANN. § 451.703 (Supp. 1981) (¶ 32,123); MINN. STAT. ANN. § 80A.10 (West) (Supp. 1981) (¶ 33,110); MO. ANN. STAT. § 409.303 (Vernon) (1979) (¶ 35,109); MONT. REV. CODES ANN. § 30-10-204 (1979) (¶ 36,111); NEB. REV. STAT. § 8-1106 (1977) (¶ 37,106); N.M. STAT. ANN. § 58-13-7 (Supp. 1980) (¶ 41,108); N.C. GEN. STAT. § 78A-26 (1981) (¶ 43,133); OKLA. STAT. ANN. tit. 71, § 303 (West) (1965) (¶ 46,143); 70 PA. CONS. STAT. § 1-205 (1981) (¶ 48,115); P.R. LAWS ANN. tit. 10, § 873 (1978) (¶ 49,123); S.C. CODE §§ 35-1-840, 35-1-860, 35-1-950 (1977) (¶¶ 51174, 51176, 51185); S.D. CODIFIED LAWS ANN. §§ 47-31-18.1, 47-31-18.2, 47-31-18.3 (Supp. 1980) (¶¶ 52,129-31); TEX. REV. CIV. STAT. ANN. art 581-7 (Vernon) (Supp. 1980) (¶ 55,583); UTAH CODE ANN. § 61-1-9 (1978 & Supp. 1979) (¶ 57,109); VA. CODE § 13.1-509 (1978) (¶ 60,109); WASH. REV. CODE ANN. §§ 21.20.180, 21.20.190, 21.20.200 (1978 & Supp. 1979) (¶¶ 61,117-19); W. VA. CODE § 32-3-303 (1975) (¶ 63,123); WIS. STAT. ANN. § 551.25 (West) (1980) (¶ 64,115); WYO. STAT. ANN. § 17-4-109 (Michie) (1977) (¶ 66,109).

[67] The following states allow registration by coordination with a Regulation A filing (parenthetical notations to BLUE SKY L. REP. (CCH)); ALASKA STAT. § 45.55.090 (Supp. 1977) (¶ 81230); COLO. REV. STAT. ¶ 11-51-109 (1974) (¶ 13,110); DEL. CODE ANN. tit. 6, § 7305(d) (1975) (¶ 15,105); IOWA CODE ANN. § 502.206 (West) (Supp. 1981) (¶ 25,116); MD. CORP. & ASS'NS CODE ANN. ¶ 11-503(d) (¶ 30,153); MO. ANN. STAT. ¶ 409.303(d) (Vernon) (1979) (¶ 35,109); 70 PA. CONS. STAT. § 1-205 (1981) (¶ 48,115); WASH. REV. CODE ANN. § 21.20.180 (1978 & Supp. 1980) (¶ 61,117); WYO. STAT. ANN. § 17-4-109 (Michie) (1977) (¶ 66,109).

[68] *See* Brooks, note 38 *supra*, at 565. *See also* Securities Act Release No. 33-6275, *reprinted in* [Jan. 12, 1981] FED. SEC. L. REP. (CCH) No. 894 at 49 (disclosure in Regulation A offering circulars often similar in quantity and quality to registered offering disclosure).

[69] 17 C.F.R. § 239.28 (1980), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7301.

[70] Form S-18 requires an issuer to provide twenty different categories of information. *See* Form S-18, 2 FED. SEC. L. REP. (CCH) ¶ 7301. Form S-1 requires responses in thirty categories of information, Form S-1, *id.* ¶ 7122-¶ 7124, and imposes numerous additional undertakings and instructions on an issuer as well. *Id.* ¶ 7125-¶ 7128. *See* text accompanying notes 78-81 *infra*.

and Regulation A, only American or Canadian corporate issuers may use Form S-18.[71] Companies reporting under the 1934 Securities and Exchange Act[72] may not use Form S-18,[73] nor may certain "unworthy issuers."[74] A corporate issuer may use Form S-18 to sell up to five million dollars worth of securities per annum.[75] Since the SEC's statutory authority to promulgate Form S-18 does not derive from Section 3(b),[76] Form S-18's monetary limit is not subject to Section 3(b)'s aggregation or integration requirements.[77] With the exception of financial data,[78] a Form S-18 registration statement contains essentially the same information as an S-1 registration statement.[79] An issuer that uses Form S-18 must present audited financial statements to the SEC prepared according to generally accepted accounting procedures.[80] Nevertheless, Form S-18 does not require financial statements that are as complex as Form S-1's.[81]

Form S-18's simplified requirements for narrative and financial disclosure tend naturally to make a Form S-18 filing with the SEC less difficult and time-consuming than a Form S-1 filing.[82] Form S-18 offers

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[71] *Compare* Form S-18, General Instruction A(a)(1), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7302 *with* Form S-1, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7121 *and* Regulation A, *reprinted in* FED. SEC. L. REP. ¶¶ 5501-5675.

[72] *See* 15 U.S.C. § 78l, § 78o(d) (1976) (reporting provisions of the 1934 Exchange Act).

[73] *See* Form S-18, General Instruction A(a)(2), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7302.

[74] *See id.*, General Instruction A(a)(3)-(7), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7302. Form S-18's "unworthy issuers" include limited partnership interests, *id.*, General Instruction A(a)(3), investment companies, *id.*, General Instruction A(a)(4), and persons who engage in certain oil & gas related operations, *id.*, General Instruction A(a)(5).

[75] 17 C.F.R. § 239.28(a) (1980).

[76] The SEC's authority to prescribe Form S-18 orginated in § 19(a) of the Act, 15 U.S.C. § 77s (1976). The SEC may require use of any form it deems necessary to effect the purpose of the Act. *Id.*

[77] Form S-18 is subject to the aggregation requirements set forth in General Instruction A(c), *reprinted in* FED. SEC. L. REP. (CCH) ¶ 7302. An issuer must add the amount of all the issuer's offerings and all secondary offerings made during the course of a year pursuant to Form S-18. The issuer must then subtract the total from the form's $5,000,000 ceiling per annum to determine the level of the ceiling for a given point in the year. *Id.*

[78] A Form S-18 statement does not have to include a five-year comparative summary of operations. *See* Form S-1, Item 6(a) *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 8145 (five year summary required). Also, Form S-18 requires only a two year statement of income and source and application of funds instead of the three-year statement of Form S-1. *Compare* Form S-18, Item 15(b), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7303 *with* Form S-1, Instructions as to Financial Statements A.2, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7127. The SEC deleted Form S-1's "Instructions as to Financial Statements" to take effect for companies with fiscal years ending after December 15, 1980. *See* Securities Act Release No. 6234, *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 72,303. Nevertheless, an issuer that uses Form S-1 must still provide statements of income and changes in financial position for a three year period. *Id.*, 6 FED. SEC. L. REP. (CCH) ¶ 72,303 at 62, 839.

[79] *See* text accompanying notes 31-35 *supra.*

[80] Form S-18, Item 15, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7303.

[81] *Id., reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7303.

[82] *See* note 38 *supra* (difficulty of Form S-1 filing requirements).

two advantages over Regulation A. Form S-18 offers an issuer the chance to raise 5 million dollars per year[83] as opposed to Regulation A's 1.5 million dollar limit.[84] In addition, since Form S-18 is a formal registration, an issuer that uses the form can take advantage of the states' registration by coordination provisions.[85] States usually deny a Regulation A issuer a similar option.[86]

Form S-18 has only a few disadvantages. Since only corporate issuers may use Form S-18,[87] the form excludes more types of issuers than either Form S-1 or Regulation A.[88] An issuer may use Form S-18 to raise no more than five million dollars.[89] In contrast, Form S-1 contains no limitation on the amount of capital an issuer may raise. Rules regarding secondary resale of securities issued under Form S-18 may reduce the amount a Form S-18 issuer may raise to 3.5 million dollars,[90] but even this figure exceeds the Regulation A limit of 1.5 million dollars.[91] Unlike an issuer under Regulation A, a Form S-18 issuer must present an audited financial statement to the SEC.[92] The disadvantage of required audited statements is more apparent than real. Since most state blue sky laws require audited financial statements, an issuer that uses Regulations A must prepare them regardless of Regulation A's less restrictive provisions.[93] Finally, a material misstatement or omission in a Form S-18 registration statement might subject an issuer to the potentially broad liability of Section 11 of the Act.[94] An issuer under Form S-1 shares the risks of Section 11 liability with a Form S-18 issuer,[95] but a Regulation A

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[83] *See* text accompanying note 75 *supra.*

[84] *See* text accompanying note 47 *supra.*

[85] *See* note 66 *supra.*

[86] *See* note 67 *supra.*

[87] *See* text accompanying note 71 *supra.*

[88] Form S-1 contains no restrictions concerning what issuers may use its provisions. Regulation A bars only non-American and non-Canadian issuers and a few classes of "unworthy issuers" from the use of its provisions. *See* notes 45 & 46 *supra.* Non-corporate issuers may use Regulation A. *See* text accompanying note 46 *supra.*

[89] *See* text accompanying note 75 *supra.*

[90] *See* Form S-18, General Instruction (A)(b), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7303. Form S-18 allows persons other than an issuer to use its provisions. *Id.*, 2 FED. SEC. L. REP. (CCH) ¶ 7303. The annual aggregate amount of secondary offerings made under S-18 cannot exceed $1.5 million. *Id.*, at FED. SEC. L. REP. (CCH) ¶ 7303. For purposes of calculating Form S-18's yearly $5 million ceiling, the SEC aggregates the amount sold in secondary offerings with the amount the issuer itself raises. Form S-18, General Instruction (A)(c), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7303. Thus, if shareholders take full advantage of the resale features of Form S-18, an issuer can raise only $3.5 million per year with the form.

[91] *See* text accompanying note 47 *supra.*

[92] *See* text accompanying note 80 *supra.*

[93] *See, e.g.*, HAWAII REV. STAT. § 485-9(8)(b)(4) (1976); N.J. STAT. ANN. § 49:3-59 (West) (1970); OKLA. STAT. ANN. tit. 71 § 701 (Supp. 1980). *But see* note 67 *supra* (states allowing registration by coordination with Regulation A).

[94] *See* text accompanying notes 17-19 & notes 26 & 27 *supra.*

[95] *See* note 17 *supra.*

issuer is subject only to the narrower provisions of Sections 12 and 15 and the antifraud provisions of the 1934 Securities and Exchange Act.[96] Despite the form's disadvantages Form S-18 has proved to be a popular financing device.[97]

The SEC has promulgated rule 242[98] to respond further to the difficulty that small businesses encounter in raising capital. The rule allows corporations to raise funds through public offerings of unregistered securities.[99] An issuer may sell up to two millon dollars of its securities during a six-month period under rule 242.[100]

A rule 242 issue is available to the public on only a limited basis. No more than thirty-five unaccredited[101] persons may purchase the issuer's securities during a single offering.[102] An issuer, however, may sell securities to an unrestricted number of accredited persons.[103] Accredited persons include institutional investors,[104] or wealthy individuals.[105] An issuer has an affirmative duty to inquire whether a purchaser is accredited or non-accredited.[106] An issuer may not advertise or make any general solicitation in connection with the offering.[107]

The disclosure requirements of rule 242 draw a distinction between the information that an issuer must offer a sophisticated investor and the information an issuer must supply to an ordinary, nonaccredited investor. If only accredited persons buy an issuer's securities, rule 242 does not require an issuer to disclose any information to a purchaser.[108] If

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[96] *See* text accompanying note 62 *supra.*

[97] *See* [Current] FED. SEC. L. REP. (CCH) ¶ 82,848. Since the SEC adopted Form S-18 in April 1979, six Form S-18 registrations have become effective for every comparable Form S-1. *Id.* Issuers used Form S-18 to raise $236 million in the first 18 months of its use. *Id.* The eighteen month figure is especially significant when contrasted with the small size of the average Form S-18 issuer. The average Form S-18 issuer during the eighteen month period had $273,000 in assets and only $54,000 in annual revenues. *Id.*

[98] 17 C.F.R. § 230.242 (1980).

[99] *Id.*

[100] *Id.* § 230.242(c). Rule 242's monetary limit was originally pegged to the monetary limit of § 3(b), 15 U.S.C. § 77(c)(d)(1976). When Congress raised the § 3(b) limit from $2,000,000 to $5,000,000, the SEC acted to retain rule 242's $2,000,000 limit. *See* Securities Act Release No. 6250 (Oct. 22, 1980) [1980] FED. SEC. L. REP. (CCH) ¶ 82,671.

[101] An unaccredited person is any person that falls outside the ambit of 17 C.F.R. § 230.242(a)(1) (1980). *See* text accompanying notes 104-05 *infra.*

[102] 17 C.F.R. § 230.242(e)(1) (1980).

[103] *Id.* § 230.242(a)(1).

[104] *Id.* § 240.242(a)(1). Rule 242's definition of an accredited investor includes banks, insurance companies, and pension funds. *Id.* The definition excludes business development companies. *See* text accompanying notes 158-161 *infra.*

[105] Rule 242 defines any person who purchases $100,000 or more issuer's securities during a single offering as an accredited investor. *Id.* § 230.242(a)(1)(ii).

[106] *Id.* § 230.242(e)(1).

[107] *Id.* § 230.242(d).

[108] Rule 242 contains definitions of accredited and unaccredited investors to provide issuers with objective criteria for identifying sophisticated investors. Securities Act Release No. 6180 [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,426 at 82,813. The

even one non-accredited person buys a security under the issue, however, rule 242 obligates an issuer to disclose extensive information[109] to all buyers of the issue.[110]

Rule 242, like Regulation A, is subject to the SEC's aggregation rules,[111] but unlike Regulation A, the rule contains a "safe harbor" from the Commission's integration rules.[112] Securities issued under rule 242 are restricted securities[113] and therefore are subject to rule 144's resale restrictions.[114] An issuer must use reasonable care to ensure that an initial buyer of its securities under rule 242 does not intend to resell the securities.[115]

SEC assumes that an accredited investor has the economic bargaining power to acquire the information from the issuer that is necessary for intelligent investment decisions. *Id.* at 82,815. Hence, rule 242 does not require an issuer to disclose specified information to accredited investors before selling securities to them. 17 C.F.R. § 230.242(f)(1) (1980); *see* text accompanying notes 109-110 *infra*.

[109] 17 C.F.R. § 230.242(f)(1) (1980). When an issuer must disclose financial information under rule 242, the information must be the same sort of information specified in Part I of Form S-18, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7303. The information that Form S-18 requires includes a description of the issuer's capital structure, business practices, potential legal liabilities, and the issuer's underwriting arrangements for distributing the issue. *Id.*

[110] 17 C.F.R. § 230.242(f)(1) (1980).

[111] *See* note 48 *supra*. An issuer must deduct from the amount of rule 242's monetary limit the aggregate gross proceeds from all securities sold as part of the same offering pursuant to a §3(b) exemption. 17 C.F.R. § 230.242(c) (1980). The requirement to deduct the amount of other §3(b) sales arises only if the sales occurred during the six months preceding the beginning of the rule 242 offering or during the offering's completion. *Id.* Other § 3(b) exemptions include Regulation A, 17 C.F.R. § 230.251-63 (1980); *see* text accompanying notes 43-54 *supra*; Rule 234, *id.* § 230.234 (exemption of first lien notes); and Rule 236 *id.* § 230.236 (shares of stock as dividends, or for stock splits, mergers, or similar transactions).

[112] 17 C.F.R. § 230.242(b) (1980). The SEC does not consider any offerings that occur either six months before or six months after a rule 242 offering as part of the rule 242 offering. *Id.* Rule 242's safe harbor protects an issuer against integration problems that arise with Regulation A. *See* note 48 *supra*.

[113] *See id.* § 230.144(a)(3) ("restricted securities" defined to include rule 242 offerings). A "restricted security" is a security acquired in a non-public offering. *Id.*

[114] *See id.* § 230.144(d)(1). An investor must hold restricted securities beneficially for two years before resale. *Id.* After the holding period, as a prerequisite to resale, a shareholder must disclose to the buyer any public information the seller has about the issuer. *Id.* § 230.144(c). Rule 144 severely restricts the amount of securities that a shareholder may sell during a given period. *Id.* § 230.144(e). A shareholder that wishes to sell must also file a notice of proposed sale with the SEC and in the stock exchange where the shareholder sells the securities. *Id.* § 230.144(h); *see* Form 144, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7411. The SEC will consider a shareholder that fails to comply with Rule 144's provisions to be an underwriter as defined by § 2(11) of the Act, 15 U.S.C. § 77(b)(11) (1976). *See* Securities Act Release No. 5223, 37 Fed. Reg. 596 (1972). As an underwriter, a shareholder that violates Rule 144 also violates § 5's provisions requiring registration, 15 U.S.C. § 77e. *See id.* 77d(1) (§ 5 applied to underwriters).

[115] 17 C.F.R. § 230.242(g)(1). A rule 242 issuer must inform a purchaser of the restrictions on resale of the securities, *id.* § 230.242(g)(2), and place a legend on the share certificates that announces the restrictions on transferability. *Id.* § 230.242(g)(3).

With Rule 242, the SEC goes further than it did with Regulation A toward helping small businesses to raise capital. The rule exempts entirely an issue of securities from the registration process or Regulation A's analog of the process so long as all purchasers of the issue are accredited.[116] In addition, the rule offers an issuer the opportunity to make a private placement[117] without complying with the SEC's dangerously unclear prerequisites to the use of private placements.[118] The monetary limit on the value of securities an issuer can sell under rule 242, at 4.0 million dollars per year,[119] is substantially higher than Regulation A's limit of 1.5 million dollars.[120] Thus, an issuer can collect more funds using rule 242 than an issuer can through Regulation A.

Under most circumstances, rule 242 also requires substantially less disclosure than Regulation A or Forms S-1 and S-18.[121] Unlike the regulation and forms, rule 242 does not require formal registration.[122] Finally, although rule 242's monetary limit prevents an issuer from realizing Form S-1's unlimited potential to raise capital, the provision's 4.0 million dollar limit may sometimes provide an issuer more capital than that offered by Form S-18 due to Form S-18's secondary resale limitations.[123]

Rule 242 has a few significant disadvantages. Only corporations may use rule 242.[124] Regulation A remains available for most forms of business entities.[125] Rule 242's restriction on resale might prevent potential purchasers from acquiring securities offered under rule 242 for fear

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[116] *See* text accompanying notes 61-65 *supra.*

[117] A private placement is a non-public offering that is exempt from the registration provisions of § 5 of the Act. *See* 15 U.S.C. § 77e (1976).

[118] *See* Note, *SEC Rules 144 & 146: Private Placements for the Few*, 59 VA. L. REV. 886, 901-903 (1973) (nebulous prerequisites for private placements an intolerable burden). An offeree of a private placement must have access to information of the type that Schedule A requires. 17 C.F.R. § 230.146(e) (1980). A close family or employment relationship, or equal bargaining power between the offeree and the issuer may satisfy the private placement access to information requirement. *Id.* § 230.146(e) (Note). By allowing sale of securities through its accredited purchaser provisions, *see* text accompanying notes 103-107 *supra*, rule 242 allows an issuer to sell to the same purchaser who might have bought under a private placement. Because the issuer does not technically make a private placement, however, the issuer does not have to disclose the information required by Schedule A.

[119] Rule 242 contains a $2,000,000 ceiling on securities that an issuer may offer during a six-month period under its provisions. 17 C.F.R. § 230.242(c) (1980), *as amended by* Securities Act Release No. 6250 (Oct. 22, 1980) [1980] FED. SEC. L. REP. (CCH) ¶ 82,671.

[120] *See* text accompanying note 47 *supra.*

[121] *See* text accompanying notes 108-10 *supra.*

[122] Although rule 242 is not a formal registration, an issuer that desires to use the rule must file a notice of sale form with the SEC. *See* Form 242, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7433.

[123] *See* note 90 *supra.*

[124] Rule 242 is available only to domestic or Canadian corporations that are engaged in significant oil, gas, or mining operations and do not function as investment companies. 17 C.F.R. § 230.242(a)(5) (1980).

[125] Regulation A bars only a few classes of issuers from the opportunity to use its provisions. *See* note 45 *supra.*

that market conditions might erode the value of their investment.[126] In contrast, neither Regulation A nor Form S-18 contain rule 242's resale restrictions. An issuer using rule 242 may sell an offering to no more than thirty-five unaccredited purchasers.[127] Neither Regulation A nor Form S-18 impose restrictions on the number or type of an offering's buyers. Finally, under some circumstances, a corporate issuer can raise up to one million dollars less under rule 242 than the issuer can raise with Form S-18.[128]

Congress recently assisted the SEC's attempt to ease the burden that federal securities regulation imposes on small issuers. In Title III of the Small Business Investment Incentive Act of 1980, Congress raised the ceiling for a Section 3(b) exemption from two million dollars to five million dollars.[129] In the Small Business Issuers' Simplication Act of 1980 (SBISA),[130] Congress added Section 4(6) to the 1933 Act, which codifies an exemption scheme that is similar to the scheme contained in rule 242.[131] Section 4(6) authorizes sales of unregistered securities to accredited investors.[132] Rule 242 contains similar provisions.[133] Section 4(6), however, does not contain a parallel to rule 242's provision allowing sale to unaccredited purchasers.[134] The newly enacted Section 2(15) of the 1933 Act provides a definition of "accredited investor" for Section 4(6).[135] Although Section 2(15) substantially conforms to rule 242,[136] Section 2(15) does not include a purchaser of at least $100,000 of an issue as an accredited investor.[137] The section also varies from rule 242 by excluding directors and executive officers of the issuer from consideration as accredited investors.[138] Due to Section 2(15)'s definitional restraints, an issuer may

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[126] Venture capitalists avoid investment when they cannot readily convert their profits into cash. The limitations that the SEC has placed on secondary sales of securities have substantially contributed to the concentration of capital funding in well-established corporations. *See* Casey Report, note 2, *supra*, at 85; note 165 *infra*.

[127] *See* text accompanying note 101 *supra*.

[128] As an alternative to rule 242's $4 million yearly offering limit, *see* text accompanying note 100 *supra*, an issuer can potentially raise up to $5 million by using Form S-18. *See* text accompanying note 75 *supra*.

[129] *See* note 42 *supra*.

[130] Small Business Issuers' Simplifiction Act of 1980, Pub. L. No. 96-477, § 601, 94 Stat. 2294.

[131] *Id.*

[132] *Id.* § 602.

[133] 17 C.F.R. § 230.242(e)(2)(iv) (1980); *see* text accompanying notes 103-05 *supra*.

[134] *See id.* § 230.242(e)(1)-(3); text accompanying notes 101-02 *supra*.

[135] S. REP. No. 96-958, 96th Cong., 2d Sess., *reprinted in* [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 880 at 116-17 [hereinafter cited as SENATE REPORT].

[136] *Compare* Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 603, 94 Stat. 2294 *with* 17 C.F.R. § 230.242(a)(1)(i) (1980). Section 603 of the SBISA adds § 2(15) to the Act, which defines "accredited investor" for the purposes of § 4(6) of the Act. Section 2(15) will be codified as 15 U.S.C. § 77b(2)(15).

[137] *Compare* Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 603, 94 Stat. 2294 *with* 17 C.F.R. § 230.242(a)(1)(ii) (1980).

[138] *Compare* Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 603, 94 Stat. 2294 *with* 17 C.F.R. § 230.242(a)(1)(iii) (1980).

use the Section 4(6) exemption to sell securities only to institutional investors.[139]

Section 4(6) includes further restrictions. An issuer may not sell securities with an aggregate value greater than the amount that Section 3(b) of the Act allows,[140] currently, five million dollars. In addition, an issuer or its agent may not publicly solicit potential purchasers.[141] An issuer must also file a notice of sales with the SEC.[142] Moreover, since securities sold under Section 4(6) are exempt from the provisions of Section 5, [143] an issuer that uses Section 4(6) is liable only under Sections 12(2)[144] and 17[145] of the 1933 Act and under the antifraud provisions of the 1934 Securities and Exchange Act.[146] At this writing, the SEC has not clarified whether Rule 144's resale restrictions apply to securities sold pursuant to Section 4(6).

Despite Section 4(6)'s limitations, the provision offers small businesses several advantages over other small issue exemptions and over Form S-18. The most important advantage that Section 4(6) offers a small issuer is the opportunity to raise more money than the issuer can raise with other exemptive provisions.[147] In contrast to Section 4(6), rule 242 offers an issuer the opportunity to raise only four million dollars per annum.[148] Moreover, an issuer that uses rule 242 must subtract the value

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[139] Section 2(15)(ii) of the amended Act allows the SEC to expand § 2(15)'s definition of an accredited investor. In considering an expansion of the definition, the SEC should weigh such factors as a prospective accredited investor's financial sophistication, net worth, and the amount of assests subject to the investor's management. *See* Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 603, 94 Stat. 2294. The SEC is currently considering adding officers and directors of an issuer and $100,000 purchasers to § 2(15)'s definition of accredited investors. *See* Securities Act Release No. 33-6274, 46 Fed. Reg. 2631, 2634 (1981).

[140] *See* Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 602, 94 Stat. 2294.

[141] *Id.*

[142] *Id.* The SEC has adopted an interim notice of sales form, designated Form 4(6) (to be codified as 17 C.F.R. § 239.246), that an issuer must use to sell securities pursuant to § 4(6) of the amended 1933 Act. *See* Securities Release No. 33-6256, 45 Fed. Reg. 75,182 (1980), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7451. Form 4(6) is similar to Form 242, 17 C.F.R. § 239.242 (1980), which an issuer uses to file under rule 242. 45 Fed. Reg. 75,182 (1980). The SEC has removed some material that appears in Form 242 from Form 4(6), however, because Form 4(6) requires less disclosure to investors than does Form 242. *Id.* at 75,183.

An issuer must file Form 4(6) no later than ten days after the first sale of securities in reliance on Section 4(6)'s exemption. *Id.* The issuer must also file no later than ten days after the completion of the issue. *Id.*

[143] Section 4, 15 U.S.C. § 77d (1976), explicitly exempts offerings covered by its provisions from the requirements of § 5, *id.* § 77e.

[144] 15 U.S.C. § 77l(2) (1976).

[145] *Id.* § 77g.

[146] *See* note 62 *supra. See generally* 1 L. LOSS, SECURITIES REGULATION 710 (2d ed. 1961, Supp. 1969)

[147] Form S-18, like § 4(6), gives an issuer the opportunity to raise $5 million. Under some circumstances, however, Form S-18's provisions may bar an issuer from raising the full amount. *See* text accompanying note 90 *supra.*

[148] *See* text accompanying note 100 *supra.*

of all securities sold pursuant to a Section 3(b) exemption if the other sales are outside of rule 242's safe harbor.[149] Because an issuer must sometimes subtract other Section 3(b) sales, a small business cannot always expect every rule 242 offering to raise the full amount of the rule's monetary ceiling.[150]

Regulation A is a poor alternative to Section 4(6) because the regulation allows an issuer to raise only 1.5 million dollars per year.[151] In addition, the filing and disclosure requirements that Regulation A imposes on small issuers far exceed the complexity of Section 4(6)'s filing requirements.[152] The small issuer's form S-18 option[153] allows an issuer to raise up to five million dollars per year,[154] but Form S-18 is also more difficult to prepare than the simple notice of sale form that provides access to Section 4(6)'s five million dollar limit.[155]

Section 4(6) provides an additional advantage over other financing options available to a small enterprise. Only certain corporate issuers may offer securities under rule 242 and Form S-18.[156] In contrast to rule

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[149] *See* text accompanying note 111 *supra*.

[150] The superiority of § 4(6) over rule 242 with respect to their comparative ceiling limits is not absolute. Unlike rule 242, § 4(6) does not currently contain a safe harbor provision. *See* note 111 *supra*. An issuer that uses § 4(6) must determine which of the issuer's sales of securities the SEC might integrate as part of the same issue when calculating the section's ceiling. The SEC will consider standard factors to determine whether to integrate separate sales transactions. *See* SENATE REPORT, note 135 *supra*, at 116 (SEC should apply existing interpretations of the term "issue of securities"); note 48 *supra* (traditional factors used by SEC when making integration calculations). Because § 4(6) does not have a safe harbor provision, an issuer can never be sure that the SEC will not integrate similar transactions and find an issuer's § 4(6) offering to be in excess of the section's ceiling. The SEC is considering a safe harbor provision for § 4(6) to provide a § 4(6) issuer some security against an unexpected integration. Securities Act Release No. 33-6274, 46 Fed. Reg. 2631, 2635 (1981).

[151] *See* text accompanying note 47 *supra*.

[152] *Compare* Form 1-A, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7325 (notification form under Regulation A) *with* Form 4(6), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7451 (notification form under § 4(6)). *See* text accompanying note 68 *supra*.

[153] 17 C.F.R. § 239.28 (1980). *See* 2 FED. SEC. L. REP. (CCH) ¶ 7301 (Form S-18 reprinted in current form). *See also* text accompanying notes 69-82 *supra* (discussion of Form S-18).

[154] *But see* note 90 *supra* (circumstances in which issuer can raise only $3.5 million per year).

[155] *Compare* Form S-18, *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶ 7301 *with* Form 4(6), *reprinted in* 2 FED. SEC. L. REP. ¶ 7451. Although Form S-18 is more difficult to prepare than Form 4(6), one salient advantage that Form S-18 offers an issuer over § 4(6) is the opportunity to sell securities to both accredited and unaccredited purchasers. Section 4(6) allows sales only to accredited purchasers. *See* text accompanying notes 132-134 *supra*.

[156] *Compare* 17 C.F.R. ¶ 230.242(a)(5)(i)-(v) (1980) *with* Form S-18, General Instruction A(a)(1)-(5), *reprinted in* 2 FED. SEC. L. REP. ¶ 7302 at 6433-17. The SEC restricted the type of issuers that could use rule 242 and Form S-18 because the Commission considered the provisions to be experimental and proceeded cautiously. Securities Act Release No. 33-6274, 45 Fed. Reg. 2631, 2634 (1981). Rule 242 and Form S-18 were significant departures from traditional disclosure rules. *Id.* Only American and Canadian corporations may use rule 242 and Form S-18. Investment companies, companies engaged in significant oil, gas, or mining ar-

242 and Form S-18, Section 4(6) is available to any issuer regardless of the issuer's organizational form.[157]

Section 4(6) contains a final advantage over rule 242. Business development companies[158] are promising sources of capital for small enterprises.[159] Nevertheless, business development companies do not qualify as accredited investors under rule 242.[160] An issuer may sell securities to a business development company only through rule 242's provision allowing sales to an unaccredited investor.[161] By selling to an unaccredited investor, however, the issuer activates the rule's wider disclosure requirements for such a sale.[162] Section 4(6) provides an issuer easier access to a business development company's funds. A business development company is an "accredited investor" within the purview of Section 4(6)'s exemption from registration.[163] Given the company's accredited status, an issuer must file only a notice of sale with the SEC to offer and sell securities to a business development company under Section 4(6).[164] Section 4(6)'s application to business development companies provides access to significant funds less easily reached under rule 242.[165]

A small issuer that desires to enter the American capital market has a variety of financing alternatives to Regulation A and Form S-1

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rangements, and companies that are subsidiaries of issuers that are not qualified to use the provisions may not issue securities pursuant to rule 242 or Form S-18. *See* rule 242, 17 C.F.R. § 230.242(a)(5)(i)-(v) (1980); Form S-18, General Instruction A(a)(1)-(5), *reprinted in* 2 FED. SEC. L. REP. ¶ 7302 at 6433-17. The SEC is considering allowing some mining companies to use Form S-18. *See* Securities Act Release No. 6245, [1980] FED. SEC. L. REP. (CCH) ¶ 82,661.

[157] *See* Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 602, 94 Stat. 2294.

[158] The SB11A defines a business development company as a domestic company that operates to invest in securities of certain specified issuers, and provides significant managerial assistance to the issuers. *See* Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 101, 94 Stat. 2275.

[159] *See* H.R. REP. No. 96-1341, 96th Cong., 2d Sess., *reprinted in* [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 880 at 21.

[160] The SEC considers business development companies to be outside the scope of rule 242's definition of an accredited investor. *See* Securities Act Release No. 6274, 46 Fed. Reg. 2631, 2633 (1981).

[161] *See* 17 C.F.R. § 230.242(e) (1980).

[162] *See* text accompanying notes 108 &109 *supra.*

[163] *See* § 2(15)(i) of the Act, Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 603, 94 Stat. 2294.

[164] *See* note 142 *supra.*

[165] *See* Casey Report, note 2, *supra* at 75. Companies that engage primarily in risking funds in unusual business opportunities have assets estimated at $1.7 billion. *Id.* Venture capital companies invest over $100 million per year, but in recent years most of their funds have gone to large and well-established firms. *Id.* About one thousand large corporations have dominated access to American capital markets for several years. Oct. 17. 1977 BUSINESS WEEK 63. The SB11A constitutes Congress' attempt to encourage venture capital companies to assist small or financially troubled enterprises instead of devoting their funds to safer ventures. *See* H.R. REP. No. 96-1341, 96th Cong., 2d Sess., *reprinted in* [Oct. 9, 1980] FED. SEC. L. REP. (CCH Special) No. 880 at 23.

registration. Each choice entails advantages and restrictions that the other alternatives do not share. No single alternative best fulfills the needs of all small issuers. Given the wide range of problems and choices that confront a small issuer, a small business that needs capital should definitely consult an attorney.

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